

Office of Chief Counsel
Internal Revenue Service
Memorandum

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Via Regular Mail

date: February 8, 2013

to:

Revenue Agent
(Large Business & International)

from:

Attorney
(Large Business & International)

subject: Treatment of Voluntary Separation Payments as Qualified Research Expenditures Under I.R.C. § 41

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This memorandum responds to your e-mail request dated Date 1, requesting our Office's assistance in determining whether the voluntary separation payments described herein are qualified research expenditures for purposes of I.R.C. § 41.

LEGEND

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Year 1 =
Taxpayer =
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ISSUE

The issue in this case is whether separation payments paid by Taxpayer to certain salaried employees who voluntarily separated from the company pursuant to a Voluntary Separation Program ("VSP") initiated by Taxpayer are qualified research expenditures ("QREs") for purposes of section 41. If the VSP payments are QREs, Taxpayer would be allowed to claim the section 41 credit for increasing research activities. The determination of whether the VSP payments are QREs requires an analysis of whether the payments are deductible expenses for purposes of section 174.

The regular wages paid to the separated employees are not at issue in this case and are assumed to represent reasonable compensation expenditures paid to engineers or other similarly employed individuals engaged in qualified research on behalf of the Taxpayer.

CONCLUSION

The VSP payments paid by Taxpayer to certain salaried employees who voluntarily separated from the company are not deductible expenses for purposes of section 174. Therefore, the payments do not qualify as QRE's for purposes of section 41 and Taxpayer should not be allowed to claim the VSP payments under section 41 as a credit for increasing research activity. In addition, Taxpayer has not shown the required nexus between the payments and qualified research for the VSP payments to be considered QREs under section 41.

In this case, we do not address, and no inference is intended regarding, the federal income tax treatment of the regular wages paid to the separated employees.

FACTS

The facts of this case are as follows:

In Year 1, Taxpayer claimed \$Amount 1 of includable VSP payments as QREs across several of its subsidiaries as set forth below:

Subsidiary	VSP Amount (\$)
Subsidiary 1	Amount 2
Subsidiary 2	Amount 3

Subsidiary 3	Amount 4
Subsidiary 4	Amount 5
Subsidiary 5	Amount 6
Subsidiary 6	Amount 7
Subsidiary 7	Amount 8
Subsidiary 8	Amount 9
Subsidiary 9	Amount 10
Subsidiary 10	Amount 11
Subsidiary 11	Amount 12
Total	Amount 1

In its response to an Information Document Request (“IDR”) issued by the Service, Taxpayer stated it made VSP payments as part of a voluntary workforce reduction program which was necessitated by the implementation of a new global operating model combining Division 1 and Division 2 into a single business unit, Division 3. Eligibility to participate in the VSP was limited to specific positions and designed to eliminate surplus employment.

Taxpayer did not treat the combining of Division 1 and Division 2 into Division 3 as a section 338 reorganization. Division 1 and Division 2 were not separate legal entities but business divisions within the same legal entity, which Taxpayer restructured during the tax year.

VSP QREs were only claimed for salaried, not hourly, personnel. In return for agreeing to separate from the company, Taxpayer had each target employee complete a separation package which included, *inter alia*, agreements to:

- 1) Fully and forever release and discharge the Company from all claims as stipulated;
- 2) Refrain from applying for or accepting employment with the Company, its subsidiaries and affiliates;
- 3) Sign a restrictive covenant (employees above a certain grade) to refrain from competing with the Company for A to B years;
- 4) Not disclose trade secrets or confidential information; and
- 5) Not disclose the terms of the VSP.

