APPEALS

TECHNICAL GUIDANCE PROGRAM

APPEALS SETTLEMENT GUIDELINES

ISSUE: **I.R.C. § 41 Research Credit – Intra-Group Receipts from Foreign Affiliates**

COORDINATORS: **Hugh Whitledge**
Joel Brotten
Charles R. Kelly
Shane J. Forsell

Telephone: **(972) 308-7016**
(206) 220-6053
(904) 665-0962
(206) 220-5819

UIL NO.: **41.51-11**

FACTUAL/LEGAL ISSUE: **Legal**

APPROVED: June 15, 2010

/s/ Cynthia Vassilowitch	**June 15, 2010**
Director, Technical Guidance	**Date**
_/s/ Kirsten B. Wielobob _______	**June 15, 2010**
Director, Technical Services	**Date**

EFFECTIVE DATE: June 15, 2010

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I.R.C. § 41 Research Credit – Intra-Group Receipts from Foreign Affiliates

STATEMENT OF ISSUE

Whether a domestic corporation ("taxpayer") and its majority-owned subsidiaries must include receipts from foreign affiliates in determining the controlled group's aggregate gross receipts for purposes of computing the research credit "base amount" under Internal Revenue Code (I.R.C.) § 41(c)(1).[1]

BACKGROUND

Under I.R.C. § 41(a), a 20 percent tax credit is given on the difference between a taxpayer's qualified research expenditures (QREs) for the taxable year and a base amount. Generally, the base amount is computed by multiplying the taxpayer's fixed base percentage by the taxpayer's average annual gross receipts for the four taxable years preceding the taxable year for which the credit is being determined. I.R.C. §§ 41(c)(1), 41(c)(7). In general, the fixed base percentage is computed by dividing the taxpayer's aggregate QREs by the taxpayer's gross receipts for the five taxable years beginning after December 31, 1983 and before January 1, 1989. I.R.C. § 41(c)(3). Given this computation method, the definition of gross receipts is critical to the determination of a taxpayer's research credit.

As originally enacted in 1981, the research credit was computed solely on the basis of a taxpayer's QREs. In 1989, Congress modified the research credit computation by determining the amount of allowable credit based on a taxpayer's increase in its research spending as a percentage of its gross receipts. As amended by the Omnibus Budget Reconciliation Act of 1989 (the 1989 Act), I.R.C. § 41(c) provides, in general, that the base amount is computed by multiplying the taxpayer's fixed base percentage by the taxpayer's average annual gross receipts for the four taxable years preceding the taxable year for which the credit is being determined. As discussed herein, Compliance and taxpayers disagree as to whether gross receipts should include intra-group transfers involving foreign affiliates.

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[1] For purposes of this document the term "foreign affiliate" is defined as a foreign corporation which is a member of the controlled group pursuant to I.R.C. § 41(f)(5). In defining the term "controlled group," I.R.C. § 41(f)(5) states that it has the same meaning given to such term by I.R.C. § 1563(a) except that:

(A) "more than 50 percent" shall be substituted for "at least 80 percent" each place it appears in section 1563(a)(1), and

(B) the determination shall be made without regard to subsections (a)(4) and (e)(3)(C) of section 1563.

COMPLIANCE POSITION

For the following reasons, Compliance's position is that a taxpayer may *not* exclude gross receipts from its controlled foreign affiliates when computing gross receipts for purposes of determining the base amount under I.R.C. § 41(c):

1. The Internal Revenue Code and the applicable Treasury Regulations under I.R.C. § 41 clearly and broadly provide an explanation of the term "gross receipts," which supports Compliance's position of inclusion of gross receipts from intra-group transactions for purposes of computing the group credit under I.R.C. § 41.

   A. The term "gross receipts" is a term of art specifically defined by the I.R.C. and Treasury Regulations for purposes of computing the research credit. I.R.C. § 41(c)(7); Treas. Reg. § 1.41-3(c).

   B. Congress specifically indicated what gross receipts should be disregarded for purposes of I.R.C. § 41(c) when it enacted I.R.C. § 41(c)(7). Section 41(c)(7) defines "gross receipts" by providing that gross receipts for any taxable year are reduced by returns and allowances made during the tax year, and, that, in the case of a foreign corporation, there shall be taken into account only gross receipts which are effectively connected with the conduct of a trade or business within the United States, the Commonwealth of Puerto Rico, or any possession of the United States (U.S. trade or business). Consequently, based upon the clear Code definition, there are only two exceptions to what is included in gross receipts (returns and allowances and foreign non-effectively connected income). All other gross receipts are included, as well as intra-group receipts.

   C. The only exclusion from gross receipts mentioned in the legislative history of the 1989 Act applies to a foreign affiliate's gross receipts that are not effectively connected with the conduct of a U.S. trade or business. See H.R. Rep. No. 101-247 at 1202-03 (1989).

