

**IN THE UNITED STATES DISTRICT COURT
FOR THE WESTERN DISTRICT OF TENNESSEE
WESTERN DIVISION**

FEDEX CORPORATION (formerly	)	
known as FDX CORPORATION)	)	
successor as common parent to	)	
FEDERAL EXPRESS CORPORATION	)	
and Subsidiaries,	)	
	)	
Plaintiff,	)	
	)	
v.	)	No. 08-2423
	)	
UNITED STATES OF AMERICA,	)	
	)	
Defendant.	)	

ORDER GRANTING PLAINTIFF’S MOTION FOR PARTIAL SUMMARY JUDGMENT

Before the Court is Plaintiff FedEx Corporation’s (“FedEx”) February 11, 2009 motion for partial summary judgment on the legal standards governing certain research tax credits FedEx claims under 26 U.S.C. § 41. More specifically, FedEx seeks summary judgment on the legal standard for the “discovery” test under 26 U.S.C. § 41(d)(1)(B) and the “internal use software” test under 26 U.S.C. § 41(d)(4)(E). The Defendant responded on March 16, 2009, and Plaintiff replied on March 24, 2009. For the reasons set forth below, Plaintiff’s motion for partial summary judgment is GRANTED.

I. BACKGROUND

A. Factual Background

Because Plaintiff's motion is an attempt to resolve a pure issue of law, the following facts from Plaintiff's Memorandum are provided only as background and do not bear on the legal issue presented in the motion. In 1996, FedEx management identified a need for a new computer business system with better revenue controls to ensure timely and accurate billing and to eliminate "revenue leakage." (Pl. Mem. 3.) No existing client-server system was capable of processing data at volumes comparable to FedEx transaction volumes, so FedEx embarked on a research project to develop a new and innovative technology. (Id. at 5.) Ultimately, the technological challenges associated with the project were too great to overcome, and FedEx abandoned the project in 2001. (Id. at 7.)

FedEx incurred substantial expenditures researching and developing the project. (Id.) On its federal income tax returns for fiscal years ending May 1997 through May 2000, FedEx claimed certain "qualified research expenses" for the project. (Id.) As a result, FedEx claimed research tax credits under 26 U.S.C. § 41. (Id. at 8.) The Internal Revenue Service ("IRS") denied the research tax credits. (Id.) Plaintiff filed this action on June 26, 2008, seeking recovery of \$11,647,819 in federal income taxes assessed against and collected from Plaintiff by Defendant for the taxable years 1997 through 2000. (Compl. ¶ 1.)

B. Regulatory History

To qualify for the research tax credit, the research activity must be “qualified research” as defined in 26 U.S.C. § 41(d). Although there are several aspects of this definition, the parties disagree only on the appropriate legal standard to determine whether Plaintiff’s research satisfies the “discovery” test and the “internal use software” test. Research on computer software by (or for the benefit of) the taxpayer primarily for internal use by the taxpayer is not considered “qualified research” except to the extent provided in the regulations. 26 U.S.C. § 41(d)(4)(E). The Secretary of the Treasury has issued several sets of regulations under 26 U.S.C. § 41 that address the definition of a “qualified research expense.”

On January 3, 2001, the Treasury issued final regulations (“2001 Final Regulations”) that were effective for expenditures paid or incurred on or after January 3, 2001, but the regulations addressing internal use software were applicable to years beginning after December 31, 1985. T.D. 8930, 66 Fed. Reg. 280. The 2001 Final Regulations impose a “discovery” test that requires that research be undertaken to “obtain knowledge that exceeds, expands, or refines the common knowledge of skilled professionals in a particular field of science or engineering.” T.D. 8930 § 1.41-4(a)(3). Under the 2001 Final

Regulations, "internal use software" may be eligible for the "qualified research" credit if:

(A) The software is innovative in that the software is intended to result in a reduction in cost, improvement in speed, or other improvement, that is substantial and economically significant;

(B) The software development involves significant economic risk in that the taxpayer commits substantial resources to the development and there is a substantial uncertainty, because of technical risk, that such resources would be recovered within a reasonable period; and

(C) The software is not commercially available for use by the taxpayer in that the software cannot be purchased, leased, or licensed and used for the intended purpose without modifications that would satisfy the requirements of paragraphs (c)(6)(vi)(A) and (B) of this section.

T.D. 8930 §§ 1-41(c)(6)(vi)(A)-(C).

On December 26, 2001, the Treasury published proposed regulations under 26 U.S.C. § 41 ("Proposed Regulations"). 66 Fed. Reg. 66362. The Proposed Regulations were proposed to apply to taxable years ending on or after December 26, 2001.