Pursuant to the terms of the VSP separation package, employees were required to execute a document titled “Title 1” (the “Release”), which governed the severance payments and the manner in which the severance payments would be provided to the employee. Upon acceptance of the terms of the VSP, including the conditions outlined in the Release, the employee generally received a lump sum payment equal to C or D months of their current base annual salary (less applicable withholding). The VSP payments to any eligible employee (regardless of department) were generally based on a formula using base salary at the time of separation and years of service on the date of separation according to the following table:

Years of Service	Months of Pay
Less than E	M
E	E
F	N
G	F
H	O
I	G
J through K	P
More than L	Q

In addition, the Release set forth that the employee and Taxpayer agreed that the severance payment was in addition to other compensation that the employee was entitled to receive. Employees could not defer any portion of the severance payment. The Release also governed payments in the event of the employee's untimely death prior to the date that payment was scheduled to be made and set forth that the severance payment would be paid in a lump sum to the employee's designated beneficiaries, or its estate, as soon as possible after notification of death. Accordingly, the severance payments were paid based on the employee's salary and years of service, and paid directly to the employee or the employee's estate or beneficiaries, in exchange for the cessation of employment. The severance payment would be included in W-2 earnings; paid from the general funds as payroll; and subject to federal, state, social security, and Medicare taxes as at the time of payment. The Release also set forth that the manner of receiving the severance payment could not be changed at a later date.

The Release advised employees on post-employment benefits including health and life insurance, group life and optional life insurance, retirement savings and investments, and pension benefits. The Release also governed any future reemployment with the Taxpayer or any subsidiary or affiliate of the Taxpayer. Employees were required to agree to refrain from applying for or accepting reemployment with the Taxpayer or any subsidiary or affiliate of the Taxpayer. A violation of such clause could subject the previously severed employee to lawful termination pursuant to the terms of the Release.

LAW & ANALYSIS

Section 41 of the Internal Revenue Code allows taxpayers a credit against taxes for increasing research activities. In general, the credit is an incremental credit equal to the sum of 20 percent of the excess (if any) of the taxpayer's "qualified research expenses" for the taxable year over the base amount. I.R.C. § 41(a)(1).

The research credit was introduced with the enactment of the Economic Recovery Tax

Act of 1981, Pub. L. No. 97-34, sec. 221(a), 95 Stat. 241.¹ Congress enacted the research credit to “stimulate a higher rate of capital formation and to increase productivity,” S. Rep. No. 97-144 at 76-77 (1981), 1981-2 C.B. 412, 438-439; H.R. Rep. No. 97-201 at 111 (1981), 1981-2 C.B. 352, 358, and “to encourage business firms to perform the research necessary to increase the innovative qualities and efficiency of the U.S. economy.” S. Rep. No. 99-313 at 694 (1986), 1986-3 C.B. (Vol. 3) 1, 694; H.R. Rep. No. 99-426 at 177 (1985), 1986-3 C.B. (Vol. 2) 1, 177.

In 1986, however, Congress became concerned that taxpayers were interpreting the research credit too broadly and that “some taxpayers ... claimed the credit for virtually any expenses relating to product development.” S. Rep. No. 99-313, *supra* at 694-695; *see also* H.R. Rep. 99-426, *supra* at 178. Therefore, Congress amended the research credit by the Tax Reform Act of 1986, Pub. L. No. 99-514, sec. 231(b), 100 Stat. 2173, to provide a definition of “qualified research.”

To be eligible for a credit under section 41(a)(1) a taxpayer must show that it has performed “qualified research.” To be qualified research, the research must satisfy four requirements. I.R.C. § 41(d)(1). The first requirement is that the expenditures connected with the research must be eligible for treatment as expenses under section 174.² Section 41(d)(1)(A) provides that “[t]he term ‘qualified research’” means research “with respect to which *expenditures may be treated as expenses under section 174.*” (Emphasis added).

Therefore, to qualify as expenditures for “qualified research” under section 41, the VSP payments at issue in this case must be eligible to be treated as an expense under section 174.

I. THE TAXPAYER’S VSP PAYMENTS ARE NOT FOR “QUALIFIED RESEARCH” FOR PURPOSES OF SECTION 41 BECAUSE THE EXPENDITURES ARE NOT ELIGIBLE TO BE TREATED AS EXPENSES UNDER SECTION 174.