   D. In implementing the 1989 Act changes, Treas. Reg. § 1.41-3(c) adopted a very broad definition of gross receipts for purposes of the research credit computation. The term "gross receipts" is broadly defined as "the total amount, as determined under the taxpayer's method of accounting, derived by the taxpayer from *all* its activities and from *all* sources . . . ." Treas. Reg. § 1.41-3(c)(1) (emphasis added).

E. While Treas. Reg. § 1.41-3(c)(2) provides for exclusions to gross receipts[2] and Treas. Reg. § 1.41-3(c)(3) provides that, in the case of a foreign corporation, there shall be taken into account only gross receipts which are effectively connected with the conduct of a trade or business within the United States, the Commonwealth of Puerto Rico, or any possession of the Untied States, there is no exclusion from gross receipts for intra-group transfers.

2. Excluding gross receipts from a taxpayer's foreign affiliates when computing gross receipts for purposes of determining the base amount under I.R.C. § 41(c) is contrary to the intent of Congress because a taxpayer would be eliminating gross receipts which Congress believed were used to establish the taxpayer's research budget.

   A. In 1989 Congress made gross receipts an integral factor in determining the amount of the research credit because businesses often determine their research budgets as a fixed percentage of gross receipts. Congress determined that it was appropriate to index each taxpayer's base amount to average growth of gross receipts. By indexing to gross receipts, Congress believed the credit would better achieve its purpose of rewarding taxpayers for research expenses in excess of amounts which would have been expended in any case. See H.R. Report No. 101-247, at 1200 (1989).

   B. When receipts from a foreign affiliate are excluded, no receipts relating to the foreign affiliate are included in the computation of base amount gross receipts because receipts by the foreign affiliate are eliminated unless the foreign affiliate has an effectively connected United States trade or business. This total exclusion of gross receipts is counter productive to Congress's intent of only allowing the credit for research expenditures in excess of amounts which would have been expended in any case.

   C. It is appropriate to take into account gross receipts from transactions between members of a controlled group in certain situations to prevent unreasonable results. Haggar Co. v. Helvering, 308 U.S. 389, 394 (1940); United States v. American Trucking Ass'ns, 310 U.S. 534, 543 (1940). These cases stand for the general proposition that statutes must be construed in light of overall purpose and the interpretation should not lead to absurd results. It is therefore appropriate to require a taxpayer to include in gross receipts the

[2] The Regulations provide for only six exclusions to the definition of gross receipts: (i) returns or allowances; (ii) receipts from the sale or exchange of capital assets; (iii) repayments of loans or similar instruments; (iv) receipts from a sale or exchange not in the ordinary course of business; (v) amounts received with respect to sales tax or other similar state and local taxes; and (vi) amounts received by a taxpayer in a taxable year that precedes the first taxable year in which the taxpayer derives more than $25,000 in gross receipts other than investment income. Treas. Reg. § 1.41-3(c)(2).

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amounts it receives from the foreign members of the controlled group for purposes of I.R.C. § 41(c).

D. Including in gross receipts the amounts a domestic member of a control group receives from a foreign member of the group is consistent with the broad definition of gross receipts contained in I.R.C. § 41(c)(7) and Treas. Reg. § 1.41-3(c).

3. I.R.C. § 41(f)(1), provides, in relevant part, that in determining the amount of the research credit all members of the same controlled group of corporations shall be treated as a single taxpayer (single taxpayer rule). When enacting this provision Congress sought to prevent the manipulation of expenditures within a controlled group, not the elimination of items of income.

   A. I.R C.§ 41(f)(1), as originally enacted, prevents manipulation of the research credit by treating all members of a controlled group as a single taxpayer for purposes of computing the research credit and allocates the research credit to the members of the group based on the member's proportionate share of the increase in QREs giving rise to the credit.

   B. The legislative history to the Economic Recovery Tax Act of 1981 (the 1981 Act) indicates that the research credit aggregation rule was enacted to ensure that the research credit would be allowed only for actual increases in research expenditures. The aggregation rule was intended to prevent artificial increases in research expenditures by shifting expenditures among commonly controlled or otherwise related persons. H.R. Rep. No. 97-201, at 123 (1981), *reprinted in* 1981-2 C.B. 352, 364; S. Rep. No. 97-144, at 83 (1981), *reprinted in* 1981-2 C.B. 412, 442.

   C. There is no special rule in the research credit provisions as enacted in 1981 (or as amended by the 1989 Act) that addresses the treatment of transactions among members of the same controlled group of corporations or trades or businesses under common control.

   D. The only reference to the intra-group transaction rule in any legislative history to I.R.C. § 41 reflects Congress' intent for the aggregation rule to prevent commonly controlled taxpayers from using the contract expenditure rules to manipulate the amount of QREs eligible for the credit. <u>See</u>, General Explanation of the Economic Recovery Tax Act of 1981 at 129.

   E. The 1989 Act amendments did not change the aggregation requirement in I.R.C. § 41(f)(1). Neither the 1989 Act's statutory language nor its legislative history indicates that Congress intended that intra-group transfers generating gross receipts be disregarded.

