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News Analysis: A Failed Attempt to Vary the Variance Doctrine

by Jeremiah Coder

Summary by taxanalysts

In news analysis, Jeremiah Coder questions the government's attempt to use the substantial variance doctrine as a litigation tool forcing burdensome documentation presentations in research credit refund cases.

Trying to get money back from the government is difficult. Once tax has been paid to the IRS, the taxpayer must file an amended return, wait out the administrative refund claim period, and file a refund suit if the claim is denied. Patience is necessary, with any number of factors standing ready to derail the refund.

The government has tried to make the process even more daunting for taxpayers that think they should get money back as a result of deductible expenses for permissible research activities. An alluring incentive to taxpayers, the research credit has become a critical area of review in IRS audits. Through regulations and other guidance, Treasury and the IRS have tried to increase the compliance requirements for determining qualified research expenses, but the result is frequent litigation over a company's ability to take credits for research activities.

The government last month failed in its procedural attempt to deny a company's claimed research credits despite invoking a favorite common law procedural doctrine: variance. Had it been accepted by the presiding judge, the government's

extreme argument regarding when a portion of a refund claim varies from prior claims could have put companies nationwide on alert. But the court was unwilling to credit the government's interpretation and denied a request for summary judgment.

Bayer

In *Bayer*, the healthcare products and research company sought a refund for expenses it claimed were for qualified research under section 41. The statute sets out a test requiring a separate determination for each business component of whether an expense was incurred for qualified research. Unlike some companies, Bayer uses an accounting system that tracks expenses based on cost centers rather than individual projects. (For *Bayer Corp. v. United States*, No. 2:09-cv-00351 (W.D. Pa. 2012), see *Doc 2012-19746* or *2012 TNT 185-22*.)

Bayer hired Deloitte & Touche LLP to study its research expenses to determine whether it was claiming all of the section 41 credits it was entitled to. The results led the company to submit a $49 million refund claim to the IRS, which then examined portions of the Deloitte report during audit. The IRS apparently did not ask Bayer at that time to present any of its supporting expense documentation by business component. Because the IRS didn't respond to the refund claim within six months, Bayer filed suit in federal district court.

However, in discovery, the Justice Department gave Bayer an interrogatory that requested identification of each business component for which the alleged research expenses were attributable. Bayer responded that it had more than 100,000 business components, that its books did not track expenses based on individual components, and that there was no legal requirement to do so. The government compelled Bayer to answer after the company's motion to use statistical sampling was denied.

The government's motion for summary judgment was based in part on its belief that Bayer had changed the factual bases in its refund suit from those presented in the administrative claim to the IRS. There was no disagreement that Bayer had consistently advanced the same legal basis for its refund claim: that its qualified research expenses were allowed credits under section 41.

The substantial variance doctrine is a judicially recognized rule arising from the interpretation of section 7422(a) and reg. section 301.6402-2(b)(1). Because the reg requires a taxpayer's refund claim to supply detailed grounds on which it rests, courts have held that taxpayers may not pursue refund litigation in which the legal theories or factual bases "substantially vary" from what was presented to the IRS. The doctrine is designed to ensure that the IRS is not disadvantaged in litigating issues that are different from the refund claim it considered at the administrative

stage.

Prior Precedent

In *Lockheed Martin*, the premier case in the area, the Federal Circuit held that under the substantial variance rule, the taxpayer was prevented from introducing evidence of additional expenses once litigation was initiated that would increase its refund from research credits. (For *Lockheed Martin Corp. v. United States*, 210 F.3d 1366 (Fed. Cir. 2000), see *Doc 2000-12106* or *2000 TNT 83-10*.)

Lockheed filed an administrative refund claim with the IRS for claimed research credits arising from fixed price contracts it had with the government. The company provided a schedule of expenses for the research activity, but the IRS denied the refund request, concluding that the research wasn't qualified under section 41. During discovery in litigation over the refund claim in the Court of Federal Claims, Lockheed filed a motion asking to include in the complaint more research expenses it had discovered.

The Court of Federal Claims dismissed Lockheed's motion on the grounds that because an IRS refund claim requires submitting detailed legal and factual evidence for the refund, introducing additional expenses to the claim in litigation would constitute a substantial variance from the administrative claim. The additional expenses would form a separate basis for a refund from the factual basis of Lockheed's claim to the IRS, the court held. (For *Lockheed Martin Corp. v. United States*, No. 96-161T (Fed. Cl. 1998), see *Doc 98-33990* or *98 TNT 226-6*.)

On appeal, the Federal Circuit held for the government. Despite Lockheed's argument that its administrative refund claim was broadly written to put the IRS on notice that any of its research activity was involved because it encompassed the same legal basis and categories of expense, the circuit court held that the taxpayer was limited to the expenses it listed in its original refund claim with the IRS. The court interpreted the substantiation rule of reg. section 301.6402-2(a) as requiring specific evidence in the administrative stage that would be factually altered by additional claims later. The substantial variance rule "limits any subsequent litigation to those grounds that the IRS had an opportunity to consider and is willing to defend," the court held.

