

Morgan Lewis

SEVENTH ANNUAL

# RESEARCH & DEVELOPMENT TAX CREDIT SYMPOSIUM

Symposium Co-Chairs: Alex Sadler and Doug Norton  
November 8-12, 2021

*Welcome  
Remarks*

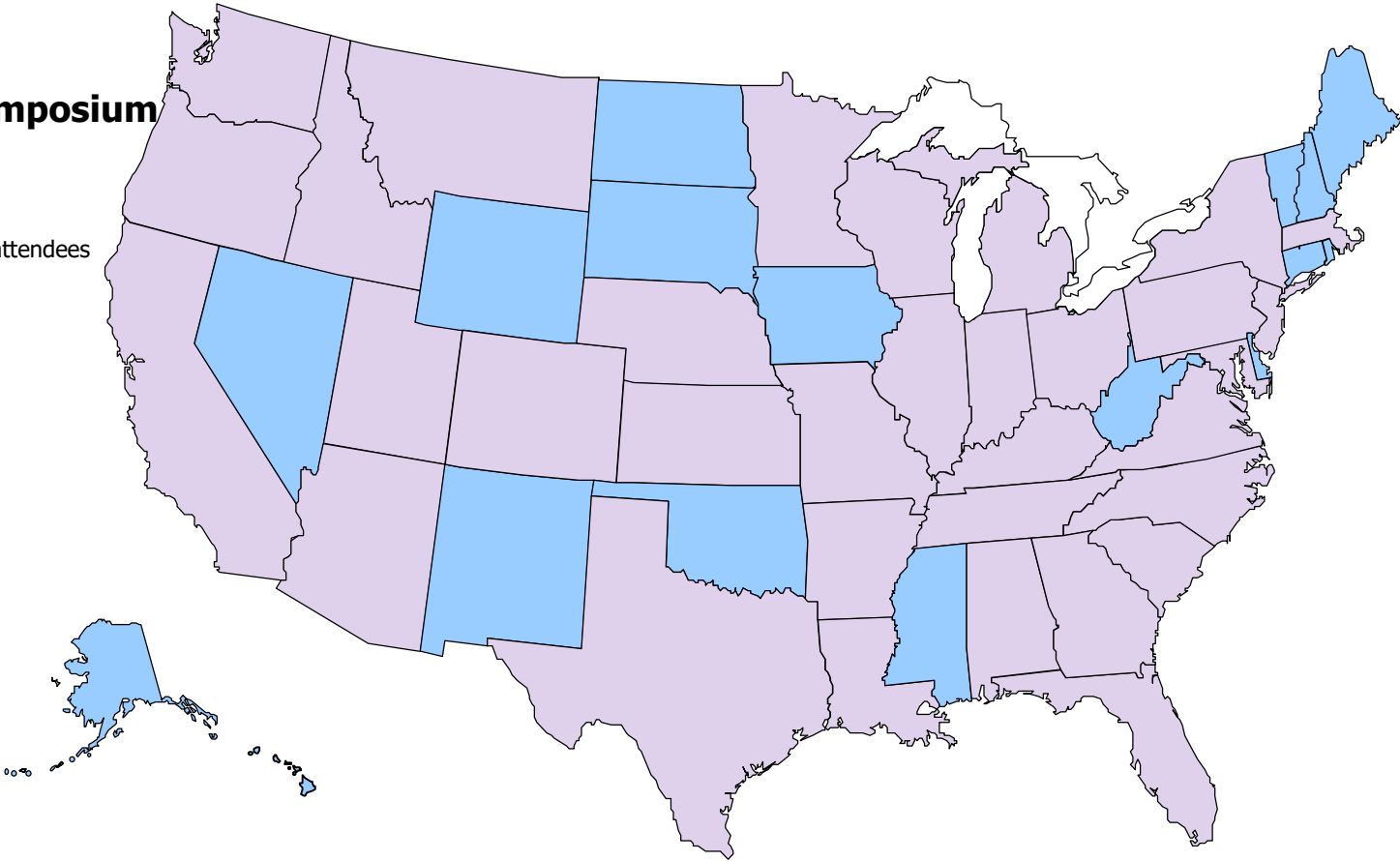
# The 2021 All-Virtual Symposium

- Total # of registrants – Nearly 600 for each session day
- Total # of companies represented – More than 100
- Total # of providers represented – More than 80

# 2021 ML R&D Symposium

## Attendees by State

 = states represented by attendees



# 2021 R&D Tax Credit Symposium

## Companies Represented (1 of 2)

- 3M Company
- A-Dec, Inc.
- ADP
- Alcott HR
- Amazon
- American Honda Motor
- AYAL Capital
- Baxter International, Inc.
- BCP Engineers & Consultants
- Best Buy
- Cadence Design Systems
- CalAmp
- CFO Services
- Charles Schwab
- Cisco Systems, Inc.
- CommScope
- Constellation Brands
- Cox Enterprises
- Cushman & Wakefield
- Ducommun Incorporated
- Eastman Chemical Company
- Eli Lilly and Company
- Emerson Climate Technologies, Inc.
- Exelon
- Exeter Finance
- Facebook
- Fairview Health Services
- Fireeye Inc.
- Fulcrum Strategy
- Futurewei Technologies Inc.
- GE Renewable Energy – Offshore Wind
- GlaxoSmithKline
- Google
- Heraeus
- Hewlett Packard Enterprise
- IHG (InterContinental Hotels Group)
- Ingevity Corporation
- Intel Corporation
- IPG
- inTEST Corporation
- JBT Corporation
- JSO Logistics
- LEAR Corporation
- Lionsgate
- Lixil
- Lockheed Martin
- Mandiant, Inc.
- McCormick & Company



# 2021 R&D Tax Credit Symposium

## Companies Represented (2 of 2)

- Micro Technology, Inc.
- Midmark Corporation
- Nexteer Automotive
- Novocure Inc.
- NYU
- Olympus Corporation of the Americas
- Oshkosh Corporation
- Pinterest
- Polymer Enterprises
- PTC Therapeutics
- Principal Financial Group
- PsiQuantum Corp
- Quaker Houghton
- Quarry Strategic Capital
- Robinhood Markets
- SB Telecom America Corp.
- Sealed Air Corporation
- Silicon Laboratories
- SMART Modular Technologies
- SPRX Technologies
- SPX Corporation
- Steel Dynamics
- The Boeing Company
- The Coca-Cola Company
- The Home Depot
- The Swarthmore Group
- The Vanguard Group, Inc.
- The Walt Disney Company
- UnitedHealth
- Varian Medical Systems, Inc.
- Verizon Communications Inc.
- Viocare, Inc.
- VMware, Inc.
- Walgreen Co.
- Walmart
- Wells Fargo
- Western Digital

# 2021 R&D Tax Credit Symposium

## Providers Represented (1 of 2)

- Alvarez & Marsal Taxand
- AGH Specialized Tax Solutions
- AICPA
- Anchin, Block & Anchin
- Anglin Reichmann Armstrong
- Aprio
- Asher & Associates, LLC
- BDO USA, LLP
- Bedford Team
- Bennett Trasher, LLP
- BKD
- Black Line Group
- Boostr Consulting
- BPM LLP
- Carrazco Innovative Tax Solutions
- Cherry Bekaert
- CLA LLP
- Clark Number PS
- CliftonLarsonAllen, LLP
- CohnReznick
- Crowe
- CTI LLC
- Dixon Hughes Goodman
- DST Advisory Group
- EEPB Innova Tax
- Eide Bailly LLP
- EisnerAmper LLP
- Ernst & Young
- FG MK, LLC
- Frazier & Deeter
- Grant Thornton LLP
- Hegre, McMahon & Schimmel, LLC
- Hentry + Horne
- Hull & Knarr LLP
- Interim Executive Management LLC
- Intuitive Tax Consulting
- J.E. Cunningham & Associates, LLC
- Jeff Carter CPA-LLC
- Kaufman Rossin
- KBKG
- Kings Peak Tax Consulting, LLC
- Koch Siedhoff Hand & Dunn, LLP
- KPMG
- Leaf Specialty Tax Consultants
- Lumsdsen McCormick
- Massie R&D Tax Credits
- McGill, Power, Bell & Associates, LLP

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# 2021 R&D Tax Credit Symposium

## Providers Represented (2 of 2)

- McGuire Sponsel
- Monetek
- Moss Adams LLP
- Pace Tax
- Plante Moran
- PriceWaterhouseCoopers
- RCG Tax Partners
- R&D Incentives Group
- Rehmann
- Ryan, LLC
- Source Advisors
- Stambaugh Ness
- Strike R&D Tax Credits
- Tanner
- Tax Incentive Solutions
- TaxTaker
- TCX
- Think LLP
- TTG
- Warner Robinson LLC
- Warren Averett
- Wendy A. Lurie, Esq., LLC
- Wipfli LLP
- Withum
- Wojeski & Company CPAs PC

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# R&D Experience

- Aerospace
- Assembly lines
- Automotive supply chain
  - Subsystems
  - Tires
  - Tooling
- Chemicals & plastics
- CPA & advisory firms
- Energy
- Engineering & construction
- Financial Services
- Food & agriculture
- Government contracting
- Medical device
- Oil & gas
- Paints and coatings
- Pharmaceuticals
- Retail
- Steel & ironmaking
- Software development

