COURTS GIVE GREEN LIGHT TO CLAIMING R&D CREDIT FOR SUPPLIES

PRACTICAL TAX STRATEGIES

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Championed by politicians on both sides of the aisle and by businesses both large and small, the credit for increasing research activities[1], more commonly known as the research and development (R&D) tax credit, has also become a contested issue between taxpayers and the IRS in recent years. In April 2007, the service designated the credit a Tier I audit issue.[2] Much of the debate between taxpayers and the service centers around the credit's murky standards for the qualification of research and expenses and the level of documentation required to substantiate the credit.[3] After a lengthy period without the publication of significant case law or constructive IRS guidance since the issuance of regulations in 2003, five important, taxpayer-favorable court opinions on the R&D credit were issued in the past year:

1. *Union Carbide Corp.*[4]
2. *McFerrin.*[5]
3. *FedEx Corp.*[6]
4. *TG Missouri Corp.*[7]
5. *Trinity Industries, Inc.*[8]

Of these cases, Union Carbide, *TG Missouri*, and *Trinity* will have a substantial impact on an issue that has rarely been discussed at length in the courts: the qualification of supply costs for the R&D credit. The lack of judicial guidance on this issue has led to significant confusion on two issues relating to supply costs:

1. When are supplies used in qualified research?

2. What constitutes property of a character subject to depreciation?

This article will discuss the extent to which *Union Carbide, TG Missouri, and Trinity* clarify the qualification of supply costs for the R&D credit and the way in which practitioners should apply these rulings,

Background of Section 41
Enacted in 1981,[9] the R&D credit provides a 20% credit for all qualified research expenses (QREs) in excess of a taxpayer's base amount.[10]

Qualified expenses.
A taxpayer's QREs consist of its in-house research expenses and its contract research expenses.[11] In-house research expenses, in turn, consist of:

- Wages paid to an employee of the taxpayer for the performance of qualified services. Qualified services include the performance of qualified research, the direct support of qualified research, and the direct supervision of qualified research.[12]

- "[A]ny amount paid or incurred for supplies used in the conduct of qualified research. "[13] Contract research expenses consist of 65% of the amounts paid or incurred to any person, who is not an employee of the taxpayer, for qualified research[14]

Research activity.
In order to qualify for the credit, a taxpayer's research must meet the following requirements:

- The research must be intended to develop a new or improved business component (i.e., a product, process, computer software, technique, formula, or invention)[15]

- The taxpayer must be uncertain regarding the capability, method, or design of the business component.[16]

- Substantially all of the taxpayer's research activities must be a process of experimentation designed to reduce or eliminate the aforementioned uncertainty.[17]

- Finally, the taxpayer must attempt to discover information that fundamentally relies on the principles of the physical or biological sciences, engineering, or computer science.[18]

Certain activities are specifically excluded from the definition of qualified research under Section 41(d)(4) These activities include research conducted after the beginning of commercial production, the adaptation or duplication of existing business components, any research based on marketing, the social sciences, or aesthetics, and research funded by another person.

Code and regulatory guidance
Section 41 allows taxpayers to include "any amount paid or incurred for supplies used in qualified research" in their QREs for the tax year.[19] The Code defines supplies as "any tangible property other than (i) land or improvement to land and (ii) property of a character subject to depreciation."[20] Similarly, Section 174 excludes costs for the acquisition or improvement of land or the acquisition or improvement of property of a character subject to an allowance for depreciation from expense treatment.[21]

The Code's definitions relating to supplies still leave the two primary questions unanswered:

1. In determining when supplies are used in research, is it sufficient that supplies bear tangential connection to a taxpayer's research, as is the case with materials used to make products during the testing of a new production process? Or must the supplies bear a more direct relationship to the research , such as those consumed during research , as in a prototype that is ultimately destroyed during testing?

2. Regarding property of a character subject to depreciation, must the property actually be depreciable in the hands of the taxpayer claiming the credit in order to be qualified? Or is any property automatically disqualified that might have a useful life of longer than one year, for any taxpayer?

The code's silence on these issues, as well as the IRS's administration of the credit, has led to significant confusion among taxpayers trying to identify supplies that can be allocated toward the R&D tax credit. Not only do substantial gray areas remain in the law, the IRS's failure to provide substantive guidance on the R&D tax credit makes compliance much more difficult.

