

FINAL-REG, TAX-REGS , §1.41-2. Qualified research expenses

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(a) *Trade or business requirement--(1) In general.* An in-house research expense of the taxpayer or a contract research expense of the taxpayer is a qualified research expense only if the expense is paid or incurred by the taxpayer in carrying on a trade or business of the taxpayer. The phrase “in carrying on a trade or business” has the same meaning for purposes of section 41(b)(1) as it has for purposes of section 162; thus, expenses paid or incurred in connection with a trade or business within the meaning of section 174(a) (relating to the deduction for research and experimental expenses) are not necessarily paid or incurred in carrying on a trade or business for purposes of section 41. A research expense must relate to a particular trade or business being carried on by the taxpayer at the time the expense is paid or incurred in order to be a qualified research expense. For purposes of section 41, a contract research expense of the taxpayer is not a qualified research expense if the product or result of the research is intended to be transferred to another in return for license or royalty payments and the taxpayer does not use the product of the research in the taxpayer’s trade or business.

(2) *New business.* Expenses paid or incurred prior to commencing a new business (as distinguished from expanding an existing business) may be paid or incurred in connection with a trade or business but are not paid or incurred in carrying on a trade or business. Thus, research expenses paid or incurred by a taxpayer in developing a product the sale of which would constitute a new trade or business for the taxpayer are not paid or incurred in carrying on a trade or business.

(3) *Research performed for others--(i) Taxpayer not entitled to results.* If the taxpayer performs research on behalf of another person and retains no substantial rights in the research, that research shall not be taken into account by the taxpayer for purposes of section 41. See §1.41-5(d)(2).

(ii) *Taxpayer entitled to results.* If the taxpayer in carrying on a trade or business performs research on behalf of other persons but retains substantial rights in the research, the taxpayer shall take otherwise qualified expenses for that research into account for purposes of section 41 to the extent provided in §1.41-5(d)(3).

(4) *Partnerships--(i) In general.* An in-house research expense or a contract research expense paid or incurred by a partnership is a qualified research expense of the partnership if the expense is paid or incurred by the partnership in carrying on a trade or business of the partnership, determined at the partnership level without regard to the trade or business of any partner.

(ii) *Special rule for certain partnerships and joint ventures.--(A)* If a partnership or a joint venture (taxable as a partnership) is not carrying on the trade or business to which the research relates, then the general rule in paragraph (a)(4)(i) of this section would not allow any of such expenditures to qualify as qualified research expenses.

(B) Notwithstanding paragraph (a)(4)(ii)(A) of this section, if all the partners or venturers are entitled to make independent use of the results of the research, this paragraph (a)(4)(ii) may allow a portion of such expenditures to be treated as qualified research expenditures by certain partners or venturers.

(C) First, in order to determine the amount of credit that may be claimed by certain partners or venturers, the amount of qualified research expenditures of the partnership or joint venture is determined (assuming for this purpose that the partnership or joint venture is carrying on the trade or business to which the research relates).

(D) Second, this amount is reduced by the proportionate share of such expenses allocable to those partners or venturers who would not be able to claim such expenses as qualified research expenditures if they had paid or incurred such expenses directly. For this purpose such partners' or venturers' proportionate share of such expenses shall be determined on the basis of such partners' or venturers' share of partnership items of income or gain (excluding gain allocated under section 704(c)) which results in the largest proportionate share. Where a partner's or venturer's share of partnership items of income or gain (excluding gain allocated under section 704(c)) may vary during the period such partner or venturer is a partner or venturer in such partnership or joint venture, such share shall be the highest share such partner or venturer may receive.

(E) Third, the remaining amount of qualified research expenses is allocated among those partners or venturers who would have been entitled to claim a credit for such expenses if they had paid or incurred the research expenses in their own trade or business, in the relative proportions that such partners or venturers share deductions for expenses under section 174 for the taxable year that such expenses are paid or incurred.

(F) For purposes of section 41, research expenditures to which this paragraph (a)(4)(ii) applies shall be treated as paid or incurred directly by such partners or venturers. See §1.41-9(a)(3)(ii) for special rules regarding these expenses.