# Faculty Firms



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# Special Thank You



# 15 AREAS OF SERVICE

Antitrust & Competition	Intellectual Property
Corporate & Business Transactions	Investment Management
eData	Labor & Employment
Employee Benefits/Executive Compensation	Litigation
Energy	Private Client
FDA	Structured Transactions
Finance	Tax
	Telecommunications, Media & Technology

# 11 FOCUSED INDUSTRY SECTORS

Automotive	Energy	Investment Funds	Sports
Banking	Healthcare	Life Sciences	Technology
Education	Insurance	Retail	

**31 OFFICES**  
**ACROSS 17**  
**TIME ZONES**





# MORGAN LEWIS TAX

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PRACTICE**



# Select Tax Accolades

## **Tier 1, Tax Law**

US News & World  
Report/Best Lawyers –  
Best Law Firms  
(2018-2021)

## **Band 1, Tax Controversy (Nationwide)**

Chambers USA  
(2017-2021)

## **Band 1, Tax (DC)**

Chambers USA  
(2017-2021)

**US Transfer Pricing Firm  
of the Year and North  
America Transfer  
Pricing Firm of the Year**  
International Tax Review  
(2021)

## **Tier 1, Tax Litigation**

US News & World  
Report/Best Lawyers –  
Best Law Firms  
(2018-2021)

## **Band 1, Tax (Pennsylvania)**

Chambers USA  
(2017-2021)

## **Tier 1, Tax: Contentious**

Legal 500 US  
(2017-2021)

## **Tier 1, Tax: Not-for-Profit (Nonprofit and Tax- Exempt Organizations)**

Legal 500 US  
(2017-2021)

# R&D Experience

- Position development
- Pre-filing review & opinions
- Audit defense strategy
- Appeals
  - Fact development
  - Protest preparation
  - Conference presentation & settlement negotiations
- Litigation – Tax Court, Court of Federal Claims, Federal district and appellate courts

# Monday's Program – November 8, 2021

12:00 pm – 12:20 pm	<b>Welcome Remarks</b> Morgan Lewis: Alex Sadler and Doug Norton
12:20 pm – 1:20 pm	<b>Hot Topics &amp; Technical Developments</b> Ernst & Young: Alexa Claybon
1:20 pm – 1:25 pm	<b>BREAK</b>
1:25 pm – 2:25 pm	<b>New Section 174 Capitalization Regime</b> Morgan Lewis: Doug Norton Alvarez & Marsal Taxand: Kathleen King Tanner: Shawn Marchant
2:25 pm – 2:30 pm	<b>BREAK</b>
2:30 pm – 3:30 pm	<b>Recent Trends in Research Credit Cases</b> Morgan Lewis: Alex Sadler and Doug Norton Crowe: Devin Hall
3:30 pm	<b>Quiz</b>

# CLE and CPE Credit

**CLE CREDIT:** All three programs today are eligible for CLE credit. There will be an alphanumeric code announced during each program. Attendees must note the alphanumeric code AND complete the CLE certification form.

**CPE CREDIT:** In order to receive CPE credit for any one or more of today's three programs, attendees must remain logged in for the entire (50-60 minute) program and must answer at least 3 of the 4 polling questions. Please note that you must be logged in via computer (and not dialed in via telephone) in order to view and answer polling questions. No other forms are required for CPE credit.

# More R&D Tax Credit Quiz Fun to Come...

- On Monday, November 8 and Wednesday, November 10, after each substantive program has finished, we will have a brief quiz.
- Attendees who complete the quiz and answer all or most of the 15 questions correctly will be entered into a raffle to win one of two R&D treatises raffled each day!
- Answers must be submitted via WebEx.
- Winners will be announced on the following session day.



# Join us for Faculty Q&A and Wrap/Closing Remarks on Friday, November 12



Alexa Claybon  
EY



Kathleen King  
Alvarez & Marsal  
Taxand



Tom Linguanti  
Morgan Lewis



Shawn Marchant  
Tanner



Doug Norton  
Morgan Lewis



Adam Quattlebaum  
DHG



Alex Sadler  
Morgan Lewis

Please use the chat function to submit any questions throughout the week of programming.

We will address submitted questions in the Faculty Q&A panel at the end of the day on **Friday, November 12.**





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

**HOT TOPICS AND TECHNICAL DEVELOPMENTS**

Presenter: Alexa Claybon (EY)

Monday, November 8, 2021

# Presenters



**Alexa Claybon**  
Principal, EY  
Washington, DC

**Morgan Lewis**

# Hot Topics & Technical Developments - Agenda

- Legislation
- Chief Counsel memorandum
- Texas R&D credit final regulations
- Recent R&D credit cases
- 2020 R&D Directive and Campaign
- What else?

# Legislation

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# Legislation

- House Ways & Means proposals:
  - Delay the effective date for the modifications made to §174 by the TCJA for four years (beginning in 2026)
    - Revenue score, per JCT: -\$4B
  - Limit §45C credit for clinical testing expenses for orphan drugs to “first indication”
    - Revenue score, per JCT: +\$2.7B
    - Follows TCJA amendment that reduces credit rate from 50% to 25%
  - New general business credit, §45AA, for public university research infrastructure contributions
    - Revenue score, per JCT: -\$125M
    - 40% credit for qualifying cash contributions, as designated by the institution

# Polling Question 1

**What change do you believe would increase the effectiveness of R&D tax incentives the most?**

- A. Allow current deduction of R&D expenditures.
- B. Allow a reduced tax rate on income generated from R&D activities.
- C. Allow a super-deduction (above 100%) for R&D expenses and R&D assets.
- D. An increase in the R&D credit rate.
- E. Allow the credit to be refundable or used to offset other federal tax liabilities.
- F. Simplification of the current R&D credit regime (no base computation; credit based on book R&D; eliminate internal use software exclusion; etc.)

# Chief Counsel Memorandum

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# Chief Counsel Memorandum

- On October 15, 2021, the IRS released a Chief Counsel memo on R&D credit refund claims
  - The memo addresses what information the IRS believes is necessary for a taxpayer to include with the refund claim to be considered a valid claim
  - The memo states that specific information is “required” in order for a refund claim to meet the specificity requirements of Treas. Reg. §301.6402-2(b)(1), which requires that a refund claim “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”
  - The IRS News Release announcing the Chief Counsel memo stated that the IRS will provide a “grace period” (until January 10, 2022) before requiring the inclusion of this information with timely filed R&D credit refund claims. Thereafter, there will be a one-year period in which taxpayers will have 30 days to perfect their refund claim (presumably by providing the information “required” by the memo)

# Chief Counsel Memorandum

- The following “required” information is referred to as “five essential pieces of information that must be provided by a taxpayer for the Service to adequately consider whether the refund claim can be paid or must be examined further”:
  - Identification of all the business components to which the research claim relates
  - Identification of all research activities performed for each business component
  - Identification of all individuals who performed each research activity for each business component
  - Identification of all the information each individual sought to discover for each business component
  - Total qualified employee wage expenses, total qualified supply expenses, and total qualified contract research expenses

# Chief Counsel Memorandum

- The memorandum suggests that taxpayer provide the facts in a written statement, but if the taxpayer provides documents (for example, a credit study), they must specify the exact page that supports a specific fact.
- The memorandum **recommends** rejecting a deficient refund claim (i.e., a claim that does not contain the information described in the memorandum) before initiating an audit or otherwise actively considering the refund claim on the merits
  - To reduce the likelihood that the IRS will be found to have waived the specificity requirement
  - To preclude a taxpayer from perfecting their refund claim (satisfying informal claim requirements)

# Chief Counsel Memorandum

- What options do taxpayers have to protect their claim?
  - 1. provide the information identified in the memorandum
  - 2. be prepared to file suit in court
- How could this have gone better?
  - Publish a Directive to examiners that they should not reject a R&D credit refund claim that includes the identified information
  - Publish authoritative guidance providing a safe harbor from having a claim rejected for taxpayers that provide the identified information
- What is the justification for treating R&D credit refund claims differently from all other refund claims?

# Chief Counsel Memorandum

- Things to note:
  - A Chief Counsel memorandum is a “written determination,” which cannot be used or cited as precedent
  - The government has lost three amended return R&D credit claim cases this year arguing that the taxpayers claim did not meet the specificity requirement
  - *Little Sandy Coal* case reference – does this mean that the information requested is limited to employees who directly performed research (and not employees that directly supervised or directly supported research)?
  - How will this memorandum apply in cases where statistical sampling is used to support the credit claimed?

## Polling Question 2

**How will the Chief Counsel memorandum relating to amended return research credit claims impact you?**

- A. We will supplement the information provided in a recently filed amended return.
- B. We will supplement the information only if we receive an inquiry.
- C. We are planning on filing an amended return and will be including additional information.
- D. We do not believe the information requested is required and will file a suit in court if our claim is rejected.
- E. Not applicable (do not have amended returns pending nor plan to file an amended return; in losses; do not claim the R&D credit; etc.)

# **Texas R&D Credit Final Regulations**

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# Texas R&D Credit Final Regulations

- On October 4, 2021, Texas released its final regulations relating to the Texas R&D credit
- The rules will be effective **retroactively** for Texas franchise tax reports originally due on or after January 1, 2014
- The preamble to the final regulations states that the applicable reference to the IRC for R&D credit purposes is the IRC in effect as of December 31, 2011 and specified that any federal regulation adopted after this date is only included to the extent a taxpayer was required to comply in the 2011 tax year
- The Texas rules adopt much of the structure and definitions of section 41 and the federal regulations, with a few very notable exceptions

# Texas R&D Credit Final Regulations

## Differences between federal and Texas R&D credit rules

### Business Component Definition

Texas specifically excludes service provided to a customer or a design from the definition of business component.