To be eligible for the research credit under section 41(a)(1), a taxpayer must incur QREs during the credit year. QREs include a taxpayer's in-house research expenses that are paid or incurred during the taxable year in carrying on the taxpayer's business. I.R.C. § 41(b)(1)(A). Section 41(b)(2)(A) defines in-house research expenses relating to wages as “any wages paid or incurred to an employee for qualified services performed

¹ The credit provisions first appeared as section 44F. The Deficit Reduction Act of 1984 redesignated section 44F as section 30. The Tax Reform Act of 1986 amended the research credit provisions and redesignated section 30 as section 41.

² The second requirement is that the research must be undertaken for the purpose of discovering technological information. I.R.C. § 41(d)(1)(B)(i). The third requirement is that the taxpayer must intend that the information to be discovered will be useful in the development of a new or improved business component of the taxpayer. I.R.C. § 41(d)(1)(B)(ii). The fourth requirement is that substantially all of the research activities must constitute elements of a process of experimentation for a purpose relating to a new or improved function, performance, reliability, or quality. I.R.C. § 41(d)(1)(C), (3).

by such employee.” The term “qualified services” means services consisting of: “(i) engaging in *qualified research*, or (ii) engaging in the direct supervision or direct support of research activities which constitute *qualified research*.” I.R.C. § 41(b)(2)(B)(i)&(ii) (emphasis added).

A wage QRE, therefore, must be incurred or paid for engaging in, supervising or directly supporting “qualified research.” As discussed above, qualified research only includes expenditures that may be treated as expenses under section 174.

Because section 174 refers to research and experimental expenditures, the determination of which costs constitute QREs under section 41(b) requires us to consider whether those costs may be treated as expenses under section 174:

The phrase “the research expenditures may be treated as expenses under section 174” is meant to require the taxpayer to satisfy *all* the elements for a deduction under section 174. The legislative history of section 41 supports this requirement. See H. Conf. Rept. 99-841 (Vol. II), *supra* at II-71, 1986-3 C.B. (Vol. 4) at 71 (“the conference agreement limits research expenditures eligible for the incremental credit to ‘research or experimental expenditures’ eligible for *expensing* under section 174. * * * Under the conference agreement, research satisfying the section 174 *expensing* definition is eligible for the credit”).

Norwest Corp. & Subs. v. Commissioner, 110 T.C. 454, 491 (1998) (emphasis added)

[Taxpayer] cannot avoid the restrictions of section 174 by arguing that section 174 is relevant only for determining whether activities constitute qualified research and has no bearing on whether the costs of those activities may be QREs. See *Norwest Corp. & Subs. v. Commissioner*, 110 T.C. at 491; H. Conf. Rept. 99-841 (Vol. II), *supra* at II-71, 1986-3 C.B. (Vol. 4) at 71 (“the conference agreement limits research expenditures eligible for the incremental credit to ‘research or experimental expenditures’ eligible for expensing under section 174.”).

Union Carbide Corporation v. Commissioner, T.C. Memo 2009-50, 2009 WL 605161, at *114.

For the reasons set forth below, it is our position that the VSP payments at issue in this case do not satisfy all the elements required for a deduction under section 174. Because the VSP payments do not satisfy all of the elements for a deduction under section 174, the payments cannot be QREs for purposes of computing the research credit under section 41.

A. The Taxpayer’s VSP Payments Are Not Research and Development Costs in the “Experimental or Laboratory Sense” as Required by

Section 174(a).

Section 174(a) provides that research or experimental expenditures paid or incurred during the taxable year in connection with a taxpayer's trade or business may be deducted currently rather than capitalized. Spellman v. Commissioner, 845 F.2d 148, 149 (7th Cir.1988), aff'd T.C. Memo.1986-403. The taxpayer must establish the right to treat expenditures as deductible expenses under section 174. Coors Porcelain Co. v. Commissioner, 52 T.C. 682, 697-698 (1969), aff'd, 429 F.2d 1 (10th Cir.1970) (holding that the taxpayer was not entitled to a deduction under section 174 because, in part, the taxpayer did not prove that the expenditures met the definition of research and development under section 174).

