No. 02-1291

In the Supreme Court of the United States

TAX AND ACCOUNTING SOFTWARE CORPORATION, ET AL., PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

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QUESTION PRESENTED

Whether the expenses that petitioners incurred in developing computer software for sale to customers qualify for the income tax credit provided for "qualified research expenses" under Section 41(a) of the Internal Revenue Code, 26 U.S.C. 41(a).

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-27a) is reported at 301 F.3d 1254. The opinion of the district court (Pet. App. 28a-47a) is reported at 111 F. Supp. 2d 1153.

JURISDICTION

The judgment of the court of appeals was entered on August 30, 2002. The petition for rehearing was denied on December 2, 2002 (Pet. App. 48a-49a). The petition for a writ of certiorari was filed on March 3, 2003 (Monday). The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. Section 41(a) of the Internal Revenue Code provides an income tax credit for "qualified research expenses." 26 U.S.C. 41(a). Under Section 41(d) of the Code, there are four separate and independent requirements that must be satisfied for an expense to be a "qualified research expense." 26 U.S.C. 41(d). First, the expense must qualify as a "research or experimental expenditure" that may be deducted currently (and therefore need not be capitalized and amortized) under the provisions of Section 174 of the Code. 26 U.S.C. 41(d)(1)(A). Second, the research activity must have been undertaken for the purpose of "discovering information * * * which is technological in nature." 26 U.S.C. 41(d)(1)(B)(i). Third, the information to be discovered must be "intended to be useful in the development of a new or improved business component of the taxpayer." 26 U.S.C. 41(d)(1)(B)(ii). Fourth, substantially all of the research activities must have constituted "a process of experimentation" for the purpose of achieving "a new or improved function," "performance," "reliability or quality." 26 U.S.C. 41(d)(1)(C), (3).

2. Petitioner Tax & Accounting Software Corp. (TAASC) is a Subchapter S corporation that developed and improved tax and accounting software products for sale to customers during 1993 and 1994. Pet. App. 2a-3a. TAASC claims that it was entitled to the research tax credit provided by Section 41 for its software development expenses during those years.

The Internal Revenue Service disallowed the claimed research credit. The Commissioner did not dispute (i) that TAASC was entitled to a current deduction for these expenditures under Section 174 of the Code and (ii) that the purpose of the research was to further the development of a new or improved business product. The Commissioner therefore acknowledged that the first and third requirements of the Section 41 credit were satisfied. The Commissioner determined, however, that TAASC failed to satisfy the second and the fourth prerequisites of the credit—that the research be undertaken for the purpose of "discovering information which is technological in nature" (26 U.S.C. 41(d)(1)(B)(i)) and that substantially all of the research activities constituted a "process of experimentation" (26 U.S.C. 41(d)(1)(C)).

3. When the Internal Revenue Service disallowed the claimed credit, petitioners paid the resulting tax and brought this suit for a refund. Pet. App. 4a. The district court ruled in petitioners' favor. *Id.* at 28a-47a. The court held that the "discovery" requirement of Section 41(d)(1)(B)(i) does not require a discovery of new technological information but instead requires only that the taxpayer use technological information in the course of developing a product. The court concluded that this minimal requirement was met in this case because TAASC employed technological information in developing new software products. *Id.* at 9a-10a, 39a-43a. The court further held that these software development activities satisfied the "process of experimentation" requirement of Section 41(d)(1)(C) because TAASC investigated and applied alternative programming techniques in the course of developing its final software programs. *Id.* at 46a.

4. The court of appeals reversed. Pet. App. 1a-27a. The court concluded that the district court made two separate errors in allowing the research credit in this case.

First, the court held that the district court failed to honor the plain text of the statute and improperly "read the 'discovering information' language out of the statute." Pet. App. 16a. The court pointed out that, as used in Section 41(d)(1)(B), the word "discover" requires that "what is 'discovered'—in this case, information—be something new or previously unknown." *Id.* at 14a-15a (footnote omitted). The court concluded that "[t]he term 'discovery' means that the researcher must find new information or, in other words, must expand existing knowledge." *Id.* at 16a. The court further held that, because the information discovered must be "useful in the development of a new or improved business component" (26 U.S.C. 41(d)(1)(B)(ii)), the new information discovered by the taxpayer "cannot merely be the product itself but must also have independent value that can be applied in the development of a new product." *Id.* at 15a.