The regulations are devoid of any detail and completely fail to set reasonable guidelines or standards for taxpayers and practitioners to follow. Under Reg. 1.41-2(b)(l), supplies are used in the conduct of qualified research if they are used in the performance of qualified services by an employee of the taxpayer. This guidance is circular, incomplete, and lacks any concise standards. The definition provided by the regulations gives no guidance as to the extent to which a taxpayer must use supplies in research in order to trigger their qualification. For example:

- Must the supplies be used in the actual process of experimentation, such as with chemicals used in laboratory experiments?

- Alternatively, may supplies that were used in direct support of qualified research, such as the paper used by a secretary to copy lab notes, also qualify for the credit?

- What about beakers and pipettes, which are used in the process of experimentation but are not raw materials?

- What about bulk materials used to test production processes? What about materials used in prototypes that are destroyed?
- What about materials used in prototypes that are ultimately sold to customers?
- Where are the lines with regard to allocable vs. non-allocable supply costs?

Clearly, the Section 41 regulations fail to provide guidance on the type of supply costs that are allocable. Likewise, the regulations for Section 174 research expenditures, addressing supplies "of a character subject to depreciation," assist little in filling this void. The Section 174 regulations provide that in the event that research and experimentation has an end product consisting of depreciable property to be used in the taxpayer's trade or business, or if the taxpayer pays a third party to construct such property, certain costs, but not others relating to that property, may qualify for Section 174 treatment.[22] Specifically, the regulations allow taxpayers to deduct the expenditures related to the property that are attributable to research or experimentation; however, "the costs of the component materials ..., the costs of labor ... involved in its construction and installation, [and the] costs attributable to the acquisition or improvement of the property.[]" are excluded.[23] Like the regulations for Section 41, the regulations for Section 174 provide a broad picture and set of rules for what supply costs may be identifiable as research expenditures. Detailed guidance on the application of these general rules, however, is not provided.

Case law prior to 2009

Prior to the issuance of *UCC, TG Missouri*, and *Trinity* only one case, Ekman,[24] provided any explanation on the qualification of R&D supply costs. In *Ekman,*[24] the taxpayer sought to develop modifications for a Porsche 928 S4 engine that would permit the car to be used either as a race car or as a street-legal vehicle. In order to test his concept, the taxpayer purchased a damaged Porsche 928 S4 engine. which he repaired and modified. The taxpayer used the engine in several iterations of testing and modification, causing significant damage to the engine. The taxpayer argued that the engine was not depreciable in nature because it was used in ongoing research.

Although the court recognized that "the engine was purchased with the intention of blowing it up" it disagreed with the taxpayer and disallowed the engine as a Section 174 expense. In so doing, the court ruled that the character of the property, not its use, was the critical factor in determining Section 174 deductibility.

Interesting in its opinion, however, was the court's recognition of the fact that, although the engine was used in destructive testing, it was not completely destroyed. In fact, the taxpayer made repairs to the engine and reused it. Because the taxpayer relied on an assumption that the engine was not subject to wear and tear because it was "intentionally being destroyed as part of the on-going research[,]" his case was undermined by his own attempts to repair and reuse the property. *Ekman* highlights the importance of gathering, and correctly and effectively presenting, the facts surrounding the taxpayer's supply costs.

IRS position on supplies

Not surprisingly, given the relative dearth of case law and formal guidance, the IRS has taken restrictive positions on supply costs in its own internal guidance to its auditors. Specifically, the IRS has maintained that in order to qualify for the credit, supplies must not only be used, but also totally consumed during the research activity.[25] On the issue of depreciable property, the IRS has taken the position that it does not matter whether the property is depreciable in the hands of the taxpayer; rather, it matters only whether the property could be depreciable in the hands of any taxpayer.[26]

Although the IRS has not provided relevant guidance to taxpayers, it has directed its auditors to take a restrictive view of qualifying supplies. In a 1998 field service advice, the IRS stated its position on supplies as follows:

> *Supplies are tangible property other than land, land improvements, or property of a character subject to the allowance for depreciation. To be considered a qualifying supply, the item must be ... totally used or consumed in the qualified research activity supplies should represent a small percentage of the credit. A review of the taxpayer's business should suggest a reasonable percentage of qualified supplies. Generally, supplies should only represent the costs to build prototypes.*[27]