(iii) The following examples illustrate the application of the principles contained in paragraph (a)(4)(ii) of this section.

Example (1). A joint venture (taxable as a partnership) is formed by corporations A, B, and C to develop and market a supercomputer. A and B are in the business of developing computers, and each has a 30 percent distributive share of each item of income, gain, loss, deduction, credit and basis of the joint venture. C, which is an investment banking firm, has a 40 percent distributive share of each item of income, gain, loss, deduction, credit and basis of the joint venture. The joint venture agreement provides that A's, B's and C's distributive shares will not vary during the life of the joint venture, liquidation proceeds are to be distributed in accordance with the partners' capital account balances, and any partner with a deficit in its capital account following the distribution of liquidation proceeds is required to restore the amount of such deficit to the joint venture. Assume in Year 1 that the joint venture incurs \$100x of "qualified research expenses." Assume further that the joint venture cannot claim the research credit for such

expenses because it is not carrying on the trade or business to which the research relates. In addition A, B, and C are all entitled to make independent use of the results of the research. First, the amount of qualified research expenses of the joint venture is \$100x. Second, this amount is reduced by the proportionate share of such expenses allocable to C, the venturer which would not have been able to claim such expenses as qualified research expenditures if it had paid or incurred them directly, C's proportionate share of such expenses is \$40x (40% of \$100x). The reduced amount is \$60x. Third, the remaining \$60x of qualified research expenses is allocated between A and B in the relative proportions that A and B share deductions for expenses under section 174. A is entitled to treat \$30x ($(30\% / (30\% + 30\%)) \$60x$) as a qualified research expense. B is also entitled to treat \$30x ($(30\% / (30\% + 30\%)) \$60x$) as a qualified research expense.

Example (2). Assume the same facts as in example (1) except that the joint venture agreement provides that during the first 2 years of the joint venture, A and B are each allocated 10 percent of each item of income, gain, loss, deduction, credit and basis, and C is allocated 80 percent of each item of income, gain, loss, deduction, credit and basis. Thereafter the allocations are the same as in example (1). Assume for purposes of this example that such allocations have substantial economic effect for purposes of section 704(b). C's highest share of such items during the life of the joint venture is 80 percent. Therefore C's proportionate share of the joint venture's qualified research expenses is \$80x (80% of \$100x). The reduced amount of qualified research expenses is \$20x ($\$100x - \$80x$). A is entitled to treat \$10x ($(10\% / (10\% + 10\%)) \$20x$) as a qualified research expense in Year 1. B is also entitled to treat \$10x ($(10\% / (10\% + 10\%)) \$20x$) as a qualified research expense in Year 1.

(b) *Supplies and personal property used in the conduct of qualified research--(1) In general.* Supplies and personal property (except to the extent provided in paragraph (b)(4) of this section) are used in the conduct of qualified research if they are used in the performance of qualified services (as defined in section 41(b)(2)(B), but without regard to the last sentence thereof) by an employee of the taxpayer (or by a person acting in a capacity similar to that of an employee of the taxpayer; see example (6) of §1.41-2(e)(5)). Expenditures for supplies or for the use of personal property that are indirect research expenditures or general and administrative expenses do not qualify as in-house research expenses.

(2) *Certain utility charges--(i) In general.* In general, amounts paid or incurred for utilities such as water, electricity, and natural gas used in the building in which qualified research is performed are treated as expenditures for general and administrative expenses.

(ii) *Extraordinary expenditures.* To the extent the taxpayer can establish that the special character of the qualified research required additional extraordinary expenditures for utilities, the additional expenditures shall be treated as amounts paid or incurred for supplies used in the conduct of qualified research. For example, amounts paid for electricity used for general laboratory lighting are treated as general and administrative expenses, but amounts paid for electricity used in operating high energy equipment for qualified research (such as laser or nuclear research) may be treated as expenditures for

supplies used in the conduct of qualified research to the extent the taxpayer can establish that the special character of the research required an extraordinary additional expenditure for electricity.

