

U.S. IRS, Lockheed fight over R&D 'rocket science' tax break

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* Case tests line between research and prototype production

* Other companies closely monitoring \$13.6 million dispute

* Retroactive R&D credit claims can be IRS red flag-tax experts

WASHINGTON, Jan 25 (Reuters) - Lockheed Martin Corp is challenging the U.S. government in court over \$13.6 million in research tax credits in a case that tests the often hazy line between research and production, with future R&D claims by other companies possibly at stake.

The aerospace group argued in December in U.S. District Court that the Internal Revenue Service had wrongly rejected research tax credits Lockheed claimed for two projects: a space rocket launcher and a New York City surveillance system.

The IRS disallowed Lockheed's claims in May 2012. Lockheed has challenged the IRS' position that some retroactive R&D credit claims were impermissible because they involved costs not for research, but for making prototypes resulting from research.

Lockheed said in its court filing that some of the credits were claimed for prototypes, but argued that the designs were new and unproven and should qualify as research.

"With Lockheed, you have the actual question of whether this is rocket science," said William Schmalzl, a partner at the law firm Mayer Brown with clients facing similar issues.

The case also draws attention to the timing of R&D credit claims. Lockheed's 2012 claims on the rocket launcher and surveillance system projects were both made retroactively for tax years 2004 through 2007, according to its court filing.

While retroactive claims are frequently allowed, they tend to attract closer IRS scrutiny, tax lawyers said.

When a credit is sought retroactively, "you really aren't relying on it as an incentive" to do research, Schmalzl said.

Maryland-based Lockheed, a top Defense Department supplier, declined to comment. The IRS also declined to comment.

The agency has yet to file a formal response to the Lockheed court action. No court date has been set in the U.S. District Court for the District of Maryland in Greenbelt.

A Lockheed court loss could jeopardize other companies' R&D claims and allow the IRS to be more aggressive, while a Lockheed victory could prompt other companies to look at past tax returns and claim retroactive credits, tax experts said.

PROMOTING SCIENCE

The R&D credit was created by Congress in 1981 to encourage business investment in science.

The "traditional" R&D credit allows companies to cut their tax bills by 20 percent of qualified research spending based on a formula dating back to the mid-1980s. An "alternative simplified credit," established in 2007, allows a claim of 14 percent based on the three prior years of research spending.

The credit is not refundable for cash, except in limited circumstances, and there is no cap on the credits a company can claim. Unused credits can be carried back one year and carried forward 20 years. The credit is limited to research funds spent in the United States. Wages and supplies account for the bulk of spending, and capital expenses are not applicable.

In reporting its quarterly financial results on Thursday, Lockheed said separately from the case that it expects to receive \$75 million in R&D credits for 2012 and 2013.

Though simple in concept, the R&D credit is a frequent source of messy tax disputes. Companies, including Dow Chemical Co, Trinity Industries and Bayer AG, are also fighting the IRS in court over research credits.

Dow lost a case in U.S. appeals court in September involving \$8 million in credits. Dow unit Union Carbide wanted to apply the credits retroactively to cover costs for supplies, even though it ended up selling the finished goods.

The Dow decision gave the IRS "ammunition to attack" certain credit claims for supply costs, said Jeff Malo, a director with tax advisory firm WTP Advisors.

In December, Dow asked the Supreme Court to hear its case.

Germany's Bayer is facing off against the IRS over \$170 million of disputed research credits spanning 17 years. Texas-based Trinity is appealing a \$5 million tax credit dispute.

"The confusion and ambiguity as to what qualifies, and the fights that this ambiguity engenders, undermine the credit's intended incentive effect," said Alex Sadler, a partner at law firm Ivins, Phillips & Barker.

The R&D credit is widely backed by President Barack Obama and members of both political parties, many of whom want to make it a permanent part of the tax code. It is presently a "temporary" measure requiring regular extension.

It was renewed again this month, along with other tax breaks known collectively as the "tax extenders." The R&D credit, which will expire again at the end of this year, is estimated to cost U.S. taxpayers \$14.3 billion over 10 years.

This month the non-partisan Congressional Budget Office urged Congress to consider changes to the credit "to reduce excessive revenue costs and economic inefficiencies."

The case is Lockheed Martin Corp v. United States of America, in the U.S. District Court for the District of Maryland Southern Division No. 3725.