### Process of Experimentation

Texas specifically identifies “non-experimental methods” (including ‘simple trial and error’) and describes factors that may be considered in determining whether a trial and error method is experimental or non-experimental.

### Rules of Applicability

Texas’ rules add non-exclusive lists of software development activities that are both likely and unlikely to constitute qualified research.

### Excluded Research Activities

Texas lists activities that do not constitute qualified research that reflects the federal rules, other than the exclusion of internal use computer software

### Internal Use Software Definition

Texas’ rules define internal use software to mean software developed for use in the operation of the business. Internal use software excludes software that is developed to be commercially sold, leased, licensed or otherwise marketed for separate consideration.

### Contract Research Disclosures

Texas’ rules state that a taxpayer performing research for another person must identify any other person paying for the research activities and any person with substantial rights to the results of the research.

# Polling Question 3

**What impact will the Texas R&D rules have on your plans to conduct research in Texas?**

- A. We will consider reducing our Texas R&D activities or moving our R&D personnel to another state.
- B. We will consider moving only our software development activities to another state.
- C. We will reconsider plans to locate business activities in Texas.
- D. We will consider increasing our Texas R&D activities or move our R&D personnel to Texas.
- E. Not applicable (no current or planned Texas R&D activities; no R&D activities)

# **2020 R&D Directive and Campaign**

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# 2020 R&D Directive and Campaign

- “The campaign objective is to promote voluntary compliance, focus resources on the highest risk research issues and increase consistency of examinations”
- Based on our clients’ experience so far, the Campaign seems to be a data gathering exercise
- Exam agents say that they are compelled to issue Campaign IDRs; Campaign personnel say that the exam agents control the exams
  - Campaign IDR process has been different from process described in the Internal Revenue Manual
- Do not see much difference in exam as a result of the Research Risk Review Team strategy implemented under the 2020 R&D Directive

# Recent R&D Credit Cases

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# Recent R&D Credit Cases

## Refund Claim Cases

### Harper v. U.S.

Overruling the District Court's determination that it lacked jurisdiction to hear the R&D credit refund claim because the taxpayer failed to satisfy the specificity requirement in Treas. Reg. §301.6402-2(b)(1), the 9<sup>th</sup> Circuit held that the government had waived the requirement due to its multi-year examination of the taxpayer's claim and receipt of information and documents relating to the claim.

### Intermountain Electronics, Inc. v. U.S.

The District Court denied the government's motion to dismiss (which was based on the same grounds as *Harper* - taxpayer failed to satisfy the specificity requirement in Treas. Reg. §301.6402-2(b)(1)), and found that the government had waived the specificity requirement due to its multi-year examination of the taxpayer's claim and disallowing the claim on the merits.

### Premier Tech, Inc. v. U.S.

The District Court denied the government's motion to dismiss (which was based on the same grounds as *Harper* and *Intermountain* - taxpayer failed to satisfy the specificity requirement in Treas. Reg. §301.6402-2(b)(1)), and found that the information provided in the amended return was sufficiently specific, stating that the specificity requirement "is not a high standard."

# Recent R&D Credit Cases

## Funding Cases

### **Meyer, Borgman & Johnson v. Comm'r.**

The Tax Court granted the government's summary judgment motion on the question of whether the taxpayer's research was funded. Research was required to satisfy the terms of the engineering services contract, but the taxpayer was not contracted to perform research on the customer's behalf; the contracts were fixed price. The court found that research is unfunded ONLY when payment is contingent on the success of the research. This case is in direct conflict with *Populous Holdings*.

### **Tangel v. Comm'r.**

The Tax Court granted the government's summary judgment motion on the question of whether the taxpayer's research was funded because the taxpayer retained no "substantial rights" in the research it performed under a contract. The contract contained restrictive terms that prohibited the taxpayer from using or disclosing information other than in performing services for its customer, without the customer's prior written consent.



# Recent R&D Credit Cases

## Other Cases

### **Little Sandy Coal Co., Inc. v. Comm'r.**

The Tax Court found that a shipbuilding company failed to show that at least 80% of the company's research activities constituted elements of a process of experimentation, when wages of employees constructing the business components were excluded because their activities "directly supported" the research and only activities that were direct engagement of qualified research were relevant to measure POE. Novel interpretation of the POE "substantially all" test.

### **Leon Max v. Comm'r.**

Tax Court held that a clothing designer may not claim research credits for amounts spent on turning an idea into a garment, finding that the fashion design process is not qualified research. The taxpayer did not have uncertainty, the activities were not technological in nature, no proof that at least 80% of the activities were for a qualified purpose. Similar result in California case *In re Swat-Frame, Inc.*

### **Kroeschell, Inc. v. Comm'r.**

Tax Court denied the taxpayer's motion to limit the subject matter for discovery and trial to 10 test projects identified from a population of 673 projects that the taxpayer used for a statistical sample for tax years 2002-2013 (out of 8,008 total projects for the five years). The court found that the election of 10 projects is not supported by statistical sampling theory and that the taxpayer inappropriately sought to limit the focus to 673 projects (which could prejudice the IRS).

# What else?

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# What else?

**1**

**Form 3800 contains a new check box and instructions for taxpayers amending their carryforward schedules**

**2**

**“Rapid Appeals Process” being suggested – it is Appeals’ “fast track” with Appeals acting as a mediator**

**3**

**Appeals Team Case Leader Conferencing Initiative: Summary of Findings and Next Steps (Sept. 2021)**

**4**

**Priority Guidance Plan includes regulations under section 174 (but no specifics); method change guidance? substantive guidance?**

## Polling Question 4

**What do you think the most useful improvement to the Appeals' process would be?**

- A. Excluding exam from the taxpayer's presentation to Appeals.
- B. Allowing exam to attend the taxpayer's presentation to Appeals only if the taxpayer consents.
- C. Requiring case managers to attend the Appeals conference.
- D. Requiring the local exam team to present exam's case to Appeals.
- E. Not applicable (no opinion; most useful improvement not listed).

# Biography



**Alexa Mortenson Claybon**  
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Alexa Mortenson Claybon is a principal at EY's National Tax Department in Washington, DC and is EY's Research Credit Technical Leader. Prior to joining EY, she was an Attorney Adviser in the Treasury Department's Office of Tax Policy (2011-2015), working with the IRS Chief Counsel's office to develop regulations and other guidance. Alexa worked primarily with issues concerning the tax treatment of research costs under sections 41 and 174.

She has been a guest lecturer for the Tax Executives Institute, Denver Tax Institute, Tulane Tax Institute, American Bar Association, and other organizations.

Alexa earned a JD from Northeastern University and an LLM (Tax) from Georgetown University Law Center.

# THANK YOU

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**Please use the chat function to submit any questions regarding this presentation. We will address submitted questions in the Faculty Q&A panel on Friday.**

**Let us know your thoughts! Please take our very brief, three question, two-minute survey on the speakers and content you've just heard.**

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**5 MINUTE BREAK...WE WILL RESUME SHORTLY**





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**SEVENTH ANNUAL  
RESEARCH &  
DEVELOPMENT TAX  
CREDIT SYMPOSIUM  
NEW SECTION 174 CAPITALIZATION REGIME**

Presenters: Doug Norton (Morgan Lewis), Kathleen King (Alvarez & Marsal Taxand), and Shawn Marchant (Tanner)

Monday, November 8, 2021

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# Presenters



**Kathleen King**

Managing Director and National  
R&D Practice Leader  
Alvarez & Marsal Taxand  
Washington, DC



**Shawn Marchant**

Tax Principal, Tanner LLC  
Salt Lake City, UT



**Doug Norton**

Associate, Morgan Lewis  
Washington, DC

**Morgan Lewis**

# Agenda

- \* Background**
- \* Implications**
- \* Case Study**
- \* Going Forward**

# Polling Question #1

- Section 174 was first enacted in
  - A. 1981
  - B. 1974
  - C. 1967
  - D. 1954

# Background

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# Amendments to 174

- TCJA amendments to section 174, effective for taxable years beginning after December 31, 2021
- Current law – may deduct research and experimentation (R&E) expenses
- 2022 and beyond – required to capitalize and amortize R&E
- Proposed legislation would extend the effective date by four more years

# Old 174

- Statute enacted in 1954, fundamentally unchanged through 2017/2022
- H. Rep. No. 1337 (Ways & Means)
  - "No specific treatment is authorized by present law for research and experimental expenditures. To the extent that they are ordinary and necessary they are deductible; to the extent that they are capital in nature they are to be capitalized and amortized over useful life. Losses are permitted where amounts have been capitalized in connection with abandoned projects, and recovery through amortization is provided where the useful life of these capital items is determinable, as in the case of a patent. However, where projects are not abandoned and where a useful life cannot be definitely determined, taxpayers have had no means of amortizing research expenditures."

# Old 174

- H. Rep. No. 1337 (Ways & Means)
  - "*To eliminate uncertainty and to encourage taxpayers to carry on research and experimentation* the committee bill provides that these expenditures... may, at the option of the taxpayer, be treated as deductible expenses. It also provides that a taxpayer may elect to capitalize such expenditures and if no other means of amortization is provided, may write them off over a period of not less than 60 months, beginning with the month in which benefits are first realized."



