IRS Eager to Exploit Tax Court Win on R&D, Practitioners Say

by Kristen A. Parillo

A recent Tax Court victory against a flour company is likely to be used as a leveraging tool by the IRS when arguing that taxpayers didn't do enough experimentation to merit a research credit.

"I think *Siemer Milling* is going to be huge" for IRS examiners and attorneys trying to argue that research expenses don't qualify for the credit, Diane Stogiannes of DST Advisory Group said November 7.

Speaking at the Research & Development Tax Credit Symposium hosted by Morgan, Lewis & Bockius LLP in Washington, Stogiannes was among several practitioners who highlighted the significance of the Tax Court's April 15 decision in *Siemer Milling Co. v. Commissioner*, T.C. Memo. 2019-37.

Kathleen King of Alvarez & Marsal agreed that the IRS is eager to leverage its win, noting that the case is already being cited in exams.

The court held in that case that Siemer, an Illinois-based flour supplier, wasn't entitled to section 41 research credits for either tax year at issue because none of the seven projects under review satisfied all elements of the four-part test necessary for obtaining the credit.

According to the Tax Court, Siemer failed to show how its purported research activities were part of a scientific process or systematic process of experimentation.

Reviewing each project, the court said the company didn't establish that it had a "methodical plan involving a series of trials to test a hypothesis, analyze data, refine the hypothesis, and retest the hypothesis so that it constitutes experimentation in the scientific sense."

Details Matter

According to David S. Hudson of EY, the *Siemer* case provides a valuable lesson in how taxpayers shouldn't present a research credit case to a court.

All of Siemer's projects "should have qualified 100 percent," Hudson said. However, the company didn't give the court enough details, he said, adding that judges expect a high degree of precision from taxpayers trying to explain why their activities qualify for a credit.

The company's defeat demonstrates that taxpayers and their advisers "need to get in there and identify the business component that's going to be developed, identify what the specific uncertainties are that we're trying to overcome as part of the research, how the process of experimentation was conducted, and what the technological nature of the research is," Hudson said.

Hudson noted that some of Siemer's projects didn't even satisfy the technological information test, which requires that a research activity be undertaken for the purpose of discovering technological information.

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"That almost never happens," Hudson said, adding that the projects appeared to be genuine engineering projects.

Hudson said he read the trial transcripts to see if he could figure out what went wrong. That Siemer offered its vice president of production as its only expert witness may have been a major tactical error, he said.

The witness "was a technical guy and he was somewhat involved in most of these projects, but I think he lacked the level of detail that the court was looking for to talk specifically about what [the company was] trying to test," Hudson explained.

"He talked more in generalities," Hudson said. "I don't think they did a very good job of talking methodically about a process of experimentation that the court was looking for."

The witness also appeared to have confused the court by describing a vendor product as a business component, Hudson said. What Siemer was actually doing was experimenting with the product's pulse-waving technology to see if it

could adapt the technology for its own processes in developing flour products, he said.

Siemer could have presented a stronger case by putting an outside expert on the stand, Hudson said.

That type of witness "could have brought more color to what type of R&D they were doing and explained to the court why this really is how you do R&D in a process of experimentation in an industrial setting — you take various pieces of equipment and technologies, try to employ them, and see how they impact your processes," Hudson said. ■