

## Cases Confirm Applicability of Estimates in Research Credit Claims

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Two recent cases involving the research tax credit, codified under section 41 as the credit for increasing research activities, provide significant guidance for taxpayers in substantiating their claims for the credit. The two cases are a welcome development for businesses seeking to benefit from the incentives provided by Congress in the research tax credit.

The research tax credit is one of the largest tax incentives available to American businesses.<sup>1</sup> Following the issuance of proposed regulations on the research tax credit in 2001,<sup>2</sup> taxpayers have been given little to no guidance on what constitutes adequate substantiation for the credit. Although the research tax credit is widely popular in Congress,<sup>3</sup> the IRS has issued audit technique guides, industry director directives, and other guidance for IRS agents on how to audit taxpayers and limit their ability to claim the credits.<sup>4</sup> However, the IRS has issued

very limited guidance to taxpayers on how to properly substantiate their research tax credits.

Two recent cases, *United States v. McFerrin*<sup>5</sup> and *Union Carbide Corp. et al. v. Commissioner*,<sup>6</sup> follow congressional intent and clarify the ways in which taxpayers may substantiate their research credits. In *Union Carbide* the Tax Court allowed the taxpayer to apply the *Cohan* rule<sup>7</sup> and to rely on estimates and employee testimony in substantiating its research credit.<sup>8</sup> In *McFerrin*, in which one of the authors served as lead counsel at the appellate level, the Fifth Circuit went further by ordering the district court to "look to testimony and other evidence, including the institutional knowledge of employees, in determining a fair estimate" of the credit.<sup>9</sup> These cases run counter to the Service's position that a failure to provide complete contemporaneous documentation for every aspect of the credit is sufficient to cause its disallowance.<sup>10</sup> By allowing taxpayers to use reasonable estimates based on testimony and by directing the district court to make its own estimates, the courts in *McFerrin* and *Union Carbide* refined and expounded on taxpayers' ability to rely on testimony and estimates to substantiate their research tax credits. These opinions continue the doctrine that had previously been defined by the Tax Court's decisions in *Fudim v. Commissioner*<sup>11</sup> and *Eustace v. Commissioner*,<sup>12</sup> and by the credit's legislative history.

Ind. Dir. Directive #1 on Research and Experimentation (R&E) Credit Claims, LMSB-4-0307-025 (Apr. 4, 2007), *Doc 2007-8754*, 2007 TNT 66-55; Ind. Dir. Directive #2 on Research Credit Claims, LMSB-4-0608-035 (Jan. 15, 2009), *Doc 2009-1684*, 2009 TNT 15-17.

<sup>5</sup>No. 08-20377 (5th Cir. June 9, 2009), *Doc 2009-13123*, 2009 TNT 109-15.

<sup>6</sup>T.C. Memo. 2009-50, *Doc 2009-5285*, 2009 TNT 45-5.

<sup>7</sup>See *Cohan v. Commissioner*, 39 F.2d 540 (2d Cir. 1930). The *Cohan* rule stands for the proposition that, when a taxpayer can demonstrate that it has incurred some amount of qualified expenses but cannot conclusively quantify that amount, the court should estimate the allowable deduction. *See id.* at 544. In *Cohan* the taxpayer was able to demonstrate that he had incurred a substantial amount of entertainment expenses but was unable to document an exact amount. *See id.* at 543. The court ordered the Board of Tax Appeals to estimate the allowable deduction because "to allow nothing at all appears to us inconsistent with saying that something was spent." *Id.* at 544. The court further noted that "it is not fatal that the result will inevitably be speculative; many important decisions must be such." *Id.*

<sup>8</sup>See *Union Carbide*, T.C. Memo. 2009-50 at 254, 268, and 271.

<sup>9</sup>See *McFerrin*, No. 08-20377 at \*10.

<sup>10</sup>See *id.*; 2005 audit techniques guide, *supra* note 4 at 29; 2008 audit technique guide, *supra* note 4.

<sup>11</sup>T.C. Memo. 1994-235, *Doc 94-5115*, 94 TNT 103-19.

<sup>12</sup>T.C. Memo. 2001-66, *Doc 2001-8175*, 2001 TNT 55-9, *aff'd* 312 F.3d 905 (7th Cir. 2002), *Doc 2002-27407*, 2002 TNT 242-9.

<sup>1</sup>The president's fiscal 2010 budget estimates that a permanent extension of the research credit will cost more than \$74 billion between 2010 and 2019. Office of Management and Budget, Executive Office of the President, Analytical Perspectives: Budget of the U.S. Gov't, \*274 (Feb. 26, 2009).

