

tax notes

Big Tax Court Win for Small Businesses, Research Tax Credit

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At a time when the United States needs to encourage entrepreneurs and innovative small businesses, the Tax Court in **Eric G. Suder v. Commissioner** sent a positive signal that small businesses can and should look to tax savings from the research tax credit. From my perspective, there are several important lessons from the case – it provides good news for business owners and a setback for efforts to create a class of “routine research” or “routine engineering” that isn’t eligible for the research tax credit.

Background

The case involves the classic American success story – the petitioner, Eric Suder, founded Estech Systems Inc. (ESI) in 1987 to develop various products, including hardware and software, in the telecommunications industry. At first, he was chief cook and bottle washer, developing and designing products. ESI hired its first employee in 1988 and by 2004 had grown to 125 employees – including 40 engineers – and revenues of \$38.5 million. Throughout that time of growth, Suder was actively involved in ESI as a fount of new ideas and designs, a trait typical of a founder/innovator – see Steve Jobs.

ESI engaged the services of alliantgroup, LP to establish a method and approach for the company to claim the research tax credit. Based on that method, ESI claimed research tax credits for tax years 2004 to 2007 based on 76 projects undertaken during those years.

Analysis

To facilitate a smoother trial process, the parties in the case agreed to sample 12 of the 76 claimed projects as representatives. Over a three-week trial, the Tax Court heard extensive testimony and looked at documentary

evidence, and determined that of the 12 projects reviewed, 11 met the four-part test required for the research tax credit:

- expenditures connected with the research must be eligible to be treated as expenses under section 174;
- the research must be undertaken for the purpose of discovering technological information;
- the information to be discovered must be useful in the development of a new or improved business component of the taxpayer; and
- substantially all of the research activities must constitute elements of a process of experimentation for a purpose concerning new or improved function, performance, reliability or quality.

Further, based on the alliantgroup method, the court found that the projects and allocations of time for all employees had been properly substantiated and that the taxpayer could claim the research tax credit.

The IRS's argument revolved around its expert witness – and failed. The court found that the expert had “no factual basis in his report” for the assertions made against ESI. It then found that “many statements in [the expert's] report are contradicted by credible evidence in the record.”

More importantly, the Suder decision indicates that businesses – which are often building on the work of others – may be eligible for the research tax credit. The court emphasized that there is not a requirement under the research tax credit to reinvent the wheel. It recognized the reality that much of the work of industry is the application of known engineering principles to components and that those components “do not function in isolation. They interact with each other and with many other components, such as resistors, capacitors, and transistors, on a circuit board. Determining the appropriate configuration of the components involved a considerable research effort.” Another key factor in the court's decision is that it recognized the research involved in developing new software that either was layered on top of newly developed hardware, or added features or functionality to existing systems. In short, the court understood the real world of businesses and innovation.

The Suder decision is a brushback pitch on efforts to push forward in the examination a concept of “routine research” or “routine engineering” as being outside the scope of the research tax credit – ignoring the reality of incremental changes and modifications that are the heart and soul of innovation performed by companies in the real world and of economic growth in America. The Tax Court in Suder has put a stake through the heart of that argument.

The other relevant issue to business owners stemming from the Suder decision is whether Suder's wages were qualified research expenses (QREs). Some at the IRS have had difficulty wrapping their minds around the idea that a CEO can also be an innovator (which is actually the most common reality for many small and medium-size businesses – the top guy is the top innovator). The court found Suder and others to be credible witnesses regarding his playing a major role in the product development at ESI. It noted that even the IRS's own witnesses corroborated that fact. This resulted in Suder's 75 percent allocation being sustained.

There was one loss for the taxpayer in this case. The court found that Suder's overall compensation did not meet the reasonableness test under section 174. The court agreed with the taxpayer's expert on reasonable compensation (finding that Suder's base compensation, bonus and long-term incentive were reasonable as

claimed) and, most importantly, with the taxpayer's allocation of 75 percent of Suder's wages towards QREs (and 25 percent to nonqualified service). However, it did not consider the royalty component of Suder's overall compensation to be QREs and instead elected to establish a new standard for the reasonableness determination under section 174. The court reduced Suder's overall salary accordingly – therefore, at the end of the day, allowing to be included in reasonable compensation \$2.3 million for 2004, \$2.4 million for 2005, \$2.5 million for 2006 and \$2.6 million for 2007 in calculating the QREs at 75 percent. In doing so, the court has further complicated an already complex analysis. In other words, don't try this at home, boys and girls. The court even noted it is a very complex area of the tax code, according to UTP statistics. The lesson is that salaries of CEOs involved in research can be QREs, but royalty payments to those CEOs cannot.

Unsurprisingly, the court tossed out all of the IRS's efforts to impose penalties on the taxpayer. It cited in detail the company's reliance on the alliantgroup method in claiming the research tax credit for 2004-2007. The court ruled that ESI had operated in good faith by following alliantgroup's practices and standards. Imposition of a penalty should be reserved for extraordinary situations and should not be a default option.

Conclusion

The Tax Court in Suder sent a strong positive message to small businesses that the research tax credit is meant to cover a broad range of innovation and work encompassing both applied and basic science (and yes, even routine research), and that reinventing the wheel is not required. Compensation of CEOs and other senior officials involved in research and product development can be included (or partially included) in QREs, but keep your feet on the ground.



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