

INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

April 12, 2023

Third Party Communication: None
Date of Communication: Not Applicable

Number: **202327015**
Release Date: *7/7/2023*
Index (UIL) No.: 41.00-00, 41.50-03
CASE-MIS No.: TAM-105894-22

Appeals Team Case Leader
IRS Independent Office of Appeals

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No
Year(s) Involved:
Date of Conference:

LEGEND:

Taxpayer =

Project =

Brand 1 =

Line 1 =

Business Component =

Location =

Year 1 =

Year 2 =

Year 3 =

Year 4 =

Year 5 =

b =

c =

e =

f =

g =

h =

i =

i =

k =

l =

m =

n =

o =

p =

q =

r =

s =

t =

ISSUES

1. Whether the research activities with respect to the development of the Business Component are for a qualified purpose under § 41(d)(3)?
2. Whether research activities with respect to the development of the Business Component may satisfy the process of experimentation test under § 41(d)(1)(C) if Taxpayer undertook the activities for both qualified and non-qualified purposes under § 41(d)(3)?

CONCLUSIONS

1. Possibly. Certain research activities with respect to the development of the Business Component may be for a qualified purpose under § 41(d)(3).
2. Yes. The research activities with respect to the development of the Business Component may satisfy the process of experimentation test under § 41(d)(1)(C) if Taxpayer undertook the activities for both qualified and non-qualified purposes under § 41(d)(3), if substantially all of the research activities for the Business Component constitute elements of a process of experimentation for a qualified purpose described in § 41(d)(3)(A).

FACTS

Background

IRS Exam (“Exam”) entirely disallowed Taxpayer’s research credit claims for Year 1, Year 2, Year 3, Year 4, and Year 5 (the “taxable years”). During the examination, particular business components were selected to review that were identified as representative of the business components for which research credits were claimed. The development process for Project was selected as an example of a business component for . Exam issued a Notice of Proposed Adjustment that disallowed Taxpayer’s claimed research credits for the Business Component, in part, because all of Taxpayer’s development activities for the Business Component were non-qualified activities undertaken for purposes of style, taste, cosmetics or season design factors. Taxpayer protested the proposed disallowance to the IRS Independent Office of Appeals (Appeals). Appeals tentatively agreed with Exam’s proposed disallowance. Subsequently, Taxpayer sought technical advice from the Office of Associate Chief Counsel (Passthroughs and Special Industries) with respect to the Business Component.

Appeals and Taxpayer were not able to agree on all relevant facts. Therefore, each party submitted its own statement of facts pursuant to section 7.06 of Rev. Proc 2022-2, which allows a taxpayer and the IRS to each submit a separate statement of facts when the parties cannot resolve their disagreement on the facts. CCDM 33.2.2.1.2 (3) provides, in part, that if the Associate office chooses to issue technical advice, and the

Associate office would rule the same way on either set of facts, then the technical advice will be issued and will note that the factual dispute is immaterial. If the Associate office would rule differently based on which specific set of facts is considered, the technical advice will be issued describing the resolution based on each set of facts. The conclusions in this technical advice memorandum are the same under both party's represented facts.

Facts submitted by Taxpayer

Taxpayer is a [redacted] apparel retail company, headquartered in Location with over b stores [redacted]. Taxpayer sells [redacted]. Taxpayer's sales consist primarily of its own private label products. During the taxable years, Taxpayer's products consisted of [redacted]. The market in which Taxpayer operates is competitive and saturated. Typically, Taxpayer has e to f seasons per year. For each season, Taxpayer designs and develops new and/or revised product lines.

Taxpayer employs cross-functional product development teams to develop each of its product lines. Taxpayer's product development team personnel generally can be categorized by their functional specialties within the product development process, including [redacted].

During Year 3 and Year 4, Taxpayer undertook the Project to develop the Business Component. The Business Component would be part of Line 1 of [redacted]. Taxpayer recognized that no product in the market was [redacted]. Taxpayer concluded that altering the [redacted] Line 1 base and specification formula, without compromising the product line's fundamental performance standards, created development challenges.

Taxpayer identified key performance standards at the inception of the Business Component, requiring that [redacted]

[redacted] Taxpayer concluded that [redacted] would meet its performance requirements.

To establish a baseline, Taxpayer directed its [redacted]

and provide them to Taxpayer's [redacted] for testing. Taxpayer's [redacted]

determined that it could not use its because application of the h percent. Based on the testing results and Taxpayer's determination that there was no suitable , Taxpayer's concluded that it would have to develop

After using products proved unsuccessful, Taxpayer's . At the direction of Taxpayer's product development team, sent these prototypes to Taxpayer's product development team for evaluation.