Id. "Notwithstanding this prospective effective date, Treasury and the IRS believe that these rules prescribe the proper treatment of the expenditures they address, and the IRS generally will not challenge return positions consistent with the proposed regulations." Id. Based on comments, "the statute and legislative history, the Treasury and the IRS have determined that the definition of qualified research set out in T.D. 8930 [the 2001 Final Regulations] does not fully address Congress' concerns regarding the importance of research

activities to the U.S. economy.” Id. The IRS explained their rationale for changes to the “discovery” test contained in the Proposed Regulations as follows:

Accordingly, Treasury and the IRS have eliminated in these proposed regulations the requirement that qualified research must be undertaken to obtain knowledge that exceeds, expands, or refines the common knowledge of skilled professionals in a particular field of science or engineering. Rather, Treasury and the IRS believe that the requirement that qualified research be “undertaken for the purpose of discovering information which is technological in nature” is intended to distinguish technological research, which may qualify for the research credit, from non-technological research, which does not.

Id.

The Proposed Regulations were finalized on December 31, 2003 (the “2003 Final Regulations”). T.D. 9104, 69 Fed. Reg. 22. “Because these final regulations only clarify the provisions of the 2001 proposed regulations, these final regulations apply to taxable years ending on or after December 31, 2003.” Id. “For taxable years ending before December 31, 2003, the IRS will not challenge return positions that are consistent with these final regulations.” Id.

The “discovery” test set out in the Proposed Regulations and adopted in the 2003 Final Regulations differs dramatically from the “discovery” test found in the 2001 Final Regulations. Under the 2003 Final Regulations, the “discovery” test may be satisfied by research that “is intended to eliminate certain

uncertainty concerning the development or improvement of a business component.” T.D. 9104 § 4.41-4(a)(3).

The 2003 Final Regulations do not adopt the “internal use software” test from the Proposed Regulations. No new “internal use software” test was adopted in the 2003 Final Regulations; instead, §4.41-4(c)(6) is marked “Reserved.” T.D. 9104 § 4.41-4(c)(6).

On February 9, 2004, the IRS invited comments on the internal use software test. Acknowledging that the 2003 Final Regulations did not address internal use software, the IRS provided the following guidance to taxpayers:

With respect to internal-use software for taxable years beginning after December 31, 1985, and until further guidance is published in the Federal Register, taxpayers may continue to rely upon all of the provisions relating to internal-use software in the 2001 proposed regulations (66 FR 66362). Alternatively, taxpayers may continue to rely upon all of the provisions relating to internal-use software in T.D. 8930 (66 FR 280). For example, taxpayers relying upon the internal-use software rules of T.D. 8930 must also apply the “discovery” test as set forth in T.D. 8930.

Announcement 2004-9, 2004-6 I.R.B. 441, 2004 WL 228516 (“2004 Announcement”).

II. JURISDICTION

This Court has jurisdiction under 28 U.S.C. § 1346(a)(1) over this action because it is a “civil action against the United States for the recovery of any internal-revenue tax

alleged to have been erroneously or illegally assessed or collected....” Id.

III. STANDARD OF REVIEW

Federal Rule of Civil Procedure 56(c) provides that summary judgment is proper “if the pleadings, discovery and disclosure material on file, and any affidavits show that there is no genuine issue as to any material fact and that the movant is entitled to judgment as a matter of law.” Fed. R. Civ. P. 56(c); Celotex Corp. v. Catrett, 477 U.S. 317, 322 (1986). Plaintiff seeks summary judgment on the purely legal question of the tests the IRS should have applied to determine whether FedEx was eligible for research tax credits for “qualified research expenses.”

Treasury Department regulations are “given controlling weight unless they are arbitrary, capricious, or manifestly contrary to the statute.” See Chevron U.S.A. Inc., v. Natural Res. Def. Council, 467 U.S. 837, 843 (1984). Courts should enforce such regulations as long as they have a rational basis and are reasonably related to the purposes of the enabling legislation. See Martin v. Occupational Safety and Health Review Comm’n, 499 U.S. 144, 150-51 (1991).

Although an agency’s interpretation of its own regulations is entitled to deference, interpretations that lack the force of law do not warrant Chevron-style deference. Christensen v.

