

Morgan Lewis

SIXTH ANNUAL
**RESEARCH &
DEVELOPMENT
TAX CREDIT**
SYMPOSIUM

*Welcome
Remarks*

Alex Sadler, Tom Linguanti & Doug Norton | November 13, 2020
Session 3

Faculty Firms



FUJIFILM



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Special Thank You



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Welcome to Session 3!

- BUT, FIRST:

THANK YOU to all who have joined us throughout this week as attendees at our first-ever **virtual** R&D Tax Credit Symposium!

- **Session 1 (Monday 11/9)**: 440 virtual attendees
- **Session 2 (Wednesday 11/11)**: 422 virtual attendees

- THEN: Quick run-through of answers to Wednesday's quiz, followed by live raffle to pick Session 2 winners...

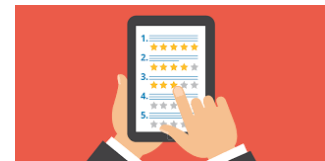
- FINAL QUIZ: Will close out today's program with quiz around 3:25 pm

- Answers must be submitted via WebEx; those with all or the most correct answers will be entered into our raffle

- NEXT WEEK: We will circulate a list of Session 3 raffle winners, a link to all presentations from this week, and a post-event survey. We'd love to hear from you!



QUIZ TIME



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Answers to Wednesday's Quiz (Session 1: Questions 1-5)

1. A taxpayer must file a Form 3115, Application for Change in Accounting Method, if it deducts a new type of cost as a research or experimental expenditure under section 174.
False
2. In which case did the court allow the cost of paint as a supply QRE?
Trinity Industries
3. When Michael Jordan played for the Chicago Bulls, how many NBA Championships did he win?
Six
4. The issuance of a patent by the Patent & Trademark Office is conclusive evidence that a taxpayer has engaged in qualified research.
False
5. The following type of cost is allowable if the taxpayer is able to show its expenditures were extraordinary:
Utilities

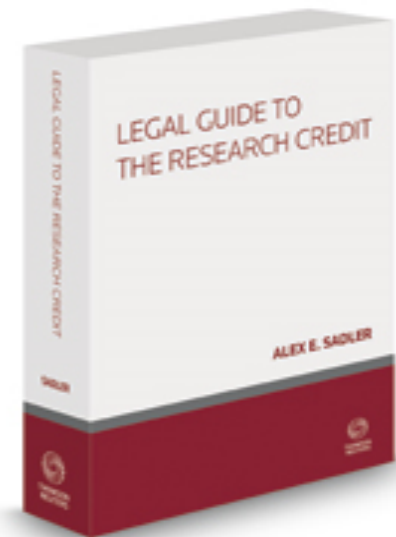
Answers to Wednesday's Quiz (Session 1: Questions 6-10)

6. How many hearts does an octopus have?
Three
7. In what case did ML attorney Tom Linguanti, working for the Justice Department, persuade a district court that the taxpayer had failed to provide its base period?
Research, Inc.
8. Which of the following research credit cases was *not* appealed.
Norwest Corp.
9. Which planet is the hottest in the solar system?
Venus
10. Which country produces the most coffee in the world?
Brazil

And Wednesday's Session 2 raffle winners are...



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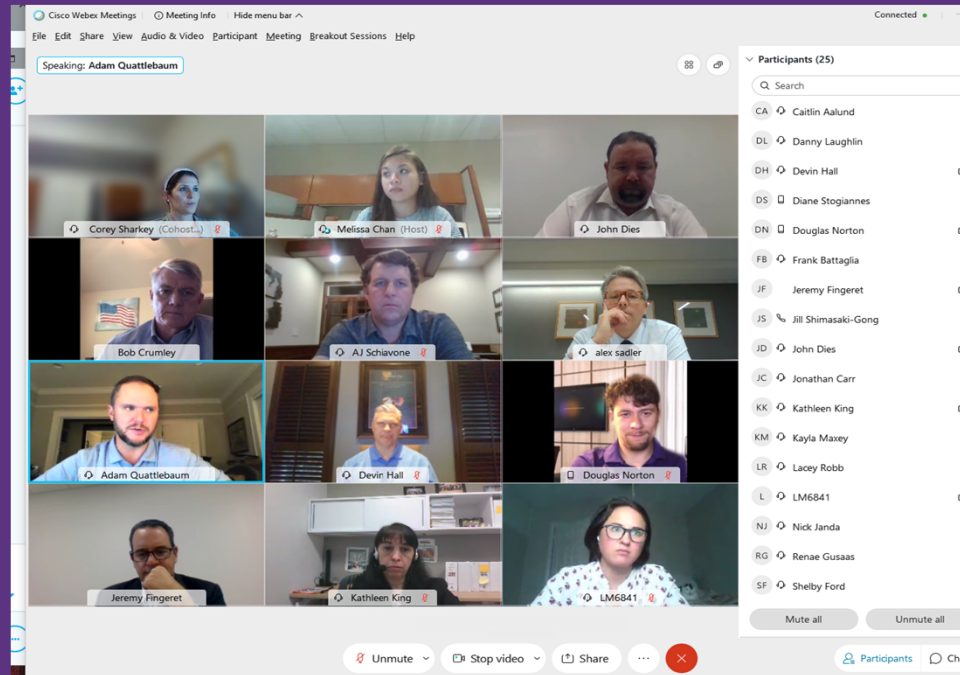
Friday's Program – November 13, 2020

