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INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
CHIEF COUNSEL

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR
AREA COUNSEL

FROM: Paul F. Kugler
Associate Chief Counsel CC:PSI

SUBJECT: Credit for Increasing Research Activities under Section 41 of
the Internal Revenue Code

This Chief Counsel Advice responds to your memorandum dated December 5, 2001. In accordance with section 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

Taxpayer:

Subsidiary 1:

Subsidiary 2:

Date 1:

Date 2:

Date 3:

Date 4:

Date 5:

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Date 6:

Date 7:

Date 8:

ISSUES

(1) How should Taxpayer compute its credit for increasing research activities under section 41 (research credit) for the taxable year including the date it distributed all of its stock in Subsidiary 1, a wholly-owned subsidiary, to its shareholders?

(2) How should Subsidiary 1 compute its research credit for its taxable year beginning on the day following the date Taxpayer distributed all of its stock in Subsidiary 1 to Taxpayer's shareholders?

(3) How should Taxpayer compute its research credit for the taxable year including the date it distributed all of its stock in Subsidiary 2, a wholly-owned subsidiary, to its shareholders?

(4) How should Subsidiary 2 compute its research credit for its taxable year beginning on the day following the date Taxpayer distributed all of its stock in Subsidiary 2 to Taxpayer's shareholders?

CONCLUSIONS

(1) Taxpayer should compute its research credit for the taxable year including the date it distributed all of its stock in Subsidiary 1, a wholly-owned subsidiary, to its shareholders by computing two components. The first component will include the research credit allocable to the qualified research expenses paid or incurred by Subsidiary 1 during its short credit year beginning Date 1 and ending Date 2. The second component will include the research credit attributable to all members of Taxpayer's controlled group as of the end of its taxable year beginning on Date 1 and ending on Date 4.

(2) Subsidiary 1 should compute its research credit for its taxable year beginning on the day following the date Taxpayer distributed all of its stock in Subsidiary 1 to Taxpayer's shareholders using the short taxable year rules described in Treas. Reg. § 1.41-3(b).

(3) Taxpayer should compute its research credit for the taxable year including the date it distributed all of its stock in Subsidiary 2, a wholly-owned subsidiary, to its

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shareholders by computing two components. The first component will include the research credit allocable to the qualified research expenses paid or incurred by Subsidiary 2 during its short credit year beginning Date 5 and ending Date 6. The second component will include the research credit attributable to all members of Taxpayer's controlled group as of the end of its taxable year beginning on Date 5 and ending on Date 8.

(4) Subsidiary 2 should compute its research credit for its taxable year beginning on the day following the date Taxpayer distributed all of its stock in Subsidiary 2 to Taxpayer's shareholders using the short taxable year rules described in Treas. Reg. § 1.41-3(b).

FACTS

Taxpayer is a publicly traded corporation. For all relevant taxable years, Taxpayer filed a Form 1120, U.S. Corporation Income Tax Return, including all members of Taxpayer's consolidated return group.

For taxable years preceding the taxable year beginning on Date 1, Subsidiary 1 was a wholly-owned subsidiary of Taxpayer and a member of Taxpayer's consolidated return group. On Date 2, Taxpayer distributed all of its stock in Subsidiary 1 to Taxpayer's shareholders.

Subsidiary 1 filed a Form 1120 for the taxable year commencing on Date 3, the day after Date 2, and ending on Date 4. Subsidiary 1 also filed Forms 1120 for each taxable year beginning after Date 4.

For taxable years preceding the taxable year beginning on Date 5, Subsidiary 2 was a wholly-owned subsidiary of Taxpayer and a member of Taxpayer's consolidated return group. On Date 6, Taxpayer distributed all of its stock in Subsidiary 2 to Taxpayer's shareholders.

Subsidiary 2 filed a Form 1120 for the taxable year commencing on Date 7, the day after Date 6, and ending on Date 8. Subsidiary 2 also filed Forms 1120 for each taxable year beginning after Date 8.

