

**APPEALS
SETTLEMENT GUIDELINES**

ISSUE: Research Credit, Section 41(b)
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**Research Tax Credit
Appeals Settlement Guideline for
Qualified Research Expenses U.I.L. 41.51-01**

Statement of Issue

Whether amounts paid or incurred as depreciation expenses, general and administrative expenses, employee benefit expenses, and travel and entertainment expenses that relate to “self-constructed supplies” can constitute qualified research expenses under section 41(b) of the Code in determining the credit for increasing research activities under section 41.

Whether amounts paid or incurred for overhead and other indirect expenses that relate to “self-constructed supplies” can constitute qualified research expenses under section 41(b) of the Code in determining the credit for increasing research activities under section 41.

Whether amounts paid or incurred for depreciation expense, general and administrative expense, employee benefit expense, travel and entertainment expense, overhead and other indirect expenses can constitute qualified research expenses under section 41(b) of the Code by virtue of the manner in which these costs are treated for financial accounting purposes.

Compliance's Position

Based upon Code section 41(b), Treasury Regulation section 1.41-2(b), and the legislative history to Code section 41, depreciation expense, general and administrative expenses, employee benefit expenses, and travel and entertainment expenses that relate to "self-constructed supplies" are not "in-house research expenses" as defined in Code section 41(b).

Based upon Code section 41(b), Treasury Regulation section 1.41-2(b), and the legislative history to Code section 41, overhead and other indirect expenses related to "self-constructed supplies" are not "in-house research expenses" as defined in Code section 41(b).

Amounts paid or incurred for depreciation expense, general and administrative expenses, employee benefit expenses, travel and entertainment expenses, overhead and other indirect expenses may not be treated as "in-house research expenses" as defined in Code section 41(b), by virtue of the treatment of these costs for financial accounting purposes.

Taxpayer Position

An argument advanced by taxpayers is that the cost of purchased supplies used in qualified research activities can constitute qualified research expenses under section 41(b) of the Code.

The cost of purchased supplies would likely have some element of the type of expenditures at issue, *i.e.*, depreciation, general and administrative, employee benefit, travel and entertainment, overhead and other indirect expenses factored into the purchase price by the supplier. However, the taxpayer could claim the entire cost of the purchased supplies as qualified research expense if they were, in fact, used in qualified research activities.

To the contrary, the aforementioned expenses are not allowed as qualified research expenses if the taxpayer incurs the cost to self-construct the supplies.

Discussion

FACTS (as stated in Compliance's Coordinated Issue Paper (CIP))

X built a plant to manufacture chemicals. For a period of time, X used the plant to produce chemicals for use in qualified research. X treated the chemicals used in qualified research as supplies used in the conduct of qualified research. In determining the amount paid or incurred for these chemicals for its taxable year ended December 31, 2001, X allocated its direct and indirect manufacturing costs to the supplies.

LAW

Code section 41 provides a credit against tax for increasing research activities (research credit). The research credit is equal to the sum of (1) 20 percent of the excess of the taxpayer's qualified research expenses over its base amount, and (2) 20 percent of the taxpayer's basic research payments determined under Code section 41(e)(1)(A).

Code section 41(b) defines the term "qualified research expenses" to include in-house research expenses and contract research expenses.

Code section 41(b)(2) defines the term "in-house research expenses" as

- (i) Any wages paid or incurred to an employee for qualified services performed by such employee.
- (ii) Any amounts paid or incurred for supplies used in the conduct of qualified research, and
- (iii) Under regulations prescribed by the Secretary, any amount paid or incurred to another person for the right to use computers in the conduct of qualified research.

Clause (iii) shall not apply to any amount to the extent that the taxpayer (or any person with whom the taxpayer must aggregate expenditures under subsection (f)(1)) receives or accrues any amount from any other person for the right to use substantially identical property.

Code section 41(b)(2)(B) provides that the term "qualified services" means services consisting of engaging in qualified research, or engaging in the direct supervision or direct support of research activities that constitute qualified research.

Treasury Regulation section 1.41-2(c)(1) provides that the term "engaging in qualified research" as used in Code section 41(b)(2)(B) means the actual conduct of qualified research (as in the case of a scientist conducting laboratory experiments).

Treasury Regulation section 1.41-2(c)(2) provides that the term “direct supervision” as used in Code 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.

Treasury Regulation section 1.41-2(c)(3) provides that the term “direct support” as used in Code Section 41(b)(2)(B) means services in the direct support of either persons engaging in the actual conduct of qualified research, or 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 Treasury Regulation section 1.41-2(c)(2).

Treasury Regulation section 1.41-2(d) provides that 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 non-qualified 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.

If however, substantially all of the services performed by an employee for the taxpayer during the taxable year consist of services meeting the requirements of Code 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 Code 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 Code 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.

Code section 41(b)(2)(C) defines the term “supplies” as any tangible property other than land or improvements to land, and property of a character subject to the allowance for depreciation. In addition, Treasury Regulation section 1.41-2(b)(1) provides that supplies and personal property (except to the extent provided in Treasury Regulation section 1.41-2(b)(4)) are used in the conduct of qualified research if they are used in the performance of qualified services (as defined in Code 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 Treasury Regulation section 1.41-2(e)(5)). Finally, 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.