12:00 pm – 12:15 pm	Welcome Remarks Morgan Lewis: Alex Sadler, Doug Norton, and Tom Linguanti
12:15 pm – 1:15 pm	In-House Perspectives on Methodology, Documentation, and Audits Massie R&D Tax Credits: Peter Green Massie R&D Tax Credits: Jason Massie FUJIFILM: Peter De Nicola InterContinental Hotels Group: Kay Kousek Caterpillar Inc.: Daniel Mansfield
1:15 pm – 1:20 pm	BREAK
1:20 pm – 2:20 pm	Stat Sample Offense and Defense; R&D Audit Defense Tactics PwC: Joe Maselli PwC: Linden Smith
2:20 pm – 2:25 pm	BREAK
2:25 pm – 3:25 pm	Top 10 Sticking Points in R&D Controversies Morgan Lewis: Doug Norton Morgan Lewis: Tom Linguanti Morgan Lewis: Alex Sadler
3:25 – 3:30 pm	Quiz
5:00 pm – 6:00 pm	Informal Networking Session with Panelists and Attendees

VIRTUAL HAPPY HOUR @ 5:00 PM ET

ALL PRESENTERS AND ATTENDEES WELCOME

BRING QUESTIONS, COMMENTS, AND A BEVERAGE OF YOUR CHOICE!



From our Wednesday/Session 2 networking session...



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TAX CREDIT SYMPOSIUM

In-House Perspectives on Methodology, Documentation, and Audits

Jason Massie, Founder and President, MASSIE R&D Tax Credits
Peter Green, CEO, MASSE R&D Tax Credits

Peter De Nicola, Director of Taxes, FUJIFILM
Kay Kousek, Senior Tax Manager, InterContinental Hotels Group
Daniel Mansfield, Senior Tax Consultant, Caterpillar

Presenters



Peter De Nicola
Director of Taxes
FUJIFILM



Peter Green
CEO
MASSIE R&D Tax Credits



Kay Kousek
Senior Tax Manager
InterContinental Hotels Group



Daniel Mansfield
Senior Tax Consultant
Caterpillar



Jason Massie
Founder and President
MASSIE R&D Tax Credits

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Polling Question #1

What month do you typically start your R&D tax credit and how long does your process last?

- A. January/February
- B. March/April
- C. June/July
- D. Year round, no real start date

Polling Question #2

Do you have SMEs involved in the project planning and in the year-end wrap up meetings?

- A. Yes, involved in pre-project and post-project
- B. Yes, only involved in pre-project
- C. Yes, only involved in post-project
- D. No

Polling Question #3

Have you changed your process based on success or failure after examinations?

- A. No
- B. Yes, we now cover more projects with write-ups
- C. Yes, we now gather more details on projects
- D. Yes, both B and C

Polling Question #4

What is one thing you'd like to change if you had more time, money or resources?

- A. Cover more projects
- B. Gather more documentation
- C. Explore new innovation areas
- D. Automate process more

Biography



Peter De Nicola

Director of Taxes
FUJIFILM

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Peter De Nicola heads the tax function for FUJIFILM's Americas region. He has over 40 years of diverse tax experience, including 30 years at FUJIFILM. In his role as director of taxes, Peter oversees the company's transfer pricing policies, domestic and international tax compliance for North and South America and is heavily involved in mergers, acquisitions and restructurings. Prior to joining FUJIFILM, he held various tax management positions with General Signal, Emery Worldwide and Siemens.

A certified public accountant, Peter earned a BS in Accounting and an MBA in Taxation from New York University. He is the President of the Westchester-Fairfield Chapter of the Tax Executives Institute and serves on its national Board of Directors. In addition to authoring numerous articles on taxes and investments, he has been interviewed in the *Wall Street Journal* and on Bloomberg Television. He is co-author of the book, *Mergers and Acquisitions: A Practitioner's Guide to Successful Deals*, published by *Scientific Publishing*.

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Biography



Peter Green

CEO
MASSIE R&D Tax Credits
pgreen@massietaxcredits.com

Peter Green is CEO of MASSIE R&D Tax Credits. Responsible for the company's vision, growth objectives, and client experience initiatives, Peter brings impressive experience to MASSIE. His career in the tax credit industry began in 2001. In 2007, he became President of WALLACE. Implementation of his own improvement initiatives and ideas grew the company at a rapid rate over several years until it was noticed and acquired by ADP in 2011.

Peter's expertise and detailed understanding of the tax credit industry is acknowledged by his service as a former member of specialty taxation committees for both the Georgia Chamber of Commerce and the Georgia Economic Development Association. He is also a frequent speaker on tax credit policy and best practices nationwide.