# Old 174

- Section 174(a)(1): "A taxpayer may treat research or experimental expenditures which are paid or incurred by him during the taxable year in connection with his trade or business as expenses which are not chargeable to capital account. The expenditures so treated shall be allowed as a deduction."

# New 174

- Enacted in 2017 with changes effective for tax years beginning after 12/31/21
- H. Rep. 115-409 (Ways & Means)
  - *"The Committee recognizes that research and experimentation expenditures have a useful life beyond the tax year in which the expenditures are incurred, and that the tangible and intangible property created through research and experimentation activities provide value to a business beyond a single tax year. The Committee also acknowledges that the costs of developing software closely resemble the types of research and experimental expenditures that fall within the purview of section 174, and therefore should be accorded similar treatment. For these reasons, the Committee believes research expenses, including software development costs, should be amortized over a period beyond the current year."*

# Item-by-Item Comparison

## Current 174

- Taxpayer may
  - Treat R&E expenditures during the taxable year as deductible expenses, 174(a)
  - Elect to amortize R&E expenditures and deduct them ratably over 60+ months, 174(b)
  - Elect to amortize R&E expenditures over 10 years, 59(e)
- Under Rev. Proc. 2000-50, costs of developing computer software "closely resemble" 174 costs and can similarly be deducted

## New 174

- Taxpayer must
  - Capitalize current-year R&E expenditures ("specified research or experimental expenditure")
  - Amortize over 5 (US) or 15 (foreign) years
- No recovery of capitalized amounts on disposition, retirement or abandonment of associated property
- Any amount incurred in connection with the development of software is included under 174(c) and must be capitalized and amortized

# Considerations Under New 174

- Shift from voluntary and favorable provision to mandatory and unfavorable.
  - Government and taxpayer response to change
  - New controversies with taxpayers claiming they are not conducting research
  - Lots of old authority – what does it mean now?
- Companies will need to identify all R&E expenditures
  - Previously, could ignore unless trying to deduct or claim R&D credit
  - Scope not limited to activities currently identified as R&E for tax, financial or other purposes
- What is the scope of software *development* for this purpose?

# Implications

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# Polling Question #2

- What do you think will happen to new section 174?
  - A. Take effect as originally scheduled
  - B. Delayed effective date, 1-3 years
  - C. Delayed effective date, 4+ years
  - D. Complete repeal of new 174

# Where to Start?

- Identify the key data points that need to be tracked
  - Capitalized costs
  - Amortization periods
  - Tracking “Asset”
- Recognize the differences between Sec. 174 and Sec. 41
  - Activities are more expansive
  - Expenses are more inclusive
  - All software development activities are of interest
- Understand what data and systems are available
  - Section 41 workpapers
  - ASC 730, ASC 350, and other financial workpapers

# Section 174 v. 41 Activities

- Software development
- Consider additional tests under sec. 41
  - Process of Experimentation
  - Technical Uncertainty
- Research credit exclusions
  - Offshore v. onshore
  - Funded research
  - Internal-Use software



# Section 174 v. 41 Costs

- Section 41 – Wages, Supplies and Contract Research
- Section 174 – all such costs “incident to” the development or improvement of a product
  - A product includes any pilot model, process, formula, technique, patent or similar property
  - Salaries, non-taxable benefits and fringe
  - Materials, facilities, and equipment costs
- How broadly does “incident to” apply?
  - Indirect costs
  - Overhead
  - Depreciation
  - Rent
  - Patent costs (attorney fees in making and perfecting a patent)

# Contract Research

- Are expenses for research performed for a third party under a contract subject to new 174?
- Core role of uncertainty – activities must be intended to discover information that would eliminate uncertainty concerning the development or improvement of a product
  - Timeline uncertainty – research may continue until uncertainty concerning the development or improvement of the product is eliminated
  - Contractually allocated risks – taxpayer may deduct expenses for research or experimentation incurred in connection with the construction of depreciable property by another only if made upon the taxpayer's order and at his risk
- IP retention

# Categories of Software

- IRS Audit Guidelines on the Application of the Process of Experimentation for all Software
  - White paper on software activities (high, medium, low risk activities)
  - Are software development activities classified as “high risk” subject to sec. 174?
- Does Rev. Proc. 2000-50 help define software development?
- Development as opposed to...
  - Maintenance?
  - Implementation?
  - Routine coding?
  - Integrating open-source or third-party software?

# Case Study

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## Polling Question #3

- I anticipate the most difficult aspect of implementing the new 174 requirements to be:
  - A. Identifying software activities and costs to be capitalized
  - B. Tracking activities and expenses on a project basis
  - C. Separately accounting for offshore R&D
  - D. Identifying and accounting for the impact to other tax areas such as international, COGs, SALT, etc.
  - E. Something else – input into chat

# Case Study

Runway Multinational Corporation (“RunMNC”) develops and manufactures consumer products, many of which have embedded software that control the products. They use a contract manufacturer based in China to manufacture the goods. Hardware R&D occurs in the US. Software development occurs in the US and offshore.

# Case Study – Process Engineering & Offshore R&D

- Product R&D occurs in California, Connecticut, and Texas.
- RunMNC manufactures products using a contract manufacturer based in China. US employees frequently visit the Chinese factory to assist with process improvements and ensure quality control, often staying 8-12 weeks over the course of a year. Many of the process improvements satisfy the section 174 uncertainty requirement.
- They average 20 patent applications a year.

# Case Study – Software Development

- RunMNC employs software developers in California, Texas, and Georgia and contracts with offshore developers in India and Ukraine. US employees design the software architecture and develop initial proof-of-concept. They also directly interact with the offshore developers, including providing design specifications and performing QA reviews of the software prior to release.



# Case Study

- In 2022, RunMNC is developing inventory management software. The software will not meet the high-threshold of innovation test for internal-use software under section 41. Personnel from shipping, operations, project management, finance and software development all participate in weekly planning and status meetings to review requirements and resolve technical and resource. They also serve as alpha testers during the development phase.

# Going Forward

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## Polling Question #4

- If new 174 is delayed or repealed (i.e., old 174 remains the law), what will you do going forward to identify sec. 174 costs?
  - A. Same effort as in the past
  - B. Use book R&D amount (e.g., ASC 730)
  - C. Perform a more detailed analysis
  - D. Not applicable

# Planning

- Buy v. build
- Onshore v. offshore
- Systems to track development activity
- Impact of 280C from corporate rate change
- International tax implications
  - GILTI/BEAT calculations
  - Cost sharing arrangements
  - 59e interplay
- Long-term contract accounting
- Sec. 174 costs historically embedded in COGS. Now have to pull those costs out and CAPX

# What Does the Future Hold?

- Legislative Outcome
  - Deferral of effective date to 2026 is included in the latest Build Back Better legislation
  - Key challenges:
    - Potential on tax rate reduction
    - SALT cap fix is likely necessary to get votes
- IRS Guidance
  - The IRS has added the sec. 174 capitalization to the 2021-2022 Priority Guidance Plan

# Biography



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Douglas Norton is an associate in the tax practice of Morgan, Lewis & Bockius LLP in Washington, DC and focuses primarily on tax controversy. He has represented clients during IRS audits and appeals hearings, in Tax Court, and in federal district and appellate court proceedings. Doug has particular experience with disputes involving the research credit under section 41.

He is the author of several articles about aspects of sections 41 and 174 and speaks regularly on related technical and controversy topics. Doug holds a master's degree in economics in addition to his law degree and regularly incorporates his understanding of economic analysis into his legal work in areas including transfer pricing and valuation.

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Kathleen King, a managing director of A&M Taxand, has over 25 years of experience advising corporate clients on federal tax matters. Her experience includes helping clients claim, document and sustain tax incentives, including federal and state research tax credits, investment credits, fixed asset treatment and meals & entertainment deduction. Kathleen's projects range from targeted consulting engagements designed to address a specific issue to large scale projects utilizing engagement teams working concurrently in multiple locations.

She has advised clients in a variety of industries including aerospace and defense, food products, manufacturing, financial services, pharmaceutical products, and IT/software. Prior to joining A&M, Kathleen served as a National Office for the Research Credit Services team at Big Four accounting firms. She has written numerous articles and regulatory comments on the research credit and is a frequent speaker on research credit issues.

Kathleen earned her bachelor's degree in Mineral Land Management from the University of Colorado and her master's degree in Accounting from American University in Washington, D.C. She is a certified public accountant.

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Shawn Marchant is a tax principal at Tanner LLC. For more than 20 years he has been advising clients regarding federal and state tax credits and incentives, primarily in the area of research credits. His experience ranges from initial scoping through project implementation and delivery, project management, IRS and state audit support, and evaluation of benefits for financial statement presentation. Shawn spent 16 years in the Big Four, most recently with Ernst & Young in the Southeast region. He began his career in Deloitte's national R&D tax credit group and spent two years in its accounting methods and periods national practice group in Washington, DC.

A frequent speaker on the R&D credit, Shawn is an attorney licensed in California. He received a JD from BYU J. Reuben Clark Law School and an LLM (Tax) from Georgetown University Law School.