The IRS has created a legal position-demanding that taxpayers "consume" supplies during research-around a concept that does not appear in the Code or Regulations. Not only is there no requirement in the Code or Regulations that supplies be consumed, there is no requirement that supplies be used to build prototypes. Even so, the IRS again reiterated the concept that supplies "should represent a small portion of total QREs" in its June 2005 Research Credit Audit Technique Guide.[28] Similarly, in the IRS's mandatory IOR for the R&D credit, Question 8(f) asks taxpayers to identify contemporaneous documentation to substantiate "the amount of QRE supplies consumed in the conduct of qualified research ..."[29]

The IRS's use of the term "consumed" contrasts sharply with the statutory language, which requires that supplies be only "used" in research. In addition, the IRS MSSP Training Guide for the manufacturing industry describes qualified supplies as property "used or consumed" in qualified research.[30] The IRS's internal use of terminology, which differs from the statutory language, muddies the waters for taxpayers who do not know what to expect when their R&D credit claim is under IRS exam. Because these views are not discussed in the code or regulations, taxpayers may misinterpret the IRS's view of supplies, and those without expert assistance will have a difficult time navigating the service's positions and distinguishing them with the actual law. Based on the divergence between the actual law and IRS position, it is not surprising that lay taxpayers and even practitioners without expertise in this area are finding it difficult to identify allocable supply costs properly.

The IRS gives similar guidance to its auditors regarding the identification of depreciable property. In its MSSP training guide on the aerospace industry, the IRS informs its auditors that " [t]he design and testing of the prototypes may be considered qualified research while the construction of the prototypes may be considered the acquisition of depreciable property."[31] In discussing the fact that many prototypes in the aerospace industry are pre-sold to customers while the item undergoes testing, the training guide states that "[i]n general, items pre-sold represent property of a character which is subject to depreciation. The nature of the property and not the particular usage by the taxpayer is determinative under IRC §174:" Therefore, under the IRS's rationale, any property that might have a useful life of more than one year is disqualified for the purposes of the R&D credit.

The IRS, however, also included an example wherein property that was actually destroyed within a year did qualify for the credit. In an example, ten prototype missiles are constructed and five of the missiles are "consumed in a process of experimentation, testing Simulating battle conditions; they qualify as QRE." However, the remaining missiles, which were retained by the taxpayer for additional research, transferred to the military for use as a "baseline," and transferred to the military for training purposes respectively, did not qualify, according to the Service.[32]

The IRS confirmed that the determination of whether property is considered depreciable in nature does not hinge on the taxpayer's actual treatment or depreciation of the property in TAM 199927001. In that TAM, the taxpayer in question designed plastic injection molds, which it then used to produce unique plastic products for customers in a variety of industries, including the automotive industry. Because the products that the taxpayer manufactures are often unique to the customer for whom they are made, the customer frequently takes title to the mold once the taxpayer has established that it is capable of producing satisfactory products. In these instances, even though the customer assumes the risk of loss or damage to the mold, the taxpayer will typically retain possession of the mold to produce products from it.

Sometimes, the molds are initially produced by a third-party contractor and then modified by the taxpayer until they produce acceptable parts. In these instances, the taxpayer sought to claim the cost of the mold as a research expense under Section 174. The IRS ruled that because the molds were subject to wear and tear, and were used in the taxpayer's trade or business, they were property that was depreciable in nature and thus ineligible for Section 174 treatment. As is discussed in detail below, based on the Tax Court's ruling in *TG Missouri*, this position is simply wrong.

Ultimately, the IRS's internal guidance is not precedential authority, and therefore cannot be us ed in court. In fact, in its January 2010 Report to Congress, the IRS Taxpayer Advocate noted that "[t]he IRS audit technique guide, which expressly rejects the Cohan rule in the context of the research credit, may now be obsolete."[33] (The Cohan rule stands for the proposition that when a taxpayer is entitled to a deduction, but cannot adequately substantiate the amount of that deduction , the court may estimate the proper amount.) However, the documents described–regardless of whether correct in their legal positions–demonstrate the adversarial legal positions that the IRS is likely to take regarding R&D supply cost issues.