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Biography



Kay Kousek

Senior Tax Manager
InterContinental Hotels Group
Kay.Kousek@ihg.com

Kay Kousek has over 10 years of experience with R&D Tax Credits, and 22 years in Tax with InterContinental Hotels Group where she is currently a senior tax manager. In her role she specializes in tax research and planning, R&D tax credit engagement management, and corporate transactions work. Over the years, Kay has provided expertise in compliance issues, audits, tax credits and tax planning. She takes a team building approach to projects she manages, where strong relationships with key stakeholders of the business help achieve optimal project outcome. Kay resides in Jasper, GA and in her free time she likes to explore the North Georgia mountains, socialize with friends and family, and spend time on the beaches of Florida where she was raised.

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Biography



Daniel Mansfield

Senior Tax Consultant
Caterpillar

Dan Mansfield is a senior tax consultant in Caterpillar's Global Tax Data, Technology and Strategy Group. With more than 30 years of experience, he specializes in leading technology focused projects, including database applications, tax system implementations and data migrations. Over the years, Dan has provided leadership and extensive expertise in building a best in class Tax R&D reporting processes at Caterpillar. He combines flexibility and creativity infused with process excellence to meet and exceed client and corporate goals. Dan resides in Peoria, Illinois and in his free time he likes to hike, bike, travel, and spend time with his wife, Monica McGill, and their two dogs, Coco and Benny.

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Biography



Jason Massie

Founder and President
MASSIE R&D Tax Credits

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Jason Massie is founder and president of MASSIE R&D Tax Credits, where he is responsible for the quality, consistency and integrity of the firm's tax credit service offerings. He heads the Delivery Team at MASSIE and leads all Architecture and Controversy Phases for clients across the United States. He was first introduced to R&D tax credits during his time at a Big 6 accounting firm in Washington, DC. Over the next few years, he led Big 4 and law firm practices in managing many types of federal and state tax planning, credits, incentives and other cash flow strategies. He is widely recognized as an expert by his peers in the R&D Tax Credit and R&D Expenditure areas, with frequent speaking and writing engagements.

Jason is also an endurance enthusiast. He has competed in over 40 marathons and eight Ironman Triathlons. His favorite races include the Honolulu, Boston, Chicago and NYC Marathons and Ironman Wisconsin and Chattanooga.

He received a BS in Accounting from Christian Brothers University and a JD from the University of Memphis.

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BREAK...WE WILL RESUME SHORTLY

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TAX CREDIT SYMPOSIUM

Stat Sample Offense and Defense; R&D Audit Defense Tactics

Joseph Maselli, Director of Tax Controversy and Dispute Resolution, PwC

Linden Smith, Managing Director of the Washington National Tax Services (WNTS), PwC

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Presenters



Joe Maselli
Director of Tax Controversy
and Dispute Resolution



Lin Smith
Managing Director of the
Washington National
Tax Services (WNTS)

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Polling Question #1

What is a sample unit in an R&D examination?

- A. Employee wages
- B. project expenditures
- C. Cost center expenditures
- D. Contract research expenditures
- E. Any of the above

Why IRS and Taxpayers Use Statistical Sampling for R&D

- Taxpayers are increasingly using statistical sampling to determine amounts on original returns and in refund claims to achieve efficiency gains, documentation quality improvements, IRS acceptance on examination, and ease of acceptance in tax provision reviews.
- By focusing on a small subset of employees, projects, or other qualifying expenditures, data accumulation is more efficient and allows more detailed and substantive documentation to be developed than otherwise practical.
- The validity of statistical sampling and projection methodologies consistent with IRS sampling guidance in Rev. Proc. 2011-42 generally will not be challenged by the IRS.
- When the sample is valid, IRS will rely on those sample units selected for the taxpayer's study and will not select its own sample items for review, which avoids duplication of data accumulation and documentation efforts for an examination.

Audit Defense for R&D Tax Credits

- IRS is increasingly using statistical sampling as a more efficient methodology for an in-depth examination of QREs reported on current year returns and in refund claims. To support growth, IRS has hired more sampling specialists.
- Typically, the IRS treats QREs reported for employees or projects as sample items to investigate qualification in greater detail than otherwise practical.
- IRS uses well-established statistical methodologies implemented by Computer Audit Specialists and Statistical Sampling Coordinators.
- IRS specialists often understand that IRS samples will be more efficient and precise when developed in cooperation with taxpayers and advisors.
- Taxpayers often are not equipped to evaluate IRS sampling plans and are unaware of when or how to question IRS specialists or how to develop and propose statistically appropriate alternatives.

Statistical Sampling Controversy Objectives

- Statistical support is commonly needed to:
 - Navigate IRS statistical sampling rules
 - Develop test samples similar to those IRS uses to identify exposure areas
 - Work with the IRS to limit the sampled population to areas with legitimate uncertainty
 - Help achieve a sample size that balances the competing needs representativeness, achieves reasonable precision, and is not to be unduly burdensome to the IRS and the taxpayer
 - Confirm all IRS calculations are consistent with sampling guidance
 - Expedite the exam and settlement process

Key Statistical Concepts Encountered in Exam

- **Sample item** – typically, employee wages, contractor expense, supply or prototype expense, or business component cost (e.g., a project) for which taxpayers reported QREs
- **Sampling frame** – refined population of sample items from which the sample is selected
- **Sample design** – framework for organizing the sampling frame typically using dollar size stratification
- **Point estimate** – total QREs disallowed as projected using one of 4 allowed methods. Specific guidance is provided in Rev. Proc. 2011-42 on the selection of the best projection method.
- **Sampling error** – measure of statistical uncertainty based on the variability of sample results within each stratum. Good sample design will reduce variability and sampling error, as will larger samples.
- **Relative precision** – sampling error as a percentage of the point estimate. If sampling error exceeds 10% of point estimate, the point estimate of the disallowance is reduced

Polling Question #2

What is sampling error?