Treas. Reg. § 1.174-2(a)(1) provides:

The term research or experimental expenditures, as used in section 174, means expenditures incurred in connection with the taxpayer's trade or business which represent research and development costs in the experimental or laboratory sense. The term generally includes all such costs incident to the development or improvement of a product. The term includes the costs of obtaining a patent, such as attorneys' fees expended in making and perfecting a patent application.

The Tax Court gives the terms "experimental" and "laboratory" their plain and ordinary meanings. See, e.g., TSR, Inc. & Sub. v. Commissioner, 96 T.C. 903, 914 (1991). In TSR, the Tax Court concluded that according to the definition of those two terms in Webster's Third New International Dictionary, "'Experimental' is defined as 'relating to, or based on experience'" and "'Laboratory' is defined as 'a place devoted to experimental study in any branch of natural science or to the application of scientific principles in testing and analysis.'" Id. The Tax Court has held further that "[t]he goal of the research must be scientifically reasonable. ... It requires some element of experimentation." Agro Science Co. v. Commissioner, T.C. Memo.1989-687, aff'd, 934 F.2d 573 (5th Cir.1991). Thus, the Tax Court has consistently held that research and development expenditures are generally those expenditures related to scientific and laboratory-based activities.

Expenditures may qualify as research and development expenses in "the experimental or laboratory sense" if they are incurred for activities to "eliminate uncertainty concerning the development or improvement of a product." Treas. Reg. § 1.174-2(a)(1). Uncertainty exists if the information available to the taxpayer does not establish the capability or method for developing or improving the product or the design of the product. Id. The taxpayer must perform activities intended to discover information not otherwise available regarding the capability of improving the product or for improving the design or development of the product. Id.

The VSP payments in this case do not represent research and development costs in the experimental or laboratory sense. The payments were not made for scientific and

laboratory based activities designed to resolve uncertainty concerning the development or improvement of a product. Instead, the VSP payments were made to allow Taxpayer to reduce its workforce in order to improve its cost structure and to cut back on general operational activities including research activities. As a form of compensation based upon the employment relationship between each severed employee and the Taxpayer, the payments should be claimed under section 162 as ordinary business expenses, and not as research or experimental expenditures under section 174. See, e.g., Associated Elec. Coop, Inc. v. United States, 83 AFTR2d 749 (Ct. Fed. Cl. 1999).

While the definition of “research or experimental expenditures” is broad, the definition should be read in the context of Congress’s purpose for enacting section 174. The legislative history of section 174 indicates that Congress had two purposes for enacting the section: (1) to encourage research and experimental activities; and 2) to eliminate the uncertainty as to the tax treatment of research and experimental expenditures. House Ways and Means Committee Report No. 1337 noted, “[t]o eliminate uncertainty and to encourage taxpayers to carry on research and experimentation the committee bill provides that these expenditures . . . may, at the option of the taxpayer, be treated as deductible expenses.” H.R. Rep. No. 1337 at 28 (1954). See also Rev. Rul. 85-186, 1985-2 C.B. 84.

There is no indication that the enactment of section 174 would expand the allowance of a deduction for research expenditures into the realm of severance pay. In essence, section 174 is a special accounting method for research expenditures, not a vehicle for allowing section 174 treatment for severance pay.

Severance payments, as with other ordinary and necessary trade or business expenses, are generally deductible under section 162, which provides in relevant part that, “There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including-- (1) a reasonable allowance for salaries or other compensation for personal services actually rendered....” Id.

