

Tax Court's Scorched-Earth Opinion Disallows Research Credits for Dress Design Activities

April 23, 2021

For practitioners advancing research credit claims, a recent Tax Court case is of concern because it said more than was necessary to reject the taxpayer's claim. The Commissioner may seize upon dicta in the opinion to disallow other taxpayers' research credit claims.

To claim federal income credits for research activities, a taxpayer must prove that it conducted "qualified research." Research is qualified if it satisfies a four-part test. Part One requires the taxpayer to prove that, at the outset of the research project, its proposed product design is technologically uncertain. Part Two asks the taxpayer to prove that it undertook its research activities for the purpose of discovering technological information to eliminate the technological uncertainties. Part Three asks the taxpayer if it intends to use technological information that it discovers to develop or improve the product design. Part Four requires the taxpayer to prove that "substantially all" of the research activities constitute elements of a process of experimentation for specified technological purposes related to the function, performance, reliability or quality of the product. IRC §41(d)(1).

Leon Max, Inc., an S-corporation, designs and sells women's apparel, for which it claimed federal research tax credits. The taxpayer, the shareholder of Leon Max, Inc., carefully addressed each of the elements of proof required to sustain a research credit claim, but the Tax Court was unpersuaded that the taxpayer qualified for the credits. T.C. Memo. 2021-37 (Mar. 29, 2021). The opinion opens with a comment that "[b]eginning with hand-drawn sketches and using knowledge that is common to people in their field, designers, patternmakers, and sample makers take great care to turn the sketches into garments people will want to purchase." Using "common knowledge" is no basis to attack the credit. Scientists and engineers use their common knowledge – their professional knowledge and training – to conduct research. Entitlement for the credit does not require scientists and engineers to expand common knowledge. A reference to "common knowledge" revives a dispute settled long ago and is best left unsaid. Treas. Reg. §1-41-4(a)(3)(ii).

The court continued: "Designers, patternmakers, and sample makers often knew which threads worked with the fabric, but they tested thread thickness, needle size, and sewing machine adjustments through a process of trial and error for garments with visible stitching." The sentence seems to disaggregate design uncertainty by stating that the category of thread to be used but not the thickness of the thread to be used was known. Design uncertainty does not work that way. The question is whether the information available to the taxpayer does not establish the capability or method for developing or improving the product or the appropriate design of the product. Treas. Reg. §1.174-2(a)(1). If thread thickness was unknown, the taxpayer was uncertain about it.

The court's discussion of the requisite proof of "uncertainty" cited a 1966 case for the proposition that the expenses incurred must be "investigative." The court would have done better if it relied on the language of Treas. Reg. §1.174-2, which was adopted in 1994, rather than on language in a 1966 opinion. "Investigative" and "investigate" do not appear in Treas. Reg. §1.174-2. Moreover, the court stated that the investigative activities had to be used to "develop" the concept of a model. But the sentence in Treas. Reg. §1.174-2 that uses the term "developing" also talks of the "appropriate design" of the product, which is what the Leon Max case is all about. At this point in the opinion, inclusion and discussion of "appropriate design" also would have been appropriate.

Continued

The opinion shifts gears to discuss the process that must be used to eliminate uncertainty, which is where the opinion could have started and finished. The difference between activities allowing a tax credit for research expenditures, and activities allowing only a tax deduction for research expenditures, is that credit-worthy activities must include a "process of experimentation," while deductible research expenditures are not predicated on performance of a process of experimentation. IRC §41(d)(1). Here, the court might have been on firmer ground in deciding that the taxpayer did not engage in the type of systematic activity that constituted a process of experimentation, but in saying so, the court said much that was unnecessary and erroneous. The court found that the taxpayer was conducting only non-credit-eligible quality control testing because "[i]t developed [internal] standards to meet its own needs but also followed prescribed standards from recognized industry organizations." The court confused experimental testing with quality control testing. Quality control testing occurs after a product is designed and after the production system to produce the product is designed. Quality control testing determines if the taxpayer is producing the product that it has designed after all design uncertainty has been resolved. The identity of the source of the testing is immaterial. Engineers internally develop failure modes and effects analyses to design products. These tests are experimental processes even though they are internally developed. Also, tests mandated by external organizations – for example, the federal government – can be experimental processes, but none of that transforms the testing from experimental testing into quality control testing.

A process of experimentation must fundamentally rely on principles of physical or biological sciences, engineering or computer science. In determining that the taxpayer's testing was not an experimental process, the court stated that the testing did not rise to the testing required for the "design and manufacture of complex products, such as bridges, satellites, computers, or other products that require the expertise of an engineer to construct." There is no requirement that the product be "complex." The court made that up out of whole cloth. Also, the court relied on language in a Congressional committee report to require that the technology be "high." There is no statutory or regulatory requirement that the technology be "high," and the court ought not give the Commissioner a new unsupported and vague reason to disallow research credits.

The court finally discussed Leon Max's nonqualified activities "related to style, taste, and seasonal design factors." Those activities are, indeed, not qualified, IRC §41(d)(3)(B), but the court then states that "even nondisqualified activities did not undergo a process of experimentation." That statement makes no sense because style, taste and seasonal design factors can never undergo a process of experimentation. Why say that the taxpayer did not conduct a process of experimentation for activities for which a process of experimentation can never be performed? The court may have been confused about the circumstances in which the cost of these activities might count as qualified research expenses even though these activities, themselves, were not the subject of a process of experimentation. Again, confusion in the court's analysis can give the Commissioner new unsupported reasons to disallow research credits.

We will continue to monitor the impact of this ruling. Please contact the authors or your Miller Canfield attorney to discuss this issue further.