***United States v. Commissioner of Internal Revenue, 132 T. C. 1 (2009)***

In a landmark decision, the U. S. Tax Court ruled in favor of a taxpayer, allowing the inclusion of production mold costs as qualified research expenses for the calculation of the research credit under Section 41 of the Internal Revenue Code. The court clarified that the term "property of a character subject to the allowance for depreciation" applies to the property's depreciability in the hands of the taxpayer. This ruling significantly impacts how businesses account for research and development expenses, potentially increasing their eligibility for tax credits and affecting corporate tax planning strategies.

**Parties**

The petitioner, United States, filed a petition against the respondent, Commissioner of Internal Revenue, in the U. S. Tax Court challenging the disallowance of research credits claimed for the tax years 1998 and 1999. The Commissioner had issued a notice of deficiency to the petitioner on February 6, 2006, asserting adjustments to the taxpayer's claimed research credits.

**Facts**

The petitioner, a manufacturer of injection-molded products for the automotive industry, contracted with customers to develop and produce injection-molded components. The process involved designing and constructing production molds, either in-house or through third-party toolmakers. After construction, the petitioner purchased the molds, which were then modified to meet customer specifications. Depending on the agreement, the molds were either sold to the customers or retained by the petitioner, who used them to produce the desired parts. For molds retained, the petitioner depreciated the costs and adjusted the per-unit price of the parts. For molds sold, the petitioner included the costs as qualified research expenses under Section 41 to calculate its research credit for the tax years 1997, 1998, and 1999. The Commissioner disallowed these costs, asserting they were for depreciable assets and not qualified research expenses.

**Procedural History**

The Commissioner issued a notice of deficiency to the petitioner on February 6, 2006, determining deficiencies in the petitioner's federal income tax for the years 1998 and 1999. The petitioner timely filed a petition with the U. S. Tax Court contesting the Commissioner's adjustments to its research credits. The case was submitted fully stipulated under Rule 122, and the court granted motions to file an amicus brief by Northrop Grumman Corp. The court reviewed the case de novo and ultimately held in favor of the petitioner.

**Issue(s)**

Whether the costs incurred by the petitioner for purchasing production molds from third-party toolmakers qualify as “supplies” under Section 41(b)(2)(C) and as research expenditures under Section 174, thus allowing the petitioner to include these costs in calculating its research credit?

**Rule(s) of Law**

Sections 41 and 174 of the Internal Revenue Code govern the research credit and the treatment of research and experimental expenditures, respectively. Section 41(b)(2)(C) defines “supplies” as tangible property other than land or improvements to land and property of a character subject to the allowance for depreciation. Similarly, Section 174(c) excludes from its scope expenditures for the acquisition or improvement of property of a character subject to depreciation. The court must determine the meaning of the phrase “property of a character subject to the allowance for depreciation” as used in these sections.

**Holding**

The U. S. Tax Court held that the production molds sold to customers by the petitioner are not assets of a character subject to the allowance for depreciation under Sections 41(b)(2)(C) and 174(c). Consequently, the costs of these molds can be included as the cost of supplies in calculating the petitioner’s Section 41 research credit for the tax years in question.

**Reasoning**

The court’s reasoning focused on the interpretation of the phrase “property of a character subject to the allowance for depreciation. ” The court determined that this phrase refers to property that is depreciable in the hands of the taxpayer, not to a generic character of the property itself. This interpretation was supported by a review of the statutory language, the context of other Code sections, and relevant case law. The court noted that the petitioner did not have an economic interest in the molds sold to customers and could not depreciate them, thus the molds were not of a character subject to depreciation in the petitioner’s hands. The court also considered the legislative history and the overall statutory scheme, emphasizing that the purpose of Sections 41 and 174 is to prevent taxpayers from expensing the full cost of property that should be recovered over time through depreciation. The court rejected the Commissioner’s argument that the molds’ character did not change upon sale, as the petitioner did not bear the economic risk of loss for the sold molds. The court also addressed the Commissioner’s objection to certain exhibits, ruling that they were not relevant to the de novo review of the case.

**Disposition**

The court ruled in favor of the petitioner, holding that the Commissioner’s adjustments to the petitioner’s 1998 and 1999 tax returns were erroneous and not sustained. The court directed that a decision be entered under Rule 155.

**Significance/Impact**

This decision significantly impacts the interpretation of Sections 41 and 174 of the Internal Revenue Code, clarifying that the eligibility of costs for the research credit hinges on the property's depreciability in the hands of the taxpayer. This ruling may lead to increased claims for research credits by businesses that sell depreciable assets used in research and development activities. It also underscores the importance of considering the economic interest and tax treatment of assets in the context of tax credit calculations. The decision has been cited in subsequent cases and has influenced the IRS's guidance on research credit eligibility, highlighting the need for careful analysis of the taxpayer's specific circumstances in determining the applicability of tax credits.

 