



Recent Developments Update: Research Tax Credit

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Agenda

- Legislative Update
- Housing and Economic Recovery Act: Monetizing Carry Forward Research and AMT Credits
- Litigation
- Financial Accounting Considerations and IFRS
- Technical Guidance Update: Where does Treasury stand on the issues that matter?
- IRS Enforcement Efforts: Tier One, etc.

Legislative Update



Research Credit Extended thru 2009

- 10/3/08: President Signs Extender Bill (HR 1424) into Law
 - A ***two-year seamless extension*** of the research credit for qualified research expenses paid or incurred from January 1, 2008 through December 31, 2009
 - An ***increase in the Alternative Simplified Credit*** (ASC) from 12% ***to 14%*** for the 2009 year
 - The ***Alternative Incremental Research Credit can no longer be elected*** for taxable years beginning after December 31, 2008

HR 1424: Effective Date ASC

- Special effective date for the increased ASC rate of 14%:
 - A taxpayer with a fiscal year ending in 2009 could elect the ASC at 14% for its entire 2009 fiscal year, even though a portion of the tax year is in 2008
- ***ASC MUST BE ELECTED ON A TIMELY FILED ORIGINAL RETURN:***
 - Protective elections?
 - Interplay with gross receipts issue?

GAO Study: Research Credit

- GAO Study commenced over 2 years ago and is expected to address:
 - Burdensome aspects of documenting and substantiating RCs
 - IRS complaints about aggressive positions taken by taxpayers on amended returns
 - Recordkeeping
 - Design of the credit
 - Is the choice of which credit to elect always clear cut clear and based on the relative size of the credit generated by each option
 - Significant transition issues if the only credit option is the ASC?
 - 280C elections

GAO Study: Research Credit

- Implications of GAO Study Results:
 - Eliminate regular credit to address base amount substantiation issues
 - Documentation requirements
 - Enhanced Pre-Filing Agreement and Research Credit Recordkeeping Agreement Program
 - Likelihood of a permanent credit?

Permanent Research Credit?

- An **Obama** administration:
 - Supports a permanent research credit, but unclear on whether pay-as-you-go must apply to extenders
 - If Obama is elected he has positioned health-care reform as his kick-off issue – but Congressional leaders believe that tax reform has a better chance of a quick victory
 - With Congress at his beck and call he could pass extenders, but in light of deep economic turmoil, he will not want revenue raisers to be perceived as prolonging the downturn
 - Rangel has said that he is committed to delivering Obama's legislative priorities for 2009

Permanent Research Credit?

- **McCain** administration:
 - Supports a permanent R&D credit equal to 10 percent of R&D wages
 - Repeal [Section 199](#) domestic production activities deduction
 - McCain will face a democratic-controlled Congress and is likely to be pragmatic – agreeing to some revenue raisers – if he can get some key Bush tax cuts from 2001 and 2003 extended
 - Difficult to predict if he would make tax reform a lead-off issue

State Research Credit Issues



California Legislative Update

- 9/23/08: CA enacts 2008-2009 budget legislation providing:
 - Net Operating Loss (NOL)
 - Suspends NOL deductions for 2008 and 2009 tax years
 - Carryforward period extended from 10 to 20 years for NOLs generated beginning in 2008 tax year
 - NOLs generated after January 1, 2011 will have a 2 year carryback - subject to a few transitional limitations
 - Tax Credits
 - Tax credits will only be allowed to offset 50% of the tax liability for years beginning on or after January 1, 2008 and before January 1, 2010
 - Credit utilization limitation does not apply to taxpayers with income subject to tax of less than \$500,000

California Legislative Update

- 9/23/08: CA enacts 2008-2009 budget legislation providing (con't):
 - Assignment of tax Credits
 - Allows irrevocable assignment of tax credits to combined reporting group members. Credits may be assigned during taxable years beginning on or after July 1, 2008, and may be utilized by the assignee in any taxable year beginning on or after January 1, 2010
 - General Motors Corp. v. Franchise Tax Board, 39 Cal.4th 773 (2006)
 - Reaffirmed longstanding trapping problem of California credits (and NOLs) where R&D credits can be trapped and not fully utilizable in entities that generate the QRE's but do not have sufficient California apportionment factor numerators to fully utilize those credits
 - New legislation allowing assignment of credits provides limited relief
 - If trapping is a chronic problem, a single member LLC or other restructuring can be considered

Other California Differences

- California does not conform to the federal Alternative Simplified Credit
- California Base Amount
 - California only receipts
 - Receipts of property delivered or shipped to California (receipts from services and intangibles generally should not be included)
 - Sales “thrownback” to California should be excluded

Update: Other State Research Credits

- State legislative proposals:

- CA = blackout 2008 – 10 (enacted)
- AZ = increased credit % (enacted June 27, 2008)
- FL = add research credit (died in committee May 2, 2008)
- MD = added a research credit for cellulosic ethanol technology R&D (enacted April 24, 2008)
- GA = expand credits eligibility to broadcasting activities (signed into law May 14, 2008)
- MA = created a research credit for “qualified life sciences companies” (enacted June 16, 2008)
- MI = credit for developing fuel efficiencies (not likely to pass) (Note: MI has a new R&D credit for 2008)
- MN = increasing RC rate and flat credit (not likely to pass)
- NM = credit extension (held up in Senate)

Update: Other State Research Credits

- State legislative proposals (con't):
 - MO = reinstates a research and development credit (signed into law June 11, 2008)
 - NY = add research credit (not likely to pass)
 - RI = bill to revoke credits (not likely to pass)
 - UT = modification of credit rates (signed into law February 12, 2008)
 - VA = credit for nanotechnology activities (not likely to pass)

Housing and Economic Recovery Act of 2008 (P.L. 110-289)



IRC § 168(k)(4)

- **IRC § 168(k)(4):** NOL/AMT corporations qualifying for bonus depreciation can claim up to 6% of their pre-2006 carryforward research and AMT credits (capped at \$30M) to generate refundable credits or use against current-year AMT liability
- **Benefit is limited to the lesser of:**
 - \$30M or
 - 20% of the *bonus depreciation amount* – which is the difference between the bonus depreciation that could be claimed and the highest amount of depreciation that could be claimed if bonus dep'n is not elected
- **Impact of Election:** If a corporation elects the new refundable credit, qualified property will be depreciated under the straight-line method. Consequently, if new credit is elected, depreciation deductions will merely be deferred compared to bonus and accelerated MACRS depreciation

IRC § 168(k)(4)

- Effective date:
 - Election **must** be made for first taxable year ending after March 31, 2008
 - Applies to bonus depreciation for qualified property placed in service between 4/1/08 and 12/31/08 (and for certain long-lived property and transportation property placed in service in 2009)
- Maximum benefit is a \$30M cash refund for 2008 calendar year (or 2009 fiscal year) taxpayer if:
 - \$500M in carry forward R&D and AMT credits from pre-2006 tax years **AND**
 - \$375M of 5-year recovery period assets placed in service between 4/1 and 12/31/08

IRC § 168(k)(4)

- Rev. Proc. 2008-65; 2008 IRB LEXIS 773 (October 10, 2008):
 - Corporations can "elect out" of section 168 treatment for all property in a particular class of property (e.g., 7-year property), such that MACRS depreciation will be available for such property in that particular class and, then, with respect to all remaining "eligible qualified property" the section 168(k)(4) refundable credit would apply as would straight-line depreciation
 - Corporation can choose to allocate its section 168(k)(4) credit amount to any R&E credit carryforward amounts (which otherwise could expire in the future) before the remaining portion (if any) of the section 168(k)(4) credit amount is allocated to any AMT credit carryforward amounts (which never expire)

IRC § 168(k)(4)

- Rev. Proc. 2008-65 indicates that the Treasury Department and IRS intend to publish future guidance regarding the "time and manner" of making the section 168(k)(4) election:
 - No forms for claiming credits have been issued
 - Treasury Official, Brandon Carlton, publicly stated that fiscal-year taxpayers will be allowed to make a section 168(k)(4) election on an amended return. IRS Priority Guidance Plan for 2008 – 2009:
 - Additional guidance may be issued addressing the interaction of section 168(k)(4) with section 383 limitations on credit utilization after a change of ownership

Litigation



Issues in Litigation

- *US v. McFerrin*, 492 F. Supp. 695 (S.D. Texas 2007) will be appealed:
 - Legal std for pre-final reg tax years
 - Discovery test and process of experimentation
 - Substantiation
- Patent Attorney Expenses
- Section 174 Treatment
- Supply Expenses – Test Runs
- Base Period Consistency – acquisitions/dispositions
- Base Period Documentation
- Gross Receipts adjustment for transactions with CFCs
- Research related to process improvements (e.g. tooling)
- Prototypes (tooling) are property of a character subject to allowance for depreciation

Technical Guidance Update



Technical Guidance Projects

- 2008-2009 Priority Guidance Plan: Issued 9/11/08
 - New Project: Regulations on the reduced section 41 credit election under section 280C(c)(3). May address:
 - Whether protective elections of the reduced credit can be made. If yes, what constitutes an effective protective election (which was sanctioned in AM 2008-002 (dated 1/31/08))
 - Can each member of the control group make a separate determination with respect to electing the reduced credit under section 280C(c)(3)?