Harris County, 529 U.S. 576, 587 (2000) (citing Skidmore v. Swift & Co., 323 U.S. 134, 140 (1944)). Under the Administrative Procedure Act, an agency's interpretation of its own regulations "must be given controlling weight unless it is 'plainly erroneous or inconsistent with the regulation.'" Flamingo Exp., Inc. v. F.A.A., 536 F.3d 561, 567-68 (6th Cir. 2008) (citing Battle Creek Health Sys. v. Leavitt, 498 F.3d 401, 409 (6th Cir. 2007) (quoting Thomas Jefferson Univ. v. Shalala, 512 U.S. 504, 512 (1994))). "To be sure, we are not required to defer to the [agency's] interpretation if an 'alternative reading is compelled by the regulation's plain language or by other indications of the [agency's] intent at the time of the regulation's promulgation.'" U.S. v. Cinemark USA, Inc., 348 F.3d 569, 578 (6th Cir. 2003) (citing Thomas Jefferson Univ., 512 U.S. at 512). "[D]eference is warranted only when the language of the regulation is ambiguous." Christensen, 529 U.S. at 588. "If the language of the regulation is clear, then '[t]o defer to the agency's position would be to permit the agency, under the guise of interpreting a regulation, to create a *de facto* new regulation.'" Kentucky Waterways Alliance v. Johnson, 540 F.3d 466, 474-74 (6th Cir. 2008) (quoting Christensen, 529 U.S. at 588).

IV. ANALYSIS

Plaintiff argues that the 2003 Final Regulations set out the “discovery” test that governs this case. See 26 C.F.R. § 1.41-4(a)(3)(i) and (iii). Plaintiff also contends that the 2001 Final Regulations set forth the “internal use software” test that governs this case. See 26 C.F.R. § 1.41-4(c)(6)(vi). Defendant responds that Plaintiff cannot cut and paste portions of the 2001 and 2003 Final Regulations in crafting the legal standards to be applied. According to the Defendant, the 2001 Final Regulations apply to the Plaintiff because the tax years at issue are 1997 through 2000. In the alternative, Defendant’s memorandum suggests that Plaintiff could choose to rely on the provisions of the 2001 Proposed Regulations at 66 F.R. 66362.

The Secretary of the Treasury has the authority to “prescribe all needful rules and regulations for the enforcement” of the internal revenue laws. 5 U.S.C. § 7805(a). Those regulations, when consistent with and reasonably adapted to enforcement of the statutes, must be sustained. Comm’r of Internal Revenue v. Portland Cement Co. of Utah, 450 U.S. 156, 169 (1981) (citing Comm’r v. South Texas Lumber Co., 333 U.S. 496, 501 (1948)). When the Treasury wants to change the effect of an existing regulation, “it may amend its regulations to provide for a different one.” United Dominion Indus., Inc. v. United States, 532 U.S. 822, 838 (2001).

Plaintiff maintains that it may rely on the 2003 Final Regulations. The preamble to the 2003 Final Regulations and the Proposed Regulations support Plaintiff's position. The issue is what effect to give the absence of the "internal use software" test in the 2003 Final Regulations. Plaintiff argues that, because the Treasury has not issued a final regulation revising its position on the "internal use software" test, Plaintiff should apply the "internal use software" test contained in the 2001 Final Regulations.

Defendant contends that the 2004 Announcement reflects the IRS' interpretation of the regulation—that a taxpayer seeking a credit for internal use software must comply with the 2001 Final Regulations or the Proposed Regulations. Defendant argues that the "discovery" and "internal use software" provisions are not severable. It cites North Carolina v. Environmental Protection Agency, 531 F.3d 896, 929 (D.C. Cir. 2008) for the proposition that "severance and affirmance of a portion of an administrative regulation is improper if there is 'substantial doubt' that the agency would have adopted the severed portion on its own." According to the Defendant, the IRS' 2004 Announcement provides substantial doubt that the agency intended the regulation to be severable.

North Carolina is inapposite here because there is a significant difference between affirming a regulation, what the

Court in North Carolina was called to do, and determining what regulations apply to a taxpayer. This Court is not being asked to sever a regulation. The 2003 Final Regulations do not provide for "internal use software," and the question is how to construe the absence of that provision.

An agency's interpretation of its own regulation is due deference only when consistent with the regulation. Here, the IRS impermissibly attempts to amend the 2003 Final Regulations with an announcement. See United Dominion Indus., Inc., 532 U.S. at 838. The 2004 Announcement purports to permit taxpayers to disregard changes in the 2003 Final Regulations, which the Treasury and the IRS state they believe "prescribe the proper treatment of the expenditures they address," 66 Fed. Reg. 66362, and apply the 2001 Final Regulations or the Proposed Regulations. The Treasury and the IRS have clearly stated that the 2001 Final Regulations do not accurately reflect Congressional intent regarding the "discovery" test, 66 Fed. Reg. 66362, and, yet, Defendant now seeks to require Plaintiff to satisfy that test in its former, inadequate incarnation.