Treas. Reg. § 1.162-10(a) specifically identifies “dismissal wages” as deductible under section 162(a) to the extent that they are ordinary and necessary expenses of the trade or business: “Amounts paid or accrued within the taxable year for dismissal wages, unemployment benefits, guaranteed annual wages, vacations, or a sickness, accident, hospitalization, medical expense, recreational, welfare, or similar benefit plan, are deductible under section 162(a)...”³

In 1994, the IRS ruled that severance payments were deductible as section 162 ordinary and necessary business expenses, notwithstanding the Supreme Court’s decision in INDOPCO v. Commissioner, 503 U.S. 79 (1992). See Rev. Rul. 94-77;

³ The regulations provide that payments used to provide benefits under a stock bonus, pension, annuity, profit-sharing, or other deferred compensation plan referred to in section 404(a) are governed by section 404 and the regulations promulgated thereunder.

1994-2 C.B. 19.⁴

In INDOPCO, the Supreme Court, affirming the Third Circuit, ruled that legal and accounting fees paid as part of a friendly takeover were capital in nature and not deductible under section 162(a). In response, the IRS ruled that “The INDOPCO decision does not affect the treatment of severance payments, made by a taxpayer to its employees as business expenses which are generally deductible under § 162 and § 1.162-10.” Rev. Rul. 94-77.

The VSP payments at issue in this case were not made to encourage Taxpayer to perform research. The payments were made as a cost cutting measure to reduce Taxpayer’s workforce and are more analogous to dismissal wages deductible under section 162, Regulation section 1.162-10(a), and Rev. Rul. 94-77.

As previously stated, Congress enacted the research credit “to encourage business firms to perform the research necessary to increase the innovative qualities and efficiency of the U.S. economy.” Severance payments, like the VSP payments at issue in this case, were not the type of expenditure that Congress envisioned would be encouraged by enactment of the research credit in 1981. Rather, Congress enacted section 162 to provide for a deduction of ordinary and necessary trade or business expenses, including severance payments.

B. The Taxpayer’s VSP Payments Are Not “Reasonable” Research and Experimental Expenditures as Required by Section 174(e).

Section 174 applies to research and experimental expenditures only to the extent that the amount thereof is reasonable under the circumstances. I.R.C. § 174(e). Treas. Reg. § 1.174-2(a)(6) states:

Section 174 applies to a research or experimental expenditure only to the extent that the amount of the expenditure is reasonable under the circumstances. In general, the amount of an expenditure for research or experimental activities is reasonable if *the amount would ordinarily be paid for like activities by like enterprises under like circumstances*. Amounts supposedly paid for research that are not reasonable under the circumstances may be characterized as disguised dividends, gifts, loans, or similar payments. The reasonableness requirement of this paragraph (a)(6) does not apply to the reasonableness of the type or nature of the activities themselves.

(Emphasis added).

⁴ By its terms, Rev. Rul. 94-77 does not address the federal income tax treatment of severance payments made as part of the acquisition of property.

Section 174(e) requires that the amount of claimed wages for research be reasonable. Thus, section 174(e), and the regulations thereunder, prohibits a taxpayer from claiming a section 174 deduction for the full amount of large employee salaries when the value of the research services performed by the employees is worth far less than the amount of the payment made for the research services.

Taxpayer claims that the VSP payments relate to wages for research activities performed by the terminated employees in their final year of employment. The terminated employees were each paid a regular salary for whatever research was performed during the portion of the year that the employees remained with Taxpayer. It is assumed that these regular salaries are reasonable and would be paid in the amounts claimed by like enterprises for the services performed by the terminated employees. The terminated employees at issue received, in addition to their regular salary, severance payments equal to M to Q months of additional salary without having to perform any additional research. Moreover, because the employment relationship was terminated upon the employee's acceptance of the VSP payment, the employee was effectively being paid not to do additional research.

For these reasons, the VSP payments are unreasonable expenditures under section 174. Further, like enterprises would not pay their employees to do research similar to Taxpayer's research at a wage rate that was paid to Taxpayer's terminated employees. Like enterprises would only pay the reasonable regular salary paid to Taxpayer's employees without the additional expenditure in the amount of the severance pay. Thus, the VSP payment is an unreasonable additional amount paid for performing research similar to that being performed by non-terminated employees of Taxpayer or other similar enterprises.