LAW

Section 41 provides a nonrefundable income tax credit for qualified research expenses paid or incurred by a taxpayer during the taxable year. Under the general rule, the research credit is equal to the sum of twenty percent of the excess (if any) of the taxpayer's qualified research expenses for the taxable year over its base amount,

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and the base amount is computed by multiplying the taxpayer's fixed-base percentage by its average annual gross receipts for the preceding four years. A taxpayer's fixed-base percentage is the percentage that the aggregate qualified research expenses of the taxpayer for taxable years beginning after December 31, 1983, and before January 1, 1989, is of the aggregate gross receipts of the taxpayer for such taxable years. Section 41(c)(3)(A).

Section 41(f)(1)(A) requires that for purposes of determining the amount of research credit, all members of the same controlled group of corporations are to be treated as a single taxpayer. Prop. Treas. Reg. § 1.41-8(a)(1)¹ provides that in determining the amount of research credit allowed with respect to a trade or business that at the end of its taxable year is a member of a controlled group of corporations, all members of the group are treated as a single taxpayer. The research credit allowable to any member of the controlled group is equal to that member's proportionate share of the qualified research expenses and basic research payments giving rise to the credit.

Prop. Treas. Reg. § 1.41-8 provides guidance on how a controlled group of corporations should compute its research credit. When a controlled group computes its base amount, the group must first aggregate each member's base year qualified research expenses, base year gross receipts, and average annual gross receipts for the four years preceding the credit year. Also, the group's credit year qualified research expenses are the aggregate of each member's credit year qualified research expenses.

Prop. Treas. Reg. § 1.41-8(c)(1) provides that the credit allowable to a member of a controlled group of corporations is that member's share of the aggregate credit computed as of the end of such member's taxable year. In computing the aggregate credit in the case of a group whose members have different taxable years, a member shall generally treat the taxable year of another member that ends with or within the credit year of the computing member as the credit year of that other member. In computing the aggregate base amount, the gross receipts taken into account with respect to another member shall include that other member's gross receipts for the four taxable years of that other member preceding the credit year of that other member.

Section 41(f)(3)(A) provides that if a taxpayer acquires the major portion of a trade or business of another person (hereinafter in this paragraph referred to as the "predecessor") or the major portion of a separate unit of a trade or business of a

¹Unless otherwise noted in this document, all references to Prop. Treas. Reg. § 1.41-8 refer to proposed amendments to the Income Tax Regulations relating to the aggregation and allocation of the research credit published in the Federal Register on January 4, 2000. See REG-105606-99 (65 FR 258).

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predecessor, then, for purposes of applying section 41 for any taxable year ending after such acquisition, the amount of qualified research expenses paid or incurred by the taxpayer during periods before such acquisition shall be increased by so much of such expenses paid or incurred by the predecessor with respect to the acquired trade or business as is attributable to the portion of such trade or business or separate unit acquired by the taxpayer, and the gross receipts of the taxpayer for such periods shall be increased by so much of the gross receipts of such predecessor with respect to the acquired trade or business as is attributable to such portion.

Further, section 41(f)(3)(B) provides that if a taxpayer disposes of the major portion of any trade or business or the major portion of a separate unit of a trade or business in a transaction to which section 41(f)(3)(A) applies, and the taxpayer furnished the acquiring person such information as is necessary for the application of section 41(f)(3)(A), then, for purposes of applying section 41 for any taxable year ending after such disposition, the amount of qualified research expenses paid or incurred by the taxpayer during periods before such disposition shall be decreased by so much of such expenses as is attributable to the portion of such trade or business or separate unit disposed of by the taxpayer, and the gross receipts of the taxpayer for such periods shall be decreased by so much of the gross receipts as is attributable to such portion.

Treas. Reg. § 1.41-7(b) provides that, for the meaning of “acquisition,” “separate unit,” and “major portion,” see Treas. Reg. § 1.52-2(b). In addition, Treas. Reg. § 1.41-7(b) provides that an “acquisition” includes an incorporation or a liquidation. No further clarification or examples describing an acquisition are provided in the regulations under section 41.

Treas. Reg. § 1.52-2(b)(1)(i) provides that the term “acquisition” includes certain lease agreements. Further, Treas. Reg. § 1.52-2(b)(1)(ii) provides that neither the major portion of a trade or business nor the major portion of a separate unit of a trade or business is acquired merely by acquiring physical assets. The acquisition must transfer a viable trade or business.