- A. A statistical measure of uncertainty
- B. A mistake in calculating the statistical results
- C. The number of sample items treated as nonqualifying

Example Sample of QRE Wages Design for Use in Exam

Data are illustrative and not for a particular taxpayer

Stratum	Dollar Value Boundary for QREs per Employee Reported	Population Count	QRE Population Dollars	Sample Count	QRE Sample Dollars	Sample QREs Disqualified
1	\$1,000 <= Amount <= \$118,000	722	\$ 54,968,342	30	\$ 2,196,151	\$ 219,615
2	\$118,000 < Amount <= \$170,000	390	\$ 54,972,297	30	\$ 4,212,474	\$ 631,871
3	\$170,000 < Amount <= \$250,000	272	\$ 54,966,184	30	\$ 6,210,115	\$ 1,242,023
4	\$250,000 < Amount <= \$1,600,000	142	\$ 54,486,185	30	\$ 11,359,921	\$ 3,407,976
5	Amount > \$1,600,000	4	\$ 8,961,869	4	\$ 8,961,869	\$ 3,584,748
Total		1,530	\$ 228,354,877	124	\$ 32,940,530	\$ 9,086,233

Projected Results (based on difference estimator)

Point estimate of adjustment	\$ 44,493,518	Sum of statistically weighted disallowed QRE across strata
Sampling error	\$ 8,898,704	Statistical measure of uncertainty at 95% level of confidence
Relative precision	20.0%	Sampling error as a percentage of the point estimate
Sampling error adjustment if precision > 10%	\$ 8,898,704	Reduction in projected adjustment for sampling error
Final adjustment	\$ 35,594,815	Point estimate less sampling error adjustment

Issues to Consider in IRS Samples

- Request a copy of the IRS sampling plan if one is not provided and review it carefully.
- Request modifications in sampling plan as needed – do not assume it is locked in when received.
- Explore adjustments to the population where IRS and the taxpayer may have a mutual interest in working together to remove highly qualified employees or projects unlikely to be adjusted from the sampled population.
- Recognize that if the IRS wishes to discuss a settlement offer well into the examination they may already know how their sample will project and don't like the answer. A taxpayer might achieve a better examination result by completing the review and projection.
- Watch for poor IRS sample projections. If the sampling error exceeds the adjustment amount (relative precision exceeds 100%), the IRS may not project the results.

Polling Question #3

When the IRS uses statistical sampling, which relative precision is most beneficial to the IRS?

- A. Less than 10%
- B. 50%
- C. 100%

Summary of Observations on Statistical Sampling in Examinations

- Get technical assistance when you first learn IRS is considering sampling your QREs. This is helpful before you respond to the first IDR requesting data because it may influence how you respond.
- The most important step in the sampling process is making agreed upon adjustments to the population from which IRS will select the sample.
- You will be better positioned in an eventual exam if you use your own statistical sample for documenting QREs because the IRS generally will rely on a taxpayer's sample that is consistent with Rev. Proc. 2011-42. If that case, the IRS will limit its review to the samples you have already analyzed and documented.

IRS R&D Audit Techniques

- 1. Titles organized into three buckets: low, medium and high risk.
- 2. Mixed audit methods:
 - challenge cost center SME surveys and also
 - use IRS statistical sample
- 3. Convert survey study to projects
 - bring in MITRE on larger QRE projects
 - is software IUS (threshold issue)
 - post 2015 regulations (new IUS rules)
 - dual function software

Polling Question #4

What is MITRE's primary role in an examination?

- A. Review all large expenditures
- B. Review highly compensated employees
- C. Review internal use software

IRS R&D Audit Techniques

- 4. Propose a judgement sample
 - Need for formal closing agreement
 - Projects selected need to be truly representative
 - Allow taxpayer to select the projects
- 5. Strict documentation standards
 - Documents must have name of sample employee or survey SME
 - Documents must tie employee to particular business component (similar to forcing project accounting methodology)
 - Continued rejection of all documents produced
 - IRS will often ask for employee position descriptions and evaluations
- 6. Use of new risk assessment group/Issue Practice Network

IRS R&D Audit Techniques

- Witness interviews (job titles, SMEs in surveys, employee sample units in statistical samples (taxpayer and IRS), and technical employees in MITRE interviews)

Becoming more common in audits

Need to prepare witnesses

Anticipate IRS agent/engineer/MITRE questions

Have witnesses prepared to discuss facts that help the taxpayer's position

IRS usually allows questions from representatives at the end of the interview.

One witness per interview

Covid19 remote interviews now being conducted

- IDR process

- IDR procedures have a threat of a summons.

- Not normally an issue since audit teams provide “draft” IDRs with flexible time frames.

- Even if IDR time limits are violated, once the documents are produced the threat of a summons is eliminated.