Treasury Regulation section 1.41-2(b)(2) provides that, 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. However, 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.

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.

Code section 41(b)(3)(A) defines the term “contract research expenses” as 65 percent of any amount paid or incurred by the taxpayer to another person (other than an employee of the taxpayer) for qualified research. For taxable years beginning after June 30, 1996, 75 percent of any amount paid or incurred by the

taxpayer to a qualified research consortium for qualified research is a qualified research expense. Code Section 41(b)(3)(C).

ANALYSIS

The issues in Compliance's Coordinated Issue Paper concern X's determination of its "in-house research expenses" eligible to be included in its research credit computation for the taxable year ended December 31, 2001. X, a chemical manufacturer, is in the business of developing, testing, manufacturing, and marketing chemicals. In conducting qualified research during the year at issue, X used chemicals manufactured at X's plant. X treated all costs (direct and indirect) allocated to the manufactured chemicals used in qualified research as "in-house research expenses" eligible to be included in its research credit computation for the taxable year ended December 31, 2001. These costs include depreciation expenses, general and administrative expenses, employee benefit expenses, travel and entertainment expenses, overhead expenses, and other indirect expenses.

Issues (1) and (2):

Code section 41(b) was added to the Code by the Economic Recovery Tax Act of 1981 (the 1981 Act). Code section 41(b) lists expenditures eligible to be included in the research credit computation. The 1981 Act was very specific about the types of in-house expenditures eligible for the research credit computation. Except for the repeal of the provision treating amounts paid for the right to use personal property in qualified research as eligible for the research credit, Code section 41(b)(2) has not been changed.

With regard to "in-house research expenses", it is clear that the only wage expenses eligible to be included as "in-house research expenses" are wages paid or incurred to employees performing services (1) in the actual conduct of qualified research, (2) the direct supervision of qualified research, and (3) in the direct support of either persons engaging in the actual conduct of qualified research or persons who are directly supervising persons engaging in the actual conduct of qualified research. Further, the only other in-house expenditures that are eligible to be treated as an in-house research expense are supply expenses and certain expenditures for the use of computer time in the conduct of qualified research.

The regulations under Code section 41(b) make it very clear that any other expenditure paid or incurred in-house is not an "in-house research expense". See Treasury Regulation section 1.41-2(b)(1). In addition, the legislative history to the 1981 Act makes it clear that not all research expenditures that are deductible under Code section 174 are eligible to be included in the research credit computation. Research expenditures eligible to be included in the research credit computation must be paid or incurred in carrying on a trade or

business of the taxpayer. Also, certain categories of research expenditures, such as overhead expenses, general and administrative expenses, indirect research expenditures and depreciation allowances that may be deductible under Code section 174, are not eligible to be included in the research credit computation. The legislative history to the 1981 Act provides that:

Since only wages paid for qualified services enter into the credit computation, no amount of wages paid for overhead or for general and administrative services, or of indirect research wages, qualifies for the new credit. Thus, no amount of overhead, general and administrative, or indirect wage expenditures is eligible for the new credit, even if such expenditures relate to the taxpayer's research activities, and even if such expenditures may qualify for section 174 deduction elections or may be treated as research expenditures for accounting and financial purposes. By way of illustration, expenditures not eligible for the credit include such items as wages paid to payroll personnel for preparing salary checks of laboratory scientists, wages paid for accounting services, and wages paid to officers and employees of the taxpayer who are not engaged in the conduct of research although engaged in activities (such as general supervision of the business or raising capital for expansion) which in some manner may be viewed as benefiting research activities.

H.R. Rep. No. 97-201, at 117-118.

In addressing supply expenses, the legislative history provides that:

Determinations of whether and to what extent research expenditures of a taxpayer qualify under the second or third category of in-house research expenditures are to be made in accordance with the rules, described and illustrated above, applicable in determining whether and to what extent wage expenditures qualify for the credit. Thus, for example, the credit is not available for expenditures for supplies, or for the use of personal property, if such expenditures constitute indirect research expenditures, or if such expenditures constitute or are part of general and administrative costs or overhead costs (such as utilities).

By way of illustration, supplies eligible for the credit include supplies used in experimentation by a laboratory scientist, in the entering by a laboratory assistant of research data into a computer as part of the conduct of research, or in the machining by a machinist of a part of an experimental model. On the other hand, supplies used in preparing salary checks of laboratory scientists or in performing financial or accounting services for the taxpayer (even if related to individuals engaged in research) are not eligible for the new credit. Similarly, amounts paid to another person as computer user charges for use of a computer in the conduct of qualified research are eligible for the credit, but computer user charges paid for use

of a computer for payroll preparation, routine data collection, market research, production quality control, etc., are not eligible.

Id., p. 118.

