

INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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Index (UIL) No.: 41.00-00, 1502.00-00
CASE-MIS No.: TAM-107730-10

Maria S. Hwang
LMSB:CTM:DFOW

Taxpayer's Name:
Taxpayer's Address:

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

LEGEND:

Parent =
Target =
Fiscal Year =
Date A =
Date B =
Date C =
Date D =
Month =
Year 1 =
Year 2 =
Year 3 =
Year 4 =

ISSUES:

1. Whether Parent can include Target's and Target subsidiaries' qualified research expenses ("QREs") for the period Date A through Date B in Parent's computation of the credit for increasing research activities ("research credit") under § 41 of the

Internal Revenue Code on Parent's federal consolidated income tax return for the taxable year ending on Date D?

2. Whether Parent includes the average annual gross receipts ("AAGRs") for Target's and Target Subsidiaries' four taxable years preceding Parent's taxable year ending on Date D in Parent's base amount when computing the research credit for Parent's federal consolidated taxable year ending on Date D?

CONCLUSIONS:

1. Parent cannot include Target's and Target subsidiaries' QREs for the period Date A through Date B in Parent's computation of the research credit on Parent's federal consolidated income tax return for the taxable year ending on Date D.

2. Parent includes the AAGRs for Target's and Target subsidiaries' four taxable years preceding Parent's taxable year ending on Date D in Parent's base amount when computing the research credit for Parent's federal consolidated taxable year ending on Date D. However, because Target and Target subsidiaries are members of the Parent consolidated group for only a portion of Parent's taxable year beginning on Date A and ending on Date D, the portion of the base amount determined under § 41(c)(1) of the Internal Revenue Code attributable to Target and Target subsidiaries must be reduced by multiplying such amount by the number of months in the period from Date C through Date D and dividing the result by twelve.

FACTS:

Parent is the common parent of a consolidated group filing federal income tax returns on a Fiscal Year basis. Target was the common parent of its own unrelated consolidated group that filed federal income tax returns on a calendar year basis. On Date B, Parent acquired the stock of Target in exchange for stock and cash in a transaction that did not constitute a reverse acquisition within the meaning of § 1.1502-75(d)(3) of the Income Tax Regulations, thus terminating the Target consolidated group.

Parent included Target's and Target subsidiaries' QREs for the period Date A through Date B in its computation of the Parent group's research credit for its taxable year ending on Date D. Parent did not include Month in its original computations, but did file an informal amended claim to include Month. Parent did not deduct any QREs for the period Date A through Date B and is not claiming any deduction for these QREs. In calculating the research credit for Parent's group for the taxable year ending Date D, Parent included Target's and Target subsidiaries' gross receipts for the period Date A through Date B in the computation of Parent's base amount. Additionally, Target included the same QREs for the period Date A through the end of Year 4 and for Month in its computation of the Target group's research credit for the Year 4 taxable year and the short taxable year ending on Date B, respectively. However, because these years

were both loss years for the Target group, none of the credits were utilized to offset income tax of the Target group. Instead, Parent carried or intends to carry the credits forward to Parent's consolidated return years, subject to limitation under § 383. Thus, Parent and Target both included Target's and Target subsidiaries' QREs for the period Date A through Date B in the computation of the research credit.

LAW:

Section 41(a)(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 QREs 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.

Section 41(c)(1) provides that the term "base amount" means the product of (A) the fixed-base percentage, and (B) the AAGRs of the taxpayer for the four taxable years preceding the taxable year for which the credit is being determined (that is, the "credit year").

Section 41(c)(3) provides that the "fixed-base percentage" is the percentage that the aggregate QREs 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(f)(1)(A) provides that in determining the amount of the credit (i) all members of the same controlled group of corporations shall be treated as a single taxpayer, and (ii) the credit allowable to each member shall be its proportionate share of the QREs.

Section 1.41-6(b)(1) provides that all members of a controlled group are treated as a single taxpayer for purposes of computing the research credit. The group credit is computed by applying all of the § 41 computational rules on an aggregate basis.

Section 41(f)(5) provides that the term "controlled group of corporations" has the same meaning given to such term by § 1563(a), except that "more than 50 percent" shall be substituted for "at least 80 percent" each place it appears in § 1563(a)(1), and the determination shall be made without regard to § 1563(a)(4) and (e)(3)(C).

Section 1563(a)(1) provides that the term "controlled group of corporations" means any group of one or more chains of corporations connected through stock ownership with a common parent corporation if (A) stock possessing at least 80 percent

of the total combined voting power of all classes of stock entitled to vote or at least 80 percent of the total value of shares of all classes of stock of each of the corporations, except the common parent corporation, is owned by one or more of the other corporations; and (B) the common parent corporation owns stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote or at least 80 percent of the total value of shares of all classes of stock of at least one of the other corporations, excluding, in computing such voting power or value, stock owned directly by such other corporations.

Section 41(f)(4) provides that in the case of any short taxable year, QREs and gross receipts shall be annualized in such circumstances and under such methods as the Secretary of Treasury may prescribe by regulation.

Section 1.41-3(b)(1) provides that if a credit year is a short taxable year, then the base amount determined under § 41(c)(1) shall be modified by multiplying that amount by the number of months in the short taxable year and dividing the result by 12.

