



TaxNewsFlash

United States



No. 2021-076
February 11, 2021

U.S. Tax Court: Research tax credit disallowed

The U.S. Tax Court today issued an opinion disallowing a taxpayer's research tax credit claimed under sections 38 and 41(a) for expenses incurred by the taxpayer's subsidiary.

The case is: *Little Sandy Coal Company, Inc. v. Commissioner*, T.C. Memo 2021-15 (February 11, 2021). Read the Tax Court's [opinion](#) [PDF 188 KB]

The IRS determined a deficiency in the taxpayer's federal income tax for its tax year ended June 30, 2014, and an accuracy-related penalty under section 6662 for that same year. The deficiency arose from the IRS's disallowance of a claimed research credit under sections 38 and 41(a). The claimed credit relates to activities conducted by taxpayer's shipbuilding subsidiary in developing 11 vessels. In accordance with an agreement between the parties, the trial in April 2019 addressed issues related to just two (a tank barge project and a dry dock project) of the 11 projects in issue:

- Whether the taxpayer met its burden of proof that substantially all (80% or more) of the activities involved elements of a process of experimentation to be qualified research under section 41(d)(1)(C) and Treas. Reg. §1.41-4(a)(6) with respect to the business components identified for the building of a tank barge and a dry dock
- Whether any exclusion found in section 41(d)(4) applied with respect to the business components identified for the projects
- The includible amount of qualified research expenses for the business components identified for projects
- The issues with respect to projects on which the subsidiary collaborated with a related corporation

The Tax Court today determined:

- The subsidiary did not meet its burden of proof that substantially all (80% or more) of the activities involved elements of a process of experimentation to be qualified research, as defined by section 41(d), with respect to the tanker or the dry dock. Significantly, the Tax Court did not consider the direct support and direct supervision activities of the employees as being "engaged in" research under section 41(d)(1)(C). Even though section 41(b)(2)(B) and Treas. Reg. §1.41-2(c) define

“qualified services” to include (1) engaging in qualified research; (2) engaging in the direct supervision; or (3) direct support of qualifying research, the Tax Court held that

One who provides services in direct supervision or support of research is not “engaged in” research.... Therefore, the activities of such a person cannot “constitute elements of a process of experimentation” for purposes of section 41(d)(1)(C).

- Because the subsidiary did not conduct qualified research, within the meaning of section 41(d), in developing either the tanker or the dry dock, the Tax Court did not need to consider the applicability to either project of the exclusions provided in section 41(d)(4).
- The includible amount of qualified research expenses for each of the tanker and the dry dock pursuant to section 41(a) and (b) was zero.
- No portion of the qualified research expenses the taxpayer reported in respect of the other projects was allowable for the purpose of computing the research credit allowed by section 41(a).

The information contained in TaxNewsFlash is not intended to be "written advice concerning one or more Federal tax matters" subject to the requirements of section 10.37(a)(2) of Treasury Department Circular 230, as the content of this document is issued for general informational purposes only, is intended to enhance the reader's knowledge on the matters addressed therein, and is not intended to be applied to any specific reader's particular set of facts. Although we endeavor to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. Applicability of the information to specific situations should be determined through consultation with your tax adviser.

KPMG International is a Swiss cooperative that serves as a coordinating entity for a network of independent member firms. KPMG International provides no audit or other client services. Such services are provided solely by member firms in their respective geographic areas. KPMG International and its member firms are legally distinct and separate entities. They are not and nothing contained herein shall be construed to place these entities in the relationship of parents, subsidiaries, agents, partners, or joint venturers. No member firm has any authority (actual, apparent, implied or otherwise) to obligate or bind KPMG International or any member firm in any manner whatsoever.

Direct comments, including requests for subscriptions, to [Washington National Tax](#). For more information, contact KPMG's Federal Tax Legislative and Regulatory Services Group at + 1 202.533.4366, 1801 K Street NW, Washington, DC 20006-1301.

To unsubscribe from TaxNewsFlash-United States, reply to [Washington National Tax](#).

[Privacy](#) | [Legal](#)