<sup>2</sup>See REG-112991-01, 66 Fed. Reg. 66,362 (Dec. 26, 2001), *Doc 2001-31709*, 2001 TNT 251-35 (2001 proposed regulations). The IRS finalized the 2001 proposed regulations on December 30, 2003, in T.D. 9104, 69 Fed. Reg. 22, *Doc 2004-150*, 2004 TNT 7-20 (2003 final regulations).

<sup>3</sup>A recent bipartisan bill to permanently extend the research credit was cosponsored by no fewer than 14 senators. *See* S. 1203, Grow Research Opportunities With Taxcredits' Help Act, 111th Cong. (2009), *Doc 2009-12982*, 2009 TNT 108-38.

<sup>4</sup>See Audit Techniques Guide: Credit for Increasing Research Activities (i.e., research tax credit) section 41 (June 2005), *Doc 2007-27518*, 2007 TNT 244-29 (2005 audit techniques guide); Research Credit Claims Audit Techniques Guide (RCCATG): Credit for Increasing Research Activities Section 41 (May 2008), *Doc 2008-12059*, 2008 TNT 107-41 (2008 audit techniques guide);

(Footnote continued in next column.)

To fully appreciate the positive impact of *McFerrin* and *Union Carbide* for taxpayers, it is necessary to understand the history of research and development substantiation. In 1994 the Tax Court issued its opinion in *Fudim*. The taxpayers in *Fudim* claimed research credits on their 1986, 1987, and 1988 tax returns.<sup>13</sup> The research expenditures claimed for the credit consisted of supply costs from the development of a rapid modeling process, wages paid to Fudim's wife and daughter, and Fudim's self-employment income.<sup>14</sup>

Although the taxpayers failed to keep contemporaneous documentation regarding the use of the supplies or the activities for which they claimed wages, the court allowed them to claim all qualified research expenditures except those for the daughter's wages.<sup>15</sup> The court did so by applying the two-step analysis extolled by the *Cohan* rule.<sup>16</sup> Namely, the court determined whether the taxpayers engaged in qualified research and if so, whether there was a basis on which to estimate the expenditures.<sup>17</sup> The court found that the taxpayers did indeed perform qualified research. Referring to *Fudim*, it observed:

His training and background certainly attest to his capability to develop the rapid modeling process. Moreover, the record includes contemporaneous letters and scientific articles acknowledging and describing petitioner's newly developed rapid modeling process. Most importantly, contemporaneously, petitioner was awarded two patents for the rapid modeling process which reflected the results of his research during 1986, 1987, and 1988.<sup>18</sup>

In determining whether there was a basis on which to estimate the taxpayers' expenses, the court relied on testimony and other evidence because the taxpayers did not have "contemporaneous written records of the time and activities spent" by Fudim, his wife, or his daughter.<sup>19</sup> The court paid particular attention to the background and prior experience of Fudim and his employees, noting his degrees, his status as a member in multiple engineering societies, and that he had "published 38 scientific papers and been granted 39 patents by various companies."<sup>20</sup> The court also noted that Fudim's wife held a mechanical engineering degree and had experience as a computer programmer.<sup>21</sup> Correspondingly, the court disallowed the expenses claimed for Fudim's daughter: "The record fails to reveal [her] age, training, or level of experience. Petitioner also failed to present any evidence as to what services [she] rendered."<sup>22</sup> The clear meaning of the court's ruling in *Fudim* is that all evidence, including testimony, documentation, the prior history of the taxpayers' employees, and any-

thing else that may be of significance, should be considered when determining a taxpayer's eligibility for the research credit and, when applicable, whether the *Cohan* rule should be applied to estimate the amount of the taxpayer's expenditures.

Following the Tax Court's decision in *Fudim*, the IRS issued proposed regulations for the research credit (the 1998 proposed regulations).<sup>23</sup> The 1998 proposed regulations struck a markedly different tone from that of *Fudim* when it came to documentation and substantiation.<sup>24</sup> Prop. reg. section 1.41-4(a)(5)(iii) required taxpayers to record the results of their experiments.<sup>25</sup> In instituting the specific documentation requirement, the IRS stated that the requirement was "not intended to cause taxpayers to create records that would not otherwise be created. Rather the recording of the results is inherent in a process of experimentation to discover information that is technological in nature."<sup>26</sup> While renewing the credit the following year, Congress made it clear that the IRS should not impose unreasonable record-keeping requirements: "The conferees . . . are concerned about unnecessary and costly recordkeeping burdens and reaffirm that eligibility for the credit is not intended to be contingent on meeting unreasonable recordkeeping requirements."<sup>27</sup>

