

SETTLEMENT GUIDELINE

Qualifying Wages Under Section 41 in Determining the Tax Credit for Increasing Research Activities

Effective Date: September 1, 1998

STATEMENT OF ISSUE

Whether remuneration for employment that is excluded from the definition of wages under section 3401(a) of the Internal Revenue Code (the "Code") can constitute qualified research expenses under section 41(b)(1)(A) of the Code in determining the credit for increasing research activities under section 41.¹

EXAMINATION DIVISION'S POSITION

Such payments cannot constitute qualified research expenses. Section 41 grants a tax credit for increasing research activities, which is calculated using the amount constituting a taxpayer's qualified research expenses. In defining qualified research expenses to include wages for qualified services, the Code provides that wages will have the same meaning given under section 3401(a), which defines wages for collection of income tax at source. Under section 3401(a), the term wages specifically excludes certain remuneration for employment, including employer contributions to tax-qualified trusts. If certain remuneration is excluded from the meaning of wages under section 3401(a), it cannot constitute wages or qualified research expenses under section 41 for purposes of calculating a tax credit for increasing research activities.

DISCUSSION

In the fact pattern discussed in the Examination Division's Coordinated Issue Paper, the Taxpayer, in carrying on its business, hires employees who perform "qualified services" as defined in section 41(b)(2)(B) of the Code.² The Taxpayer maintains a qualified profitsharing plan (the "Plan") under section 401 of the Code. The

¹ The credit for increasing research activities was initially enacted as section 44F pursuant to section 221 of the Economic Recovery Tax Act of 1981, 1981-2 C.B. 256, 293. Section 44F was redesignated as section 30 pursuant to section 471(c)(1) of the Deficit Reduction Act of 1984, 1984-3 (Vol. 1) C.B. 2, 334. Section 231(d)(2) of the Tax Reform Act of 1986, 1986-3 (Vol. 1) C.B. 2, 95, amended the research credit provisions and redesignated section 30 as section 41.

² 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. See section 41(b)(2)(B). "Qualified research" is defined in section 41(d) but is not directly relevant to the issue present in these guidelines.

Plan incorporates a trust satisfying the requirements of section 401(a), making it tax-exempt under section 501(a). The Plan also includes a qualified deferred compensation arrangement meeting the requirements of section 401(k). Under the Plan's deferred compensation arrangement, eligible employees may elect to have the Taxpayer contribute up to 10 percent of their compensation to the Plan's trust (hereinafter "elective contributions"). Certain eligible employees have so elected to defer their compensation and make elective contributions. The Taxpayer also contributes an additional amount for each dollar deferred by its employees (hereinafter "matching contributions").

In computing the credit for increasing research under section 41(a) of the Code, the Taxpayer treats both the elective contributions and the matching contributions as qualified research expenses.

The position taken in the Coordinated Issue Paper is that neither elective nor matching contributions are qualified research expenses under section 41(b)(2)(A) of the Code because they are excluded from the meaning of wages under section 3401(a) of the Code.

Section 41 provides a credit against tax for increasing research activities. This incremental credit equals the sum of 20 percent of the excess of the taxpayer's qualified research expenses for the taxable year over a base amount, plus 20 percent of the taxpayer's basic research payments.

The general rule is provided in section 41(a):

for purposes of section 38³, the research credit determined under this section for the taxable year shall be an amount equal to the sum of--

(1) 20 percent of the excess (if any) of—

the qualified research expenses for the taxable year, over the base amount, and

(2) 20 percent of the basic research payments determined under subsection (e)(1)(A). (Emphasis added).

The term "qualified research expenses" includes "in-house research expenses." Under section 41(b)(2)(A), in-house research expenses includes "any wages paid or incurred to an employee for qualified services⁴ performed by such employee."

³ Section 38 of the Code allows a general business credit equal to the sum of the taxpayer's business credit carryforwards, current year business credit, and business credit carrybacks. The research credit under section 41(a) is one of eleven current year business credits. See section 38(b)(4).

The paper contends that the term "wages" under section 41(b)(2)(D) has the same meaning as the term "wages" under section 3401(a) in determining whether certain qualified research expenses qualify for the credit for increasing research activities under section 41. Section 41(b)(2)(D) is cited. That section clearly provides that the term "wages" under section 41 "has the meaning given such term by section 3401(a)." Accordingly, the paper looks to the meaning of wages under section 3401(a) to determine the meaning of wages under section 41.

Under section 3401(a), wages means all remuneration for services performed by an employee for his employer, including the cash value of all remuneration not paid in cash, subject to certain exceptions. See section 3401(a)(1)-(20). Under section 3401(a)(12)(A), the term wages does not include remuneration paid on behalf of an employee to a trust under section 401(a), which is tax-exempt under section 501(a) at the time the payment is made. Another exception provides that the term wages also does not include remuneration paid as fringe benefits under section 132. See section 3401(a)(19).

The paper cites the legislative history of the Economic Recovery Tax Act to show that Congress intended the term wages under section 41(b)(2)(D) to have the same meaning as the term wages under section 3401(a). "[A]mounts of compensation which are not subject to withholding, such as certain fringe benefits, do not enter into the credit computation even though paid for service in performing research." H. Rept. 97-201 (1981), 1981-2 C.B. 352, 361. (The legislative history is that of section 44F, the predecessor of section 41. However, for purposes of this issue, there is no difference between section 44F as originally enacted and section 41. See, *Sun Microsystems, Inc.* T.C. Memo 1995-69, 69 TCM 1884, Footnote 2.)

The paper cites two recent cases where the Tax Court has construed the term wages under section 41⁵ to have the same meaning as wages in section 3401(a). See, *Apple Computer, Inc. v. Commissioner*, 98 T.C. 232 (1992), acq., 1992-2 C.B. 1; *Sun Microsystems, Inc.*, supra. The Tax Court relied on the statutory language and the legislative history in concluding that section 3401(a) governed the meaning of wages under section 41.

SETTLEMENT GUIDELINE

#

⁴ The term "qualified services," defined under section 41(b)(2)(B), is comprised of other terms, such as "qualified research," which is defined under section 41(d). The meaning of these terms is not directly relevant to the resolution of the issues presented here and is not discussed.

⁵ In *Apple Computer, Inc.*, the court considered the term wages in section 44F, which was later redesignated section 41, the current section. See footnote 1.

(Any line marked with a # is for Official Use Only)

#