F. In interpreting I.R.C. § 41(f)(1), a rule promulgated by Congress to prevent abuse, consideration must be given to the abuse that Congress was seeking to prevent. The legislative history and post-enactment Joint Committee reports have consistently and uniformly stated that the abuse to which this provision is directed is the artificial manipulation of QREs within a controlled group. The statute, the legislative history, and these post-enactment Joint Committee prints have never identified the artificial manipulation of gross receipts as an abuse to which the rule is targeted.

4. Treas. Reg. § 1.41-6(i), regarding intra-group transactions (intra-group transaction rules), were intended to address transactions involving QREs. These rules do not address the treatment of gross receipts.

   A. On May 17, 1989, the Service and Treasury issued regulations for determining the amount of the research credit for a controlled group of corporations and trades or businesses under common control. T.D. 8251, 54 F.R. 21203 (1989) (promulgated as Former Treas. Reg. § 1.41-8(e); currently Treas. Reg. § 1.41-6(i)).

   B. Consistent with Congressional purpose, former Treas. Reg. § 1.41-8(e) provided rules intended to prevent the shifting of research expenditures among members of a controlled group.

   C. Former Treas. Reg. § 1.41-8(e)(1) provided the general rule that "[b]ecause all members of a group under common control are treated as a single taxpayer for purposes of determining the research credit, transfers between members of the group are generally disregarded." Former Treas. Reg. § 1.41- 8(e)(2)-(5) provided clarifying rules on how controlled groups should treat specific types of intra-group transfers that generate research expenditures such as in-house research expenses and contract research expenses.

   D. Treas. Reg. § 1.41-6(i) provides a regime to determine which member of the group is eligible to treat an expenditure as a QRE and what amount is a QRE.

   E. Although renumbered several times, the operative language of Treas. Reg. § 1.41-6(i) remains substantively unchanged from that of former Treas. Reg. § 1.41-8(e). Accordingly, Treas. Reg. § 1.41-6(i) continues to require that a controlled group of corporations or trades or businesses under common control only disregard generally intra-group transfers with respect to research expenditures, not gross receipts.

   F. Because the subject Treasury Regulations predate the 1989 Act, they do not reflect changes in the law made by the 1989 Act.

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TAXPAYER'S POSITION

For the following reasons, taxpayers take the position that the gross receipts component of the research credit computation for a controlled group under I.R.C. § 41(f) *excludes* gross receipts from transactions between group members:

1. Since the inception of the research credit in 1981, I.R.C. § 41(f)(1)(A)(i) and its predecessors have continuously provided that, in determining the amount of the credit, "all members of the same controlled group of corporations shall be treated as a single taxpayer." The total of the controlled group's QREs and, therefore, the total of the group's research credit, are unaffected by any intra-group transactions. Such transactions are treated the same as a transfer from one division of a single taxpayer to another division.

2. Under I.R.C. § 41(f)(1)(A)(i), all members of a controlled group are still treated as a single taxpayer "in determining the amount of the credit." The "amount of the credit" necessarily reflects all elements of the research credit calculation, including the group's current year QREs, the four preceding year's average gross receipts, and the QREs and gross receipts during the five-year base period from 1984 through 1988.

3. Disregarding gross receipts arising from transactions between members of a controlled group is also required by Treas. Reg. § 1.41-6 governing the computation of the research credit in controlled groups. Treas. Reg. § 1.41-6T(b)(1) also provides that the group credit is computed by applying all of the I.R.C. § 41 computational rules on an aggregate basis. In making those computations, Treas. Reg. § 1.41-6(i)(1) explicitly provides that "transfers between group members are generally disregarded." The Regulations, therefore, give effect to the statute and effectively treat a transaction between members of an affiliated group as having no consequence on the computation of the group's research credit.

4. Internal Revenue Code § 41(f)(1)(A) applies "in determining the amount of the credit" not just to determining the amount of a controlled group's QREs.

5. The entire calculation methodology of the credit for controlled groups depends on the application of the single taxpayer rule of I.R.C. § 41(f)(1) to gross receipts as well as expenditures. The I.R.C. § 41(f)(1) single taxpayer rule is the operative provision. This rule functions properly only if controlled group members combine their expenditures <u>and</u> gross receipts in calculating the research credit. Treas. Reg. § 1.41-6(c) details how to allocate the combined research credit to separate members. There is no way to calculate a combined research credit unless the single taxpayer rule of I.R.C. § 41(f)(1) applies to both QREs and gross receipts.

6. To claim a research credit, a taxpayer must demonstrate that its research

expenditures have increased as a percentage of its gross receipts when compared to the five-year base period 1984 through 1988. The relevant gross receipts to be taken into account in determining the research credit should be the same gross receipts that management of the controlled group takes into account in setting its research budgets. Logically, such amounts include only gross receipts arising from third-party transactions and not gross receipts from transactions between group members. It does not make sense that management would consider intra-group sales as giving rise to true gross receipts since true gross receipts can only arise when a sale is made to a third party. In setting research budgets with reference to gross receipts, management would never consider an intra-group sale as giving rise to gross receipts and, as such, these same amounts should be excluded from gross receipts for purposes of computing the credit.

