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Tax Court Denies Research Credits for Research Activities

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A recent Tax Court decision – which arguably is wrongheaded – could cause many suppliers of production parts to original equipment manufacturers to lose federal income tax credits. Suppliers are well advised to consider reviewing and redrafting their supply agreements to avoid leaving tax credits on the table.

In *Tangel v. Commissioner*, T.C. Memo. 2021-1 (2021), the Tax Court applied a regulation that Treasury finalized after the 1983 Supreme Court decision in *Motor Vehicle Mfrs. Ass'n of U.S., Inc. v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29 (1983). In *State Farm*, the Court said that "we have frequently reiterated that an agency must cogently explain why it has exercised its [regulatory] discretion in a given manner." Treasury never explained its policy choices for the tax regulation applied in *Tangel*. The tax regulation remains susceptible to a determination that, in the absence of the explanation, it violates *State Farm* and is arbitrary and capricious.

Tangel involved federal income tax credits for research expenditures under Treas. Reg. §1.41-4A(d). When a customer orders an item from a researcher, the regulation allocates the tax credits to the researcher or its customer depending on whether the agreement between them "funds" the research. If the agreement provides that the customer pays the researcher regardless of whether the research is successful, then the researcher is funded and not entitled to the tax credits. The customer is entitled to the tax credits.

Alternatively, if the agreement provides that the customer pays the researcher only if the research is successful, the researcher is not funded because the researcher bears the financial risk of unsuccessful research. In that case, the researcher gets the tax credits. But there is an exception: If the agreement between the researcher and the customer provides that the researcher "*retains no substantial rights in research under the agreement providing for the research*," the research is funded, and the researcher is not entitled to the tax credits. It is this regulatory provision that the Tax Court applied in *Tangel*.

The regulation goes on to provide circumstances in which neither the researcher nor the customer is entitled to the tax credits. If the customer is not obligated to pay the researcher if the research is unsuccessful, and if the researcher does not retain substantial rights in the research, neither the researcher nor the customer is entitled to tax credits for research performed pursuant to the agreement.

In *Tangel*, the Tax Court disallowed the researcher's tax credits because the researcher did not retain substantial rights in the research. The opinion does not expressly state that the agreement between the researcher and its customer provided that the customer was not obligated to pay the researcher if the research was unsuccessful, but a reasonable inference is that the agreement placed the financial risk of failed research on the researcher. Otherwise, the researcher would have had no argument at all for the tax credits. It thus appears that neither the researcher nor the customer in *Tangel* could claim the tax credits – a sad outcome.

The regulation is of doubtful validity under the Administrative Procedure Act ("APA"). The APA provides that after notice of proposed rulemaking is published in the Federal Register, the administrative agency must give interested persons an opportunity to participate in the rulemaking through submission of written data, views, or arguments. Then, "[a]fter consideration of the relevant matter presented, the agency shall incorporate in the rules adopted a concise general statement of their basis and purpose." 5 U.S.C. §553(c). An administrative agency satisfies the basis and

purpose mandate in the APA by cogently explaining why it has exercised its discretion in a given manner. An agency rule is arbitrary and capricious if it "entirely failed to consider an important aspect of the problem, offered an explanation for its decision that runs counter to the evidence before the agency, or is so implausible that it could not be ascribed to a difference in view or the product of agency expertise." *State Farm*, 463 U.S. 29, at 43, 48 (1983).

Treasury and the IRS had consistently rejected strict application of the APA to its rulemaking procedures. The IRS set out its position in an earlier edition of the Internal Revenue Manual: "[M]ost IRS/Treasury regulations will be interpretative regulations because they fill gaps in legislation or have a prior existence in the law." Internal Revenue Manual pt. 32.1.5.4.7.3(1). "In the Explanation of Provisions section, the drafting team should describe the substantive provisions of the regulation in clear, concise, plain language…*It is not necessary to justify the rules that are being proposed or adopted or alternatives that were considered.*" Internal Revenue Manual pt. 32.1.5.4.7.5.1(2) (Sept. 30, 2011) (emphasis added).

Treasury's labeling a rule as "interpretative" does not avoid the APA's requirement to explain its reasons for its rulemaking choices if the rule has the force of law. *Mayo Foundation for Medical Educ. and Research v. United States*, 562 U.S. 44, 56–57 (2011) ("Our inquiry … [of deference to administrative rulemaking] does not turn on whether Congress's delegation of authority was general or specific.") Treasury's direction to regulation drafters to omit justifications for administrative choices was contrary to *Mayo*, and eventually the Internal Revenue Manual was amended to delete the erroneous direction. Nonetheless, the regulation at issue in *Tangel* was drafted and finalized when Treasury thought that it did not have to explain or justify its administrative regulatory choices.

During the comment period on the regulation as proposed, Donald Lubick, a former assistant secretary for tax policy, submitted a letter criticizing the requirement in the regulation that a researcher retain substantial rights in the research to be eligible for the tax credits. Lubick said: "The proposed regulation seems to require in addition that the operating business, even if at risk, retain substantial rights in the research." He agreed that a researcher whose research is funded by a customer is not eligible for the tax credits because the researcher is not at risk if the researcher is assured of receiving funding. If, however, the researcher is an operating company – which means that the researcher is able to use the research in its operating business – and will not be paid by the customer if the research fails, then the researcher should be entitled to the credit. Lubick also observed that the regulation created circumstances in which the credit would "fall between the cracks" because neither the researcher nor its customer could claim credits for research that undeniably met the statutory definition of credit-eligible research.

Treasury's response to Lubick's criticism was stated in the preamble to the finalized regulation: "One commentator stated that, in a case where the researcher does not retain substantial rights in the results of the research and the funder's payments are contingent on the success of the research, neither the researcher nor the funder is entitled to treat any of the expenditures as paid or incurred for qualified research. The commentator's reading of the interaction of the contingent payment and the substantial rights rules is the correct reading of the two provisions. The proposed regulations are finalized as proposed on this matter."

When Treasury drafted the preamble to the finalized regulation in 1989, Treasury had no intention of satisfying *State Farm*, but instead relied on the false distinction, later rejected by *Mayo*, between a regulation that is interpretative and one that is legislative. It therefore is not surprising that its response to Lubick's comment appears insufficient to satisfy the "basis" and "purpose" mandate of the APA. The response does not explain why the statutory exclusion for research

that is funded is a "basis" for requiring an operating company to retain substantial rights in the research. Even more odd, the response does not explain how the "purpose" of a statutory incentive to promote research in the United States is vindicated by a regulation that denies tax credits to an operating company that performs research at its own financial risk and uses that research to fulfill its production requirements under an agreement related to which the research was conducted. Finally, Treasury's response does not explain how the Regulation accurately effectuates a statute incentivizing research by denying tax credits to both the researcher and its customer even though the research satisfies the statutory definition of credit-eligible research.

The taxpayer in *Tangel* was an operating company tasked with providing "the assembly, integration, controls, and packaging" for one new turbine generator unit and for redesigning (or retrofitting) three existing Vericor turbine units." The taxpayer would seem to have had a viable argument that the regulation is invalid, and that its research was not funded.

Please contact the authors or your Miller Canfield attorney to discuss these developments further.