What the IRS considered in its administrative refund review of Lockheed's claim was the summary list of expenses provided, rather than a detailed listing that would have supplied an "exact factual basis," the court said. The original claim was "based on a finite group of expenses" that could not be expanded by expenses discovered after litigation had begun, the court held, adding that the new expenses "were not among the expenses upon which Lockheed Martin predicated its claim."

Egregious Overreach?

In *Bayer*, the government failed to extend its defensive posture in refund litigation to allow the IRS to deny any refund claim in which the taxpayer's documentation was not in the government's preferred format. The government is correct that section 41 ties qualifying research to a taxpayer's specific business components. However, as the district court hinted in a footnote, the IRS still seems to honor some refund claims when taxpayer documentation is in breach of the statute. For example, in *Lockheed Martin*, the taxpayer submitted its summary expense reports without reference to its business components, but the IRS never raised the issue in its administrative review or in litigation.

The government relied heavily on *Lockheed Martin* to make its case for summary judgment in *Bayer*, but the district court held that the facts in *Bayer* were easily distinguishable. The court said Bayer's factual documentation, even if it wasn't in a business component format, didn't violate the substantial variance rule because "the credits underlying Bayer's refund claim have not changed." The court implicitly admonished the government for its attempt to disqualify the taxpayer's claim by demanding "a list of business components for the first time in this Court and then object[ing] based on the substantial variance rule to Bayer's need to gather significant, additional evidence."

The district court further held that the government "confuses the requirement that a taxpayer disclose the grounds of its refund claims to the IRS with the mistaken notion that a taxpayer must disclose all of the evidence or subsidiary components supporting those grounds." Because Bayer provided the IRS with detailed spreadsheets identifying the qualified research expenditures on which its claim for credits was based, the government's argument that the taxpayer didn't provide adequate notice of the factual bases for the credits is "baseless," the court said.

It could be argued that the court's analysis in *Bayer* is at odds with the rationale articulated in *Lockheed Martin*. The Federal Circuit expressly held that the documentation presentation in the administrative stage creates the factual bases for the refund claim and that later altering it in any way should constitute substantial variance. But in *Bayer*, the taxpayer was not claiming any expenses greater than it asked for in its refund claim to the IRS. Thus, taxpayers are likely out of luck if they try to fold in additional expenses found after the original refund claim that must be raised in the refund litigation because the statute of limitations for filing a separate refund claim has expired.

Bayer exemplifies how far the government can go in requiring a taxpayer to present data to the IRS's liking. Jeff Malo of WTP Advisors told Tax Analysts that the

primary message from the case is that, at least for that specific district court, using a cost-center method that broadly identifies the business components that give rise to a credit is a valid way to support a research credit claim.

"After Bayer raised the issue of statistical sampling, the government ran the ball to the other end of the field, trying to put the taxpayer in the difficult position of re-creating its research credit through an entirely different cost accounting methodology," Malo said. "Despite the IRS's decade-long crusade against cost centers, the court accepted this method of supporting a research credit claim."

According to David L. Click of McGladrey LLP, it is typical for pharmaceutical companies to take a cost-center approach to their research and development activities. "I think that the government was trying to whipsaw Bayer by saying that the company had to demonstrate research expenses based on a business component," he said.

Click characterized the DOJ's approach to the refund litigation in *Bayer* as aggressive. "Given the history of the research credit and its intended application to encourage research activity, this litigating position is not concerned about good tax policy," he said.

Malo added that the case will continue to be of great interest until a final decision is reached. "I suspect that at some point the parties will agree to some use of statistical sampling, because the data is unmanageable otherwise," he said.

Stuart J. Bassin of Baker & Hostetler LLP said the government's argument in *Bayer* represents "a very aggressive interpretation of the variance doctrine." While the taxpayer in *Lockheed Martin* sought to recover millions in additional qualified expenses in litigation, the taxpayer in *Bayer* "was just re-sorting the data supporting the expenses it had included in its refund claim," Bassin said. If the supporting documentation is different, that alone shouldn't trigger application of the substantial variance doctrine, he said. "The variance doctrine has a long past, and the government has interpreted it differently from administration to administration, but I believe this position by the government was way out there," he said.

It is untenable for the government to argue that information provided to auditors is subject to variance, Bassin said, adding that he believes both cases were decided correctly.

Ken Jones of Sutherland Asbill & Brennan LLP said the impression among practitioners is that the government is asserting the substantial variance doctrine more than it ever did in the past. "Historically, there seemed to be a policy that substantial variance was only asserted after review at the highest levels of the Tax Division, but now it appears that government litigators are much more willing to

assert that defense, even at the late stages of a case and even though it could result in dismissal of the entire case," he said.

Tension arises because although taxpayers are not required to present every piece of evidence upfront in a refund claim, they must make the government aware of the specific grounds for a claim, Jones said. He added that it is ironic that taxpayers that litigate in the Tax Court don't have to worry about the variance doctrine, because for any year properly at issue in litigation in that forum, all relevant claims and issues can be raised.

Tax Analysts Information

Code Sections: Section 41 -- Research Credit
Section 7422 -- Refund Suits
Section 6402 -- Authority to Make Refunds
Jurisdiction: United States
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