7. There was no reason for I.R.C. § 41(c)(7) to exclude receipts from affiliates because their exclusion is implicit in the special computational rules of I.R.C. § 41(f)(1) for controlled groups. The lack of an exclusion for receipts from controlled group members in I.R.C. § 41(c)(7) cannot override the specific treatment of controlled group members as a single taxpayer in I.R.C. § 41(f)(1) in determining whether receipts from controlled group members are included in the definition of gross receipts.

8. In determining the gross receipts component, it is necessary to know "what" gross receipts to include, but it is also necessary to know "whose" gross receipts are to be determined. I.R.C. § 41(c)(7) does address the question of what gross receipts to include; however, there is nothing that addresses the question of *whose* gross receipts are to be included in the base amount. I.R.C. § 41(f)(1) answers this question – *whose* gross receipts are to be included in the base amount – since a single taxpayer cannot create gross receipts by making a sale to itself hence gross receipts from sales among members of the controlled group of corporations should not be included.

DISCUSSION

I. Facts

This issue may arise under various fact patterns. Following is an example of a typical fact pattern:

- Taxpayer, a domestic corporation, owns more than fifty percent of certain foreign affiliates. Taxpayer performed research. In addition to research, taxpayer manufactured product and sold some of that product to its foreign affiliates. Taxpayer also developed and subsequently licensed intangibles to its foreign affiliates for which it was paid royalties.

- On its income tax returns for the years in issue, Taxpayer *included* all receipts from the foreign affiliates in its gross receipts for purposes of determining the average annual gross receipts and the gross receipts under I.R.C. § 41(c).

- Taxpayer later filed claims for refund increasing the amount of its research credit. In computing the base amount and determining the increased amount of its credit, taxpayer *excluded* all receipts from its foreign affiliates in determining gross receipts.

II. Legal Authority

A. Enactment of Research Credit Provisions in 1981

The research credit was first enacted as part of the 1981 Act as a means of providing an incentive for greater levels of private research by operating businesses. In its original form, the research credit was computed based solely on the amount of a taxpayer's QREs. The taxpayer's gross receipts did not enter into the computation of the credit.

Specifically, the credit allowable was equal to 25 percent of the excess, if any, of a taxpayer's QREs for the credit year over the taxpayer's base period research expenses. A taxpayer's base period research expenses were defined to mean the average QREs for each year in the three years preceding the credit year. I.R.C. § 44F (1981).[3]

In addition, a special rule was provided for computing the research credit of a group under common control. This rule was intended to prevent taxpayers from creating artificial increases in the level of research expenditures merely by shifting QREs among commonly controlled or otherwise related persons. Specifically, former I.R.C. § 44F(f)(1)(A)(i) provided that, in computing the amount of the research credit, "all members of the same controlled group of corporations shall be treated as a single taxpayer." I.R.C. § 44F(f)(1)(A)(i)(1981). Thus, a single research credit was computed for the entire controlled group by comparing the controlled group's aggregate QREs in the credit year with the controlled group's base period research expenses determined by computing the group's aggregate yearly average QREs during the preceding three-year period.

For this purpose, the term "controlled group of corporations" was broadly defined to have the same meaning as that term is defined by I.R.C. § 1563(a), except that "more than 50 percent" was substituted for "at least 80 percent" each place it appears therein. Importantly, the definition has been consistently recognized by the IRS to include foreign corporations where the stock ownership test is met, even in those cases in

[3] The research credit provisions were originally enacted as I.R.C. § 44F by the 1981 Act. The provisions were redesignated as I.R.C. § 30 by the Deficit Reduction Act of 1984 and then as § 41 by the Tax Reform Act of 1986.

which the foreign corporation is not otherwise engaged in a U.S. trade or business or subject to U.S. tax.

In addition to the statutory single taxpayer rule, regulations addressing the treatment of transactions between members of a controlled group were proposed in 1983 and finalized in 1989 (intra-group transaction rules). Like former I.R.C. § 44(F)(1)(A)(i), the intra-group transaction rules provided that members of a controlled group were to be treated as a single taxpayer for purposes of computing the credit. Former Treas. Reg. § 1.41-8(e)(1)(1989).[4]

B. Amendment in 1989 to Take into Account "Gross Receipts"

By 1989, the incentive effect of the original research credit was criticized to the extent that the credit was computed solely on the basis of a taxpayer's QREs. Critics argued that, while an increase in QREs initially resulted in a taxpayer receiving a larger research credit, the increase had the effect of also increasing the taxpayer's base period research expenses in later years, thereby, dampening the incentive effect of the research credit for the next several years.