Section 1.41-3(b)(2) provides that 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 12 and divided by the number of months in that year.

Section 1.41-3(b)(3) provides that no adjustment shall be made on account of a short taxable year to the computation of a taxpayer's fixed-base percentage.

Section 1502 provides that the Secretary of Treasury shall prescribe such regulations as he may deem necessary in order that the tax liability of any affiliated group of corporations making a consolidated return and of each corporation in the group, both during and after the period of affiliation, may be returned, determined, computed, assessed, collected, and adjusted, in such manner as clearly to reflect the income tax liability and the various factors necessary for the determination of such liability, and in order to prevent avoidance of such tax liability. In carrying out the preceding sentence, the Secretary of Treasury may prescribe rules that are different from the provisions of chapter 1 that would apply if such corporations filed separate returns.

Section 1.1502-76(b)(1)(i) provides that a consolidated return must include the common parent's items of 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. If the consolidated return includes the items of a corporation for only a portion of its taxable year determined without taking this section into account, items for the portion of the year not included in the consolidated return must be included in a separate return (including the consolidated return of another group). The rules of

this paragraph (b) must be applied to prevent the duplication or elimination of the corporation's items.

Section 1.1502-76(b)(1)(ii)(A)(1) provides that if a corporation, other than one described in paragraph (b)(1)(ii)(A)(2) of this section (concerning subchapter S corporations), becomes or ceases to be a member during a consolidated return year, it becomes or ceases to be a member at the end of the day on which its status as a member changes, and its taxable year ends for all federal income tax purposes at the end of that day.

Section 1.1502-80(a), as it applied for the years at issue, provided that the Internal Revenue Code, or other law, shall be applicable to the group to the extent the regulations do not exclude its application.

ANALYSIS:

The QREs at issue were paid or incurred between Date A and Date B. These are dates in which Target was the common parent of its own consolidated group. When Parent acquired the stock of Target, Target's tax year ended for all federal income tax purposes. Section 1.1502-76(b)(1)(ii)(A). Target included the QREs it incurred between Date A and Date B in its own consolidated return. However, Parent has also included Target and its subsidiaries' QREs from Date A through Date B in Parent's consolidated return.

As more fully discussed below, Target's and Target subsidiaries' QREs from the period Date A through Date B should not be included in Parent's consolidated return for the tax year ending Date D because those QREs were not paid or incurred during the portion of Parent's tax year in which Target and Target subsidiaries were members of the Parent consolidated group, but instead were paid or incurred during the portion of the year in which Target was the common parent of its own group. Under the consolidated return regulations, those QREs must be included only in the Target's group's consolidated return for the Year 4 tax year or the tax year ended Date B, whichever is appropriate, and not in the Parent group's consolidated return for the tax year ended Date D.¹

The Parent consolidated group is a controlled group of corporations under § 41(f)(1)(A). Under § 41(f)(1)(A)(i), all members of the Parent consolidated group shall be treated as a single taxpayer for purposes of computing the research credit. The Parent consolidated group must aggregate each member's credit year QREs under § 41(b). The Parent consolidated group must aggregate each member's base year QREs and base year gross receipts under § 41(c)(3).

¹ We note that we considered the potential application of § 41(f)(3); however, irrespective of § 41(f)(3) the results do not change under the consolidated return rules as discussed in this technical advice memorandum.

Under § 1.1502-76(b)(1)(ii)(A)(1), Target's consolidated group terminated at the end of the day on Date B and Target and its subsidiaries became members of the Parent consolidated group on Date C.

Under § 1.1502-76(b)(1)(i), Target's and Target subsidiaries' QREs for the period Date A through the end of Year 4 and for Month must be included in the Target consolidated group's QREs for Year 4 and Target's short taxable year ending on Date B, respectively. The Target consolidated group must use the short taxable year provision of § 1.41-3(b)(1) to compute its research credit for its short taxable year ending on Date B.

Under § 1.1502-76(b)(1)(i), Target's and Target subsidiaries' QREs for the period Date C through Date D must be included in the Parent consolidated group's QREs for the taxable year ending on Date D. The Parent consolidated group must aggregate each member's AAGRs for the four taxable years preceding the credit year under § 41(c)(1). For Parent, the four taxable years preceding the credit year are the fiscal years ending in Year 1, Year 2, Year 3, and Year 4. For Target and its subsidiaries, the four taxable years preceding the credit year are the calendar years Year 2, Year 3, and Year 4, and the short taxable year ending on Date B. Parent must use the short taxable year provision of § 1.41-3(b)(2) to compute Target's and Target subsidiaries' gross receipts for the short taxable year ending on Date B. Therefore, Target and its subsidiaries' gross receipts derived in Target's short taxable 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 the short taxable year ending on Date B. Pursuant to § 1.41-3(b)(1), because Target and Target subsidiaries were members of the Parent consolidated group for less than 12 months, in determining the Parent consolidated group's base amount, Parent must multiply the portion of the base amount determined under § 41(c)(1) attributable to Target and Target's subsidiaries by the number of months in the period from Date C to Date D and divide the result by twelve.

CAVEAT(S):

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.