Biography



Joseph Maselli

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Joe Maselli is a director in the NY Metro Tax Controversy and Dispute Resolution Team Practice. He provides advice to clients and formal written submissions to the IRS on a wide variety of procedural, administrative, and technical issues including issue resolution techniques (pre-filing agreements, fast track Appeals and regular Appeals), witness preparation, preparation of protests to IRS Appeals, post Appeals mediation submissions, 9100 relief, and numerous tax controversy matters. His most recent work involves extensive experience with the research credit, section 199 matters, transferee liability, economic substance, penalty defense, unreasonable compensation, bankruptcy, summons procedures, closing agreements, and unreported income. His research credit experience includes supervision of IRS trial teams while with the IRS and the audit defense of numerous cases involving the research credit and internal use software since coming to PwC. Recent work has involved R&D support for software development companies, defense contractors, satellite/aerospace companies, manufacturing companies and companies with large research supply costs and prototype expenses.

Joe is an attorney admitted in New York and New Jersey and a member of the ABA. He is the recipient of numerous awards including a Presidential Rank Award, the Commissioner's Award, the Chief Counsel Award and the LMSB Division Commissioner's Award. He is also a co-author of the BNA Tax Management Portfolio, *Research and Development Expenditures*, No. 556-3rd.

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Biography



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Lin Smith is a managing director in the Washington National Tax Services (WNTS) office of PwC, where he leads the Statistics and Tax Sampling (STATS) group. STATS develops and uses statistical sampling to support the filing of current and amended tax returns, as allowed by IRS and state tax agencies.

Lin frequently provides tax controversy consulting services to clients where the IRS or state and local tax agencies are using sampling during taxpayer examinations, on appeal or in advance agreements, such as pre-filing agreements (PFAs) and compliance assurance process (CAP) cases.

Prior to joining PwC, Lin worked for the Statistics of Income Division of the IRS, served as a Financial Economist in the Office of Tax Analysis at the US Treasury Department and was an economist with the Congressional Joint Committee on Taxation. Currently, Lin is actively involved with the IRS Statistics of Income (SOI) Division as a member of a panel of outside consultants that regularly advises the Division on future directions.

Lin attended graduate courses in economics at George Washington University and has a BA in economics and business administration from Kalamazoo College. He is a member of the American Statistical Association and the Washington Statistical Society and recently authored the statistical sampling section of the new BNA Research and Development Expenditures Portfolio 556-3rd (2019).

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THANK YOU

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RESEARCH & DEVELOPMENT TAX CREDIT SYMPOSIUM

Alex Sadler, Tom Linguanti & Doug Norton
November 13, 2020

*Top 10 Sticking
Points in
Research Credit
Cases*

Presenters



Alex Sadler
Partner, Morgan Lewis
Washington, DC



Tom Linguanti
Partner, Morgan Lewis
Chicago, IL



Doug Norton
Associate, Morgan Lewis
Washington, DC

“Sticking Point”

- stick·ing point
 - / 'stikiNG ,point/
 - *noun*
 - an obstacle to progress toward an agreement or goal.
 - "job security has emerged as a key sticking point in negotiations"



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Penalties

TAX
PENALTY!

Penalties

- **Sticking point** – taxpayer’s liability for a 20% accuracy-related penalty for negligence or substantial understatement of tax (IRC § 6662) or excessive refund claim (IRC § 6676)
- **Helpful things to know**
 - ‘Reasonable cause’ is a complete defense to both penalties.
 - Whether a taxpayer acted with reasonable cause and in good faith is made on a case-by-case basis, taking into account all pertinent facts and circumstances. Treas. Reg. § 1.6664-4(b)(1).
 - “Where an accountant or attorney *advises* a taxpayer on a matter of tax law, it is reasonable for the taxpayer to rely on that advice.” *United States v. Boyle*, 469 U.S. 241, 251 (1985) (italics in original).
 - In *Siemer Milling Co. v. Comm’r*, T.C. Memo. 2019-37, the Tax Court found that the taxpayer’s good-faith reliance on a research credit study prepared by a competent advisor established reasonable cause.

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Substantial Rights



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Substantial Rights

- **Sticking point** – whether a taxpayer performing research for another person retains substantial rights under the contract providing for the research; if not the research is treated as fully funded (Treas. Reg. § 1.41-4A(d)(2))
- **Helpful things to know**
 - “[A] taxpayer that retains the right to use the research results without paying for it has ‘substantial rights in the research.’” *Lockheed Martin Corp. v. U.S.*, 210 F.3d 1366, 1375 (Fed. Cir. 2000).
 - “[I]t is our conclusion that, except where a contract has explicit provisions granting ownership of all intangible or intellectual property (not merely designs, specifications, blueprints and the like) to the client, *** retains substantial rights.” 2002 IRS NSAR 20350 (Aug. 21, 2002).
 - “There is no provision in the contracts that prohibits petitioner from using the related researched technology in its business.” Order, *Populous Holdings, Inc. v. Comm’r*, Docket No. 405-17 (Dec. 9, 2019).

POLLING QUESTION #1

What standard must a taxpayer meet to establish a defense to the accuracy-related penalty under section 6662 or the penalty for erroneous refund claim under section 6676?

