



Court Sides with Taxpayer on R&D Credit Claim

The U.S. Tax Court recently issued a decision that may apply to U.S. taxpayers who are eligible for research and development (R&D) credits. This decision may have a direct positive impact on companies who claim the R&D tax credit—specifically companies that incur significant expenses for materials during the development of new products or processes. The facts of the case fit the pattern of many R&D credit-eligible companies. An overview of the case and its broader implications are presented below.

Background

The case involved a dispute between TG Missouri Corporation, an auto parts manufacturer, and the Internal Revenue Service over R&D credits claimed on TG Missouri's timely filed tax returns.

The IRS denied more than \$5 million in R&D credits because it disagreed with TG Missouri's qualified supplies calculation. The IRS maintained that TG Missouri could not include the costs of production molds that the company purchased from third-party toolmakers and later sold to customers. Although the molds were not capitalized and depreciated in the hands of TG Missouri, the IRS argued that the production molds had a "depreciable character" and were, therefore, excluded under the Tax Code's definition of qualified supplies.

Ultimately, the Tax Court sided with TG Missouri and found that the IRS's interpretation of the rules regarding qualified supplies was incorrect. The court ruled that a supply used in an R&D activity is excluded only if the taxpayer capitalizes and depreciates the property on its own books and records.

Implications

Items that are traditionally recorded as cost of goods sold (COGS) could qualify as R&D expenses. This decision generally affects those expenses associated with prototypes and materials that end up in the final product and are sold to a customer. Taxpayers will still be required to demonstrate that there was technical uncertainty in the product's design for these prototype and material expenses to qualify. Any expenses that are incurred after uncertainty ends will not qualify.

The IRS's position on this issue has previously compelled many taxpayers to include only materials that were scrapped or destroyed during the course of the taxpayers' R&D activities. This decision is encouraging taxpayers to reevaluate their approach to capturing qualified supply expenditures, as more qualified supplies will translate into larger R&D credits. Companies who this ruling may affect are strongly encouraged to discuss this matter with their tax providers.

The U.S. Tax Court handles only tax litigation, and the judges are all experts in tax law. Although the decision could be appealed to the U.S. Courts of Appeals, and then to the U.S. Supreme Court, it is important to note that most judges outside of Tax Court do not have extensive knowledge of tax law and litigation issues.

For more information regarding the R&D credit and how it applies to your company, contact one of our R&D credit specialists below.

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