In response, Congress modified the research credit as part of the 1989 Act. The research credit is no longer based solely on the amount of a taxpayer's QREs. Under the revised regime, the research credit is allowable if a taxpayer increases its research spending as a percentage of its gross receipts.

As revised and in relevant part, the research credit is equal to 20 percent of the excess, if any, of the taxpayer's current-year QREs over the taxpayer's base amount. I.R.C. § 41(a). For this purpose, a taxpayer's base amount is generally equal to the product of the taxpayer's fixed base percentage and the taxpayer's average annual gross receipts for the four taxable years preceding the credit year. I.R.C. § 41(c)(1). A taxpayer's fixed-base percentage is generally equal to the taxpayer's aggregate QREs for the five-year period from 1984 through 1988 as a percentage of the taxpayer's aggregate gross receipts during that same five-year period. I.R.C. § 41(c)(3).

With respect to the determination of gross receipts, the I.R.C., as amended by the 1989 Act and the Tax Relief and Extension Act of 1999, provides that:

> For purposes of this subsection, gross receipts for any taxable year shall be reduced by returns and allowances made during the taxable year. In the case of a foreign corporation, there shall be taken into account only gross receipts which are effectively connected with the conduct of a trade

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[4] Former Treas. Reg. § 1.41-8 was amended and renumbered as Treas. Reg. § 1.41-6 by T.D. 8930, 2001-1 C.B. 433. In 2005, the IRS issued temporary regulations governing calculation of the research credit for controlled groups. See Temp. Treas. Reg. § 1.41-6T, T.D. 9205, 2005-1 C.B. 1267. These provisions were finalized in 2006. See Treas. Reg. § 1.41-6, T.D. 9296, 71 F.R. 6572-01. Importantly, throughout this period, the operative provisions of the regulations remained unchanged.

or business within the United States, the Commonwealth of Puerto Rico, or any possession of the United States.

I.R.C. § 41(c)(7).

With the redesign of the credit, there was no change to I.R.C. § 41(f)(1), the statutory anti-manipulation rule treating all members of a controlled group as a single taxpayer. This provision continued to state that:

In determining the amount of the credit under this section --

(i) all members of the same controlled group of corporations shall be treated as a single taxpayer . . . .

I.R.C. § 41(f)(1)(A)(i).

Similarly, the relevant provisions of the intra-group transaction rules originally adopted earlier the same year were not changed to reflect the revised credit calculation. Thus, the Regulations continued to provide 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 I.R.C. § 41 computation rules on an aggregate basis.

Treas. Reg. § 1.41-6T(b). And, that:

(i) Intra-group transactions--(1) In general. Because all members of a group under common control are treated as a single taxpayer for purposes of determining the research credit, transfers between members of the group are generally disregarded.

Treas. Reg. § 1.41-6(i).[5]

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[5] These Regulations provide guidance with respect to how specific intra-group transactions are to be treated:

(2) In-house research expenses. If one member of a group performs qualified research on behalf of another member, the member performing the research shall include in its QREs any in-house research expenses for that work and shall not treat any amount received or accrued as funding the research. Conversely, the member for whom the research is performed shall not treat any part of any amount paid or incurred as a contract research expense. For purposes of determining whether the in-house research for that work is qualified research, the member performing the research shall be treated as carrying on any trade or business carried on by the member on whose behalf the research is performed.

(3) Contract research expenses. If a member of a group pays or incurs contract research expenses to a person outside the group in carrying on the member's trade or business, that member shall include those expenses as QREs. However, if the expenses are not paid or incurred in carrying on any trade or business of that member, those expenses may be taken into account as contract research expenses by another member of the group provided that the other member--

III. Service Published Guidance

In 2002 and 2006, Chief Counsel issued legal advice memoranda ("CCAs") addressing the gross receipts issue. CCA 200233011 (May 1, 2002) and 200620023 (Feb. 14, 2006). While CCAs have no precedential value, the reasoning and citations therein frequently provide insight into the Service's position. The CCAs reached opposite conclusions as to whether a controlled group's gross receipts should exclude gross receipts from foreign affiliates. Although both CCAs appear to base their respective conclusions on the particular facts and circumstances of the cases at issue, based on the facts presented in the CCAs, it is difficult to discern if there is a meaningful difference between the facts of the two cases.

IV. Legal Analysis

The parties rely upon a variety of legal arguments which will be addressed in this section.

A. Statutory Interpretation

The issue presented is legal in nature and involves the interpretation of I.R.C. §§ 41(c)(7) and 41(f)(1). In Robinson v. Shell Oil Co., the Supreme Court stated that:

> Our first step in interpreting a statute is to determine whether the language at issue has a plain and unambiguous meaning with regard to the particular dispute in the case. Our inquiry must cease if the statutory

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(i) Reimburses the member paying or incurring the expenses; and
(ii) Carries on a trade or business to which the research relates.
(4) Lease Payments. The amount paid or incurred to another member of the group for the lease of personal property owned by a member of the group is not taken into account for purposes of section 41. Amounts paid or incurred to another member of the group for the lease of personal property owned by a person outside the group shall be taken into account as in-house research expenses for purposes of section 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 lease expenses paid to the person outside the group.
(5) Payment for supplies. 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 section 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."