Technical Guidance Projects

- 2008-2009 Priority Guidance Plan: Issued 9/11/08 (con't)
 - *CA Practice Pointer:* Historically, the 280C election was generally tax neutral for federal purposes, though it is usually detrimental for California purposes
 - *Fed Practice Pointer:* 280C elections can reduce section 199 deductions by reducing QPAI. With the section 199 deduction increasing to 9% in 2010, this should be considered next year for 2010 FY taxpayers. It may also have a detrimental effect on foreign tax credit utilization

Technical Guidance Projects

- 2008-2009 Priority Guidance Plan: Issued 9/11/08 (con't)
 - Gross Receipts component of the research credit calculation:
 - Appeals Coordinated Settlement Offer allows 50% of the gross receipts adjustment:
 - If the CFC adjustment to reported gross income is \$100, then Appeals would allow an adjustment of \$50
 - Appeals has rejected a settlement approach allowing a “with” and “without” computation of the credit, with TP being allowed 50% of the difference
 - Will Appeals consider a different treatment for section 965 dividends?
 - Regulations preamble may be more important than the content of the regulations

Technical Guidance Projects

- 2008-2009 Priority Guidance Plan: Issued 9/11/08 (con't):
 - Guidance under section 174 concerning inventory property:
 - Treatment of prototype construction expenses
 - Experimental batches sold to customers
 - Guidance under section 174 regarding changes in methods of accounting from an impermissible method
 - Will Rev. Rul. 58-74, 1958-1 C.B. 148, allowing “corrections” for capitalized R&D expenditures that qualify as § 174 expenses be superseded?
 - Correction of error vs. unauthorized method change
 - Internal-Use Software:
 - Definition of Internal-Use Software
 - Tests for determining if software is “highly innovative”

Technical Guidance Projects

- 2008-2009 Priority Guidance Plan (con't):
 - Final regs on the ASC under section 41(c)(5):
 - September 25, 2008 Hearing on the proposed regs
 - No one has filed comments
 - Comments are invited as to whether a controlled group can make an election to use the ASC for both computation of the group credit and every members stand alone credits, even if the ASC does not provide the greatest stand alone entity credit
 - Issue not addressed: Protective elections for ASC?

Financial Accounting



Financial Accounting and IFRS

- Tier I experiences may influence Fin 48 for:
 - Unit of Account
 - Measurement
- Any Elimination of Valuation Allowances may result in closer scrutiny of the credit for FIN 48

Financial Accounting and IFRS

- IFRS

- US GAAP

- Research Phase – expense as incurred
 - Development Phase – expense as incurred

- IFRS

- Research Phase – expense as incurred
 - Development Phase – capitalize and amortize

- Will taxpayers adopting IFRS need to have a project accounting system?

IRS Practice: Tier I Initiative



Tier I Update – Trends

- Scope of IRS Tier I examination practices:
 - Only claims for refund?
 - All research credit examinations?
- Critical Tier I examination practices:
 - Mandatory Tier I IDR: Issued to determine if a valid claim has been filed?
 - Is the claim “auditable”?
 - Treas. Reg. § 301.6402-2:
 - No refund or credit will be allowed . . . except upon one or more of the grounds set forth in a claim filed before the expiration of such period
 - The claim must set forth ***in detail*** each ground upon which a credit or refund is claimed and ***facts*** sufficient to apprise the Commissioner of the exact basis thereof

Tier I Update – Trends

- Critical Tier I examination practices (con't):
 - Tier I IDR suggests (due to its emphasis on “business component”) that:
 - Project accounting is generally needed to properly substantiate research credit positions, yet this stance is contrary to Treasury Policy of “reasonable flexibility”
 - “Every” document relating to qualified research be provided and “all” employees who participated in qualified research be consulted
 - More involvement of RCTAs:
 - Highly recommended that examiner contacts RCTA before beginning the examination
 - RCTAs should review Tier I IDR response
 - Team managers are more inclined to have RCTAs review proposed settlements

Tier I Update – Trends

- Critical Tier I examination practices (con't):
 - Penalties more likely to be asserted under section 6676 for erroneous claims for refund:
 - Risk zone: Base amount was allowed in a prior examination, but no closing agreement
 - 2008 – 9 Priority Guidance Project defining “reasonable basis”

IRS Appeals: Coordination

- **Proposed** Appeals Guide “Substantiating Research and Experimentation Expenditures”:
 - Guide encourages “profiling” claims – rather than factual and legal analysis
 - All estimations and extrapolations are suspect regardless of the factual support for the underlying assumptions
 - Only “blind” surveys are reliable
 - IRC § 6001 imposes a record keeping obligation upon a taxpayer, but does not close the door to the introduction of other evidence
 - Examiners are using this “Draft Report” as a basis for disallowing credits!
 - **Has Appeals issued a final report? – under consideration since February 2007**

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