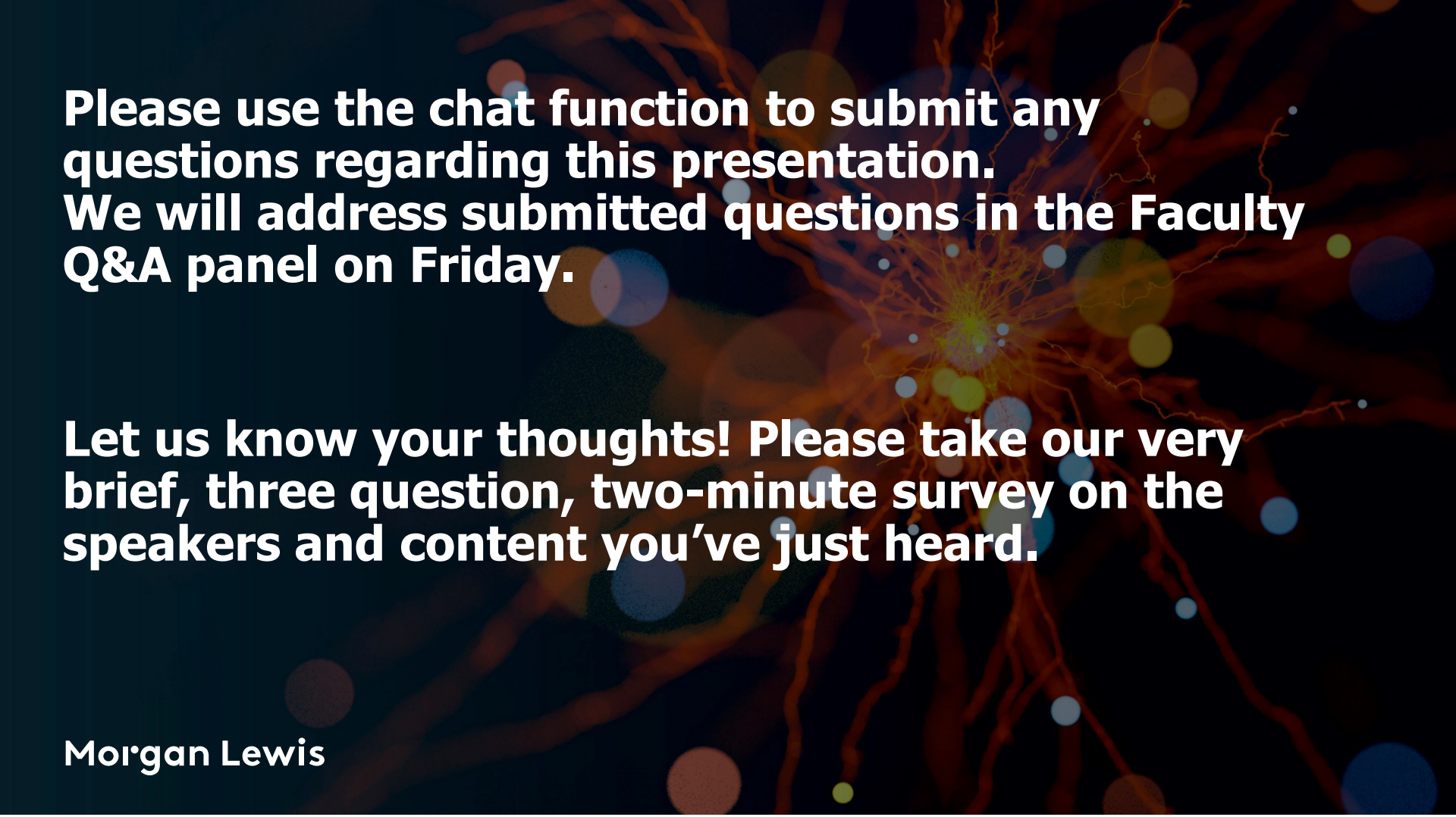
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**5 MINUTE BREAK...WE WILL RESUME SHORTLY**



Morgan Lewis

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

**LEARNINGS FROM RECENT R&D CASES**

Presenters: Devin Hall (Crowe), Doug Norton (Morgan Lewis), and Alex Sadler (Morgan Lewis)

Monday, November 8, 2021

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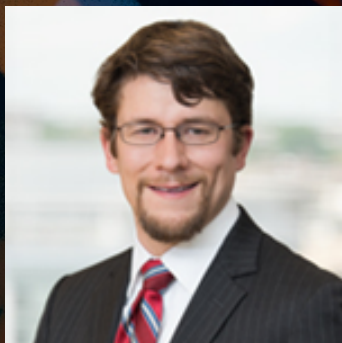


# Presenters



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**Morgan Lewis**

# 2021 in Review

- 2021 has not been a good year for R&D cases with a string of taxpayer losses.
  - One notable exception was 3 cases related to the sufficiency of refund claims.
  - However, the recent CCA has effectively undone the benefit of these cases.
- These outcomes are attributable to 'hard cases' with challenging facts.
- Some of the results are unsurprising given the facts and law.
- We can glean some tactical learnings for use in preparing and defending claims.
- Keep in mind that, while these resulted in outright losses, most R&D disputes are settled before or during litigation – i.e., in audit or Appeals – on terms satisfactory to the taxpayers.

# Claim Requirements

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# Form 6765, Credit for Increasing Research Activities

## Instructions for Form 6765

(Rev. December 2020)

### Credit for Increasing Research Activities



Department of the Treasury  
Internal Revenue Service

Section references are to the Internal Revenue Code unless otherwise noted.

#### Future Developments

For the latest information about developments related to Form 6765 and its instructions, such as legislation enacted after they were published, go to [IRS.gov/Form6765](https://www.irs.gov/Form6765).

#### Reminder

**Tax rate.** The graduated corporate tax structure was replaced with a flat 21% corporate tax rate.

### General Instructions

#### Purpose of Form

Use Form 6765 to figure and claim the credit for increasing research activities (research credit), to elect the reduced credit under section 280C, and to elect to claim a certain amount of the credit as a payroll tax credit against the employer portion of social security taxes.

Partnerships and S corporations must file this form to claim the credit. All others are generally not required to complete or file this form if their only source for this credit is a partnership, S corporation, estate, or trust. Instead, they can

- Surveys or studies.
- Research relating to certain internal-use computer software.
- Research conducted outside the United States, Puerto Rico, or a U.S. possession.
- Research in the social sciences, arts, or humanities.
- Research funded by another person (or governmental entity).

If you incur qualified clinical testing expenses relating to drugs for certain rare diseases, you can elect to claim the orphan drug credit for these expenses instead of the research credit. See Form 8820, Orphan Drug Credit.

See section 41 and Regulations sections 1.41-2 and 1.41-4 for other definitions and special rules.

#### Eligible Small Business (For Purposes of Offsetting AMT Only)

An eligible small business is:

- A corporation whose stock isn't publicly traded,
- A partnership, or
- A sole proprietorship.

The average annual gross receipts of the corporation, partnership, or sole proprietorship for the 3-tax-year period preceding the tax year of the credit can't exceed \$50 million.



# ***Harper v. U.S.*, No. 19-55933 (9<sup>th</sup> Cir. 2/25/21)**

- Specificity under Treas. Reg. § 301.6402-2(b)(1)
  - Taxpayer's 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."
  - "A claim which does not comply with this paragraph will not be considered for any purpose as a claim for refund or credit."
  - Applies when taxpayer seeks refund on amended return based on entitlement to R&D credit
- District court had dismissed taxpayers' tax refund suit seeking research credits because administrative refund claims to IRS attached only Form 6765 with some estimates & did not describe qualified research activities in any detail.
- 9<sup>th</sup> Circuit reverses: "The IRS's substantive examination [over 4 years] and final denial constitutes a textbook case of waiver [by the IRS] here."
  - FN 1: "[W]e need not and do not consider whether Taxpayer's filing of Form 6765 itself satisfied the formal claim requirements."

# ***Premier Tech, Inc. v. U.S. (D. Utah 7/15/21)***

- 1120X amended return with completed Form 6765 “satisfies the specificity requirement and constitutes a claim.”
  - “If the IRS wants more information about the research tax credits, the IRS could require that information **on Form 6765**. It does not, and the IRS cannot now say its own forms are not sufficient to constitute claims for refund.”
  - This was welcome news for claimants.
- “The Court is disturbed by the United States’ gratuitous criticisms of Alliantgroup and [a related law firm], Premier’s tax consulting firm and attorneys, respectively.”

# ***Intermountain Elec., Inc. v. U.S. (D. Utah 7/16/21)***

- Developer of customized electrical and control equipment for mining and other applications, based on study, filed amended returns seeking ~ \$1.7 million in credits for 2010–2011.
- Upon IRS disallowance of claims, Intermountain filed a tax refund suit in district court.
- DOJ moved to dismiss on the grounds that
  - administrative refund claims were fatally deficient
  - complaint failed to allege a legally cognizable claim
- District court passed on formal claim issue but, as in *Harper*, concluded IRS waived by conducting lengthy audit & reaching several merit-based justifications for claim denials.
- District court dismissed claim, without prejudice, based on FRCP 12(b)(6) for failure to state a claim because complaint merely parroted factual elements and did not allege supporting facts.

# Chief Counsel Advisory 20214101F (Sept. 17, 2021)

- Administrative guidance interpreting Treas. Reg. § 301.6402-2(b)(1) to require taxpayer's claim to include additional information.
- Effective 1/10/22, requires R&D refund claims to include the following information in order to be adequate under the regulation:
  - All business components to which the claim relates for that year;
  - For each business component
    - ❑ All research activities performed
    - ❑ All individuals who performed each research activity (i.e., 'nexus light')
    - ❑ All information each individual
  - Total wage, supply & contract research QREs
- CCA p. 11, n.27: "The Service and Counsel are aware of the opinion in the United States District Court of the District of Utah in Premier Tech, Inc. v. United States ... that was issued on July 15, 2021. The Service and Counsel are currently evaluating the opinion."

