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JCT expands analysis of Obama administration proposal for permanent research credit

The staff of the Joint Committee on Taxation (JCT) recently released its analysis of the revenue provisions in President Barack Obama's proposed fiscal year 2012 budget. As in previous JCT analyses of Administration budget proposals, this year's JCT pamphlet includes a lengthy analysis of the Administration's research credit proposal.

The new budget reaffirms the Obama Administration's prior proposal to make the section 41 research credit permanent; the George W. Bush Administration also had called for a permanent credit. This year, the Administration also proposes to increase the rate of the alternative simplified credit (ASC) from 14 percent to 17 percent. The proposals would be effective for amounts paid or incurred after 2011.

While most of the JCT document simply repeats its analysis last year of the Administration's research credit permanence proposal for fiscal year 2011, the JCT has added a discussion of two key definitional issues that affect administrability of the research credit. These issues have been the subject of important, taxpayer-favorable court decisions.

Background

Under section 41, a taxpayer may claim a research tax credit equal to 20 percent of the amount by which the taxpayer's qualified research expenditures for a tax year exceed its "base amount" for that year. That is, the credit generally is available with respect to incremental increases in qualified research. Taxpayers also may claim the 14-percent ASC in lieu of the regular credit.

The research credit has been re-enacted on a temporary basis many times -- several of those on a retroactive basis. The credit currently is scheduled to expire for



amounts paid or incurred after 2011.

Key definitional issues

The issues affecting administrability of the research credit, according to a 2009 Government Accountability Office study, include the definitions of internal-use software and credit-eligible supplies.

Internal-use software

The JCT explains how Congress in 1986 imposed several restrictions on the credit-eligibility of research expenditures for the development of computer software for a taxpayer's own internal use. Congress added some of these requirements to section 41, and intended that the IRS would promulgate regulations imposing additional requirements for internal-use software research to be eligible for the credit.

These extensive requirements have led to uncertainty as to the availability of the credit for internal-use software research expenditures. A 2004 Notice of Advance Rulemaking (Announcement 2004-9) noted that "Treasury and the IRS are concerned about the difficulty of effecting Congressional intent behind the exclusion for internal-use software with respect to computer software being developed today. Despite Congress' broad grant of regulatory authority in section 41(d)(4)(E), the Treasury Department and the IRS believe that this authority may not be broad enough to resolve those difficulties." The JCT notes that this uncertainty regarding availability of the credit "may shift investment away from such research to other research which it is clear is eligible for the credit. *Such a shift may not represent the efficient allocation of research funding.*" (Emphasis added.)

Observations: The JCT did not discuss the 2009 decision of the U.S. District Court for the Eastern District of Tennessee in the *FedEx* case. In *FedEx*, the district court rejected the IRS's attempt in Announcement 2004-9 to require taxpayers attempting to claim the research credit for internal-use software to adhere to the more stringent version of the so-called "discovery test" set forth in final regulations issued in 2001. Instead, the court concluded, taxpayers could rely on the revised discovery test set forth in final regulations issued in 2003.

For discussion of the *FedEx* decision, see WNTS Insight, "[Stringent research credit discovery test held not to apply to internal-use software](#)," June 11, 2009.

Supplies

Addressing the definition of supplies eligible for the credit, the JCT notes the Tax Court's 2009 decision in *TG Missouri*, in which the court, reversing an IRS determination, held that a significant amount of research supplies that a parts supplier had purchased from a toolmaker and later resold to the parts supplier's customer, an equipment manufacturer, could be included in the taxpayer's research credit calculation. (For discussion of the *TG Missouri* decision, see WNTS Insight, "[Purchased and resold supplies may qualify for the research credit, Tax Court holds](#)," November 17, 2009.)

The JCT also cites, without discussion, the taxpayer-favorable 2010 decision of the U.S. District Court for the Northern District of Texas in *Trinity Industries*, in which the court held that substantial portions of the wages, supplies, and contract research costs involved in developing, testing, and building certain prototype ships were qualified research and development expenses for purposes of the research credit. (For discussion of the *Trinity Industries* decision, see WNTS Insight, "[Research credit allowed for prototypes designed and built under contract](#)," February 15, 2010.)

In light of decisions such as *TG Missouri* and *Trinity Industries*, the JCT explains that, "While allowing credits for a relatively expansive definition of research supplies might increase total credits claimed substantially, this does not by itself make the credit more or less efficient," because, the JCT explains, the economic efficiency of research subsidies is determined by "the extent to which such subsidies cause new research that generates benefits for other firms or individuals."

Final observations

By ending the uncertainty that results from the temporary nature of the current section 41 research tax credit, making the research credit permanent -- combined with increasing the rate of the ASC -- would boost U.S.-based research and development.

Crafting legislation to make the credit permanent also would give Congress the opportunity to resolve policy issues associated with the credit, such as the definitional issues discussed above.

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