

Tax Alert

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Another Taxpayer R&D Victory at the Courthouse!

Houston, February 4, 2010

On January 29th, the U.S. District Court for the Northern District of Texas (Dallas) issued its ruling in *Trinity Industries, Inc. v. U.S.* The legal holdings in the case provide yet another victory for taxpayers claiming the R&D tax credit. In its ruling, the court held that all of the taxpayer's projects relating to the design and development of special order ships contained qualified research. In doing so, the court specifically rejected several key government arguments that the IRS frequently raises.

Business Components: The IRS tried to argue that the taxpayer's made-to-order ships were ineligible for the R&D tax credit because they were not held for sale in the taxpayer's ordinary trade or business. The Court held that the IRS' argument was without merit, stating that "[t]he government cites no authority ... and the Court sees nothing in the statute that would require such a narrow meaning." To the contrary, the Court ruled that the development of these products – even if based on custom orders from clients – qualified as business components under IRC §41.

Integrating Existing Components: The IRS then tried to argue that the taxpayer's research did not qualify because the taxpayer merely integrated existing components, such as hulls, propulsion systems, and engines. The court held that this interpretation "greatly oversimplifies" the taxpayer's research because the systems in question "do not exist in a vacuum" but rather "interact with each other, sometimes in complex and nonintuitive ways." The court therefore ruled that "[d]etermining the degree of QRE involved requires an examination of the overall scope of the effort required to specify the components and integrate them into the overall design of the ship." This ruling helps to clarify that although some portions of a research project may have been previously developed or used by a taxpayer – that does not preclude the new project from being qualified.

Substantially All: The Court held that, under the substantially all rule, if 80% of a project constitutes a process of experimentation, then all costs associated with the project qualify. Specifically, the IRS criticized the taxpayer for claiming costs related to painting an experimental ship. The court ruled that when the product meets the substantially all requirement, "the risk of failure attaches to the entire project. The potential loss includes not just the experimental aspects, but also the paint." This rule contradicts numerous positions taken by the IRS and opens the door for many costs – previously thought not to be allocable to research projects – to be included within the credit calculation.

According to Dean Zerbe, alliantgroup National Director and former Tax Counsel and Sr. Counsel on the Senate Finance Committee, "The court's decision in *Trinity Industries, Inc. v. U.S.* is a ray of sunshine for manufacturers struggling in this difficult economy. *Trinity* is now the fifth case in a row that has provided good news for the manufacturing sector. This will make it easier for businesses to claim the R&D tax credit. With these court decisions, and Congress about to extend the R&D credit, now is the time for manufacturers and their financial advisors who have not previously elected to take advantage of this powerful credit, to reconsider the significant benefits of doing so. Overall, the District Court's ruling is good news for taxpayers who have been wary of the IRS' heavy handed administration of the R&D credit."

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