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**COORDINATED ISSUE
ALL INDUSTRIES
CREDIT FOR INCREASING RESEARCH ACTIVITIES –
QUALIFIED RESEARCH EXPENSES
UIL 41.51-01**

OVERVIEW

This Coordinated Issue Paper addresses whether amounts paid or incurred as depreciation expenses, general and administrative expenses, employee benefit expenses, travel and entertainment expenses, and overhead and other indirect expenses that relate to "self-constructed supplies" are qualified research expenses as defined in I.R.C. § 41(b).

ISSUES

- (1) Whether amounts X paid or incurred as depreciation expenses, general and administrative expenses, employee benefit expenses, and travel and entertainment expenses that relate to "self-constructed supplies" (i.e., chemicals manufactured in X's plant) are "in-house research expenses" as defined in I.R.C. § 41(b).
- (2) Whether amounts X paid or incurred for overhead and other indirect expenses that relate to "self-constructed supplies" used in qualified research are "in-house research expenses" as defined in I.R.C. § 41(b).
- (3) Whether the expenses identified in Issues (1) and (2), above, may be treated as "in-house research expenses", as defined in I.R.C. § 41(b), by virtue of X's treatment of these costs for financial accounting purposes.

CONCLUSIONS

- (1) Based on I.R.C. § 41(b), Treasury Regulation § 1.41-2(b), and the legislative history to I.R.C. § 41, depreciation expenses, general and administrative expenses, employee benefit expenses, and travel and entertainment expenses that relate to "self-constructed supplies" are not "in-house research expenses" as defined in I.R.C. § 41(b).
- (2) Based on I.R.C. § 41(b), Treasury Regulation § 1.41-2(b), and the legislative history to I.R.C. § 41, overhead and other indirect expenses related to "self-constructed supplies" are not "in-house research expenses" as defined in I.R.C. § 41(b).

(3) The expenses identified in Conclusions (1) and (2), above, may not be treated as "in-house research expenses", as defined in I.R.C. § 41(b), by virtue of X's treatment of these costs for financial accounting purposes.

FACTS

X built a plant to manufacture chemicals. For a period of time, X used the plant to produce chemicals for use in qualified research. X treated the chemicals used in qualified research as supplies used in the conduct of qualified research. In determining the amount paid or incurred for these chemicals for its taxable year ended December 31, 2001, X allocated its direct and indirect manufacturing costs to the supplies.

LAW

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

Treasury Regulation § 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).

Treasury Regulation § 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.

Treasury Regulation § 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 Treasury Regulation § 1.41-2(c)(2).

Treasury Regulation § 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, Treasury Regulation § 1.41-2(b)(1) provides that supplies and personal property (except to the extent provided in Treasury Regulation § 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)(2)(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 Treasury Regulation § 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.

Treasury Regulation § 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 Coordinated Issue Paper concern X's determination of its "in-house research expenses" eligible to be included in its research credit computation for the taxable year ended December 31, 2001. X, a chemical manufacturer, is in the business of developing, testing, manufacturing, and marketing chemicals. In conducting qualified research during the year at issue, X used chemicals manufactured at X's plant. X treated all costs (direct and indirect) allocated to the manufactured chemicals used in qualified research as "in-house research expenses" eligible to be included in its research credit computation for the taxable year ended December 31, 2001. These costs include 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, 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 (1) in the actual conduct of qualified research, (2) the direct supervision of qualified research, and (3) 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 expenditure paid or incurred in-house is not an "in-house research expense." 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.

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), Treasury Regulation § 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 chemicals manufactured at X's facilities and used in qualified research are not "in-house research expenses" eligible to be included in the research credit computation.

ISSUE (3):

While financial accounting rules¹ 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 Internal Revenue Code and/or Treasury Regulations, financial accounting rules are irrelevant. 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.

¹ Under GAAP, the historical cost of a self-constructed asset includes "the costs necessarily incurred to bring it to the condition and location necessary for its intended use." FASB Statement No. 34, ¶ 6. This includes the allocation of depreciation, interest and other indirect costs. Id.