The court of appeals also rejected petitioners' argument that the use of alternative programming techniques in the development of computer software constitutes a "process of experimentation" for purposes of Section 41(d)(1)(C). Pet. App. 26a. The court noted that the "legislative history suggests that the credit is inapplicable when the final design is certain at the outset or the taxpayer knows how to achieve the result at the beginning of the claimed research." *Id.* at 23a. The court explained that (*id.* at 26a):

> TAASC's interpretation of the statute would allow relatively basic activities, such as debugging software, to be included as "experimentation" within the scope of § 41. *See United Stationers*, 163 F.3d at 445. Debugging software often requires the utilization of multiple known methods to eliminate the bug from the software. The software developer often has little or no doubt that one of the methods

> will eliminate the bug. Thus, without the government's limitation on what "experimentation" can mean, all debugging would qualify for the tax credit. The legislative history quoted above indicates that Congress did not intend such a result. We are further persuaded by the maxim that tax credits are to be narrowly interpreted. *See New Colonial Ice Co.*, 292 U.S. at 440. In enacting the § 41 credit, Congress did not repeal the deduction under § 174, suggesting that less risky research activities were to remain deductible, not creditable.

The court concluded that petitioners failed to qualify for the Section 41 research credit because the product developed was "technically feasible" from the outset and no bona fide "process of experimentation" was required. Pet. App. 27a.

ARGUMENT

The decision of the court of appeals is correct and does not conflict with any decision of this Court or any other court of appeals. Further review is therefore not warranted.

1. a. The court correctly held in this case that the Section 41 research tax credit is not available when the taxpayer has not sought to "discover" new technological information that is "separate from the new products that it developed." Pet. App. 27a. The other courts that have addressed the "discovery" requirement of Section 41 have reached the same result reached by the Tenth Circuit in this case. See, *e.g.*, *Eustace* v. *Commissioner*, 312 F.3d 905 (7th Cir. 2002), petition for cert. pending, No. 02-1367; *Wicor, Inc.* v. *United States*, 263 F.3d 659 (7th Cir. 2001); *United Stationers, Inc.* v. *United States*, 163 F.3d 440 (7th Cir. 1998), cert. denied, 527 U.S. 1023 (1999); *Norwest Corp.*

v. *Commissioner*, 110 T.C. 454, 496 (1998). As the court stated in *United Stationers, Inc.*, 163 F.3d at 444, "discovery demands something more than mere superficial newness; it connotes innovation in underlying principle." There is thus no conflict among the circuits to warrant further review of the decision in this case.

b. Petitioners nonetheless assert (Pet. 19) that the Section 41 research credit should be made available to TAASC in this case because it can satisfy a more lenient "discovery" test contained in certain proposed regulations issued by the Treasury on December 26, 2001. 66 Fed. Reg. 66,362. The effort to rely on these proposed regulations, however, is plainly misplaced. These proposals have not been adopted as final regulations, and they therefore remain subject to modification or further consideration by the agency.[1] It is well established that such proposed regulations have "no precedential authority." *Teweleit* v. *Hartford Life & Accident Ins. Co.*, 43 F.3d 1005, 1009 (5th Cir. 1995). See *Telecom*USA, Inc.* v. *United States*, 192 F.3d 1068, 1080 (D.C. Cir. 1999); *In re Appletree Markets, Inc.*, 19

[1] The proposed regulations that were issued on December 26, 2001 (on which petitioners seek to rely) would displace the final regulations under Section 41 that were adopted by the Secretary of the Treasury, after notice and comment, on January 3, 2001. 2001-1 C.B. 433. The final regulations adopted in January 2001 set forth a "discovery" test that is consistent with the interpretation adopted by the court of appeals in this case and by the Seventh Circuit in *United Stationers*. Pet. App. 12a-13a. Because this case involves tax years that concluded before those regulations were adopted, the Tenth Circuit correctly noted that neither the regulations adopted in January 2001 nor the amendments to those regulations proposed in December 2001 apply to this case. *Id.* at 11a.

F.3d 969, 973 (5th Cir. 1994) ("proposed regulations are not entitled to judicial deference"); *Garvey, Inc.* v. *United States*, 726 F.2d 1569, 1571-1572 (Fed. Cir. 1984).

c. Petitioners contend that the Seventh and Tenth Circuits, the Tax Court, and several district courts have all erred in rejecting the contentions that they raise in this case. Pet. 16. In particular, petitioners claim that these courts erred by failing to "follow the legislative history" of these statutory provisions. *Ibid.* That legislative history, however, does not support petitioners' claims.