After a series of evaluations involving numerous . Taxpayer evaluated i from before Taxpayer's product development team determined that, for the sample product, it needed to reduce e percent, increase j percent, and increase from k to l . Once for the sample product that met Taxpayer's standards had been approved, Taxpayer's worked with the to create and send prototype to , which the then used to build prototypes for .

Taxpayer's team worked with teams to evaluate how various

The Business Component was developed Each impacted the characteristics in different ways. Therefore, Taxpayer needed to develop different

exhibited consistent Separate for each ensured that a consistent was established for

each Taxpayer evaluated how the different and evaluated iterative exhibited consistent conditions. Taxpayer referred to this testing as

Thereafter, Taxpayer requested additional prototypes from Taxpayer's these additional prototypes. Following results for prototypes constructed for each selected what it determined were the optimal

As part of Taxpayer's evaluation, Taxpayer used prototypes to undertake different activities, and Taxpayer's evaluated the function before, during and after the activities using

provided qualitative and quantitative data regarding the Business Component's The interactively redesigned the based on a technological, analytical process.

After Taxpayer's completed Taxpayer's requested additional prototypes from took measurements, and made Revisions based on subsequent tests were incorporated into the final, approved product specifications.

Taxpayer's conducted m rounds of testing and e rounds of testing before settling on a final design for the Business Component.

Facts submitted by Appeals

Taxpayer is an apparel retailer that sells its own private label products. For the taxable years, Taxpayer claimed research credits under § 41. To develop its products, Taxpayer employs teams of professionals. Generally, these product development teams consist of Taxpayer's teams. Taxpayer included a portion of the wages paid to its product development teams as qualified research expenses ("QREs").

Taxpayer relied on the activity listings in its internal development calendars to determine the wages includable in its QREs. For the taxable year ended Year 4, the majority (n percent) of the QREs related to Taxpayer's product development teams were attributable to Taxpayer's

teams. Taxpayer reduced the amount of its wage QREs by g percent to account for any time associated with style, taste, and cosmetic design.

Taxpayer uses _____ to build and test samples and prototypes. Taxpayer did not include the costs attributable to its _____ as QREs.

Taxpayer identified projects it believes are representative of its product development activities. For taxable year ended Year 4, one of these representative projects was the Project. The purpose of the Project was to develop the Business Component.

Taxpayer began the Project after attending tradeshows at which the latest _____ trends were exhibited. Taxpayer's observations at these tradeshows led it to conclude that _____ were going to be in vogue for the upcoming _____ seasons, and Taxpayer decided to introduce _____

To maintain _____ Taxpayer's existing suite _____ the Business Component needed to exhibit g percent. Taxpayer also needed a suitable _____ The Business Component needed to meet industry standards _____

_____ performed the testing for _____ industry standards.

Taxpayer's existing _____ reduced from g percent to h percent, and as a result, Taxpayer worked face-to-face with the _____

and gave recommendations on the best _____ for the Business Component, and the _____ also conducted their own research. Over the course of the Project, i samples/ _____ were produced. The _____ for the Project consisted of o percent _____, p percent _____, and q percent. Taxpayer's existing _____ consisted of r percent _____ s percent and t percent _____.

With respect to the _____ for the Business Component, Taxpayer provided its _____ advice on what would not work but largely relied on these _____ to develop the _____. After deciding on the _____ and _____ for the Business Component, Taxpayer had the _____ produce _____ prototypes based on _____ prepared by Taxpayer. Taxpayer conducted _____ testing on these prototypes. Taxpayer provided the _____ with _____ feedback consisting of notations to the prototype specifications, indicating whether certain _____ should be increased or decreased. Also, Taxpayer provided the _____ with _____

that primarily concerned _____

The _____ testing conducted by Taxpayer was not a chemical _____

or empirical test;

Taxpayer has not provided a complete description of the activities its product development teams undertook as part of the Project, and Taxpayer has not identified which activities undertaken as part of the Project it considers qualified for purposes of § 41.

Taxpayer identified certain activities from its _____ that it classified as qualified; these activities include, but are not limited to _____

LAW

Section 41(a)(1)¹ provides, in part, that the research credit for the taxable year is an amount equal to the sum of 20 percent of the excess (if any) of the qualified research expenses for the taxable year over the base amount. Section 41(b)(1) provides that the term "qualified research expenses" means the sum of the in-house research expenses and contract research expenses that are paid or incurred by the taxpayer during the taxable year in carrying on any trade or business of the taxpayer. Under § 41(b)(2)(A), the term "[i]n-house research expenses" means, (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, 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.