While like enterprises in similar situations may, at some point in time, have to make severance payments, such payments would be considered the general cost of doing business and therefore considered a section 162 expenditure, not a research expenditure. See supra discussion on section 162 ordinary and necessary trade or business expenses.

Assuming arguendo that the VSP payments can be treated as research expenditures, the amount of such payments by the Taxpayer was unreasonable under section 174(e) and therefore the payments are not deductible section 174 expenditures.

For these reasons, it is our position that the VSP payments at issue in this case cannot be QREs for purposes of computing the research credit under section 41 because the payments do not satisfy all of the elements for a deduction under section 174. But, even if the VSP payments were to satisfy the elements required for a deduction under section 174, Taxpayer has not shown the nexus that is required between the payments and "qualified research."

II. THE TAXPAYER HAS NOT ESTABLISHED A NEXUS BETWEEN THE VSP

PAYMENTS AND QUALIFIED RESEARCH.

As previously stated, a wage QRE must be incurred or paid for engaging in, supervising or directly supporting “qualified research.”

Treas. Reg. §1.41-2(d)(1) provides generally:

Wages paid to or incurred for an employee constitute in-house research expenses only to the extent the wages were paid or incurred for qualified services performed by the employee. If an employee has performed both qualified services and nonqualified services, only the amount of wages allocated to the performance of qualified services constitutes an in-house research expense. In the absence of another method of allocation that the taxpayer can demonstrate to be more appropriate, the amount of in-house research expense shall be determined by multiplying the total amount of wages paid to or incurred for the employee during the taxable year by the ratio of the total time actually spent by the employee in the performance of qualified services for the taxpayer to the total time spent by the employee in the performance of all services for the taxpayer during the taxable year.

Taxpayer claimed QREs for the VSP payments based solely upon alleged qualified services performed by the terminated employee in his or her final year of employment. Looking only to the severed employee’s final year of employment to determine the amount of qualified services performed by that employee is incorrect because the amount of severance pay at issue was based in part upon an employee’s years of service with Taxpayer.

Wages paid or incurred for an employee constitute in-house research expenses only to the extent the wages were paid or incurred for qualified services performed by the employee. If an employee performed both qualified services and nonqualified services, only the amount of wages allocated to the performance of qualified services constitutes an in-house research expense. Because part of the severance payments made to terminated employees relate to the employees’ services performed for the company over a period of years (“the employment period”), an analysis must be made of the employment period to determine the amount of qualified services and non-qualified services that were performed by the terminated employees over the employment period.

In Apple Computer, Inc. v. Commissioner, 98 T.C. 232 (1992), the Service argued that in order for wage costs to qualify for the credit, the services generating those costs had to be performed in the year in which the credit was claimed. The Tax Court held that even though the services were performed in a year prior to the year in which the options were exercised (wages were incurred) and a research credit taken, the Court would not disregard the wage expenses for purposes of the research credit. Id. at 239-241. Apple Computer is directly on point with our position that you look to the employment period to which the severance payments relate in order to determine the amount of the severance payments that are made for qualified services.

Looking solely to the terminated employees' last year of service does not reflect a true determination of the amount of wages paid for qualified services. For example, if the amount of an employee's severance pay was based upon five years of service and that employee spent his or her first four years of employment performing non-qualified services and only performed research in his or her final year of employment, only focusing on the final year of service would not reflect an accurate determination of QREs relating to the employee.

For these reasons, it is our position that even if the VSP payments were deemed to satisfy the elements required for a deduction under section 174, Taxpayer has not established a nexus between the payments and "qualified research." Therefore, Taxpayer should not be allowed to claim a credit under section 41 for the payments.

In its response to an IDR in which Exam requested Taxpayer to explain why it considered the VSP payments to be QREs, Taxpayer cited FSA 199931012 as supporting its position. While noting that Field Service Advice is not substantive authority that can be cited as precedent, we nonetheless address Taxpayer's argument for purposes of distinguishing the FSA for purposes of this case.