(3) *Right to use personal property.* The determination of whether an amount is paid to or incurred for another person for the right to use personal property in the conduct of qualified research shall be made without regard to the characterization of the transaction as a lease under section 168(f)(8) (as that section read before it was repealed by the Tax Reform Act of 1986). See §5c.168(f)(8)-1(b).

(4) *Use of personal property in taxable years beginning after December 31, 1985.* For taxable years beginning after December 31, 1985, amounts paid or incurred for the use of personal property are not qualified research expenses, except for any amount paid or incurred to another person for the right to use (time-sharing) computers in the conduct of qualified research. The computer must be owned and operated by someone other than the taxpayer, located off the taxpayer's premises, and the taxpayer must not be the primary user of the computer.

(c) *Qualified services--(1) Engaging in qualified research.* The term "engaging in qualified research" as used in section 41(b)(2)(B) means the actual conduct of qualified research (as in the case of a scientist conducting laboratory experiments).

(2) *Direct supervision.* The term "direct supervision" as used in section 41(b)(2)(B) means the immediate supervision (first-line management) of qualified research (as in the case of a research scientist who directly supervises laboratory experiments, but who may not actually perform experiments). "Direct supervision" does not include supervision by a higher-level manager to whom first-line managers report, even if that manager is a qualified research scientist.

(3) *Direct support.* The term "direct support" as used in section 41(b)(2)(B) means services in the direct support of either--

(i) Persons engaging in actual conduct of qualified research, or

(ii) Persons who are directly supervising persons engaging in the actual conduct of qualified research. For example, direct support of research includes the services of a secretary for typing reports describing laboratory results derived from qualified research, of a laboratory worker for cleaning equipment used in qualified research, of a clerk for compiling research data, and of a machinist for machining a part of an experimental model used in qualified research. Direct support of research activities does not include general administrative services, or other services only indirectly of benefit to research activities. For example, services of payroll personnel in preparing salary checks of laboratory scientists, of an accountant for accounting for research expenses, of a janitor for general cleaning of a research laboratory, or of officers engaged in supervising financial or personnel matters do not qualify as direct support of research. This is true whether general administrative personnel are part of the research department or in a

separate department. Direct support does not include supervision. Supervisory services constitute “qualified services” only to the extent provided in paragraph (c)(2) of this section.

(d) *Wages paid for qualified services--(1) In general.* 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.

(2) *“Substantially all.”* Notwithstanding paragraph (d)(1) of this section, if substantially all of the services performed by an employee for the taxpayer during the taxable year consist of services meeting the requirements of section 41(b)(2)(B)(i) or (ii), then the term “qualified services” means all of the services performed by the employee for the taxpayer during the taxable year. Services meeting the requirements of section 41(b)(2)(B)(i) or (ii) constitute substantially all of the services performed by the employee during a taxable year only if the wages allocated (on the basis used for purposes of paragraph (d)(1) of this section) to services meeting the requirements of section 41(b)(2)(B)(i) or (ii) constitute at least 80 percent of the wages paid to or incurred by the taxpayer for the employee during the taxable year.

(e) *Contract research expenses--(1) In general.* A contract research expense is 65 percent of any expense paid or incurred in carrying on a trade or business to any person other than an employee of the taxpayer for the performance on behalf of the taxpayer of--

(i) Qualified research as defined in §1.41-5, or

(ii) Services which, if performed by employees of the taxpayer, would constitute qualified services within the meaning of section 41(b)(2)(B).

Where the contract calls for services other than services described in this paragraph (e)(1), only 65 percent of the portion of the amount paid or incurred that is attributable to the services described in this paragraph (e)(1) is a contract research expense.

(2) *Performance of qualified research.* An expense is paid or incurred for the performance of qualified research only to the extent that it is paid or incurred pursuant to an agreement that--

(i) Is entered into prior to the performance of the qualified research,

(ii) Provides that research be performed on behalf of the taxpayer, and

(iii) Requires the taxpayer to bear the expense even if the research is not successful.