Treas. Reg. § 1.41-6(i).

> language is unambiguous and the statutory scheme is coherent and consistent.

519 U.S. 337, 340 (1997) (citing United States v. Ron Pair Enterprises, Inc., 489 U.S. 235, 240, (1989)).

As noted by the Supreme Court in Robinson, the plainness or ambiguity of statutory language is determined by reference to the language itself, the specific context in which that language is used, and the broader context of the statute as a whole, 519 U.S. at 341. In analyzing tax statutes, the courts have ruled that "all parts are to be given effect" so that no parts are to be rendered "superfluous." Rhone-Poulenc Surfactants and Specialties, L.P. v. Comm'r, 114 T.C. 533, 547 (2000).

What this means is that the determination as to whether or not ambiguity exists is made not from a review of a specific subsection or subparagraph of a statute by itself, but from a review of the relevant I.R.C. section as a whole—in this case, I.R.C. § 41. Where ambiguity exists, courts may look to canons of statutory construction to determine the meaning of a Code provision. Auburn Housing Authority v. Martinez. 277 F.3d 138, 143 (2nd Cir. 2002).

The Supreme Court concluded that: "All statutes must be construed in light of their purpose. A literal reading of them which would lead to absurd results is to be avoided when they can be given a reasonable application consistent with their words and with the legislative purpose." Haggar Co., 308 U.S. at 394. A basic rule of statutory interpretation is that a "statute should not be interpreted to produce an absurd or unreasonable result." **1** MERTENS LAW OF FEDERAL INCOME TAXATION, Chapter 3 § 3.08 (2008).

When a statute is unclear, however, legislative history is the next tool of statutory construction that courts will use to determine Congressional intent. Dominion Resources, Inc. v. United States, 219 F.3d 359, 365 (4th Cir. 2000). Where ambiguity exists, courts may look to the general purposes of Congress in enacting the statute and to legislative history for helpful clues. See, e.g., United States v. Braxtonbrown-Smith, 278 F.3d 1348, 1352 (D.C. Cir. 2002).

I.R.C. §§ 41(c)7; 41(f)(1): Compliance cites these provisions in support of its position that gross receipts, for purposes of computing the credit, should include amounts received from intra-group transactions. Under I.R.C. § 41(f)(1), the research credit for a controlled group is computed by adding all of the qualified research expenditures and gross receipts of all members of the group to arrive at aggregate amounts to be used in the credit computation. Further, I.R.C. § 41(c)(7) specifically defines the term gross receipts for purposes of computing the "base amount" as follows:

> For purposes of this subsection, gross receipts for any taxable year shall be reduced by returns and allowances made during the taxable year. In

the case of a foreign corporation, there shall be taken into account only gross receipts which are effectively connected with the conduct of a trade or business within the United States, the Commonwealth of Puerto Rico, or any possession of the United States.

I.R.C. § 41(c)(7).

Thus, the plain language of I.R.C. § 41(c)(7) indicates that, for purposes of the research credit, gross receipts shall be reduced by two items:

- returns and allowances and,
- in the case of foreign corporations, gross receipts not effectively connected with the conduct of a trade or business within the United States, the Commonwealth of Puerto Rico, or any possession of the United States.

I.R.C. § 41(f)(1): Taxpayers cite this provision in support of their position that gross receipts from foreign affiliates should be excluded from gross receipts for purposes of computing the base amount. I.R.C. § 41(f) provides "special rules" for purposes of computing the credit and states that:

> Special rules.
> For purposes of this section--
>
> (1) Aggregation of expenditures.[6]
>
> > (A) Controlled group of corporations. In determining the amount of the credit under this section--
> >
> > > (i) all members of the same controlled group of corporations shall be treated as a single taxpayer, and
> > >
> > > (ii) the credit (if any) allowable by this section to each such member shall be its proportionate shares of the qualified research expenses, basic research payments, and amounts paid or incurred to energy research consortiums, giving rise to the credit.

I.R.C. § 41(f)(1)(A).

[6] It should be noted that the title of this provision refers to "expenditures." There is no specific reference in this provision to gross receipts. This is most likely due to the fact that, when I.R.C. § 41(f) was enacted in 1981, the computation of the credit was based solely on QREs. It was not until the 1989 amendment that gross receipts became a component of the computation; however, this particular section was never revised.

I.R.C. § 41(f)(1)(B) states in part that the regulations prescribed under this subparagraph shall be based on principles similar to the principles which apply in the case of subparagraph (A).

