

# *Union Carbide* decision offers research tax credit guidance

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### Tax Court decision offers research credit opportunities, traps

A new decision handed down by the Tax Court (*Union Carbide v. Commissioner*, T.C. Memo 2009-50) provides long-awaited judicial guidance and significant potential benefits to taxpayers claiming the research credit. Although the Tax Court awarded Union Carbide only a small fraction of its additional research credit claims, the decision includes several favorable elements that may offer opportunities to taxpayers.

In particular, the Tax Court generally accepted the validity of employee recollections and data extrapolation to estimate qualified research expenditures. The case also supports the idea that qualified research can occur as part of the process of producing goods for sale to customers, provides clarification on the application of the consistency rule and discovery test, and sheds light on the application of the process of experimentation requirements. Taxpayers should be aware that the decision is not without unfavorable elements, and there are traps for the unwary.

A memorandum decision does not in and of itself have precedential value in court, but the *Union Carbide* case can be considered in determining whether a taxpayer's position is supported by substantial authority.

### Overview

After negotiating an agreement with the IRS on research tax credits of \$20 million and \$141 million on its 1994 and 1995 tax returns, Union Carbide made a claim for additional credits arising from 106 projects conducted in the taxpayer's manufacturing facilities in 1994 and 1995. The IRS contested these additional credits, spurring the litigation. The Court analyzed the five largest projects to determine the eligibility of the additional claimed projects/costs.

The Court found that two of the five projects constituted qualified research activities, but it disallowed all of the additional supply costs because they were incurred in the production of goods for sale, not in the conduct of qualified research. As a result, the taxpayer was only entitled to \$1,045 of additional qualified research expenditures (of the more than \$20 million costs at issue).

### Contact information

Mark Andrus  
West Regional Partner  
T 503.276.5910  
E Mark.Andrus@gt.com

Stan Babicz  
Midwest Regional Leader  
T 414.277.1552  
E Stan.Babicz@gt.com

Joe Brown  
Southeast Regional Partner  
T 954.727.5680  
E Joseph.Brown@gt.com

Jim Wittmer  
Northeast Regional Partner  
T 215.656.3065  
E Jim.Wittmer@gt.com

Janet Wong  
Central Regional Partner  
T 832.487.1400  
E Janet.Wong@gt.com

[www.GrantThornton.com/tax](http://www.GrantThornton.com/tax)

**Substantiation and the Cohan Rule**  
Although the taxpayer's claim hinged on supply costs that were ultimately disallowed, the decision provides helpful clarification for taxpayers concerned about the proper documentation required to substantiate their credits. Despite clear statements in the legislative history that eligibility for the credit is not intended to be contingent on meeting unreasonable record-keeping requirements, the IRS has actively opposed the use of employee recollections and extrapolations from existing data to reasonably estimate the portion of expenses that may be classified properly as qualified research expenditures. However, for those projects that otherwise satisfy the qualification requirements, the *Union Carbide* decision generally rejects the IRS's arguments and accepts the validity of such evidence.

Specifically, the Court supported the use of the "Cohan Rule" (*Cohan v. Commissioner*, 39 F.2d 540) in determining a "close approximation" of qualified research activities and associated expenditures through interviews and oral testimony corroborated by documentary evidence. Of particular significance for taxpayers, the Court found that credible oral testimony "sufficiently substantiated the wages paid" to certain employees.

#### Consistency

The *Union Carbide* case is also helpful in determining the limits of the consistency rule, which requires taxpayers to identify base year qualified research activities and associated expenditures in a manner consistent with the credit year. Despite the IRS's arguments, the Court found that there is no requirement that "a taxpayer use the same types of documents to

identify qualified research in the base period as it used to identify qualified research in the claim year if the taxpayer can otherwise show that it has satisfied the consistency requirement."

The Court also found that the consistency rule needs to be applied only at the legal entity level and not at the controlled group level.

#### Product vs. process research

The decision supports the idea that qualified research may occur as part of the process of producing goods for sale to customers. The Court was careful to make a clear distinction between product research and process research. Even if a certain product has been developed to a point where it "meets the basic functional and economic requirements of the taxpayer," the Court maintained that the research credit qualification tests should be applied separately to the development or improvement of a production process for that product.

"Even after a product is ready for commercial sale, activities relating to the development of the manufacturing process may constitute qualified research," the opinion states.

The decision effectively limited the costs allowed as process qualified research expenditures to the direct costs incurred because of the research element, rejecting the taxpayer's attempt to include a portion of the production costs themselves. As a result, the supply costs were deemed related to the taxpayer's production activities and not allowed by the Court.

### Discovery test

The case supports the elimination of the “discovery test,” a favorable development for taxpayers. The discovery test was applied in prior Tax Court cases and required the taxpayer to discover information that went beyond current state of knowledge in a relevant field (e.g., *Normest Corp. & Subs. v. Commissioner*, 110 T.C. 454). In *Union Carbide*, the Court relied on the 2004 final regulations (T.D. 9104) and supported the use of these final regulations even for research credit years prior to the issuance of these regulations. The Court renamed the discovery test the “technological information test” and reiterated that this test is met as long as the information sought to be discovered is technological in nature. This guidance will be helpful for taxpayers dealing with IRS auditors who continue to apply the “discovery” requirement.

### Process of experimentation

Taxpayers should be aware that the decision reinforces the requirement that the research activities be part of a process of experimentation. The decision is stringent in its application of this standard, rejecting several projects because tests were not designed in advance to eliminate objective uncertainties.

The Court’s interpretation of the requirement states: “The taxpayer should develop a hypothesis as to how a new alternative might be used to develop a business component, test that hypothesis in a scientific manner, analyze the results of the test, and then either refine the hypothesis or discard it and develop a new hypothesis and repeat the previous steps.”

Despite the strict interpretation, the Court did acknowledge that there was no specific requirement that the experiment results be recorded.

### Next steps

Although the memorandum decision will not in and of itself have precedential value in court, it does offer clear benefits for taxpayers by providing additional clarification on the research credit. Businesses interested in seeing how the decision may affect their own research credit claims can contact Grant Thornton LLP to discuss their situation.

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