

Tax Alert

Federal Tax Alert

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Many have come to **alliantgroup** to inquire about the recent Union Carbide Corporation court decision and some of its most important points.

This case is especially important for manufacturers that operate under the mistaken belief that they do not qualify for the Research & Development (R&D) tax credit. Such companies are under the impression that the R&D credit only applies to basic research (e.g. research done in universities and laboratories); however, the intent of Congress, and the holdings in this case, further reinforce that the R&D credit is meant for manufacturers to claim with regard to activities that occur at their manufacturing facilities/plants (i.e. "applied research"). In fact, much of the basis for the R&D claim in this case arose from research undertaken for the development and improvement of manufacturing processes. Furthermore, wages were claimed for all types of employees, including engineers, testers, and operators. It bears noting that this is a U.S. Tax Court decision, and significant deference will be given by all courts as the Tax Court is a specialty venue for tax matters, and the judges are appointed based on their tax expertise.

Below are a few of the key **pro-taxpayer** holdings found in the comprehensive Tax Court Memorandum:

The United States Tax Court Issues Taxpayer-friendly Decision Regarding R&D Tax Credits

On March 10, 2009, the United States Tax Court issued an opinion regarding Research and Development tax credits (R&D credits) claimed by Union Carbide. *Union Carbide Corporation and Subsidiaries, TC Memo 2009 – 50, Code Sec(s) 41; 174. (hereinafter the UCC Opinion).*

The claimed R&D activities centered on a manufacturer that conducted R&D activities in its manufacturing facilities and plants. The opinion covers a broad range of topics pertaining to the R&D tax credit, from substantiation of the underlying R&D credit to establishing a fixed base period and expansion of substantial rights. The vast majority of legal holdings in this case rejected IRS arguments for heightened standards on the R&D tax credit. Although the taxpayer in this case had its credits substantially reduced due to certain improperly included supply costs, this opinion is a victory for taxpayers who are electing to claim the R&D tax credit.

Key Holdings

Ding-Dong, the Discovery Rule is DEAD!

Prior to trial, the IRS conceded that the claims would be decided under the current Treasury regulations (TD 9104) and not the prior Treasury regulations that included the Discovery Test (TD 8930). This is of significance as the IRS has been inconsistent in its treatment of the Discovery Test, especially when auditing R&D Claims from tax years prior to 2004. The instant case involved tax years 1994 and 1995, and furthermore, the amended claims for R&D credits were filed in 1999 before the proposed regulations (eliminating the Discovery Test) were even issued. Again, **this is a critical concession**, as the IRS has been trying to raise the Discovery Test from the dead, and now appear to have finally accepted the position that it should not be used under any circumstance.

Tax Court Gives Taxpayers Relief on Substantiating the R&D Credit

Since the IRS issued its Tier I Directive in April 2007, the IRS has demanded that taxpayers provide contemporaneous documentation to substantiate their R&D tax credit claims. These demands have been made by the IRS despite the absence of legal authority establishing this as a requirement. Throughout the UCC opinion, the Court dismissed IRS assertions that the testimony relied upon was insufficient to substantiate UCC's R&D credits. **In fact, the Court accepted oral testimony by UCC employees, 15 years after the R&D activities occurred, and found it to be sufficient to substantiate both the various R&D tax credit claims and the fixed base percentage.**

About alliantgroup

alliantgroup is an independent specialty tax services firm that works with clients to ensure that they receive the full benefits of all available federal and state government sponsored incentive programs, such as the Research and Development Tax Credit, export tax incentives, manufacturing tax incentives, energy tax incentives, enterprise zone incentives, state and local tax incentives, sales and use tax refund reviews, captive insurance companies, and tax controversy services.

alliantgroup's national headquarters are located in Houston, Texas with offices in Orange County (CA), Los Angeles, San Francisco, San Diego, Chicago, New York, Boston, Miami, Washington D.C., Toledo, Seattle, Atlanta, and New Orleans.

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Specific Holdings by the Tax Court Concluded That:

- Taxpayers were not required to have the same documentation for the base period as it had for the claim years
- Reliance on “informal documentation” such as emails and notes was permissible
- Estimates were permissible in the absence of underlying documentation
- Estimates for a base period company were allowed in the absence of any accounting records for that particular entity

Conclusion

The significance to taxpayers is that IRS examiners have sought to undermine the use of estimates during examination and assert that oral testimony is insufficient. **This case should stop the IRS dead in its tracks from using this tactic during examination, as estimates have, once again, been validated for use in quantifying R&D credits and in determining the Fixed Base Percentage for a taxpayer.**

This is clearly good news for taxpayers and their advisers as they seek to take advantage of one of the most important incentives for business in the tax code, the R&D Tax Credit.

Please feel free to contact Jeremy Fingeret at 1.800.564.4540 if you would like to discuss this case in more detail and its positive impact for your clients.



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