Recent case law

Aside from the IRS's internal memoranda and the Sixth Circuit's decision in *Ekman*. formal guidance on the issue of supply costs was minimal until the recent tax court cases, *Union Carbide Corp & Subsidiaries* and *TG Missouri Corp*. . and the opinion of the Northern District of Texas in *Trinity Indus., Inc*.

Union Carbide. In *Union Carbide*, the Tax Court examined, in depth, five of 106 Union Carbide Corporation (UCC) R&D projects. The 106 projects at issue in the case represented additional credits claimed on an amended return. The Service did not challenge UCC's credits claimed on its original return.

UCC, a manufacturer of plastics and chemicals, claimed R&D credits based on the development of new and improved production processes. The overwhelming majority of QREs that UCC claimed were supply costs attributable to raw materials used in their improved production processes. These materials were ultimately manufactured into products and sold to UCCs customers. Because it was necessary for UCC to operate its manufacturing processes for extended periods of time in order to test the improvements to the processes, UCC claimed the cost of all raw materials that went through the process–whether or not they were ultimately sold as a finished good.

In reviewing UCCs allocated supply costs, the court held that the company's claimed supply costs did not qualify. UCC argued that because the code and regulations did not define the phrase "used in the conduct of qualified research" the words should be given their plain meaning and that UCCs use of the supplies was sufficient to qualify for the credit. The court disagreed, even though it acknowledged that the research on the production process could not have occurred without purchase of the supplies in question. The court found that the development of a new production process should be distinguished from the company's product manufacturing and that UCC would have purchased the supplies used to manufacture products regardless of whether or not the company conducted the research. Because the supplies would have been purchased regardless of the research, the court held that they were, at most, indirect research expenses and not attributable to the process development. In the court's eyes, "[r]aw materials used to make finished goods that would have been purchased regardless of whether a taxpayer was engaged in qualified research are not used in the conduct of qualified research."

While the Tax Court's ruling in *Union Carbide* does not clear up the issue completely, the court clearly distinguished between supply costs used in the testing of process development and product manufacturing. The court held that taxpayers must make the distinction by and between process development and product development/manufacturing because these are two separate and distinct business components. Therefore, when developing new or improved processes, a taxpayer may not allocate as supply costs materials run through that process that ultimately end up as a finished product held for sale to a client.

A substantial amount of gray area still surrounds allocable supply costs. For example:

- While it appears that UCC did not have to increase its raw material input during the testing of its production process, might the court's decision have been different if UCC incurred additional product costs as a result of its testing?
- What if the products UCC manufactured could not be sold to customers as finished goods due to problems with the new production process?
- What if these materials could be sold, but for a reduced cost due to imperfections arising from the production process?
- What if the production process was sold to a customer–instead of a product?

Arguably, had UCC consumed additional supplies during testing of its production process, they would not have been "purchased regardless" of whether UCC was engaged in qualified research and, therefore, would be allocable to the credit. These questions, however, remain to be answered by the courts.

TG Missouri Corp. Several months later, another Tax Court ruling in *TG Missouri Corp.* provided further guidance on supply costs. The fact pattern in *TG Missouri* was remarkably similar to that of TAM 199927001 in which the IRS held that the phrase "of a character subject to an allowance for depreciation" meant that supply costs did not have to be depreciable in the hands of the taxpayer in order to be disqualified from expense treatment under Section 174. In *TG Missouri*, the taxpayer manufactured plastic molded products for customers in the automotive industry. In order to manufacture the products, the taxpayer designed and developed molds.

Often, *TG Missouri* hired a third-party contractor to fabricate a prototype mold, which the taxpayer would then improve until it was capable of producing products that met customer requirements. The third-party contractor then produced a production mold that *TG Missouri* modified until the mold was capable of producing satisfactory products. In some instances, the taxpayer retained ownership of the molds and depreciated them. In others, *TG Missouri* sold the molds to its customers and retained possession of them to use in further research and to produce replacement parts. When the company sold the molds to its customer, it claimed the costs that it incurred for the molds as supply costs in calculating its research credit.

The IRS sought to disallow the claimed research costs on the grounds that the molds in question were property of a character subject to an allowance for depreciation even though the taxpayer, itself, was not eligible to claim depreciation deductions with respect to the molds. The IRS reasoned that the character of the property itself was at issue, not the identity of the taxpayer to whom the deduction was allowed and that, since *TG Missouri* depreciated the molds to which it retained title, the molds that it sold were depreciable property for the purpose of the credit.