Under § 41(b)(2)(B), 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. Section 41(b)(3)(A) defines the term "contract research expenses" as 65 percent of any amount paid or incurred by the taxpayer to any person (other than an employee of the taxpayer) for qualified research.

Under § 41(d)(1) the term "qualified research" means research (A) with respect to which expenditures that may be treated as expenses under § 174, (B) which is undertaken for the purpose of discovering information which is technological in nature and the application of which is intended to be useful in the development of a new or improved business component of the taxpayer, and (C) substantially all of the activities of which

¹ The applicable law in this case is the law that applied prior to applicability of the amendments made by the Tax Cuts and Jobs Act, Pub. L. No. 115-97, § 13206, 131 Stat. 2111, 2113 (2017).

constitute elements of a process of experimentation for a purpose described in § 41(d)(3).

Section 41(d)(3)(A) provides that for purposes of § 41(d)(1)(C), research is conducted for a qualified purpose if it relates to a new or improved function, performance, or reliability or quality. However, § 41(d)(3)(B) provides that research shall in no event be treated as conducted for a purpose described in § 41(d)(3) if it relates to style, taste, cosmetic, or seasonal design factors.

Section 1.41-4(a)(6) of the income tax regulations provides that in order for activities to constitute qualified research under § 41(d)(1), substantially all of the activities must constitute elements of a process of experimentation that relates to a qualified purpose. The substantially all requirement of § 41(d)(1)(C) and § 1.41-4(a)(2)(iii) is satisfied only if 80 percent or more of a taxpayer's research activities, measured on a cost or other consistently applied reasonable basis (and without regard to § 1.41-2(d)(2)), constitute elements of a process of experimentation for a purpose described in § 41(d)(3). Accordingly, if 80 percent (or more) of a taxpayer's research activities with respect to a business component constitute elements of a process of experimentation for a purpose described in § 41(d)(3), then the substantially all requirement is satisfied even if the remaining 20 percent (or less) of a taxpayer's research activities with respect to the business component do not constitute elements of a process of experimentation for a purpose described in § 41(d)(3), so long as these remaining research activities satisfy the requirements of § 41(d)(1)(A) and are not otherwise excluded under § 41(d)(4). The substantially all requirement is applied separately to each business component.

Therefore, research with respect to a taxpayer's business component can be qualified research under § 41(d) if at least 80 percent of Taxpayer's research activities for the business component is for a qualified purpose relating to new or improved function, performance, or reliability or quality under § 41(d)(3)(A), and 20 percent or less of Taxpayer's activities are for purposes that relate to style, taste, cosmetic or seasonal design factors.

ANALYSIS

The statements of facts provided by Taxpayer and Appeals, suggest that certain research activities undertaken by Taxpayer as part of Project may have been for a qualified purpose under § 41(d)(3), while certain research activities may have been for a purpose that does not qualify under § 41(d)(3).

According to Taxpayer's statement of facts, the Business Component had four main performance standards:

Appeals' statement of facts provided that the Business Component needed to maintain
Taxpayer also needed

Particular research activities undertaken by Taxpayer with respect to the development of the Business Component may have been for a qualified purpose. For example, such activities appear to include ensuring that the Business Component met

. However, to the extent that these activities did not relate to a new or improved function, performance, or reliability or quality; the activities were not for a qualified purpose.

The mere fact that a taxpayer engaged in activities with respect to the Business Component that were not for a qualified purpose under § 41(d)(3), does not preclude that taxpayer from satisfying the process of experimentation test under § 41(d)(1(C)). So long as substantially all of Taxpayer's activities for Business Component constitute elements of a process of experimentation for a qualified purpose described in § 41(d)(3)(A).

While both statements of fact provided by Taxpayer and Appeals describe research activities that may be for a qualified purpose and others that may be for a non-qualified purpose, neither statement establishes whether substantially all of Taxpayer's activities were for a qualified purpose. To meet the process of experimentation test, Taxpayer must provide sufficient documentation to show that substantially all of Taxpayer's activities related to the Business Component are for a qualified purpose. See, Max v. Commissioner, T.C. Memo 2021-37 at 43.

Except as specifically set forth above, no opinion is expressed concerning the federal tax consequences of the facts described under any other provision of the Code. Further, except for the discussion concerning the application of § 41(d)(3), no opinion is expressed concerning whether Taxpayer qualifies for the research credit under § 41.

CAVEATS

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.