Under Treas. Reg. § 1.52-2(b)(2), a separate unit is a segment of a trade or business capable of operating as a self-sustaining enterprise with minor adjustments. The allocation of a portion of the goodwill of a trade or business to one of its segments is a strong indication that the segment is a separate unit. Treas. Reg. § 1.52-2(b)(2) provides several examples illustrating the acquisition of a separate unit of a trade or business. Each of these examples assumes that there is an acquisition of assets by an unrelated entity.

Treas. Reg. § 1.52-2(b)(3) provides that all the facts and circumstances surrounding the transaction shall be taken into account in determining what constitutes a major portion of a trade or business (or separate unit).

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Section 41(f)(4) provides that in the case of any short taxable year, qualified research expenses and gross receipts shall be annualized in such circumstances and under such methods as the Secretary may prescribe by regulation. Section 1.41-3(b)² contains the following rules:

(1) If a credit year is a short taxable year, then the base amount determined under section 41(c)(1) (but not section 41(c)(2)) shall be modified by multiplying that amount by the number of months in the short taxable year and dividing the result by twelve.

(2) If one or more of the four taxable years preceding the credit year is a short taxable year, then the gross receipts for such year are deemed to be equal to the gross receipts actually derived in that year multiplied by twelve and divided by the number of months in that year.

(3) No adjustment shall be made on account of a short taxable year to the computation of a taxpayer's fixed-base percentage.

Section 41(f)(5) provides that the term "controlled group of corporations" has the same meaning given to such term by section 1563(a) except that -

(A) "more than fifty percent" shall be substituted for "at least eighty percent" each place it appears in section 1563(a)(1), and

(B) the determination shall be made without regard to section 1563(a)(4) and (e)(3)(C).

Under section 1563(a)(1), a parent-subsidary controlled group exists where one or more chains of corporations are connected through stock ownership with a common parent corporation if the percentage of ownership requirements are met with regard to each corporation in the group.

ANALYSIS

The issues in this case involve the interaction of the research credit computation rules under section 41(c) and the special rules under section 41(f) for the taxable year in which the parent of a consolidated group of corporations distributes to its

²The rules under section 1.41-3(b) were amended by T.D. 8930 to reflect the changes to the computation of the research credit made by the Revenue Reconciliation Act of 1989. Although these rules are applicable for taxable years beginning on or after January 3, 2001 and Notice 2001-19 provides that the IRS and Treasury are reconsidering T.D. 8930, the rules provide guidance for all taxable years beginning after December 31, 1989.

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shareholders all of its stock in a wholly-owned subsidiary. Neither the regulations nor other published guidance specifically address these issues.

Disposition of Subsidiary 1

Under the consolidated return regulations in effect on Date 2, the consolidated return of a group must include the income of the common parent for that corporation's entire taxable year and, generally, the income of each subsidiary for the portion of such taxable year during which it was a member of the group. Treas. Reg.

§ 1.1502-76(b)(1). If the consolidated return of a group properly includes the income of a corporation for only a portion of such corporation's taxable year, then the income for the portion of such taxable year not included in the consolidated return must be included in a separate return (or, if such corporation is a member of another group which files a consolidated return for such portion of such year, then in such consolidated return). Treas. Reg. § 1.1502-76(b)(2). Any period of less than twelve months for which either a separate return or a consolidated return is filed is considered a separate taxable year. Treas. Reg. § 1.1502-76(d).

If the taxable income of a member for a taxable year must be included partly in a consolidated return and partly in a separate return, the taxable income to be reported in each such return is determined on the basis of the member's income shown on its permanent records (including work papers). Treas. Reg. § 1.1502-76(b)(4)(i). If the portion of an item of income or deduction to be reported cannot be clearly determined from the permanent records, the portion of such item to be included in each such return shall be the amount of the item for the full taxable year multiplied by a fraction, the numerator of which is the number of days for which the member's income is to be included in such return and the denominator of which is the total number of days in such year. Treas. Reg. § 1.1502-76(b)(4)(ii).

Based on the rules under Treas. Reg. § 1.1502-76, for the period beginning on Date 1 and ending on Date 2, the taxable income of Subsidiary 1 must be included on Taxpayer's consolidated return. Further, for the period beginning on Date 3 and ending on Date 4, the taxable income of Subsidiary 1 must be included in a separate return filed by Subsidiary 1.