The Tax Court disagreed with the IRS's interpretation on the grounds that everywhere else the phrase was used in the code, "property of character subject to the allowance for depreciation" meant property subject to the allowance for deprecation in the hands of the taxpayer In the limited instances that the phrase referred to other taxpayers, those taxpayers were specifically mentioned in the statute.

Notably. although the molds in *TG Missouri* were used in the development of new and improved processes, it is clear from the fact pattern that they were not consumed or destroyed. In fact, the taxpayer retained possession of the molds and used them over several years. While it is not yet clear whether the IRS will appeal this ruling, or will now choose to contest *TG Missouri's* supply costs on other grounds, the case does contradict the IRS positions that supply costs are dis-

qualified unless they are entirely consumed or destroyed. Further, although the court in UCC disallowed costs for products sold to customers during process development, the Tax Court now seems to clarify in the *TG Missouri* decision that supply costs used during process development for processes that are sold to customers are allocable to the credit.

One area in which the underlying briefs for *TG Missouri* provide valuable guidance is with regard to prototypes. Although not addressed by the Tax Court in its opinion, Northrop Grumman Corporation's brief of amicus curiae contained a lengthy discussion regarding the legislative history of the treatment of prototype costs for both Sections 174 and 41. The central theme of Northrop Grumman's argument was that Congress intended the costs of all pre-production prototypes to be includable for the research credit and that a ruling in the IRS's favor would act to prevent the qualification of many prototypes because they may be depreciable in the hands of some theoretical taxpayer.[34]

In its argument, Northrop Grumman highlights the inclusion of "all costs incident to the development of an experimental or pilot model" in the regulations.[35] The brief also points out that the legislative history behind Section 41 had included an exclusion for the cost of "copies of prototypes produced after the construction and testing of the prototypes original model(s) have been completed."[36] The legislative history indicates that multiple prototypes can qualify for the credit as long as they are constructed before testing has been completed.

Perhaps most significant, however, with regard to the proper treatment of sold prototypes is the examination of proposed 1989 regulations for Section 174 that were never finalized. The proposed regulations contained a specific exclusion for "duplicate prototypes used for market testing purposes or held for sale. "[37] This proposed regulation would have prohibited Section 174 expense treatment for prototypes held for sale and would have excluded the molds in *TG Missouri* from qualification. These regulations, however, were never finalized, and new proposed regulations were issued in 1993 that removed the prohibition on prototypes held for sale.[38]

Based on the Tax Court's ruling in *TG Missouri,* the picture on the types of supplies allocable to the R&D tax credit has become a little clearer:

1. The exclusion for supplies that are "depreciable in nature" is applicable only if those supplies are depreciable in the hands of the taxpayer claiming the credit.

2. Supplies used for the development of a process (which are not depreciable in that taxpayer's hands) are allocable to the R&D tax credit as long as they are part of that production process and not another business component (like a product).

Trinity Industries, Inc. Most recently, the District Court for the Northern District of Texas issued its opinion in *Trinity Industries*, Inc. In *Trinity*, the taxpayer sought credits for the development of special order ships. For each project, the taxpayer claimed all of the supply costs related to the development and construction of the entire first article or prototype ship. Throughout the opinion, the court rejected numerous IRS arguments, including the attempts to exclude allocated supply costs.

With regard to supply costs, the court held that, under the "substantially" all rule found within Section 41(d)(l)(C), if at least 80% of a project is part of a process of experimentation, all costs associated with the project are eligible for the credit. The Government specifically argued that non-experimental aspects of the ship development (such as painting the ships or paying for insurance) are outside the scope of allocable costs found within Section 41. The court, however, allowed these non-experimental expenditures. The court reasoned that, "[i]f a first in class ship is sufficiently experimental, the risk of failure attaches to the entire project. The potential loss includes not just the experimental aspects, but also the paint."

Trinity sold its prototype ships when its designs proved to be successful. Thus, *Trinity*, was similar to *TG Missouri*, in that the taxpayers in each case claimed supply costs for business components that they sold to outside parties. The district court in *Trinity* allowed the taxpayer to claim these costs as did the Tax Court in *TG Missouri*. The primary difference between the costs in the two cases is that the costs in *Trinity* related to product development, whereas the costs in *TG Missouri* related to process development. When combined with *Union Carbide*, the three cases start to show a consistent pattern for the way in which taxpayers should treat their supply costs.

