THE TAXONOMIST

Merry Christmas to the Tax Credit Abusers

BY ROBERT S. MCINTYRE

The Bush administration has come up with still another outrageous tax-giveaway scheme, this time not by legislation but by administrative fiat. In mid-December, the administration announced that it would soon send out billions of dollars in tax refunds to companies that have flouted the tax laws—and to the major accounting firms that helped them do so.

At issue is something called the "research and experimentation" tax credit, which dates back to Ronald Reagan's 1981 tax-cut law. According to the congressional reports on the original legislation, the free market doesn't do an adequate job of encouraging scientific advances. Not only is research inherently risky, it was argued, but businesses that engage in successful research often find that the fruits of their efforts generate public benefits well beyond the profits accruing to the companies. Consequently, "many businesses have been reluctant to allocate scarce investment funds for uncertain [or inadequate] rewards."

Whatever you may think of this argument—I find it pretty dubious—solving this "market failure" problem was clearly what Congress had in mind in 1981. But once the tax break was adopted, companies and their tax advisers quickly set out to pervert its purpose. What, after all, is "research"? Soon, horror stories emerged about tax credits being successfully claimed for such scientific breakthroughs as McNuggets, Gillette's Lemon-Lime shaving cream, and new fashions in clothing. More generically, as one wag put it, "if you send the janitor down to fix the boiler and he succeeds, it's repairs; if he fails, it's R&D."

In the 1986 Tax Reform Act, Congress tried to curb abuses of the credit by defining "research and experimentation" more narrowly. To address the McResearch issue, tax breaks were specifically denied for work on "style, taste, cosmetic, or seasonal design factors." More important, the 1986 law tightened the general definition of "qualified research."

Besides satisfying the vague 1981 rule (which refers to another tax-code section that allows a write-off for research expenses), the 1986 law required tax-credit-eligible research to meet two additional conditions. Since Congress wanted to subsidize only "risky" research that entails some chance of failure, there must be "a process of experimentation." And since the key goal is to promote science that generates public as well as private benefits, research must be "undertaken for the purpose of discovering information . . . which is technological in nature."

Consistent with the language and purpose of the statute, the IRS eventually interpreted this "public benefit" or "discovery" test to require that qualifying research must be directed at "obtaining knowledge that exceeds, expands, or refines the common knowledge of skilled professionals in a particular field of science or engineering." In other words, if everybody already knows what a "research" project is intended to "discover," then the government won't foolishly subsidize it with a tax credit.

That seems to be a pretty mild-mannered interpretation, but when Bill Clinton's Treasury Department included it in regulations proposed in 1997, a firestorm of complaints arose from the business community. Why? It appears that, acting on the advice of their accounting firms, many big companies have been routinely claiming tax breaks for "research" that has nothing to do with expanding scientific knowledge.

When and if the IRS catches them—and it's been forced to devote a huge share of its audit resources to doing so—these firms have usually lost (at least they've lost three of the four cases that have finally been decided in court). But that didn't stop the Big Five accounting firms—which are said to have hefty fees contingent on the credits being approved—from continuing to challenge the IRS position both in and out of court.

When the Clinton research-tax-credit regulations were finalized in January 2001, it looked as if the jig might be up for the corporate abusers of the credit. But with the presidency of George W. Bush came new leadership at the Treasury. That included a new Assistant Secretary of Treasury for Tax Policy named Mark Weinberger, who before joining the government was the lobbyist for the R&E Tax Credit Coalition, a business group devoted to—well, its name says it all.

It can't be a coincidence that only a few days after Bush took office, the Treasury suspended the just-finalized research-credit regulations. Or that in December, the Treasury announced revised rules that permanently drop the public-benefit-or-discovery test for qualifying research. "We are very pleased," a spokesman for PricewaterhouseCoopers told the BNA Daily Tax Report. Actually, he probably chortled, since the revisions are retroactive—and that means billions of dollars in refund checks to companies whose claims had previously been denied and handsome contingency fees for their accountants.

I hate to learn how the world works.