DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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OFFICE OF CHIEF COUNSEL

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR AREA COUNSEL (FINANCIAL SERVICES)

FROM: Associate Chief Counsel CC:PSI:FO

SUBJECT: Credit for Increasing Research Activities under I.R.C. § 41

This Chief Counsel Advice responds to your memorandum received by this office on June 25, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

Taxpayer:

ISSUES

(1) Whether amounts Taxpayer paid or incurred as depreciation expenses, general and administrative expenses, employee benefit expenses, and travel and entertainment expenses that relate to "self-constructed supplies" are qualified research expenses as defined in I.R.C. § 41(b)?

(2) Whether amounts Taxpayer paid or incurred for overhead and other indirect expenses that relate to "self-constructed supplies" are qualified research expenses as defined in I.R.C. § 41(b)?

(3) Whether Taxpayer's financial accounting treatment of depreciation expenses, general and administrative expenses, employee benefit expenses, travel and entertainment expenses, and other indirect expenses paid or incurred related to a "self-constructed supply" determines if such expenses are qualified research expenses as defined in I.R.C. § 41(b)?

(4) Whether the Supreme Court's decision in Commissioner v. Idaho Power Co., 418 U.S. 1 (1974), requires Taxpayer to treat depreciation expenses, general and administrative expenses, employee benefit expenses, travel and entertainment expenses, and other indirect expenses related to a "self-constructed supply" used in qualified research as qualified research expenses as defined in I.R.C. § 41(b)?

CONCLUSIONS

(1) and (2) Based on I.R.C. § 41(b) and Treas. Reg. § 1.41-2(b) and the legislative history to I.R.C. § 41, depreciation allowances, overhead expenses, general and administrative expenses, and indirect expenses allocable to drug products manufactured at Taxpayer's plant and used in qualified research are not "in-house research expenses" eligible to be included in the research credit computation.

(3) Because the facts do not indicate that the supplies were purchased in an intercompany transaction, Treas. Reg. § 1.41-8(e)(5) is irrelevant in this case. Further, financial accounting rules do not dictate treatment for income tax purposes. See Thor Power Tool Co. v. Commissioner, 439 U.S. 522, 538-44 (1979).

(4) The Supreme Court's decision in Commissioner v. Idaho Power Co. does not require Taxpayer to treat depreciation expenses, general and administrative expenses, employee benefit expenses, travel and entertainment expenses, and other indirect expenses related to a "self-constructed supply" used in qualified research as qualified research expenses as defined in I.R.C. § 41(b).

FACTS

Taxpayer, a pharmaceutical company, built a plant to manufacture branded pharmaceutical products. For a period of time, Taxpayer used the plant to produce drugs used for clinical trials. Taxpayer treated the drugs used in the clinical trials as supplies used in the conduct of qualified research. In determining the amount paid or incurred for these supplies, Taxpayer allocated its direct and indirect manufacturing costs to the supplies.

LAW

I.R.C. § 41 provides a credit against tax for increasing research activities. 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 I.R.C. § 41(e)(1)(A).

I.R.C. § 41(b) defines the term "qualified research expenses" to include in-house research expenses, contract research expenses, and certain amounts paid to certain research consortia.

I.R.C. § 41(b)(2) defines the term "in-house research expenses" as wages paid or incurred to an employee for qualified services performed by such employee, any amounts paid or incurred for supplies used in the conduct of qualified research, and, 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. However, amounts paid or incurred to another person for the right to use computers in the conduct of qualified research are not in-house research expenses to the extent that the taxpayer receives or accrues any amount from any other person for the right to use substantially identical property.

I.R.C. § 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 services.

Treas. Reg. §1.41-2(c)(1) provides that the term "engaging in qualified research" as used in I.R.C. § 41(b)(2)(B) means the actual conduct of qualified research (as in the case of a scientist conducting laboratory experiments).

Treas. Reg. §1.41-2(c)(2) provides that the term "direct supervision" as used in I.R.C. § 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.

Treas. Reg. §1.41-2(c)(3) provides that the term "direct support" as used in I.R.C. § 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 Treas. Reg. § 1.41-2(c)(2).

Treas. Reg. § 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 nonqualified 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 I.R.C. § 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 I.R.C. § 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 I.R.C. § 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.

I.R.C. § 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, Treas. Reg. § 1.41-2(b)(1) provides that supplies and personal property (except to the extent provided in Treas. Reg. § 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 I.R.C. § 41(b)(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 Treas. Reg. § 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.

Treas. Reg. § 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.

I.R.C. § 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. I.R.C. § 41(b)(3)(C).