- A. Reasonable basis
- B. Substantial authority
- C. Reasonable cause
- D. Not willful neglect

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Engineering, Construction & Architectural Design Claims



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Engineering, Construction & Architectural Design Claims

- **Sticking point** – whether activities of engineering, construction, and architectural design firms satisfy the definition of qualified research under section 41(d)(1)
- **Helpful things to know**
 - There are no cases or other legal authority directly addressing the qualification of such activities, although cases are percolating through the system.
 - *Populous Holdings, Geosyntec Consultants*, 2002 IRS NSAR 20350, and 2012 IRS NSAR 1401F address the applicability of the funded research exclusion to engineering and design-build projects and imply that, if unfunded, such research can meet the statutory requirements.
 - Special attention needs to be given to defining the business component, establishing a process of experimentation, and substantiating the activities and QREs.

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Senior Executives and Non-Core R&D Job Titles



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Senior Executives and Non-Core R&D Job Titles

- **Sticking point** – whether activities performed by executives and non-core R&D personnel (e.g., sales, marketing, quality, manufacturing, etc.) constitute qualified services under section 41(b)(2)(B) and Treas. Reg. § 1.41-2(c)
- **Helpful things to know**
 - R&D functions may have a flat organizational structure where managers are ‘player-coaches’.
 - In *Suder v. Comm’r*, T.C. Memo. 2014-201, the Tax Court found that the CEO had spent 75% of his time performing qualified services.
 - Section 41(d)(2)(A) provides that the qualified research requirements should be applied at the business component not employee level. Thus, the activities of each employee need not separately satisfy the tests.
 - Treas. Reg. § 1.41-2(c)(3) illustrates that services of non-core R&D personnel such as a secretary, janitor, or machinist can constitute qualified services.

POLLING QUESTION #2

Which of the following is not a qualified service?

- A. Engaging in qualified research
- B. Direct contribution to qualified research
- C. Immediate supervision (first-line management) of qualified research
- D. Direct support of persons who are directly supervising persons engaged in the actual conduct of qualified research

6

The Research after Commercial Production Exclusion

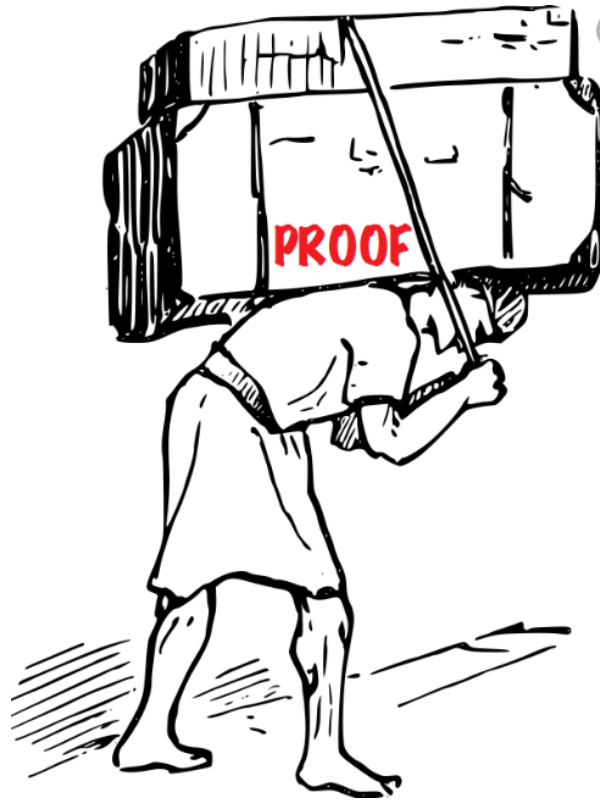


The Research after Commercial Production Exclusion

- **Sticking point** – whether research performed in a commercial production environment is excluded from the definition of qualified research under section 41(d)(4)(A) and Treas. Reg. § 1.41-4(c)(2)
- **Helpful things to know**
 - The 1986 legislative history explains that the exclusion “does not preclude the costs of significant improvements in an existing product from eligibility for the credit.” H.R. Rep. 99-841, at II-74 (Conf. 1986).
 - A taxpayer’s project to make a new or improved version of a widget that it has manufactured and sold “for several years” is not excluded. Treas. Reg. § 1.41-4(c)(10), Example 2.
 - This exclusion is not intended to apply to a research activity that otherwise meets the requirements for qualified research. TD 9104, 69 Fed. Reg. 22, 25 (Jan. 2, 2004).

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Substantiation & Nexus



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Substantiation & Nexus

- **Sticking point** – whether a taxpayer’s claim is deficient for failing to tie claimed QREs to specific research activities
- **Helpful things to know**
 - Although this is a common objection in IRS audits, the nexus requirement is not codified in section 41 or underlying Treasury Regulations.
 - In *Suder v. Comm’r*, the Tax Court rejected the IRS’s argument that “[p]etitioners failed to provide any nexus between the expenses claimed and qualified research activities, if any, performed.”
 - The allocation ratio described in Treas. Reg. § 1.41-2(d)(1) does not require the taxpayer to tie wages to specific research projects.
 - “[T]axpayers must be provided reasonable flexibility in the manner in which they substantiate their research credits.” Notice of Proposed Rulemaking, 66 Fed. Reg. 66362, 66366 (Dec. 26, 2001).