Petitioners argue that, in enacting Section 41 in 1986, Congress meant to incorporate a predecessor statute that had specified in 1981 that "qualified research" generally "has the same meaning * * * as has the term 'research or experimental' under § 174." Pet. 18 (quoting S. Rep. No. 144, 97th Cong., 1st Sess. 81 (1981)). As the Tenth Circuit carefully explained in rejecting that contention in this case (Pet. App. 21a), in enacting Section 41 in 1986, Congress expressly imposed *additional* restraints on this tax credit precisely because the language of the *prior* statute had proved too broad. S. Rep. No. 313, 99th Cong., 2d Sess. 694-695 (1986); H.R. Rep. No. 426, 99th Cong., 1st Sess. 178 (1985).[2] As set forth in detail above, Section 41(d)

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[2] The court correctly rejected petitioners' assertion that the requirements of the research credit should be deemed satisfied whenever the expense would qualify for a current deduction under Section 174. The court explained that (Pet. App. 15a-16a n.8):

> We reject TAASC's argument that the § 41 discovery requirement should be the same as the one for § 174. We find it difficult to understand how Congress, when it drafted the "discovering information" requirement of § 41 in 1986, intended to adopt a definition of "discovering information" that

imposes *four* discrete requirements for research to constitute qualified research (see page 2, *supra*) and only the *first* of these requirements is that the expenses be deductible under Section 174. 26 U.S.C. 41(d)(1)(A). In addition, the taxpayer must establish that the research was undertaken for the purpose of discovering information that is technological in nature (26 U.S.C. 41(d)(1)(B)(i)), that the information discovered is intended to be useful in the development of a new or improved business component of the taxpayer (26 U.S.C. 41(d)(1)(B)(ii)), and that substantially all of the research activities constitute elements of a process of experimentation (26 U.S.C. 41(d)(1)(C)).

If, as petitioners contend, all expenses that qualify for deduction under Section 174 automatically satisfy the requirements of Section 41(d), the experimentation test and the discovery test of the statute would simply be superfluous. Petitioners' strained contention thus manifestly conflicts with the settled principle that statutes are not to be read in a manner that fails to give separate meaning to each of their provisions. See *Hohn* v. *United States*, 524 U.S. 236, 249 (1998); *Dunn* v. *Commodity Futures Trading Comm'n*, 519 U.S. 465, 472 (1997); *United Food & Commercial Workers Union* v. *Brown Group, Inc.*, 517 U.S. 544, 550 (1996) ("the more natural reading of the statute's text, which would give effect to all of its provisions, always prevails over a mere suggestion to disregard or ignore duly enacted law as legislative oversight").

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was only developed in the Treasury Regulations *after* § 41 was enacted. *See* Credit for Increasing Research Activities, 66 Fed.Reg. at 66,363; Research or Experimental Expenditures, 58 Fed.Reg. 15,819, 15,820 (Mar. 24, 1993) (proposing the definition of "discovering information" for § 174).

d. Petitioners also err in asserting (Pet. 25-28) that the court of appeals improperly failed to consider more recent legislative reports (H.R. Conf. Rep. No. 478, 106th Cong., 1st Sess. (1999) and H.R. Conf. Rep. No. 825, 105th Cong., 2d Sess (1998)) that accompanied legislation that extended, but did not amend or otherwise modify, Section 41. As the court of appeals correctly observed, post-enactment pronouncements by a later Congress as to what an earlier Congress intended are an unreliable indicator of legislative intent. Pet. App. 23a. See *Reno* v. *Bossier Parish Sch. Bd.*, 520 U.S. 471, 484-485 (1997) (the Court "doubt[ed] that Congress" would amend the statute "by dropping a footnote in a Senate Report instead of amending the statute itself"); *Pierce* v. *Underwood*, 487 U.S. 552, 566-567 (1988) ("it is the function of the courts and not the Legislature, much less a Committee of one House of the Legislature, to say what an enacted statute means"); *O'Gilvie* v. *United States*, 519 U.S. 79, 90 (1996) ("the view of a later Congress cannot control the interpretation of an earlier enacted statute").