In *Union Carbide*, the court disallowed product costs incurred during process development because the costs were not tied closely enough to the business component in question. In *TG Missouri* and *Trinity*, however, the supply costs in question were incurred as a direct result of the taxpayers' respective process and product development. Thus, supply costs are includable when they are a part of the business component that the taxpayer seeks to develop, regardless of whether that business component is a product or a process.

Practical application

The Tax Court's opinions in *Union Carbide*, *TG Missouri*, and *Trinity* create some guidance for supply costs that clearly "do" and clearly "do not" qualify Significant areas of concern and uncertainty, however, remain. Consider the following scenarios:

1. A taxpayer develops an improvement for its manufacturing process. In order to test the design of the improved process, the taxpayer uses the process to manufacture products that it then sells to its customers.

2. A taxpayer develops a mold that it uses to develop a production process. Once the development of the process is complete, the taxpayer transfers ownership of the mold to its customer.

3. A taxpayer incurs supply costs to develop a prototype of a new, special order widget. When the design of the new widget is proven to be successful, the taxpayer sells the prototype to its customer.

The above examples are simplified versions of the fact patterns presented in the *Union Carbide*, *TG Missouri*, and *Trinity* cases respectively. The supplies in Scenario 1 clearly do not qualify for the credit, based on the opinion in *Union Carbide*, while the supplies in Scenarios 2 and 3 clearly do, based on the opinions in *TG Missouri* and *Trinity*. Consider, however, what happens when the facts change only slightly from the above.

4. Same facts as in Scenario 1, except that the taxpayer must purchase additional supplies because the test runs of the new process produce excess scrap. How much of the cost is allocable to the credit?

5. Same facts as in Scenario I, except that the products originally intended for sale cannot be sold due to defects that arise from the new manufacturing process, and all of the supplies are scrapped. Now, what are the consequences if the materials are recyclable, in whole or part?

6. A taxpayer develops new chemical compounds in its research laboratory. In addition to chemicals used its research operations, the taxpayer purchases beakers, pipettes, rubber gloves and other laboratory supplies. This equipment is used for experimentation and is not depreciated on the taxpayers' books.

7. A taxpayer designs a new piece of equipment to be used in the coal mining industry. In order to test its design, the taxpayer constructs a prototype of the equipment. Due to the nature of the equipment, the prototype will take several years to develop and test. If the prototype is successful, the taxpayer intends to hold it for lease.

8. A taxpayer develops a testing fixture designed to simulate the effect of cold weather on prototype products. The taxpayer intends to use the testing fixture for several years; however, the fixture breaks in its first year of use and cannot be repaired. What if the fixture does not break, but is scrapped after the project is cancelled?

9. A taxpayer develops a new widget. In order to test the new widget, the taxpayer simultaneously builds ten widgets. Although it intends to test all ten widgets, the taxpayer decides that it is satisfied with the widget design after testing only eight of the widgets. It sells to customers the remaining two widgets, along with three widgets that it tested but did not destroy.

10. A taxpayer develops a new variety of pet food with enhanced nutritional content. The taxpayer produces test batches of the experimental pet food that it provides, at no charge, to local animal shelters (who are regular customers of the taxpayer) . Employees of the animal shelters provide reports to the taxpayer regarding whether the animals ate the food, whether they preferred it to other pet foods, and whether they appeared to suffer from any side effects relating to the food.

No clear legal guidance currently exists to guarantee the treatment of costs described in Scenarios 4 through 10. Although some situations have been clarified by the new case law, others remain uncertain. Taxpayers and practitioners can, however, take some steps to help their tax positions:

1. Clearly identify the business component related to each supply cost being allocated toward the R&D tax credit.

2. Determine whether the allocable supply costs are ultimately being used in the business component made subject of the R&D tax credit or another business component.

3. Develop all facts and circumstances related to the use and final disposition of those supply costs.

In order to produce a sustainable credit and meet their due diligence obligations, taxpayers and their advisors must carefully develop all relevant facts and conduct a thorough analysis of their application to the law. Practitioners providing work for clients that must adhere to FIN 48 should also be careful to look at the in dependence issues when accounting for uncertain tax positions. The expansion of FIN 48 beyond public companies may create such independence issues for those practitioners with an attest client for whom they are conducting tax work and FIN 48 analyses.