POLLING QUESTION #3

In which case did the Tax Court reject the IRS's nexus argument?

- A. Union Carbide
- B. Shami
- C. Eustace
- D. Suder

4

Economic Risk



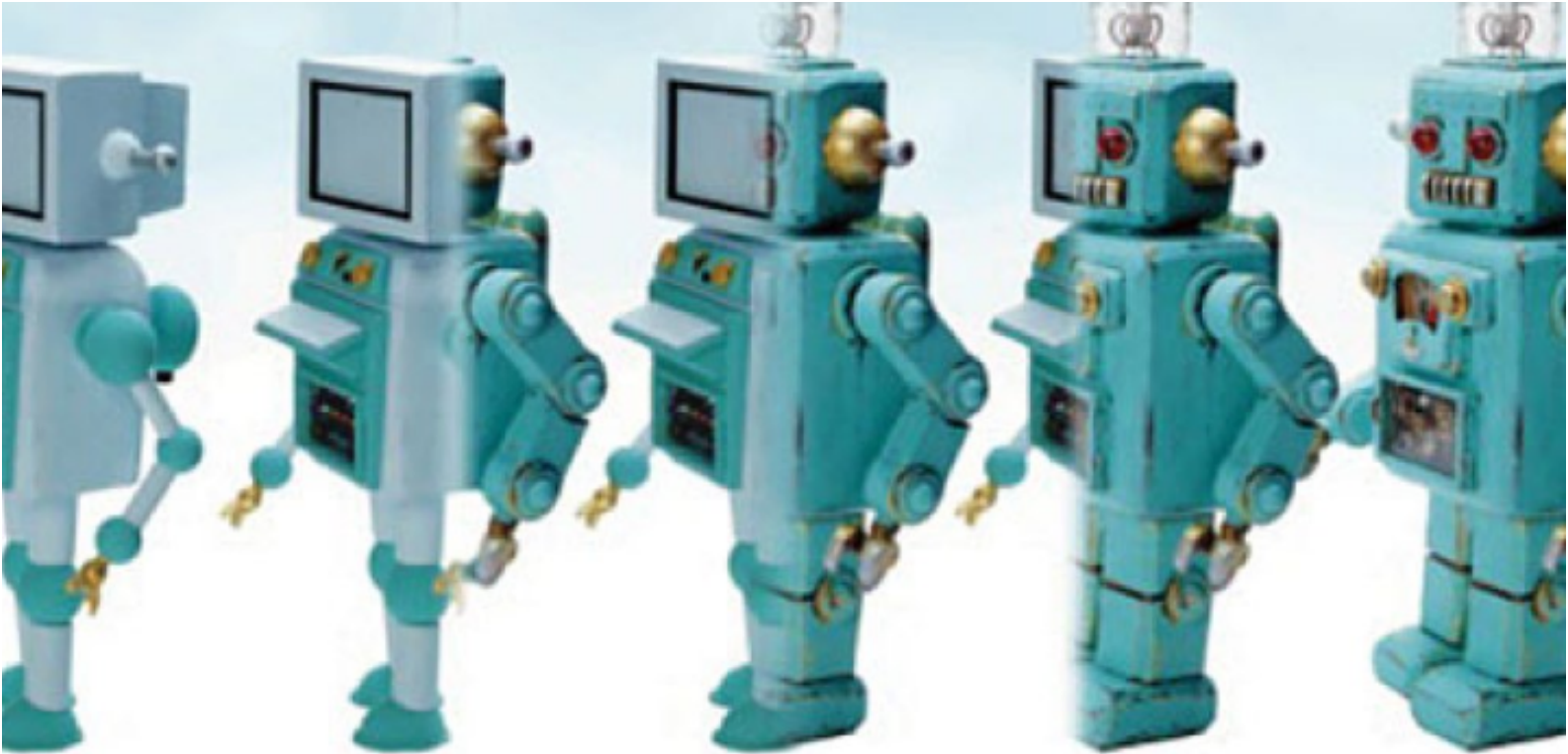
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Economic Risk

- **Sticking point** – whether amounts payable under a contract are contingent on the success of the research and thus considered to be paid for the product or result of the research and not treated as funding (Treas. Reg. § 1.41-4A(d)(1))
- **Helpful things to know**
 - With *Populous Holdings*, *Geosyntec Consultants*, *Dynetics*, and *Fairchild*, it is becoming well-established that fixed-price contracts inherently place the financial risk of research failures upon the contractor and are unfunded.
 - Contracts with other pricing mechanisms require a close examination of the contractual provisions to establish that the payments are for a product or result rather than the performance of research, give the customer a right to reject nonconforming work, impose a duty to cure on the contractor (at its expense), or otherwise shift risk to the contractor.