Despite the conferees' concerns, the IRS expanded the documentation requirement when it finalized the regulations in early 2001 (2001 final regulations).<sup>28</sup> As a prerequisite to claiming the credit, the 2001 final regulations required taxpayers to:

[prepare] documentation before or during the early stages of research project, that describes the principal questions to be answered and the information the taxpayer seeks to obtain to satisfy the requirements of [the discovery test], and [retain] that documentation on paper or electronically in the manner prescribed in applicable regulations, revenue rulings, revenue procedures, or other appropriate guidance until such time as taxes may no longer be assessed.<sup>29</sup>

It was in the wake of the 1998 proposed regulations and the 2001 final regulations that the Tax Court issued its opinion in *Eustace*. The taxpayer in *Eustace* filed research credit claims for the 1990, 1991, and 1992 tax years for an aggregate of \$652,411.<sup>30</sup> *Eustace* filed suit after the IRS disallowed all but \$180,823 following a 1996 audit.<sup>31</sup> The case focused on whether the taxpayer's research constituted qualified research by meeting the

<sup>13</sup>See *Fudim*, T.C. Memo. 1994-235 at 94-1320 and 94-1321.

<sup>14</sup>*Id.* at 94-1321.

<sup>15</sup>*Id.* at 94-1329.

<sup>16</sup>*Id.*

<sup>17</sup>*Id.*; see also *Cohan*, 39 F.2d at 544.

<sup>18</sup>See *Fudim*, T.C. Memo. 1994-235 at 94-1329.

<sup>19</sup>*Id.*

<sup>20</sup>*Id.* at 94-1320.

<sup>21</sup>*Id.*

<sup>22</sup>*Id.* at 94-1329.

<sup>23</sup>REG-105170-97, 63 *Fed. Reg.* 66,503, *Doc* 98-34970, 98 *TNT* 234-84.

<sup>24</sup>*Id.* at 66,505.

<sup>25</sup>*Id.* at 66,508.

<sup>26</sup>*Id.* at 66,505.

<sup>27</sup>H.R. Rep. No. 106-478 at 132 (1999), *Doc* 1999-36730, 1999 *TNT* 223-7.

<sup>28</sup>See T.D. 8930, 66 *Fed. Reg.* 280, *Doc* 2001-663, 2001 *TNT* 5-86.

<sup>29</sup>*Id.* at 294-295.

<sup>30</sup>*Eustace*, T.C. Memo. 2001-66 at 515.

<sup>31</sup>*Id.* at 512.

discovery test<sup>32</sup> and the process of experimentation requirements.<sup>33</sup> The taxpayer's research failed to meet these tests, and even the taxpayer's employees testified that that they did not think they had performed qualified research.<sup>34</sup> Although the case did not center on the taxpayer's substantiation of its research, the court stated in dicta that the taxpayer's "reconstruction of qualifying expenses was unreliable, inaccurate, and incomplete, and wholly insufficient to establish what various workers did and whether such expenses qualify for the research credit."<sup>35</sup> Although the court's critique of the taxpayer's substantiation occurred in dicta<sup>36</sup> and failed to cite a legal standard for what would constitute sufficient documentation, the IRS has cited *Eustace* for the proposition that a taxpayer must use contemporaneous documentation to tie every research dollar spent or claimed to projects at the subcomponent level or be subject to a complete disallowance of its research credits.<sup>37</sup>

Less than a year after the IRS published the 2001 final regulations and the Tax Court issued its *Eustace* opinion, the IRS issued new proposed regulations in response to taxpayer concerns that the 2001 final regulations in general, and the documentation requirement in particular, were not in keeping with congressional intent.<sup>38</sup> The 2001 proposed regulations eliminated the specific research credit documentation requirement found in the 2001 final regulations and instead required taxpayers to comply only with the code's general record-keeping requirement.<sup>39</sup> In eliminating the specific documentation requirement, the IRS took notice that the requirement had

forced taxpayers to prepare and keep records "unlikely to be kept for other business purposes."<sup>40</sup> The IRS also took note of Congress's concerns from 1999 and concluded:

Taxpayers must be provided reasonable flexibility in the manner in which they substantiate their research credits. Accordingly . . . the failure to keep records in a particular manner (so long as such records are in sufficiently usable form and detail to substantiate that the expenditures claimed are eligible for the credit) cannot serve as a basis for denying the credit.<sup>41</sup>

