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Fifth Circuit Overturns District Court in *U.S. v McFerrin*, Rules In Favor of Taxpayer in R&D Tax Credit Case

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Today the 5th Circuit Court of Appeals vacated the Southern District Court's ruling in *U.S. v. McFerrin*. The McFerrins had co-founded KMCO, Inc., a Corporation located in Texas that manufactures commodity and specialty chemicals. They engaged alliantgroup, the nation's leading provider of tax services to small to large businesses, to determine whether KMCO's expenditures for research and development (R&D) were eligible for the R&D Tax Credit. alliantgroup conducted the study and established that KMCO had conducted activities that qualified for an R&D Tax Credit of \$601,288 (interest included).

The IRS challenged the McFerrin's credit, and after a six-day trial, the district court ruled in favor of the IRS on the grounds that the taxpayer had failed to meet the threshold of innovation required by the "discovery test," had failed to demonstrate that the taxpayer had conducted a process of experimentation, and had failed to substantiate its research credit.

In remanding today, the 5th Circuit found that the District Court had erred by inappropriately applying the outdated "Discovery Test." The 5th Circuit also found that the District Court, because it applied the wrong legal standard, failed to consider all relevant evidence to determine the McFerrin/KMCO's eligibility for the R&D Credit. Finally, the Appellate Court made it absolutely clear that the "Cohan Doctrine" (if a qualified expense occurred, the court should estimate the allowable tax credit) is applicable to the R&D Credit and made clear that the court should "look to testimony and other evidence, including the institutional knowledge of employees, in determining a fair estimate" [citing *Fudim*].

In response to today's decision, alliantgroup's CEO Dhaval Jadav: made the following statement:

“In a grey economy, the court’s decision today in McFerrin is a big ray of sunshine. Companies engaged in research and development should be greatly heartened by the court’s decision, which will make it significantly easier for companies to benefit from the R&D tax credit.

In response to today’s decision, alliantgroup’s National Managing Director, Dean Zerbe (formerly Senior Counsel and Tax Counsel to the Senate Finance Committee 2001-2008 before joining alliantgroup) made the following statement

“It is especially important that the court made it loud and clear to the IRS that the taxpayer has a right to rely on oral testimony and other evidence to support a claim for the R&D Credit. Equally important is that the decision directed that courts, where appropriate, should look to making estimates when determining the amount of the credit. As the leader in R&D studies, alliantgroup has found that many small and medium companies often do not have the level of paperwork and support documents as a *Fortune* 500 company. The court’s decision allowing estimates, oral testimony, and other evidence to support the claim for the R&D Credit will be particularly welcome to struggling small and medium businesses.

Shane T. Frank, COO of alliantgroup made the following comment:

“With the economy where it is, this decision gives the IRS, business and tax service providers the opportunity to turn a new leaf and work together to ensure that companies are fully taking advantage of the R&D Tax Credit incentives, as is intended by Congress.”

Jeremy Fingeret, the lead counsel for the McFerrin’s who argued the case before the 5th circuit, and a partner at Fingeret, Frank and Jadav, a Houston law firm, stated: “As attorneys who represent hundreds of taxpayers claiming R&D tax credits, we are elated the 5th Circuit overturned this opinion. Not only did the Court strike down the Discovery Rule, but the 5th Circuit ordered the District Court to evaluate all evidence (including testimony) and make reasonable estimates for taxpayers claiming this valuable credit. It’s a well-written opinion applicable for taxpayers big and small.”

“It is reassuring to know that alliantgroup is devoted to helping businesses claim government incentives like the R&D cred-it. Not only did they help us claim the R&D credit, but they stood behind their work product and defended us through-out the entire process.”- Jeff McFerrin, Vice President, KMCO, inc.

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, various enterprise zone incentives, sales and use tax refund reviews, and captive insurance companies.