Consideration of the statute to which these regulations pertain also suggests that the regulations interpreting the "discovery" test and defining the exception for "internal use software" need not be applied together. 26 U.S.C. § 41(d)(1)(B) states that "'qualified research'" means research... "which is

undertaken for the purpose of discovering information—(i) which is technological in nature, and (ii) the application of which is intended to be useful in the development of a new or improved business component of the taxpayer....” The “discovery” test set forth in the regulations seeks to interpret this statutory provision. The IRS has changed its interpretation and provided valid reasons for its changed position. The Defendant now asks the Court and the Plaintiff to disregard the IRS’ stated rationale for changing its interpretation of the “discovery” test.

Twenty-six U.S.C. § 41(d)(4)(E) states that “[e]xcept to the extent provided in regulations, any research with respect to computer software which is developed by (or for the benefit of) the taxpayer primarily for internal use by the taxpayer...” is not “qualified research.” (emphasis added). Because this provision includes a specific grant of rulemaking authority to issue regulations, the “internal use software” regulations are “legislative” regulations issued under delegated legislative authority. The only regulations issued by the Treasury pursuant to this rulemaking authority that pertain to “internal use software” are contained in the 2001 Final Regulations.

The Treasury may issue Temporary Regulations, when immediate guidance is important. 26 U.S.C. §§ 7805(a) and (e); see, e.g., 71 Fed. Reg. 31128 (temporary regulations providing

guidance under section 199 for taxpayers providing computer software to customers for the customers' direct use while connected to the Internet). Temporary Regulations have the same authoritative effect as Final Regulations, must also be issued as Proposed Regulations, and automatically expire within three years after the date of issuance. 26 U.S.C. § 7805(e). The Treasury could have issued Temporary Regulations to address the "internal use software" provision, but the IRS chose, instead, to rely on an announcement to articulate its position. The 2004 Announcement does not override the Treasury's 2003 Final Regulations, which carry the force and effect of law.

An agency's interpretation of its own regulation is owed substantial deference only when it is consistent with the regulation it interprets. The Court is not required to defer to the IRS' interpretation "if an 'alternative reading is compelled by... other indications of the [IRS'] intent at the time of the regulation's promulgation.'" Cinemark USA, Inc., 348 F.3d at 578 (quoting Thomas Jefferson Univ., 512 U.S. at 512). When the Proposed Regulations and the 2003 Final Regulations were promulgated, the Treasury and the IRS clearly stated their intent to revise the "discovery" test to reflect Congressional intent. The IRS' subsequent attempt to require Plaintiff to adhere to the "discovery" test embodied in the 2001 Final Regulations is contrary to the IRS' stated intent in adopting

the 2003 Final Regulations and contrary to the IRS' stated understanding of Congressional intent. Accordingly, the IRS' interpretation in the 2004 Announcement is not due substantial deference.

Plaintiff may rely on the "discovery" test set forth in the Proposed Regulations and the 2003 Final Regulations. See 26 C.F.R. § 1.41-4(a)(3)(i) and (iii). Treasury and the IRS have explained that the revised "discovery" test reflects Congressional intent. Although the 2003 Final Regulations apply only to taxable years ending on or after December 31, 2003, the Regulations themselves provide that the IRS will not challenge return positions consistent with the 2003 Final Regulations for taxable years ending before December 31, 2003.

Plaintiff may rely on the "internal use software" test set forth in the 2001 Final Regulations. In 2001, the Treasury issued final regulations addressing the "internal use software" exception at 26 U.S.C. § 41(d)(4)(E). The Treasury may change the effect of an existing regulation by amending it to provide for a different outcome. United Dominion Indus., Inc., 532 U.S. at 838. The Treasury has never amended the definition of "internal use software" contained in the 2001 Final Regulations. It has not issued new regulations that alter the definition of "internal use software." The 2003 Final Regulations have no effect on the legal standard for "internal use software." The

only regulations that the Treasury has issued pursuant to its delegated rulemaking authority that address the “internal use software” exception are the 2001 Final Regulations. Therefore, Plaintiff may rely on the “internal use software” test from the 2001 Final Regulations at 26 C.F.R. § 1.41-4(c)(6)(vi).

V. CONCLUSION

For the foregoing reasons, Plaintiff’s motion for partial summary judgment is GRANTED.

So ordered this 9th day of June, 2009.

s/ Samuel H. Mays, Jr.
SAMUEL H. MAYS, JR.
UNITED STATES DISTRICT JUDGE