3

Pilot Models



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Pilot Models

- **Sticking point** – whether a first-of-a-kind facility, plant, production process or similar item is a pilot model as defined in Treas. Reg. § 1.174-2(a)(4) such that costs incident to the effort are research or experimental expenditures and eligible types of costs are QREs.
- **Helpful things to know**
 - This area of the law is developing, as taxpayers take positions based on the 2014 amendments to the section 174 regulations and the IRS reacts to those positions in examinations.
 - Chief Counsel Memo 20170501F (Oct. 26, 2016) concluded that a new electrical power plant was not a pilot model, nor were its major components and subcomponents. Only design, engineering, and integration of first-of-a-kind equipment was allowed as section 174 expenses.
 - Issues to consider include newness to the industry, possibility of replicability, scope of the uncertainty, integration uncertainty, and multiple pilot units.

2

Process of Experimentation



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Process of Experimentation

- **Sticking point** – whether a taxpayer’s activities constitute a process of experimentation as defined in Treas. Reg. § 1.41-4(a)(5) and cases
- **Helpful things to know**
 - *Siemer Milling* and *Union Carbide* illustrate the taxpayer’s burden to come forward with detailed evidence to prove a process of experimentation based on the scientific method.
 - The project “must involve a methodical plan involving a series of trials to test a hypothesis, analyze the data, refine the hypothesis, and retest the hypothesis so that it constitutes experimentation in the scientific sense.”
 - However, taxpayers should not lose sight of the more flexible definition of a process of experimentation provided in Treas. Reg. § 1.41-4(a)(5), *i.e.*, the 3 “core elements”.
 - Application of the core elements “is not intended to be inflexible or overly narrow” and “will depend on the facts and circumstances”. T.D. 9104, 2004-1 C.B. 406, 407–08.

POLLING QUESTION #4

In which case did the Tax Court hold that the taxpayer had failed to prove that it satisfied the process of experimentation test?

- A. Dynetics, Inc.
- B. Suder
- C. Audio Technica
- D. Siemer Milling Co.

1

Heavy Supply Costs / *Union Carbide*



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Heavy Supply Costs / *Union Carbide*

- **Sticking point** – whether the costs of materials ordinarily used in regular production are QREs when diverted to a qualified research activity
- **Helpful things to know**
 - “When section 41(d)(2)(C) applies and the relevant business component is the process, and production of the product alone would not constitute qualified research, we find that the costs of supplies that would be purchased and wages attributable to services that would have been provided regardless of whether research was being conducted are costs associated with the product business component and are not incurred in the conduct of qualified research.” *Union Carbide*, T.C. Memo. 2009-50, *113.
 - “Affording a credit for the costs of supplies that the taxpayer would have incurred regardless of any qualified research it was conducting simply creates an unintended windfall.” *Union Carbide*, 697 F.3d 104, 109 (2d Cir. 2012).
 - Compare *Union Carbide* with the treatment of product-focused costs in Treas. Reg. § 1.174-2(a), *Fairchild Industries*, *Trinity Industries*, and *TG Missouri Corp.*

Biography



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Alex is a partner in the tax group of Morgan Lewis. He represents clients in complex tax controversies and litigation. He has litigated numerous tax cases in the US Tax Court, US Court of Federal Claims, and federal district and appellate courts, and has served clients in several extended tax trials. Alex has also helped clients resolve tax disputes in audits and administrative appeals with the Internal Revenue Service.

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While Doug handles a wide range of tax controversies involving individuals and corporations, he has particular experience with disputes over the research credit under section 41.

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THANK YOU

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QUIZ

Quiz Question 1

Which of the following research credit cases was decided on summary judgment?

- A. Trinity
- B. Union Carbide
- C. Siemer Milling
- D. Populous Holdings

Quiz Question 2

Which of the following research credit cases was decided on a motion to dismiss?

- A. Harper
- B. Union Carbide
- C. Siemer Milling
- D. Populous Holdings

Quiz Question 3

Where is the Sea of Tranquility located?

- A. The Maldives
- B. The moon
- C. The Philippines
- D. China

Quiz Question 4

I give you the activities, you give me the case: “decommission and decontaminate a former rare earth processing plant in Malaysia and dispose of radioactively contaminated plant materials.”

- A. Geosyntec
- B. Fairchild
- C. Union Carbide
- D. Research Inc.

Quiz Question 5

I give you the activities, you give me the case: “His vision was to design his own innovative, full-featured telephone systems for small and midsize businesses.”

- A. Suder
- B. Fairchild
- C. Shami
- D. Quebe

Quiz Question 6

Number of electoral votes allocated to the state of Indiana:

- A. Seven
- B. Eleven
- C. Thirteen
- D. Nineteen

Quiz Question 7

What happens if a company enters into a contract which makes payment to a researcher entirely contingent on the success of her research but does not allow her to retain any rights in the results of the research?

- A. The researcher can claim the costs of research under the contract as QREs
- B. The company can claim payments made under the contract as QREs
- C. Neither party can claim costs under the contract as QREs
- D. Both parties can claim costs under the contract as QREs

Quiz Question 8

What is the title of Treas. Reg. § 1.41-7?

- A. Aggregation of expenditures
- B. Special rules
- C. Qualified research expenses
- D. Excluded activities

Quiz Question 9

In medieval England, what was used as currency, specifically for rental agreements?

- A. Garlic bulbs
- B. Jars of clotted cream
- C. Eels
- D. Feathers

Quiz Question 10

What does a Scoville unit measure?

- A. Spiciness
- B. Depth
- C. Distance
- D. Volume



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