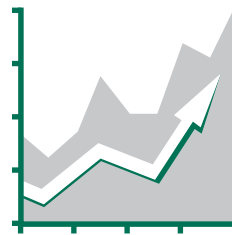


Financial Adviser



R&E Tax Credit: Recent Rulings in Favor of Taxpayer

Changes in the R&E Tax Credit

With past tax regulatory changes, the Research and Experimentation (R&E) Tax Credit was significantly expanded and enhanced. Consequently, the number of eligible taxpayers and the amount of credit claimed by taxpayers has increased considerably. Because of these increases, the Internal Revenue Service (IRS) identified this area as a high priority with increased examinations and oversight, and therefore has led to a greater number of tax case rulings; four decisions already have been issued in 2009 and 2010. The good news is that these recent cases have resulted in favorable findings for the taxpayer and provide insight in the proper application of these new rules.

Custom/Contract Manufacturing

One case in particular is good news for the custom or contract manufacturing segment in northwestern Pennsylvania. *TG Missouri v. Commissioner* is a Tax Court case (2009) dealing with a plastic injection molding manufacturer that supplies the automotive industry. This taxpayer develops and uses molds (tooling) to manufacture automotive parts for its customers. The entity also incurs additional design and engineering costs to modify molds produced by outside suppliers. As long as these molds are customer owned, the wage costs associated with the development of these molds qualify for the R&E Tax Credit. The court determined that amounts paid to outside suppliers for acquired molds also qualify for the R&E Tax Credit as a supply cost. Therefore, TG Missouri is only paid for the mold when it produces a sample part acceptable to the customer – one of the factors necessary for qualification.

Issues Addressed in Other Cases:

Business Component

Development of a “business component” can qualify for the R&E Tax Credit. Both the development of a product and the development of a process to produce a product can qualify as a “business component.” In *TG Missouri* mentioned above, the mold would be the “product,”

and the process to produce or build the mold would be the “process.”

Capability, Method or Design

One of the requirements to qualify for the R&E Tax Credit is that there must be uncertainty in either: the capability, method or design of the business component. In *TG Missouri*, the capability or the method used in developing the mold or its production process wouldn’t fall into this category. The design at inception, however, will almost always be different than the final design of the business component.

The Union Carbide Corporation v. Commissioner case (2009) provides that only uncertain design is necessary for qualification. Union Carbide had previously developed processes similar to the new process currently being developed. The IRS maintained, and the court agreed, that there was little doubt that the company would be successful with the development of this new process. The court, however, held that this development activity qualified because the final design was not known at inception.

Documentation

In recent cases, the IRS has challenged the taxpayer’s position based on inadequate documentation. In some instances, the IRS has insisted on contemporaneous recordkeeping. *U.S. v. McFerrin* (a Fifth Circuit, U.S. Court of Appeals case (issued in 2009) cites the longstanding rule of *Cohan v. Commissioner* (a 1930 case) and states that if a qualified activity occurred, the court should estimate these expenses looking to testimony and other evidence, including the institutional knowledge of the company’s employees. *Union Carbide and Trinity Industries, Inc. v. U.S.* (a 2010 case) also cite the Cohan Rule as an acceptable approach in determining the cost or expense in the absence of specific documentation.

Qualifying Activities

In the previously discussed *Trinity Industries*, a shipbuilder claimed the R&E Tax Credit for the design and development

of special order ships. The development involved the consideration of combining subassemblies as part of the ship design. The government’s challenge was that this consideration was “nothing more than ordering off of a menu – pick a hull from column A, a propulsion system from column B, an HVAC from C, etc.” The court responded that this analogy greatly oversimplifies the approach and indicated that “determining which configuration out of the universe available can ... involve a significant research effort.” The court also stated that the interaction between systems can be “complex and nonintuitive.” The result of this case appears to be more support for the qualification of the custom/contract manufacturer.

Likewise, as these recent cases demonstrate, if the taxpayer is diligent in determining and developing support for its qualifying activities, the result should be a valuable tax credit. ☆

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