Conclusion

Before these recent cases, there was great uncertainty regarding the allocation of supply costs for the R&D tax credit. The IRS used that lack of certainty to limit the ability of taxpayers to take full advantage of the R&D tax credit that was intended by Congress to provide a significant benefit to businesses. Experienced practitioners recognize that there is probably never going to be perfect knowledge and guidance for taxpayers to rely on in this area of the law. These cases, however, provide taxpayers with some illumination in what has previously been an area of darkness.

The courts, the taxpayer advocate, and the Government Accountability Office (GAO) are all part of a trend that is changing the playing field of the R&D tax credit–and all to the benefit of the taxpayer. With these new guideposts in mind, knowledgeable practitioners can better navigate the issues of supply costs and ultimately provide clients a more accurate and possibly greater R&D tax credit. More tax savings for clients in this tough economy is a welcome development indeed.

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1 Section 41 .
2 See ind. Dir. Directive #1 on Research and Experimentation (R&E) Credit Claims, 4/4/07.
3 See United States Government Accountability Office, GAO 10-1 36, "The Research Tax Credit's Design and Administration Can 8e Improved," pages 26 and 31-34 (2009); Fingeret, Frank, and Yaker, "Cases Confirm Applicability of Estimates in Research Credit Claims," 2009 TNT 161-6 (8/24/09).
4 TCM 2009-50.
5 570 F.3d 672, 103 AFTR2d 2009-2566 (CA-5, 2009).
6 103 AFTR2d 2009-2722 (DC Tenn, 2009).
7 133 TC No. 13 (2009).
8 105 AFTR2d 2010-871 (DC Tex., 2010).
9 The R&D credit was originally codified at Section 44F.
10 See Section 41 (a)(1).
11 See Section 41 (b)(1).
12 See Section 41 (b)(2)(8).
13 See 41 (b)(2).
14 See Section 41 (b)(3)(A).
15 See Section 41 (b)(2).
16 See Reg. 1.41-4(a)(3).
17 See Section 41 (d)(1)(C); Re9. 1.41-4(a)(5).
18 See Section 41 (d)(1)(8); Reg. 1.41-4(a)(4).
19 Section 41 (b)(2)A)(ii) (emphasis added).
20 Section 41 (b)(2)(C).
21 See Section 174(c).
22 See Reg. 1.174-2(b).
23 See Reg. 1.174-2(b)(4).
24 184 F. 3d 522, 83 AFTR2d 99-2658 (CA-6, 1999).
25 See FSA 5488, Vaughn 5488 (12/ 17/98); IRS Emisc rccidr1 (February 2009); MSSP Training Guide, Manufacluring Indusiry, Chap. 9, Research and Development
26 See TAM 199927001
27 FSA 5488. 12/17/98 (emphasis added).
28 Audil Techniques Guide: Credil for Increasing Research Aclivilies (i.e. Research Tax Credil) IRC Sec. 41, al page 18 (June 2005).
29 See Emisc rccidr1 (emphasis added).
30 See MSSP Training Guide, Manufacluring Indusiry, Chap. 9, Research and Development 31 MSSP Training Guide, Aerospace Indusiry, V Issues Peculiar 10 Ihe Aerospace Indusiry.
321d.
33 See Taxpayer Advocate Service, 2009 Annual Report to Congress-Volume One, 416 n. 56 (2010) (emphasis added). The Cohan rule refers to Cohan. 39 F.2d 540. 8 AFTR 10552 (CA-2, 1930).
34 See Brief for Northrop Grumman Corp. as Amicus Curiae Supporting Petitioner at 27, TG Missouri Corp., supra note7.
35 See /d.: Reg. 1.1 74-2(a)(1).
36 See H.R. Rep. No. 97 -201, 97th Cong., 1 st Sess. 11 5 (1981); Brief of Northrop Grumman at 33
37 PS-002-89, 5/17/89, 1989-1 CB 1058 (emphasis added); Brief of Northrop Grumman at 39.
36 PS-2-89. 3/24/93, 1993-1 CB 904.