The IRS stated that although the 2001 proposed regulations were effective for tax years ending on or after December 26, 2001, "these rules prescribe the proper treatment of the expenditures they address, and the IRS generally will not challenge return positions consistent with the proposed regulations."<sup>42</sup> In December 2003 the IRS finalized the research credit regulations.<sup>43</sup> The 2003 final regulations retained the reduced documentation standard from the 2001 proposed regulations and stated that although the regulations were effective for tax years ending on or after December 31, 2003, for tax years ending before December 31, 2003, the IRS would not challenge return positions that are consistent with the final regulations.<sup>44</sup>

After the issuance of the 2003 final regulations, the IRS ignored Treasury's regulatory position that "taxpayers must be provided reasonable flexibility in the manner in which they substantiate their research credits,"<sup>45</sup> and placed considerable reliance on the dicta in *Eustace*.<sup>46</sup> Taxpayers were left to wonder which standard applied — the one pressed by the IRS that "the Service does not have to accept either estimations or extrapolations,"<sup>47</sup> or the more taxpayer-friendly standard set forth by congressional intent, by the 2003 final regulations, and by *Fudim*.

After five years of relative confusion, in March 2009 the Tax Court issued its ruling in *Union Carbide*. Union Carbide claimed research tax credits for 106 projects<sup>48</sup> from the 1994-1995 tax years that previously had not been claimed as part of its research tax credit.<sup>49</sup> These projects resulted in more than \$8 million in research tax credits.<sup>50</sup> The credits were based in large part on more than \$200

<sup>32</sup>The discovery test, requiring that taxpayers expand or refine the existing principles in the field of science to qualify for the research credit, was promulgated in case law such as *Norwest Corp. v. Commissioner*, 110 T.C. 454 (1998), *Doc 98-21015*, 98 TNT 125-3, and *United Stationers, Inc. v. United States*, 163 F.3d 440 (7th Cir. 1998), *Doc 99-488*, 98 TNT 250-5, and adopted by the IRS in the 1998 proposed regulations. See *supra* note 23 at 66,504. When it issued the 2001 proposed regulations, the IRS removed the requirement that taxpayers undertake research to "obtain knowledge that exceeds, expands, or refines the common knowledge of skilled professionals in a particular field of science or engineering." See REG-112991-01, 66 Fed. Reg. at 66,362-66,363. In *McFerrin* the Fifth Circuit allowed the taxpayers to rely on the definition of discovering information found in the 2001 proposed regulations in determining their research credits for the 1999 tax year. See *McFerrin*, No. 08-20377 at \*8-\*9.

<sup>33</sup>See *Eustace*, T.C. Memo. 2001-66 at 515.

<sup>34</sup>*Id.* at 516.

<sup>35</sup>*Id.* at 515-516.

<sup>36</sup>In its brief at the appellate level, the Justice Department admitted that "the issue in this case is not whether taxpayers have substantiated amounts expended in their [research]. The issue is whether they have carried their burden of proving that those activities constituted qualified research under section 41." See Brief for the Appellee at 49, *Eustace v. Commissioner*, 312 F.3d 905 (5th Cir. 2002), *Doc 2002-20883*, 2002 TNT 188-27. We were particularly pleased to hear the IRS admit this fact during the oral arguments for *McFerrin* before the Fifth Circuit.

<sup>37</sup>See *Union Carbide*, T.C. Memo. 2009-50 at 219, 243; 2008 audit techniques guide, *supra* note 4.

<sup>38</sup>See REG-112991-01, 66 Fed. Reg. at 66,362.

<sup>39</sup>*Id.* at 66,366. Section 6001 requires taxpayers to "keep such records, render such statements, make such returns, and comply

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with such rules and regulations as the Secretary . . . deems sufficient to show whether or not such person is liable for tax under this title."

<sup>40</sup>See REG-112991-01, 66 Fed. Reg. at 66,366.

<sup>41</sup>*Id.*

<sup>42</sup>*Id.* at 66,367.

<sup>43</sup>See T.D. 9104, 69 Fed. Reg. 22.

<sup>44</sup>*Id.* at 26.

<sup>45</sup>See REG-112991-01, 66 Fed. Reg. at 66,266.

<sup>46</sup>See *Union Carbide*, T.C. Memo. 2009-50 at 219, 243; *McFerrin*, No. 08-20377 at \*10; 2008 audit techniques guide, *supra* note 4.

<sup>47</sup>*Id.*

<sup>48</sup>The 106 research projects on which the court's opinion was based were in addition to the research projects that comprised the company's original research tax credit claim. Those initial projects were part of a settlement and were uncontested during the course of the trial.