As a result, taxpayers contend that the plain language of I.R.C. § 41(f)(1) states that its rules, including the single taxpayer rule, apply "for purposes of this section" (meaning I.R.C. § 41 in its entirety); therefore, the single taxpayer rule must apply to the determination of gross receipts under I.R.C. § 41(c)(7). According to taxpayers, if Congress had intended to limit the single taxpayer rule of I.R.C. § 41(f)(1) to the calculation of QREs or to the calculation of gross receipts from domestic but not foreign affiliates, it would have used more specific statutory language to achieve such a limited result.

1.) Ambiguity of I.R.C. Section

The general rule applied by the courts in the interpretation of a statute can be summarized as follows:

> Courts must presume that a legislature says in a statute what it means and means in a statute what it says there, Barnhart v. Sigmon Coal Co., Inc., 534 U.S. 438, 461-462 (2002) (quoting Connecticut Nat. Bank v. Germain, 503 U.S. 249 (1992)), so that when the words of a statute are unambiguous, the first canon is also the last: [the] judicial inquiry is complete. However, where a statutory provision is ambiguous, it is appropriate for courts to use rules of statutory construction, Auburn Housing Authority v. Martinez*,* 277 F.3d 138, 143 (2002), and to analyze intrinsic and extrinsic sources of legislative intent.

1 MERTENS LAW OF FEDERAL INCOME TAXATION, Chapter 3 § 3.05 (2008).

The issue of ambiguity was further addressed in Robinson as follows:

> The plainness or ambiguity of statutory language is determined by reference to the language itself, the specific context in which that language is used, and the broader context of the statute as a whole.

519 U.S. at 341 (1997) (citing Estate of Cowart v. Nicklos Drilling Co., 505 U.S. 469, 477 (1992) and McCarthy v. Bronson, 500 U.S. 136, 139 (1991)).

In this case, I.R.C. § 41(c)(7*)* specifically defines the term gross receipts for purposes of computing the “base amount.*”* The plain language of the statute provides that, for purposes of the research credit, gross receipts shall be reduced by returns and allowances and, in the case of foreign corporations, gross receipts not effectively connected with the conduct of a trade or business within the United States, the Commonwealth of Puerto Rico, or any U.S. possession. The wording of this provision is quite clear and, when viewed on its own, unambiguous. It defines the term base

amount in very broad terms. This provision, when viewed alone, appears to include intra-group gross receipts.

The general rule of statutory construction is that the enumeration of specific exclusions from the operation of a statute is an indication that the statute should apply to all cases *not* specifically excluded. When statutes list a series of items included under a general rule, courts will apply the canon, "*expressio unius est exclusio alterius*," — the expression of one thing implies the exclusion of another. Cash Currency Exchange, Inc. v. Shine, 762 F.2d 542, 552 (7th Cir. 1985). Absent evidence of contrary legislative intent, this theory applies to statutes that contain specific exceptions, Andrus v. Glover Const. Co., 446 U.S. 608, 616-17 (1980), specific exemptions, BMW Mfg. Corp. v. United States, 241 F.3d 1357 (Fed. Cir. 2001), and statutory sections that incorporate other sections by reference.

For example, in BMW Mfg. Corp., the court stated as follows:

> It thus appears that Congress expressly provided for the exemption of certain merchandise from the HMT. Where it did not so provide, it is reasonable to conclude that it did not so intend … the *absence* of any provision specifically exempting goods admitted into an FTZ therefore leads to the conclusion that Congress *did not intend such an exemption*.

241 F.3d at 1361 (emphasis added).

On the other hand, I.R.C. § 41(f)(1) appears to require a single group credit computation that aggregates QREs and gross receipts of all members of a controlled group and allocates the group credit among members of the group. Like I.R.C. § 41(c)(7), the wording of I.R.C. § 41(f)(1) appears to be quite simple. It states that, in determining the amount of the research credit, "all members of the controlled group of corporations shall be treated as a single taxpayer." I.R.C. § 41(f)(1)(A)(i).

Assuming, for discussion purposes, that I.R.C. § 41(f)(1) does apply to gross receipts from foreign affiliates and allows taxpayers to *exclude* these amounts as taxpayers state. This interpretation appears to be in direct conflict with I.R.C. § 41(c)(7) which, on its face, appears to require the taxpayer to *include* these same amounts. Thus, the two provisions—despite being relatively straightforward when viewed in isolation—give rise to some ambiguity when viewed together.

2.) Subsection Titles

I.R.C. § 41(f)(1) specifically incorporates the words*:* "aggregation of expenditures" as a subtitle or heading. No specific reference is made in the heading or the body of the subsection to gross receipts. Taxpayers take the position that the subsection's heading is to be ignored in interpreting the subsection itself. Instead, they assert the

subsection’s meaning is to be determined *only* by reference to the language in the subsection’s body:

> [i]n determining the amount of the credit under this section ---
>
> > All members of the same controlled group of corporations shall be treated as a single taxpayer.

I.R.C. § 41(f)(1)(A)(i).

Taxpayers argue that Congress intentionally retained the “single taxpayer rule” in I.R.C. § 41(f)(1)(A)(i) for purposes of determining all of the various computational components of the credit*, including the gross receipts* and, since this wording is unambiguous, there is no need to consider other sources in interpreting the statute.