# Chief Counsel Advisory 20214101F (Sept. 17, 2021)

- Appears intended to formalize the Government's litigating position in *Harper*, *Premier Tech*, and *Intermountain* into published guidance that all claimants must follow after 1/10/22.
- Inconsistent with caselaw (*McFerrin*, *Premier Tech*, and *Bayer Corp.*) in which courts concluded that basic QRE information gave the IRS sufficient data to plan and execute an audit.
- Effectively uses the 'specificity' requirement of the regulation to embed substantial new requirements into eligibility to claim the credit:
  - 'All business component'
  - Nexus between employees (i.e., wages) and business components

# Chief Counsel Advisory 20214101F (Sept. 17, 2021)

- Creates incentive to claim research credit on original returns, which in general are not subject to the CCA
- Potential taxpayer challenges to the CCA
  - Let IRS reject claim as 'deficient', file a tax refund suit, and litigate the adequacy of the claim to give the IRS fair notice in District Court
  - Direct challenge under the Administrative Procedure Act
  - Lobby the IRS to withdraw the CCA

# Polling Question #1

Which of the following does CCA 20214101F not require a research credit refund claim to include after January 10, 2022?

- A. All business components to which the research credit claim relates for the claim year.
- B. All research activities for each such business component.
- C. All Individuals who performed each research activity.
- D. All the information each individual sought to discover.
- E. The college and high school academic transcripts of each such individual.

# **Little Sandy Coal Co. v. Commissioner, T.C. Memo. 2021-15**

**Morgan Lewis**



# ***Trinity Indus., Inc. v. United States*, 691 F. Supp. 2d 688 (N.D. Tex. 2009), *aff'd*, 757 F.3d 400 (5<sup>th</sup> Cir. 2014)**

- The “prequel” with substantially similar facts involving a Mark V deployment craft and Dirty Oil Barge – both first-in-class prototype vessels.



# ***Trinity Indus., Inc. v. United States*, 691 F. Supp. 2d 688 (N.D. Tex. 2009), *aff'd*, 757 F.3d 400 (5<sup>th</sup> Cir. 2014)**

- Qualification analysis
  - “The Court finds that more than 80% of the overall costs of the two Mark V prototypes were incurred in a process of experimentation and qualified research, and therefore that Trinity is entitled to claim the QRE credit for the costs of the two Mark V prototypes.”
  - “The Court finds that more than 80% of the costs incurred in developing the dirty oil barge were part of a process of experimentation and qualified research, and therefore that Trinity is entitled to claim the QRE credit for the costs of the dirty oil barge.”
- Cost analysis
  - “The Court finds that the additional expenses the government cites [insurance costs] are properly considered research expenditures in that the business component—the ship—could not have been developed without them. Under the 80% rule, the Court finds that those costs are properly included in QRE for the Mark V and the Dirty Oil Barge.”
- Understandably, Little Sandy relied heavily upon the above principles in litigating its position to the Tax Court.

# ***Little Sandy Coal Co. v. Comm’r*, T.C. Memo. 2021-15**

- Little Sandy designed and built a prototype barge and dry dock.
- Company tested ships using float tests also used for non-experimental vessels.
- Tax Court disallowed the claim for wages paid to workers who built the vessels, as well as engineering and management staff involved in the projects.
- Stipulated decision entered in August 2021.
- Little Sandy’s litigating position:
  - Evidence established that the majority of the vessels, including major systems, was re-engineered and redesigned.
  - Shipbuilding activities were direct support of qualified research, as opposed to direct research.
  - The District Court’s analysis in *Trinity Industries* established its entitlement to the research credit.

# ***Little Sandy Coal Co. v. Comm’r*, T.C. Memo. 2021-15**

- The Tax Court (Judge Halperin) found that the District Court in *Trinity Industries* erred in not applying “the quantitative analysis section 1.41-4(a)(6), Income Tax Regs., requires.”



**VERSUS**



# ***Little Sandy Coal Co. v. Comm’r, T.C. Memo. 2021-15***

- The ‘substantially all’ rule of Treas. Reg. § 1.41-4(a)(6) “is satisfied only if 80 percent or more of a taxpayer’s research activities, measured on a cost or other consistently applied reasonable basis ... constitute elements of a process of experimentation for [a qualified purpose].”

***Taxpayer’s research activities constituting elements  
of a POE***

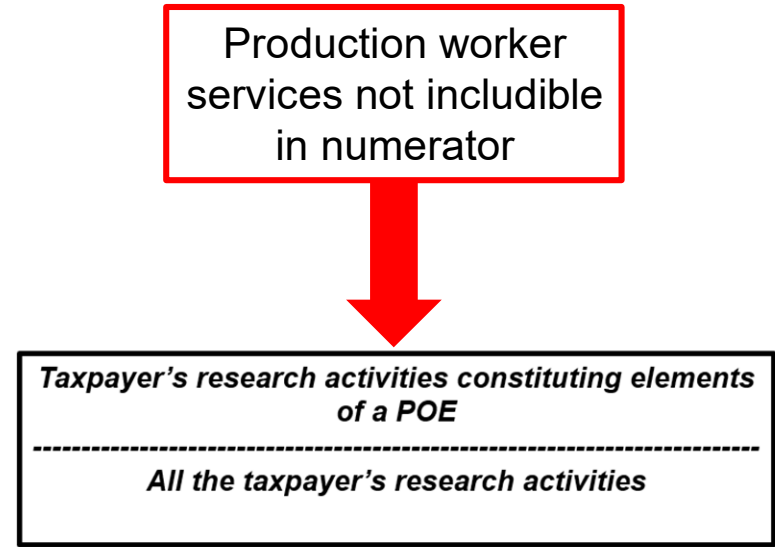
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***All the taxpayer’s research activities***

**>**

**80%**

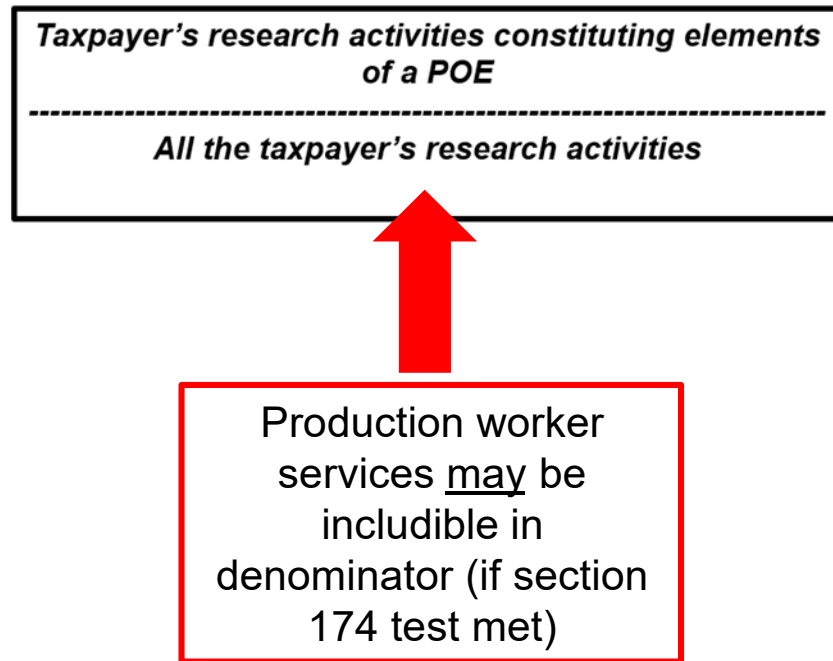
# *Little Sandy Coal* – First Holding

- Services performed by production workers were, by definition, not elements of a process of experimentation.
  - “Those who directly support research are, by definition, not engaged in research. Consequently, their activities cannot be viewed as elements of any process of experimentation that research might entail.”
- Rejected Little Sandy’s argument that production workers’ time should be included in numerator because they directly supported the research.
- Included dicta that production workers’ activities can never be part of the process of experimentation. (We disagree.)



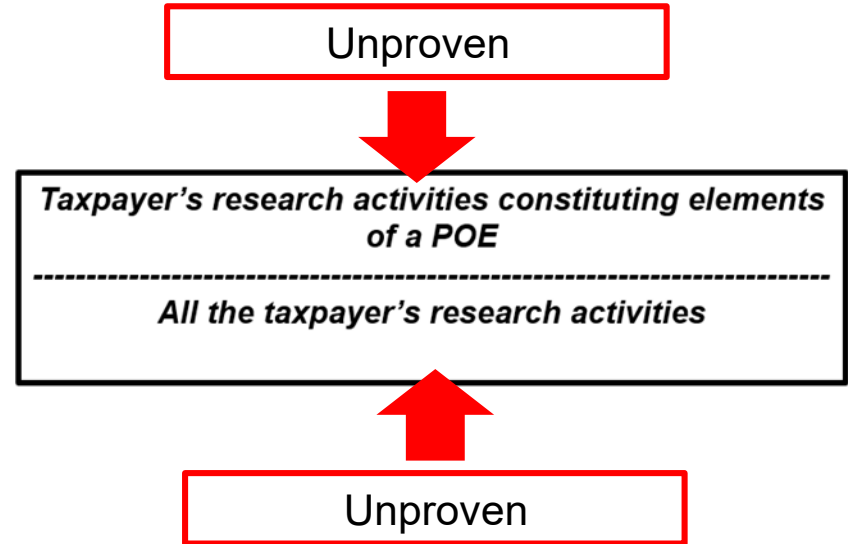
# *Little Sandy Coal – Second Holding*

- If the vessels at issue were viewed as pilot models, such that the construction costs could be viewed as R&E expenditures, the activities would be includible in the denominator – making it mathematically impossible for Little Sandy to pass the 80% threshold.
- We disagree with this conclusion because section 41 and the regulations distinguish between qualified research (includible in fraction) and direct support / supervision of such research (not includible in fraction, even if they satisfy the section 174 test).