FSA 199931012 considered two issues:

- (1) Whether separation payments from an employer to its downsized employees constitute "wages" for purposes of section 3401(a).
- (2) If the separation payments constitute "wages" for purposes of section 3401(a), whether the separation payments qualify for the credit for increasing research activities under section 41.

The answer for both issues addressed in the FSA was yes. Accordingly, Taxpayer argues that because its fact pattern is very similar to the facts in the FSA, the VSP payments are includable in QREs under section 41.

With respect to the first issue addressed by FSA 199931012, Taxpayer argues that the VSP payments are made by an employer derived from the employment relationship and would thus be treated as wages under section 3401(a) and would be subject to Federal withholding tax. Therefore, Taxpayer argues that the payments should be considered wages for purposes of section 41. Taxpayer further argues that because the wages being paid have a sufficiently strong nexus between the payment and the employment relationship so as to require the payments to be characterized as remuneration for services for withholding, FICA and FUTA tax purposes, the VSP payments should also be characterized as remuneration for services for purposes of section 41.

But, FSA 199931012 did not address the nexus argument. In fact, the advice states in several places that it was “based on the assumption that, for each employee who elected to participate in the program, during the entire length of the employee’s employment with [the taxpayer] (including the final year of employment), the employee performed only qualified research.” This assumption obviated the need to analyze the issue presented in the instant case, whether there is a nexus between the voluntary separation payments and qualified research as required by Treas. Reg. § 1.41-2(d)(1).

The FSA punctuates this point and limits the scope of its conclusions by indicating that the extent to which the services constitute section 41(b)(2)(B) qualified services has not been verified and is therefore simply an assumption: “Accordingly, the extent to which the services performed by T’s employees are qualified services under section 41(b)(2)(B) should be verified.” Moreover, the FSA makes this statement only after quoting Treas. Reg. § 1.41-2(d)(1), which provides in relevant part that “[w]ages paid to or incurred for an employee constitute in-house research expenses only to the extent the wages were paid or incurred for qualified services performed by the employee. If an employee has performed both qualified services and nonqualified services, only the amount of wages allocated to the performance of qualified services constitutes an in-house research expense.” After quoting this regulation the FSA notes that the services provided by the employees have not been verified. Accordingly, the issue presented in the instant case, whether there is a nexus between the VSP payments and qualified research is distinguishable from and was not addressed in the FSA. Therefore, it is our position that Taxpayer’s reliance on the FSA is misplaced because the FSA explicitly assumes as fact those items which are in dispute in the instant case.

Moreover, based on the facts, we have no reason to assume any nexus between the amount of the VSP payment and the services performed by the employees during the entire length of the employees’ employment with Taxpayer. In this case, Taxpayer has not established that the employees who accepted the VSP payments conducted only qualified research over the entire course of their employment with Taxpayer, including the final year of employment.

With respect to the second issue, Taxpayer argues that there is no requirement under the statute that the payments be compensatory in nature. Once it is determined that the payments are wages, then they must be considered remuneration for services. If the services provided are qualified services, then the separation payments qualify for the credit for increasing research activities.

Taxpayer assumes, without providing any support, that the full amount of the VSP payments were for qualified services performed by the employees over the entire course of their employment relationship with Taxpayer. Again, looking solely to the terminated employees’ last year of service does not reflect a true determination of the amount of wages paid for qualified services. Moreover, as set forth above, it is our position that whether the VSP payments are for qualified services requires an analysis of whether the payments would be deductible expenses for purposes of section 174.

That analysis is missing in FSA199931012.

Accordingly, it is our position that the conclusion set forth herein is more on point with the specific facts developed by Exam in this case and is based upon a more thorough analysis of both sections 41 and 174 for purposes of determining whether the VSP payments at issue in this case are qualified research expenditures for purposes of section 41. For the reasons set forth above, it is our opinion that they are not.

Please call _____ at _____ if you have any further questions.

REID M. HUEY
Associate Area Counsel
(Large Business & International)

By: _____

Attorney
(Large Business & International)