<sup>49</sup>See *Union Carbide*, T.C. Memo. 2009-50 at 7-8.

<sup>50</sup>*Id.*

million in additional qualified research expenditures, the vast majority of which came from supply costs used to produce goods for sale.<sup>51</sup> Over the course of 298 pages, the court dissected five of Union Carbide's research projects and the evidence available to substantiate them.

Throughout the case, the court rejected the IRS's view of substantiation and instead allowed Union Carbide to use available evidence. In so doing, the court made many findings that involved the use of estimates and testimony to substantiate the research tax credits at issue. The Tax Court's allowance of the use of estimates, in particular, will have a significant effect on the way taxpayers substantiate their research credits.

The following are a few examples of the Tax Court's allowance of estimates. The court allowed Union Carbide to estimate base period wages for a facility when there were no accounting records available,<sup>52</sup> to forecast material costs,<sup>53</sup> and to estimate the cost of projects for which accounting records were unavailable.<sup>54</sup> Although the Service argued that Union Carbide had used "an *ad hoc* methodology to identify base period activities and relied on documents that were highly variable in completeness and usefulness," the court held that reg. section 1.41-4(d) "does not require that a taxpayer substantiate its research credit with any particular type of documents" and that "the documents that petitioner produced were sufficient to substantiate its claim."<sup>55</sup>

Also, for one project, Union Carbide relied on testimony from its employees, who conducted the research, to substantiate wage expenses claimed for the credit.<sup>56</sup> The court found this testimony to be credible and to sufficiently substantiate the wages paid to those employees.<sup>57</sup> Moreover, when the taxpayer erred on the side of caution in determining which project to include in the calculation of the base amount under section 41(c), the court applied the *Cohan* rule in its acceptance of the taxpayer's identified projects as "a close approximation of the whole."<sup>58</sup>

A mere three months after the Tax Court's ruling in *Union Carbide*, the Fifth Circuit issued its decision in *McFerrin*, in which the taxpayers claimed research credits for the 1999 tax year on amended returns filed in September 2003.<sup>59</sup> After the IRS filed an erroneous refund suit to recover the credits, the district court determined that while some of the projects may have involved some research, "there were no records of the hours worked on any given project or of the hours worked or supplies used that involved research."<sup>60</sup>

On appeal the Fifth Circuit rebuffed the IRS's contention that "even if qualified research occurred, McFerrin failed to provide adequate documentation to substantiate the costs associated with that research."<sup>61</sup> Instead, the court held that in accordance with the *Cohan* rule, "if a qualified expense occurred, the court should *estimate* the allowable tax credit."<sup>62</sup> Finally, the Fifth Circuit ordered the district court to "look to testimony and other evidence, including the institutional knowledge of employees, in determining a fair estimate."<sup>63</sup>

The decisions in *Union Carbide* and *McFerrin* finally address the issue of substantiating research tax credits and provide taxpayers with some guidance. In summary, the courts have held that taxpayers may rely on all available evidence, including contemporaneous documentation, employee testimony, and institutional knowledge, when substantiating their research tax credits.<sup>64</sup> Further, taxpayers may use reasonable estimates when determining the credits to which they are entitled.<sup>65</sup> The courts' opinions are in keeping with congressional intent that record-keeping requirements for the research tax credit not be costly and unreasonable.<sup>66</sup> As far as Congress and the courts are concerned, *Cohan's* concept that "absolute certainty in such matters is usually impossible and is not necessary" is alive and well.<sup>67</sup> This is clearly good news for taxpayers and their advisers as they seek to take full advantage of the research credit.

<sup>51</sup>*Id.* at 14.

<sup>52</sup>*Id.* at 174-175.

<sup>53</sup>*Id.* at 177.

<sup>54</sup>*Id.*

<sup>55</sup>*Id.*

<sup>56</sup>*Id.* at 283-284.

<sup>57</sup>*Id.* at 284.

<sup>58</sup>*Id.* at 271.

<sup>59</sup>See *McFerrin*, No. 08-20377 at \*2.

<sup>60</sup>*Id.* at \*3 (internal citations omitted).

<sup>61</sup>*Id.* at \*10.

<sup>62</sup>*Id.* (emphasis added).

<sup>63</sup>*Id.*

<sup>64</sup>*Id.*

<sup>65</sup>*Id.*

<sup>66</sup>See H.R. Rep. No. 106-478, *supra* note 27, at 132.

<sup>67</sup>See *Cohan*, 39 F.2d at 543.

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