# *Little Sandy Coal* – Third Holding

- If the vessels at issue were not pilot models (such that production activities would not be includible in either the numerator or the denominator), Little Sandy had failed to provide evidence that substantially all of the activities of nonproduction employees (i.e., engineering and management staff) constituted elements of a process of





# ***Little Sandy Coal – Takeaways***

- While the opinion was adverse to Little Sandy, it provides a roadmap for taxpayers to meet the process of experimentation test going forward.
- Identify the process of experimentation (i.e., direct research) and which employees were involved in that process.
  - Quantify their allocable wages and mathematically demonstrate that the 80% test is satisfied.
  - For pilot model / prototype claims, notwithstanding the dicta in the Tax Court's opinion, we would be inclined to argue that the production workers' services are part of the process of experimentation and thus their wages are includible in both the numerator and the denominator.
- Per Tax Court, supply costs not relevant to the substantially all analysis. Contract research expenses not addressed and, in our view, could be relevant in cases where third parties perform direct research activities.
- Once the substantially all analysis is complete, identify direct support and direct supervision services and allocable wages or payments, as well as supply costs.

## Polling Question #2

The substantially all requirement of section 41(d)(1)(C) and Treas. Reg. § 1.41-4(a)(2)(iii) is satisfied only if \_\_\_ or more of a taxpayer's research activities, measured on a cost or other consistently applied reasonable basis, constitute elements of a process of experimentation.

- A. 50%
- B. 75%
- C. 80%
- D. 100%

# **Funded research exclusion – *Tangel and Meyer Borgman***

Morgan Lewis

# ***Tangel v. Comm'r*, T.C. Memo. 2021-1**

- Vericor Power Systems LLC (customer) engaged engineering firm Enercon (contractor and claimant) to develop new enclosure for turbine power generation.
- Per contract, Enercon agreed not to use technical information or tooling developed in performance “to develop or sell such Articles (or similar interchangeable or substitute Articles, or parts thereof) to anyone other than Buyer ....”
- Per Tax Court, provision deprived Enercon of ‘substantial rights’ per Treas. Reg. § 1.41-4A(d)(3).
- Tactical learnings:
  - Overcoming the funded research exclusion now even more difficult with broad IP clause.
  - A future taxpayer will need to establish that exploiting research to develop new product for performing contract (as opposed to mere contract R&D) is itself a substantial right.
  - And a future taxpayer should consider challenging the underpinnings of this regulation, which are suspect.

# ***Meyer, Borgman & Johnson v. Comm’r*, Docket No. 7805-16 (Unpublished)**

- Unpublished Tax Court order on cross-motions for summary judgment on funded research issues
- Section 41(d)(4)(H) basics
- MBJ offered structural engineering services for “complex projects that require a high level of customized engineering and design”
- MBJ relied heavily on fixed-price nature of agreements as creating risk
  - Argued that “it was being paid for its results – results that depended on research. If that research weren’t successful... then it wouldn’t be able to complete its work successfully.”
- Tax Court ruled for the IRS
  - Fixed price nature of contracts goes only to cost-of-performance risk
  - Contracts lacked provisions like quality assurance, specific barometers for success, and mechanisms for inspection, evaluation and acceptance
  - No requirement of success within or outside contract

## Polling Question #3

The Tax Court's rulings in *Tangel v. Comm'r* and *Meyer, Borgman & Johnson v. Comm'r* address the applicability of which of the following excluded activities?

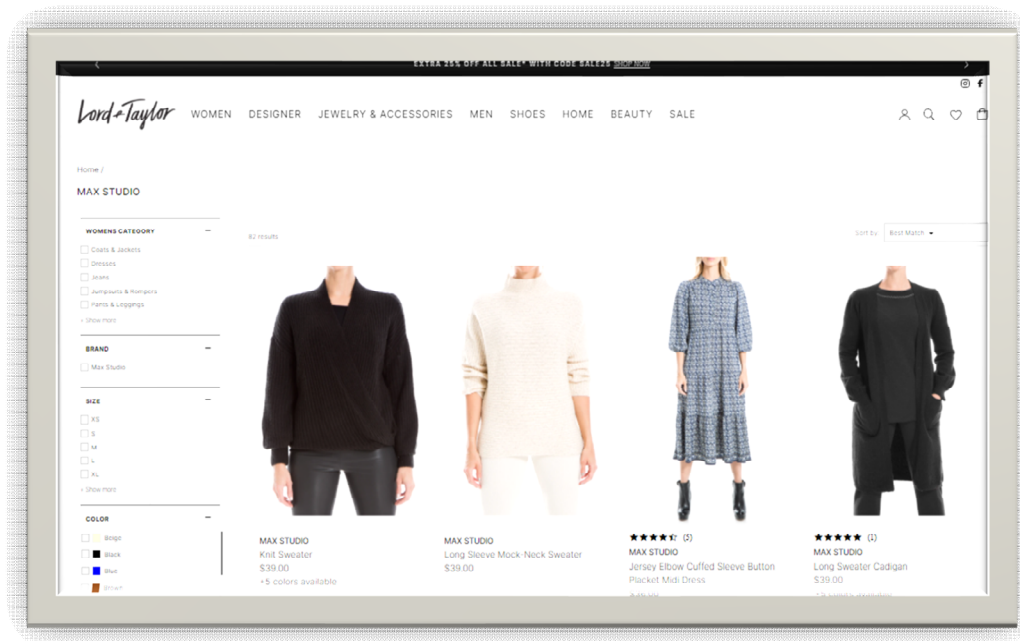
- A. Research after commercial production
- B. Duplication of existing business component
- C. Foreign research
- D. Funded research

# **Availability of the credit for garment-making activities**

**Morgan Lewis**

# Leon Max / Maxstudio

- Leon Max / Maxstudio.com, led by fashion designer Leon Max, is a Women's Luxury Fashion Brand bringing leading edge fashion and innovative styles to modern women.





# ***Leon Max v. Comm’r*, T.C. Memo. 2021-37**

- “LMI’s purpose was to create beautiful clothing that women would want to buy.”
- 48-page opinion by same judge who decided *Siemer Milling* in 2019.
  - 4-day trial in Los Angeles
  - 4 IRS trial attorneys assigned to the case
  - Multiple fact witnesses and competing experts
- Taxpayer’s garment-development process failed the section 174, technological in nature, and process of experimentation tests.



# ***Leon Max v. Comm'r*, T.C. Memo. 2021-37**

- Unhelpful dicta
  - “Moreover, expenditures must be used for an investigative purpose. Section 174 is intended to ‘limit deductions to those expenditures of an investigative nature’ used to ‘develop[] the concept of a model or product.’ Expenses for the ‘actual construction’ of the product are not of an investigative nature.” (Citing *Mayrath*).
  - “For an uncertainty to exist under section 174, a taxpayer must be uncertain about whether it can achieve its objective through research.”
  - “LMI had established parameters that textiles must meet to be used in garments .... The tests were standardized, regular, and conducted to ensure the textile conformed to the specific metrics. They were not undertaken to combat uncertainty but to ensure a high-quality product.”
- Tactical takeaways
  - The Tax Court appears to be taking an increasingly narrow view of the section 174 test; be prepared to show the existence of objectively reasonable uncertainty concerning the development or improvement of the product.
  - Forewarned is forearmed: the IRS will devote substantial resources to ‘hold the line’ where a claim is perceived to stretch the credit beyond its intended scope.

## Polling Question #4

In *Leon Max v. Commissioner*, the Tax Court found that the taxpayer's activities in the \_\_\_\_\_ industry did not constitute qualified research the costs of which were eligible for the research credit.

- A. Information technology
- B. Apparel
- C. Construction
- D. Healthcare

# Biography



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Douglas Norton is an associate in the tax practice of Morgan, Lewis & Bockius LLP in Washington, DC and focuses primarily on tax controversy. He has represented clients during IRS audits and appeals hearings, in Tax Court, and in federal district and appellate court proceedings. Doug has particular experience with disputes involving the research credit under section 41.

He is the author of several articles about aspects of sections 41 and 174 and speaks regularly on related technical and controversy topics. Doug holds a master's degree in economics in addition to his law degree and regularly incorporates his understanding of economic analysis into his legal work in areas including transfer pricing and valuation.

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A focus of Alex's practice is the research and development tax credit—a valuable corporate tax incentive. Alex is the author of the treatise "Legal Guide to the Research Credit" published by *Thomson Reuters®* and is a frequent speaker on the topic. He has litigated several research credit cases and helped clients resolve research credit issues with the IRS without litigation.