Although Taxpayer does not have any short taxable periods during the period beginning on Date 1 and ending on Date 4, Subsidiary 1 is treated as having two short taxable periods during the period, a short taxable period beginning on Date 1 and ending on Date 2 and a short taxable period beginning on Date 3 and ending on Date 4. For the short taxable period beginning on Date 1 and ending on Date 2, Subsidiary 1 was wholly-owned by Taxpayer and a member of Taxpayer's consolidated return group. For the short taxable period beginning on Date 3 and ending on Date 4, Subsidiary 1 was not a member of Taxpayer's consolidated return group. The research

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credit allocable to Subsidiary 1's qualified research expenses must be determined for each short taxable period.

Because Subsidiary 1 and Taxpayer were members of the same controlled group for Subsidiary 1's short taxable period beginning on Date 1 and ending on Date 2, the rules of section 41(f)(1) and the regulations thereunder apply to compute the amount of research credit allocable to Subsidiary 1 for its short taxable period beginning on Date 1 and ending on Date 2. Further, the research credit allocable to Subsidiary 1 for its short taxable period beginning on Date 1 and ending on Date 2 is included on Taxpayer's consolidated return for Taxpayer's taxable year beginning on Date 1 and ending on Date 4. Thus, Taxpayer's research credit for its taxable year beginning on Date 1 and ending on Date 4 must include two components, the amount of the research credit allocable to Subsidiary 1 for its short taxable period beginning on Date 1 and ending on Date 2 and the amount of Taxpayer's research credit determined under the general rules of section 41(f)(1) and the regulations thereunder.

The general rule for computing the research credit for members of a controlled group of corporations with different taxable years provides that a member shall generally treat the taxable year of another member that ends with or within the credit year of the computing member as the credit year of that other member. In this case, Taxpayer does not have a taxable year that ends with or within the credit year of Subsidiary 1. Neither the regulations nor any other published guidance address this situation. However, the principles of Section 41(f)(1) and (4) and Treas. Reg. § 1.41-8 provide guidance in computing the proper amount of research credit allocable to Subsidiary 1 for its short taxable period beginning on Date 1 and ending on Date 2 and included in Taxpayer's research credit allowed for its taxable year beginning on Date 1 and ending on Date 4.

To compute Subsidiary 1's research credit for its short taxable period beginning Date 1 and ending Date 2, the aggregate base year qualified research expenses, base year gross receipts, and average annual gross receipts of the members of Subsidiary 1's controlled group for the four years preceding the credit year must be determined. Because Subsidiary 1 and Taxpayer were members of the same controlled group of corporations for all relevant taxable years through the credit year, the group base amount is computed without regard to the rules of section 41(f)(3). After the group base amount is determined, the base amount should be modified by multiplying the amount by the number of months in the short taxable year and dividing the result by twelve.

Next, the group's credit year qualified research expenses are determined by aggregating each member's credit year qualified research expenses. However, because Subsidiary 1's credit year is a short taxable year, the credit year qualified research expenses should reflect the short taxable year. In computing the research credit allocable to Subsidiary 1's qualified research activities during the short taxable

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period beginning on Date 1 and ending on Date 2, the qualified research expenses paid or incurred by Subsidiary 1 should be determined based upon Subsidiary 1's permanent records. Further, we believe that the qualified research expenses paid or incurred by Taxpayer during the period beginning Date 1 and ending Date 2 should be determined on a reasonable basis.

Once the group's credit year qualified research expenses and the group's base amount for the short taxable period are determined, the research credit for the group based on this short taxable period and the amount of the group research credit allocable to Subsidiary 1 should be determined under rules similar to the rules in Prop. Treas. Reg. § 1.41-8. The amount allocable to Subsidiary 1 for the short taxable period beginning on Date 1 and ending on Date 2, should be included on Taxpayer's consolidated return for its taxable year beginning on Date 1 and ending on Date 4 as the amount of research credit attributable to Subsidiary 1 for the portion of the taxable year in which it was part of the Taxpayer's consolidated group.

