

## Sixth Circuit Rules on Research Tax Credit

---

July 14, 2020

In *Audio Technica U.S., Inc. v. United States*, 2020 WL 3481702 (6<sup>th</sup> Cir. 2020), the Sixth Circuit has made clear that calculation of the federal income tax credit for increasing research activities may require a taxpayer claiming the credit to prove the nature and cost of "base period" research projects conducted decades ago.

In *Audio Technica*, the taxpayer petitioned the United States Tax Court to allow research credits for 2002-2005 and 2011. The Internal Revenue Commissioner had disallowed the credits. The parties thereafter settled the cases. The settlement for 2002 through 2005 stated a dollar amount of agreed deficiencies. The settlement for 2011 stated an agreed amount of allowable research credits.

For 2006-2010, the Commissioner again disallowed the taxpayer's research credits, but unlike the procedure that the taxpayer followed for 2002-2005 and 2011, the taxpayer did not petition the Tax Court to allow the credits. Instead, the taxpayer paid the tax deficiency for 2006-2010 and sued in federal district court for a tax refund.

In the district court case, the taxpayer argued that the United States was judicially estopped from asserting that the fixed base percentage – a key calculation necessary to determine allowable research credits – was different from the fixed base percentage used in the Tax Court settlements. The district court accepted the taxpayer's argument but the Sixth Circuit reversed. The Sixth Circuit found that the Tax Court settlements made no reference to the proper fixed base percentage. Consequently, the United States did not take an inconsistent position in the district court case.

The Sixth Circuit remanded the case to the district court to determine the fixed base percentage. To obtain research credits for 2006-2010, *Audio Technica* has to prove that it increased its "qualified research expenses" over its "base amount." The base amount is the product of the "fixed base percentage" and the taxpayer's average annual gross receipts for the four taxable years preceding the taxable year for which the taxpayer will claim the credits. The fixed base percentage is the percentage resulting from dividing the qualified research expenses for tax years 1984-88 ("base period") by the gross receipts for those years. Consequently, the qualified research expenses for each of the credit years, 2006-2010 for *Audio-Technica* must exceed the 1984-88 base amount to be able to claim credits.

To prove the fixed base percentage in the district court remand proceeding, *Audio Technica* must introduce documentary evidence of the nature of the research that it conducted during 1984-1988, and, to the extent available and advisable, testimonial evidence explaining that research. Because maximizing the credit requires the lowest possible fixed base percentage, *Audio Technica's* objective is to prove that its qualified research expenses were low during 1984-88. The United States has the opposite objective. It wants the qualified research expenses to be as high as possible for 1984-88. *Audio Technica* has the burden proof, which requires it to sort all the research projects that it performed during 1984-88 between qualified research projects and non-qualified research projects. Proving the qualified research that it performed in 1984-88 is not enough. It also has to prove that other projects performed in 1984-88 were not qualified research and do not belong in the numerator of the fixed base percentage. Proving that research conducted as much as thirty-six years ago is a considerable challenge and may be an impossible burden for the taxpayer to carry.

Continued

---

An alternative to the 1984-88 base period calculation, and the evidentiary issues in proving something that happened almost 30 years ago, is the alternative simplified credit calculation. IRC §41(c)(4). The alternative simplified credit calculation may result in a smaller credit and may still require the taxpayer to prove to the IRS, in the course of an examination, the nature of research projects as much as six years old.

As the Tax Court pointed that out "[t]he research tax credit is one of the most complicated provisions in the Code. Its complexity is evidenced by the fact that it was the most commonly reported uncertain tax position on Schedule UTP, Uncertain Tax Position Statement ...." *Suder v. Commissioner*, 2014 WL 4920724, (U.S. Tax Ct., 2014). In addition, the Internal Revenue Service has admitted that the research credit is difficult to examine. The Large Business and International Division of the Internal Revenue Service announced in February 2020 that it will use its "campaign" procedure to examine the credit because traditional methods it uses to examine the credit consume too many resources. The complexity of the research credit, the excess consumption of IRS resources, plus the condition of the domestic economy suggest that Congress should simplify the credit by eliminating the base period calculation, and instead allow the credit based simply on the research performed in the tax year.

Please contact the authors or your Miller Canfield attorney if you have further questions.