If an expense is paid or incurred pursuant to an agreement under which payment is contingent on the success of the research, then the expense is considered paid for the product or result rather than the performance of the research, and the payment is not a contract research expense. The previous sentence applies only to that portion of a payment which is contingent on the success of the research.

(3) “*On behalf of.*” Qualified research is performed on behalf of the taxpayer if the taxpayer has a right to the research results. Qualified research can be performed on behalf of the taxpayer notwithstanding the fact that the taxpayer does not have exclusive rights to the results.

(4) *Prepaid amounts.* Notwithstanding paragraph (e)(1) of this section, if any contract research expense paid or incurred during any taxable year is attributable to qualified research to be conducted after the close of such taxable year, the expense so attributable shall be treated for purposes of section 41(b)(1)(B) as paid or incurred during the period during which the qualified research is conducted.

(5) *Examples.* The following examples illustrate provisions contained in paragraphs (e)(1) through (4) of this section.

Example (1). A, a cash-method taxpayer using the calendar year as the taxable year, enters into a contract with B Corporation under which B is to perform qualified research on behalf of A. The contract requires A to pay B \$300x, regardless of the success of the research. In 1982, B performs all of the research, and A makes full payment of \$300x under the contract. Accordingly, during the taxable year 1982, \$195x (65 percent of the payment of \$300x) constitutes a contract research expense of A.

Example (2). The facts are the same as in example (1), except that B performs 50 percent of the research in 1983. Of the \$195x of contract research expense paid in 1982, paragraph (e)(4) of this section provides that \$97.5x (50 percent of \$195x) is a contract research expense for 1982 and the remaining \$97.5x is contract research expense for 1983.

Example (3). The facts are the same as in example (1), except that instead of calling for a flat payment of \$300x, the contract requires A to reimburse B for all expenses plus pay B \$100x. B incurs expenses attributable to the research as follows:

Labor	\$ 90x
Supplies	20x
Depreciation on equipment	50x

Overhead	40x

Total	\$200x

Under this agreement A pays B \$300x during 1982. Accordingly, during taxable year 1982, \$195x (65 percent of \$300x) of the payment constitutes a contract research expense of A.

Example (4). The facts are the same as in example (3), except that A agrees to reimburse B for all expenses and agrees to pay B an additional amount of \$100x, but the additional \$100x is payable only if the research is successful. The research is successful and A pays B \$300x during 1982. Paragraph (e)(2) of this section provides that the contingent portion of the payment is not an expense incurred for the performance of qualified research. Thus, for taxable year 1982, \$130x (65 percent of the payment of \$200x) constitutes a contract research expense of A.

Example (5). C conducts in-house qualified research in carrying on a trade or business. In addition, C pays D Corporation, a provider of computer services, \$100x to develop software to be used in analyzing the results C derives from its research. Because the software services, if performed by an employee of C, would constitute qualified services, \$65x of the \$100x constitutes a contract research expense of C.

Example (6). C conducts in-house qualified research in carrying on C's trade or business. In addition, C contracts with E Corporation, a provider of temporary secretarial services, for the services of a secretary for a week. The secretary spends the entire week typing reports describing laboratory results derived from C's qualified research. C pays E \$400 for the secretarial service, none of which constitutes wages within the meaning of section 41(b)(2)(D). These services, if performed by employees of C, would constitute qualified services within the meaning of section 41(b)(2)(B). Thus, pursuant to paragraph (e)(1) of this section, \$260 (65 percent of \$400) constitutes a contract research expense of C.

Example (7). C conducts in-house qualified research in carrying on C's trade or business. In addition, C pays F, an outside accountant, \$100x to keep C's books and records pertaining to the research project. The activity carried on by the accountant does not constitute qualified research as defined in section 41(d). The services performed by the accountant, if performed by an employee of C, would not constitute qualified services (as defined in section 41(b)(2)(B)). Thus, under paragraph (e)(1) of this section, no portion of the \$100x constitutes a contract research expense. [Reg. §1.41-2.]

.. [T.D. 8251, 5-16-89.]