To compute the component of Taxpayer's research credit for its taxable year beginning Date 1 and ending Date 4, Prop. Treas. Reg. § 1.41-8(a)(1) provides that in determining the amount of research credit allowed with respect to a trade or business that at the end of its taxable year is a member of a controlled group of corporations, all members of the group are treated as a single taxpayer. Because Subsidiary 1 is not a member of Taxpayer's controlled group of corporations on Date 4, Subsidiary 1 is not part of the aggregation used in computing the group credit for this component of Taxpayer's research credit. Taxpayer should follow the general rules of Prop. Treas. Reg. § 1.41-8(a) to compute its group research credit.

For Subsidiary 1's short taxable year beginning Date 3 and ending Date 4, Subsidiary 1 has a separate return year. Subsidiary 1 is no longer part of Taxpayer's controlled group of corporations. To compute Subsidiary 1's research credit for its short taxable period beginning Date 3 and ending Date 4, Subsidiary 1 is no longer aggregated with Taxpayer. Further, Subsidiary 1 must compute its research credit under the short taxable year rules applicable to short credit years.

Disposition of Subsidiary 2

Under the consolidated regulations in effect from Date 5 through Date 8, a consolidated return must include the common parent's income, gain, deduction, loss, and credit for the entire consolidated return year, and each subsidiary's items for the portion of the year for which it is a member. Treas. Reg. § 1.1502-76(b)(1)(i). If the consolidated return includes the items of a corporation for only a portion of its tax year, items for the portion of the year not included in the consolidated return must be included in a separate return. Treas. Reg. § 1.1502-76(b)(1)(i). In general, a corporation ceases to be a member during a consolidated return year at the end of the day on which its status as a member changes and its tax year ends for all Federal

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income tax purposes at the end of that day. Treas. Reg. § 1.1502-76(b)(1)(ii)(A). If a transaction occurs that is properly allocable to the portion of the subsidiary's day after it ceases to be a member, the subsidiary (and all related persons) must treat the transaction as occurring at the beginning of the following day. Treas. Reg. § 1.1502-76(b)(1)(ii)(B).

The returns for the years that end and begin with a subsidiary becoming (or ceasing) to be a member are separate tax years and are subject to the rules of the Code applicable to short periods. Treas. Reg. § 1.1502-76(b)(2)(i). Although the periods ending and beginning with the subsidiary's change in status are different tax years, items (other than extraordinary items) may be ratably allocated between the periods if the subsidiary is not required to change its annual accounting period or its method of accounting as a result of its change in status and the subsidiary makes an irrevocable ratable allocation election. Treas. Reg. § 1.1502-76(b)(2)(ii).

The research credits of Subsidiary 2 must be included on Taxpayer's consolidated return for the period Date 5 through Date 6, and in a separate return for the period Date 7 through Date 8.³ In computing the research credits, the qualified research expenses paid or incurred by Subsidiary 2 should be allocated between these two periods based upon the 'closing of the books' method used by Subsidiary 2. As in the case of its disposition of Subsidiary 1, for Taxpayer's taxable year ending on Date 8, the research credit allocable to Subsidiary 2 for the period beginning on Date 5 and ending on Date 6 should be included as a component of Taxpayer's research credit for Taxpayer's taxable year including Date 6, that is, Taxpayer's taxable year beginning on Date 5 and ending on Date 8. Treas. Reg. § 1.1502-76(b)(1)(i); See Rev. Rul. 75-532, 1975-2 C.B. 295. The qualified research expenses paid or incurred by Subsidiary 2 for the period beginning on Date 7 and ending on Date 8 should be included in computing Subsidiary 2's research credit for its separate return. Treas. Reg. § 1.1502-76(b)(1)(i).

The actual computations of the amount of credit allowed for the period beginning on Date 5 and ending on Date 8 should be computed using the same methodology described above.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

³ Based upon a discussion with the Field agent, Subsidiary 2 did not make a ratable allocation election. Subsidiary 2 used the 'closing of the books' method under Treas. Reg. § 1.1502-76(b)(2)(i). Again, we are not opining on the appropriate method to be used or the accuracy of the calculations.

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Although there is no guidance addressing the appropriate method for determining Taxpayer's qualified research expenses allocable to the short credit years of Subsidiaries 1 and 2, we believe that reasonable approaches include a pro rata allocation method and an actual expense allocation method.

[REDACTED]

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Please call if you have any further questions.

By: Associate Chief Counsel
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