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DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR DISTRICT COUNSEL

FROM: Assistant Chief Counsel (Field Service) CC:DOM:FS

SUBJECT:

This Field Service Advice responds to your inquiry dated August 11, 1998. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

A:
B:
A-B Partnership:
Year 1:

ISSUE:

Whether A-B Partnership's filing of an amended tax return for Year 1 and subsequent returns to pass through to its partners qualified research expenditures, as opposed to research credits under I.R.C. § 41, is an unauthorized change in method of accounting.

CONCLUSION:

For the reasons set forth below, the actions taken by A-B Partnership do not constitute a change in accounting method.

FACTS:

In its original income tax return for Year 1, A-B Partnership filed its return as a partnership and calculated the research credit at the partnership level and then passed the research credit through to its partners based upon the partners' distributive share agreement. In an amended tax return for Year 1, A-B Partnership changed from passing the research credit through to its partners, as was done in its original Year 1 return, to passing through to the partners their distributive share of qualified research expenses for inclusion in the partners' computation of the research credit on each of the partners' tax returns.

LAW AND ANALYSIS

Section 41(a) allows a credit against tax for increasing research activities. Section 41(b) provides that the term "qualified research expenses" means the sum of the amounts which are paid or incurred by the taxpayer during the taxable year in carrying on any trade or business of the taxpayer for in-house expenses and contract research expenses.

Treas. Reg. § 1.41-9(a)(3)(i) provides that, in the case of a partnership, the research credit computed for the partnership for any taxable year shall be apportioned amount the persons who are partners during the taxable year in accordance with section 704 and the regulations.

Treas. Reg. § 1.41-9(a)(3)(ii) provides that, with respect to certain joint ventures, research expenses to which Treas. Reg. § 1.41-2(a)(4)(ii) applies shall be apportioned among the persons who are partners during the taxable year in accordance with the provisions of that section. For purposes of section 41, these expenses shall be treated as paid or incurred directly by the partners rather than by the partnership. Thus, the partnership shall disregard these expenses in computing the credit to be apportioned under section 41(a)(3), and in making the computations under section 41 each partner shall aggregate its distributive share of these expenses with other research expenses of the partner. The limitation on the amount of the credit set out in section 41(g) and Treas. Reg. § 1.41-9(c) shall not apply because the credit is computed by the partner, not the partnership.

Treas. Reg. § 1.41-2(a)(4)(i) provides that, 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.

Treas. Reg. § 1.41-2(a)(4)(ii) provides a special rule for partnerships and joint ventures. If the qualified research expenses are not paid or incurred in a trade or

business of the partnership to which the research relates, but the research is related to the trade or business of the partners or joint venturers and they are entitled to make independent use of the research results, the partners or joint venturers may treat a portion of such expenditures as qualified research expenditures directly incurred by the partners or joint venturers.

For purposes of this field service advice, we are assuming that A-B Partnership's activities rose to the level of a trade or business during the period in question and that the research credit is computed at the partnership level and then distributed to the partners. Thus, A-B Partnership does not qualify for the exceptions set out in Treas. Reg. § 1.41-9(a)(3)(ii) and Treas. Reg. § 1.41-2(a)(4)(ii), which provide that research expenses are apportioned among the persons who are partners during the taxable year and that for purposes of section 41, these expenses in question are treated as paid or incurred directly by the partners.

We concur in your conclusion that A-B Partnership's change to allocating qualified research expenses to its partners, rather than computing the research credit at the partnership level and distributing the credit in accordance with section 704 and the regulations is not a change in accounting method. In this case, the Code and regulations provide the proper method for a partnership engaged in a trade or business (as our taxpayer is) to compute the research credit. It must be done at the partnership level and the credit allocated to the partners.

The taxpayer's action does not affect the timing of the credit, but affects the amount of the credit for A-B Partnership, A, and B. A change in method of accounting does not include adjustment of any item of income or deduction which does not involve the proper time for the inclusion of the item in income or the taking of a deduction. Treas. Reg. § 1.446-1(e)(2)(ii)(*b*).

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