

There's a war over R&D tax credits. And companies keep winning.

BY JIA LYNN YANG January 24 at 4:03 pm

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Workers finishing Boeing's new C-17 Globemaster III military cargo jet (Photo by Patrick T. Fallon/Bloomberg)

One of the most generous offerings for corporate America in the U.S. tax code is about to become even more bountiful under an Obama administration proposal.

The new rules, which are being finalized by the U.S. Treasury Department, would lift restrictions on the types of activities that qualify for tax breaks for business research and development — raising the prospect that Boeing, Lockheed Martin and many smaller firms could reap hundreds of millions of dollars in fresh savings.

Administration officials say the changes merely clarify existing rules and would not dramatically broaden eligibility for a 30-year-old tax credit for research and development and related deductions.

Corporate tax lawyers have enthusiastically embraced the proposed changes. And Marty Sullivan, chief economist for the nonprofit Tax Analysts, called the new rules “a significant giveaway to business.”

“The IRS is under a lot of pressure from lobbyists to be accommodating,” Sullivan said. “So over the years, business has been successful in pushing that boundary out.”

The new rules are the result of a decades-long legal battle waged by Dow Chemical and others to broaden the standards used to decide what kind of research deserves federal subsidies. Already, the research credit and related breaks save firms more than \$12 billion a year.

The credit is also hugely popular in both parties. President [Obama has vowed](#) to expand it and make it permanent. And though the credit was among dozens of temporary tax breaks that [expired Dec. 31](#), lawmakers are laying plans to revive it and extend it retroactively, as they have done routinely in the past.

Away from the political spotlight, however, the research credit is deeply controversial. Some studies indicate that it rewards business activity that likely would have occurred anyway; others have found it a useful incentive.

Meanwhile, companies claiming the credit automatically raise red flags at the IRS — and have a good chance of being audited.

The new rules, unveiled last September, represent an effort to end some of the confusion, said Mark J. Mazur, assistant Treasury secretary for tax policy.

Currently, the IRS forbids companies from claiming tax breaks for costs associated with experimental products they ultimately sell. But after losing a number of recent lawsuits, the Treasury Department proposed last fall to let firms claim the credit for prototypes of new products, even when the companies are able to sell the prototypes themselves to their customers.

Any tax benefits under the new rules would be retroactive, permitting firms to reduce tax bills dating back years.

In a statement, Mazur said the new rules “are part of our ongoing work to clarify the tax code to provide incentives for businesses that are innovating, increasing our competitiveness and promoting economic growth. They do not expand the definition of research.”

But corporate tax lawyers who are paid to follow such changes say the new rules could prove to be a bonanza for a wide range of companies whose expenses are not currently eligible.

“Almost anybody who is making, designing things in the United States potentially could qualify for some of these benefits,” said Jeremy Fingeret, senior managing director at Alliantgroup, a tax consulting firm. “It’s a very, very broad scope.”

The research tax credit was created as a temporary tax break in 1981 under President Ronald Reagan. At the time, policymakers were rattled by fears that the U.S. economy was falling behind Japan. The tax credit was offered as an incentive for businesses to pursue discoveries and innovations that could benefit society at large and help the United States regain a competitive edge, despite sometimes high and potentially unrecoverable costs.

The difficulty of drawing a sharp line between activities that meet that standard and those that do not quickly became clear, however.

“With the rapid pace of technology development, any bright line that sought to define R&D would be artificial and unrealistic,” Mazur said. “It is simply too difficult to make clear-cut distinctions that would stand the test of time.”

Since then, administrations have toggled back and forth between tightening and loosening the rules.

Under President Bill Clinton, the Treasury Department added a “discovery rule,” under which companies were required to show that they had produced information that “exceeds, expands, or refines the common knowledge of skilled professionals in a particular field of science or engineering.”

The George W. Bush administration largely tossed that language out. Meanwhile, companies have continuously fought the IRS in court.

Unlike a tax bill on Capitol Hill, the new rules come with no official estimate of how much they would cost in lost revenue. Alex Sadler, a tax lawyer with Ivins, Phillips & Barker, estimates that, for a single large company, the proposed changes could amount to hundreds of millions of dollars in savings.

In the trench warfare between corporate tax lawyers and the government, companies such as Boeing have taken note.

In its [quarterly report](#) last fall, the aviation giant mentioned the new rules, calling them “generally taxpayer favorable.” When they take effect, probably this year, Boeing said it expects to claim new savings on tax bills dating back as far as 2007.

And earlier this month, Boeing sent a representative to a windowless auditorium at the IRS where Treasury officials held a public meeting to discuss the new rules. The Boeing tax lawyer was the only scheduled speaker.

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