ANALYSIS

The issues in this request for Field Service Advice concern Taxpayer's determination of its "in-house research expenses" eligible to be included in its research credit computation for the taxable years ended December 31, 1990 through December 31, 1997. Taxpayer, a pharmaceutical corporation, is in the business of developing, testing, manufacturing, and marketing drug products. In conducting clinical trials of a drug product during the years at issue, Taxpayer used drug products manufactured at Taxpayer's plant. Taxpayer treated all costs (direct and indirect) allocated to the manufactured drug products used in the clinical trials as in-house research expenses eligible to be included in its research credit computation for the taxable years ended December 31, 1990 through December 31,1997. These costs included depreciation expenses, general and administrative expenses, employee benefit expenses, travel and entertainment expenses, overhead expenses, and other indirect expenses.

ISSUES (1) and (2):

I.R.C. § 41(b) was added to the Code by the Economic Recovery Tax Act of 1981 (the 1981 Act). I.R.C. § 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,[1] I.R.C. § 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 (i) in the actual conduct of qualified research, (ii) the direct supervision of qualified research, and (iii) 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 I.R.C. § 41(b) make it very clear that any other in-house expenditure is not an "in-house research expenditure." See Treas. Reg. § 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 I.R.C. § 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 I.R.C. § 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.

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[1]Amounts paid by the taxpayer to another person for the use of computer time in the conduct of qualified research remains credit eligible.

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 at 118.

Based on I.R.C. § 41(b) and Treas. Reg. § 1.41-2(b) and the legislative history to I.R.C. § 41, depreciation allowances, overhead expenses, general and administrative expenses, and indirect expenses allocable to drug products manufactured at Taxpayer's facilities and used in qualified research are not "in-house research expenses" eligible to be included in the research credit computation.

ISSUE (3):

Taxpayer argues that, based on Treas. Reg. § 1.41-8(e)(5) and generally accepted accounting principles (GAAP), all costs (direct and indirect) allocable to assets used as supplies in qualified research are "in-house research expenses." Treas. Reg. § 1.41-8(e)(5) provides that, in the case of intercompany transactions, the amounts paid or incurred to another member of the group for supplies shall be taken into account as in-house research expenses for purposes of I.R.C. § 41 only

to the extent of the lesser of (i) the amount paid or incurred to the other member, or (ii) the amount of the other member's basis in the supplies. Further, GAAP rules provide that the costs of self-constructed assets include direct labor costs, raw material costs, overhead costs incurred only to the extent absorbed in constructing the assets, and interest costs incurred during the construction period.

We believe that Treas. Reg. § 1.41-8(e)(5) is irrelevant in this case. The facts do not indicate that the supplies were purchased in an intercompany transaction. Also, while financial accounting rules 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 Code and/or regulations, financial accounting rules are irrelevant. We believe that I.R.C. § 41(b)(2), the regulations thereunder, and the legislative history to I.R.C. § 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.

ISSUE (4):

Taxpayer argues that the Supreme Court's decision in Commissioner v. Idaho Power Co. requires Taxpayer to treat depreciation expenses, general and administrative expenses, employee benefit expenses, travel and entertainment expenses, and other indirect expenses related to a "self-constructed supply" as qualified research expenses as defined in I.R.C. § 41(b). In Idaho Power Co., the Supreme Court held that equipment depreciation allocable to the taxpayer's construction of capital facilities must be capitalized under I.R.C. § 263(a) (1). The Court described the purpose of I.R.C. § 263(a) (1):

> ". . . to reflect the basic principle that a capital expenditure may not be deducted from current income. It serves to prevent a taxpayer from utilizing currently a deduction properly attributable, through amortization, to later tax years when the capital asset becomes income producing." Id. at 16.

It is well-settled that income tax deductions and credits are a matter of legislative grace and the burden of showing the right to a deduction is on the taxpayer. Interstate Transit Lines v. Commissioner, 319 U.S. 590, 593 (1943); Deputy v. Du Pont, 308 U.S. 488, 493 (1940); New Colonial Ice Co. v. Helvering, 292 U.S. 435, 440 (1934).

Although the Supreme Court decision in Idaho Power Co. requires capitalization of the depreciation on equipment used in constructing capital assets is required, the decision does not address allocation of depreciation on equipment used in manufacturing products. Congress clearly intended that the costs of

depreciable property were not eligible for the research credit computation. To include depreciation expenses as a component of the supply expenses for purposes of computing the research credit would in effect include the costs of depreciable property in the research credit computation.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

Although we believe that the Code, regulations, and legislative history are clear that depreciation allowances, overhead expenses, general and administrative expenses, and indirect expenses allocable to drug products manufactured at Taxpayer's plant and used in qualified research are not "in-house research expenses" eligible to be included in the research credit computation, we believe that this case should be developed further. [redacted]

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Please call if you have any further questions.

Paul F. Kugler
Associate Chief Counsel
By: LESLIE H. FINLOW
Branch Chief
Associate Chief Counsel
(Passthroughs and Special Industries)