The cases cited by petitioners (Pet. 25-26) are inapposite. They indicate that subsequent *legislation* that declares the intent of an earlier statute is entitled to some deference in statutory construction. See, *e.g.*, *Bell* v. *New Jersey*, 461 U.S. 773, 785 (1983) ("Not only have Members of Congress stated their views, but Congress has acted on those views."); *id.* at 785 n.12 (quoting *Mount Sinai Hosp.* v. *Weinberger*, 517 F.2d 329, 343 (5th Cir. 1975) ("Congress is not merely expressing an opinion * * * but is acting on what it understands its own prior acts to mean.")); *Andrus* v. *Shell Oil Co.*, 446 U.S. 657, 666 n.8 (1980). In the present case, by contrast, no substantive statutory amendment or revision accompanied the committee reports on which petitioners rely. The court of appeals therefore correctly gave weight to the views of the Congress that enacted Section 41, not to the views of a different Congress that were expressed in reports authored more than a decade after that enactment.

e. The public policy arguments advanced by petitioners (Pet. 2-3, 15-17, 29) are both invalid and irrelevant. It is the statutes enacted by Congress, not the arguments of counsel, that determine the public policy of the United States. Congress has seen fit to deny the research tax credit for routine product development activities and to allow the credit only for activities that intend to discover information that is technological in nature and that results from a true process of experimentation. Routine software development activities do not qualify for the Section 41 credit because they are not qualified research under the statutory language.

Whether that is good public policy is a matter for Congress, not the courts. *Brogan* v. *United States*, 522 U.S. 398, 408 (1998); *Dunn*, 519 U.S. at 479-80; *United States* v. *Noland*, 517 U.S. 535, 541-542 n.3 (1996) ("Noland may or may not have a valid policy argument, but it is up to Congress, not this Court, to revise the determination if it so chooses."); *Badaracco* v. *Commissioner*, 464 U.S. 386, 398 (1984) ("The relevant question is not whether, as an abstract matter, the rule advocated by petitioners accords with good policy. The question we must consider is whether the policy petitioners favor is that which Congress effectuated by its enactment of § 6501.").

Moreover, for the reasons correctly noted by the court of appeals, the public policy arguments advanced by petitioners are ill-conceived in any event (Pet. App. 26a):

> [T]he very uncertainty of the research is a rationale for the tax credit in the first place. Allowing experimentation to qualify for the tax credit where the feasibility of the final result was certain would undermine that rationale, and might encourage companies to be more conservative in their allocation of resources, concentrating on problems with a solution that is evident from the outset.

It should be noted in this regard that TAASC has been allowed a current *deduction* for the expenses it incurred in creating the new software products. As the court of appeals emphasized, the conclusion that Congress did not intend to allow a tax *credit* for these routine product development expenses is firmly grounded in the language of Section 41 and its legislative history. Pet. App. 14a-17a.

2. The court of appeals also correctly held that the research tax credit is unavailable in this case because the software development activities of TAASC did not involve a "process of experimentation" (26 U.S.C. 41(d)(1)(C)), as the statute requires. Pet. App. 26a. As the court made clear, this additional holding is independently sufficient to support the judgment in this case even if the assertions advanced by petitioners regarding the proper scope of the "discovery" test had been accepted. *Ibid*.

The court correctly explained that, for a "process of experimentation" to occur, there must at a minimum be uncertainty about "which method [of research] will allow the taxpayer to achieve the result." Pet. App. 20a. If the taxpayer knows in advance not only *whether* a result can be achieved but *how* that result is to be achieved, the application of that known method is not an "experiment." *Id.* at 20a-21a. Other courts have consistently agreed with the government that "qualifying research must from its outset involve some technical uncertainty about the possibility of developing the product" and that "debugging programs" therefore cannot constitute a "process of experimentation." *Id.* at 22a (quoting *United Stationers*, 163 F.3d at 446). As the court concluded below, there must "be uncertainty as to whether the final result can be achieved for the 'process of experimentation' test to be satisfied." *Id.* at 19a.

Even though this consistent precedent is adverse to petitioners' claim in this case, they argue that TAASC's activities nonetheless satisfy the "process of experimentation" requirement contained in the proposed regulations issued by the Treasury in December 2001. For the reasons already described, these proposed regulations have not been adopted and have no application to this case. See note 1, *supra*. Moreover, even if the proposed regulations were adopted, petitioners could not prevail on the "process of experimentation" test. Section 1.41-4(a)(5)(ii) of the proposed regulations, 66 Fed. Reg. at 66,368, provides:

> A taxpayer's activities do not constitute elements of a process of experimentation where the capability and method of achieving the desired new or improved business component, and the appropriate design of the desired new or improved business component, are readily discernible and applicable as of the beginning of the taxpayer's research activities, so that true experimentation in the scientific or laboratory sense would not have to be undertaken to test, analyze, and choose among viable alternatives. A process of experimentation does not in-

clude any activities to select among several alternatives that are readily discernible and applicable.

The software development activities conducted by petitioner involved the application of widely-used and well-known programming techniques to create new software products. Those activities do not constitute a "process of experimentation" either under the established case law or under the last sentence of the quoted portion of the proposed regulations.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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APRIL 2003