Based on Code section 41(b), Treasury Regulation section 1.41-2(b), and the legislative history to Code section 41, depreciation allowances, overhead expenses, general and administrative expenses, and indirect expenses allocable to chemicals manufactured at X's facilities and used in qualified research are not "in-house research expenses" eligible to be included in the research credit computation.

Issue (3):

While financial accounting rules¹ may be relevant in determining taxable income, they do not dictate treatment for income tax purposes. See Thor Power Tool Co. v. Commissioner, 439 U.S. 522, 538-44 (1979). Furthermore, where the income tax treatment for an item is specified in the Internal Revenue Code and/or Treasury Regulations, financial accounting rules are irrelevant. Code section 41(b)(2), the regulations thereunder, and the legislative history to Code section 41 are very specific. In no event are depreciation expenses, overhead expenses, general and administrative expenses, and other indirect expenses "in-house research expenses" included in the research credit computation.

¹ Under GAAP, the historical cost of a self-constructed asset includes "the costs necessarily incurred to bring it to the condition and location necessary for its intended use". FASB Statement No. 34, Para. 6. This includes the allocation of depreciation, interest and other indirect costs. Id.

Settlement Guidelines

Code section 41(b)(1) defines Qualified Research Expenses to be,

- (A) In-house research expenses, and
- (B) Contract research expenses.

Code section 41(b)(2)(A) further defines “in-house research expenses” to be

- (i) Any wages paid or incurred to an employee for qualified services performed by such employee.
- (ii) Any amount paid or incurred for supplies used in the conduct of qualified research.
- (iii) Any amount paid or incurred to another person for the right to use computers in the conduct of qualified research.

Regulation section 1.41-2(d)(1) provides that 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 non-qualified services, only the amount of wages allocated to the performance of qualified services constitutes an in-house research expense.

This is consistent with the legislative history of Code section 41.

Definition of qualified services.-General requirements. A taxpayer’s wage expenditures enter into the credit computation only to the extent that they constitute wages paid or incurred for qualified services. That is, the wages must be paid for engaging in the actual conduct of research (as in the case of a laboratory scientist engaging in experimentation), must be paid for engaging in the immediate supervision of persons actually conducting research (as in the case of a research scientist who supervises other laboratory scientists, but who may not actually conduct experiments), or must be paid for engaging in the direct support of persons who actually conduct research or who immediately supervise the conduct of research. The “support” category of qualifying services would include, for example, the services of a laboratory assistant in entering research data into a computer as part of the conduct of research, of a secretary in typing reports describing the laboratory research results, or a laboratory worker in cleaning research equipment, or of a machinist in machining a part of an experimental model.

Ineligible expenditures. Since only wages paid for qualified services enter into the credit computation, no amount of wages paid for overhead or for general and administrative services, or of indirect research wages, qualifies for the new credit. Thus, no amount of overhead, general and administrative, or indirect wage expenditures is eligible for the new credit, even if such expenditures relate to the taxpayer’s research activities, and

even if such expenditures may qualify for section 174 deduction elections or may be treated as research expenditures for accounting and financial purposes.

H. R. Rep. No. 97-201, at 117-118 (1981).

Similar treatment is afforded to supplies for purposes of the credit computation. Regulation section 1.41-2(b) addresses supplies and personal property used in the conduct of qualified research, and states – (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. 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.

This too, is consistent with the legislative history, which provides for *other in-house expenditures*.—*General rules*.

The second category of in-house research expenditures eligible for the incremental credit consists of amounts paid or incurred for supplies used in the conduct of qualified research. The provision defines the term “supplies” to mean any tangible property other than (a) land or improvements to land or (b) property of a character subject to the allowance for depreciation. Property which is of a character subject to the depreciation allowance is not eligible for the credit whether or not amounts of depreciation are deductible during the year and whether or not the cost of such property can be “expensed”.

The final category of in-house research expenditures eligible for the incremental credit consists of amounts paid or incurred for the right to use personal property in the conduct of qualified research, if such amounts are paid to a person other than the taxpayer. Inter-company charges for the right to use personal property in the conduct of research are not eligible for the credit.

(Note: 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 amounts paid or incurred to another person for the right to use computers in the conduct of qualified research)

Requirements for qualification. Determinations of whether and to what extent research expenditures of a taxpayer qualify under the second or third categories of in-house research expenditures are to be made in accordance with the rules, described and illustrated above, applicable in determining whether and to what extent wage expenditures qualify for the credit. Thus, for example, the credit is not available for expenditures for supplies, or for the use of personal property, if such expenditures constitute indirect research expenditures, or if such expenditures constitute or are part of general and administrative costs or overhead costs (such as utilities).

Id.

CONCLUSION AND RECOMMENDATION

Despite what could be viewed as an inequity in the treatment of purchased versus “self-constructed” supplies, there is little hazard to Compliance’s position that the indirect expenses incurred in such construction do not meet the definition of “in-house” research expenses. Moreover, there is little, if any, reason to believe that a court would adopt anything other than a literal reading of the section 41 statute and thus limit the allowable amount to the direct expenses attributable to “self-constructed supplies”. Therefore, Compliance’s position should be sustained on all three issues.