# Biography



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Devin serves as a leader in Crowe LLP's (Crowe) National Tax Office (NTO) providing federal tax consulting solutions to his clients. The NTO group focuses on large scale federal income tax consulting projects relating to tax accounting methods and federal tax credits. Devin has developed technical expertise in the area of research and development credits, cost segregation studies and repairs and maintenance studies. He has focused his career on the R&D tax credit and he has extensive experience with the IRS and state authorities in these areas.

Devin started his public accounting career in Kansas City working in the specialty tax area. He moved onto Atlanta and then Houston where helped to build tax consulting practices in each market. Devin has over 24 years of experience performing tax services for both large multinational clients as well as privately held companies. He has developed industry expertise in several industries including the construction, engineering, oil and gas, telecommunications, utility, chemicals, manufacturing, pharmaceutical, healthcare, retail and financial services industries.

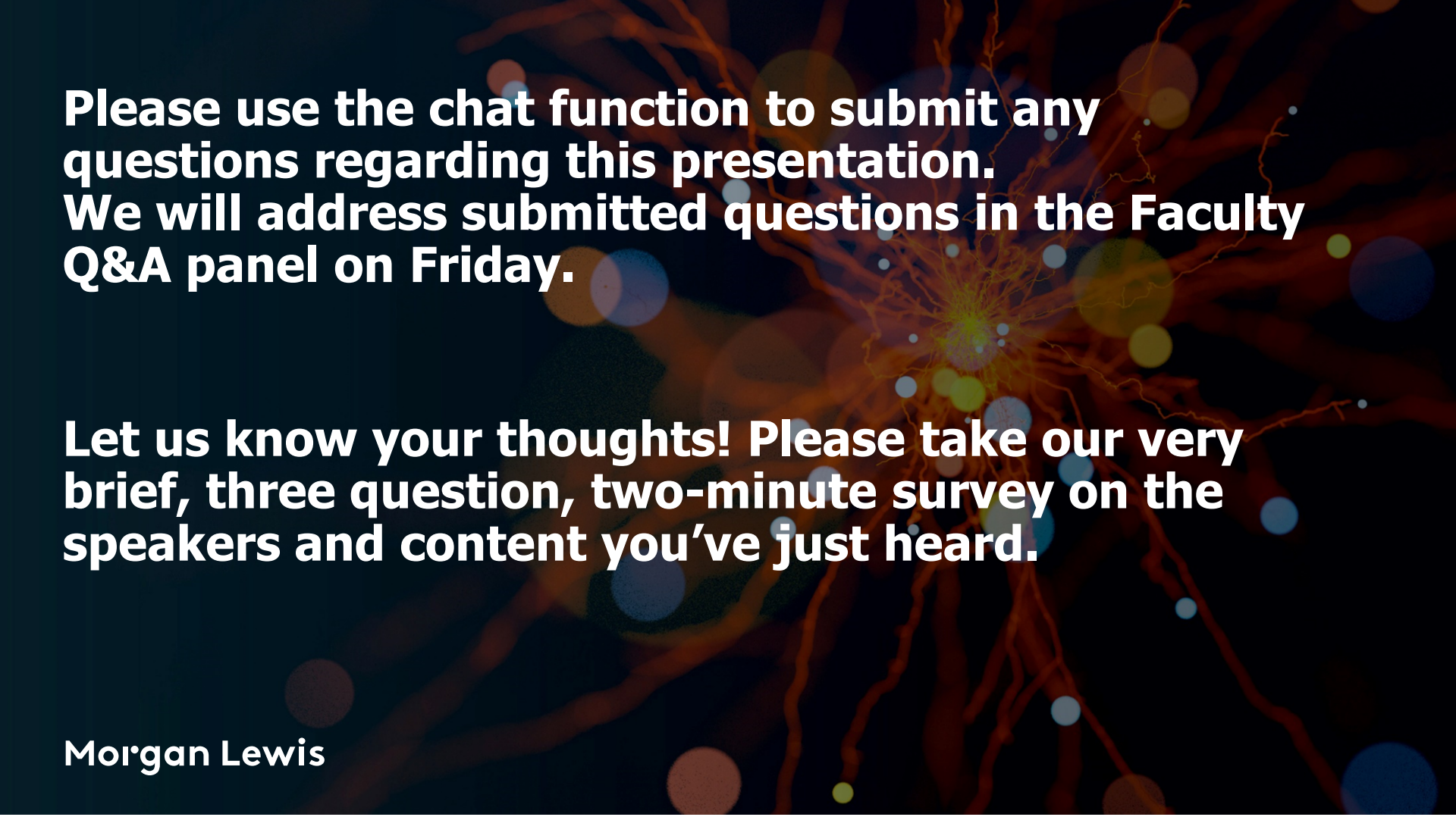
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**Morgan Lewis**



# QUIZ

# Quiz Question 1

Treas. Reg. §§ 1.41-4(a)(d) and 1.6001-1(a) require a research credit study preparer to retain copies of notes of witness interviews conducted during study preparation in the event of an IRS audit of the claimed research credit.

- A. True
- B. False

## Quiz Question 2

Treas. Reg. § 1.41-4(a)(3)(iii) prescribes that the issuance of a patent by the Patent and Trademark Office provides conclusive evidence of qualified research activities as detailed within IRC § 41(d).

- A. True
- B. False

## Quiz Question 3

If a taxpayer performing research for another person retains no substantial rights in the research *and* if the payments to the researcher are contingent upon the success of the research, then neither the performer nor the person paying for the research is entitled to treat any portion of the expenditures as QREs.

- A. True
- B. False

# Quiz Question 4

Who preceded Mary Jo White as SEC chair?

- A. Christopher Cox
- B. William Donaldson
- C. Mary Schapiro
- D. Elisse B. Walter

# Quiz Question 5

Which of the following expenses is not eligible to be treated as research or experimental expenditures under section 174?

- A. Allowances for depreciation or depletion of property that is used in connection with the research.
- B. Salaries and wages allocable to the research and experimentation.
- C. Laboratory materials and other supplies used in the research and experimentation.
- D. General overhead expenses (e.g., light, power, and heating costs) allocable to the research.
- F. The costs of applying for a patent, including attorneys' fees, for the taxpayer's invention.
- E. The costs of a study of a taxpayer's R&D management organization to identify next-generation strategic development priorities.

## Quiz Question 6

In which of the following cases did the court conclude that the taxpayer's activities in performance of fixed-price contracts were "funded research" within the meaning of section 41(d)(4)(H) and Treas. Reg. § 1.41-4A(d)?

- A. Meyer Borgman Johnson v. Commissioner
- B. Geosyntec Consultants, Inc. v. United States
- C. Dynetics, Inc. v. United States
- D. Populous Holdings, Inc. v. Commissioner

## Quiz Question 7

A taxpayer has developed software that allows its users to upload and modify photographs at no charge. The taxpayer earns revenue by selling advertisements that are displayed while users enjoy software that the taxpayer offers for free. The taxpayer also developed software that has interfaces through which advertisers can bid for the best position in placing their ads, set prices for the ads, or develop advertisement campaign budgets. Under the current regulations, are the items of software “developed ... primarily for the taxpayer’s internal use” within the meaning of IRC § 41(d)(4)(E)?

- A. Yes
- B. No



## Quiz Question 8

Which one of these schools CANNOT boast of either Alex Sadler or Doug Norton as an alumnus?

- A. Stanford University
- B. University of Virginia
- C. Williams College
- D. Yale University

## Quiz Question 9

Which of the following is not considered a trade or business under common control under IRC § 52 and its regulations (incorporated into the research credit computational structure under IRC § 41(f))?

- A. a “parent-subsidiary group under common control”
- B. a “QRE-generating group under common control”
- C. a “brother-sister group under common control”
- D. a “combined group under common control”

## Quiz Question 10

In which case did the Tax Court hold that a taxpayer's internal use software development project satisfied both the 4-part definition of qualified research and the 3-part high threshold of innovation test?

- A. Suder v. Commissioner
- B. Union Carbide Corp. v. Commissioner
- C. Norwest Corp. v. Commissioner
- D. Eustace v. Commissioner

# Quiz Question 11

In the preamble to the final regulations concerning the definition of qualified research (Treas. Reg. § 1.41-4), the Treasury Department and the IRS stated that 3 specific exclusions “do not cover research activities that otherwise satisfy the requirements for qualified research.” Which of the following was not one of the 3 exclusions referenced by the Treasury Department and the IRS?

- A. Adaptation of existing business components
- B. Duplication of existing business components
- C. Funded research
- D. Research after commercial production

## Quiz Question 12

Before SpaceX and Tesla, Elon Musk co-founded which of the following companies (later acquired by Compaq for \$307M) with his brother?

- A. Fly3
- B. Sky5
- C. Try4
- D. Zip2

## Quiz Question 13

The regulations prescribe that a taxpayer must employ “a scientific method for discovering information” in order to satisfy the process of experimentation test of IRC § 41(d)(1)(C)?

- A. True
- B. False

## Quiz Question 14

The shrinking-back rule of Treas. Reg. § 1.41-4(b) is not itself applied as a reason to exclude research activities from research credit eligibility.

- A. True
- B. False

# Quiz Question 15

The four-part definition of qualified research under section 41(d)(1) shall be applied separately with respect to:

- A. The taxpayer's trade or business
- B. Each employee's or contractor's research activities
- C. Each dollar of QRE claimed by the taxpayer
- D. Each business component of the taxpayer



**THANK YOU FOR JOINING TODAY'S SESSION!**

Morgan Lewis