The general rule followed by the courts is that the title of a statute cannot limit a statute's plain meaning, but it can be used to help interpret an ambiguous provision Montero-Martinez v. Ashcroft, 277 F.3d 1137, 1143 n.6 (9th Cir. 2002). Thus, titles and section headings can serve as limited interpretive aids if the statute itself is ambiguous. See e.g., Hardin v. City Title & Escrow Co., 797 F.2d 1037, 1039 (D.C.Cir.1986) (holding that, where section subtitle was not added by publisher or codifier, but was part of act as written and passed by Congress, subtitle was an indication of Congressional intent).

In this case, the aggregation of expenditures provisions of I.R.C. § 41(f) were originally enacted and designated I.R.C. § 44F(f) by the 1981 Act. The wording in § 44F(f) was as follows:

> Aggregation of expenditures—
>
> > (A) Controlled group of corporations. - In determining the amount of the credit under this section –
> >
> > > (i) all members of the same controlled group of corporations shall be treated as a single taxpayer, and
> > >
> > > (ii) the credit (if any) allowable by this section to each such member shall be its proportionate share of the increase in qualified research expenses giving rise to the credit.

I.R.C. § 44F(f) (1981).

According to SUTHERLAND’S STATUTES AND STATUTORY CONSTRUCTION:

> [w]here headings are enacted as a part of an act, or as part of a code, or where the meaning of the act is ambiguous or where there has been a revision, the headings may serve as an aid to the legislative intent. Either comments or notes included when the statute is passed or revised are not part of the law, but can be considered a useful guide to the legislative purpose underlying the statutory language.

Norman J. Singer, J.D. Shambie Singer, SUTHERLAND'S STATUTES AND STATUTORY CONSTRUCTION, § 47:14 (November, 2008).

To summarize, the title of the statute may be utilized as an interpretative aid only if it is determined that the statute is ambiguous.

I.R.C. § 41(f)(1) vs. I.R.C. § 41(c)(7): As noted above, taxpayers maintain that I.R.C. § 41(f)(1) is the "operative provision" for determining whether gross receipts from foreign affiliates should be included in the research credit computation, based on the subsection's introductory phrase: "for purposes of this section." In other words, taxpayers assert that the wording of § 41(f)(1) trumps or controls § 41(c)(7).

Taxpayers reason that, if Congress had intended to limit I.R.C. § 41(f) to the calculation of QREs, it would have used more specific statutory language to achieve that limited result. See Hartford Underwriters Ins. Co. v. Union Planters Bank, 530 U.S. 1, 6 (2000) (stating that when "the statute's language is plain, the sole function of the courts—at least where the disposition required by the text is not absurd—is to enforce it according to its terms").

3.) Legislative History

As noted previously, when a statute is unclear, legislative history is the next tool of statutory construction that courts will use to determine Congressional intent. Dominion Resources, 219 F.3d at 365.

According to Compliance, the legislative intent reflected in I.R.C. § 41(f)(1) is clear. When enacted, the provision applied only to expenditures and was intended to be an anti-manipulation rule. In the legislative history of the 1981 Act, Congress stated that:

> To ensure that the new credit will be allowed only for actual increases in research expenditures, the provision includes rules under which research expenditures of the taxpayer are aggregated with research expenditures of other persons for purposes of computing any allowable credit. These rules are intended to prevent artificial increases in research expenditures by shifting expenditures among commonly controlled or otherwise related persons.

H.R. Rep. No. 97-201 at 109 (1981).

The 1989 Act, however, added an entirely new factor to the research credit computation: gross receipts, thereby, materially changing the mechanics of the research credit computation. Before the amendments added by the 1989 Act, a taxpayer's gross receipts did not enter into the computation of the credit; now it does.

Taxpayers note that there are some references in the legislative history of the 1989 Act to the term "gross receipts" as well as expenditures. Their position is that the legislative history supports exclusion of gross receipts from intra-group transactions for the following reasons:

- The Conference Report for the 1989 Act states: "[t]he rules relating to aggregation of related persons and changes in business ownership are the same as under present law, with the modification that when a business changes hands, qualified research expenses and gross receipts for periods prior to the change of ownership are treated as transferred with the trade or business which gave rise to those expenditures and receipts for purposes of recomputing a taxpayer's fixed-base percentage." H.R. Conf. Rep. No. 101-386 at 542 (1989). According to taxpayers, this quote demonstrates that, when Congress added "gross receipts" to the credit calculation formula, it determined that changes to the statutory rules governing changes in business ownership under I.R.C. § 41(f)(3) were required, but there was no need to alter the existing "single taxpayer" rule under I.R.C. § 41(f)(1). This rule had already been clarified by regulation to require that intra-group transfers be disregarded, and -- under the "legislative re-enactment doctrine" -- Congress is presumed to be aware of administrative interpretations and to adopt those interpretations when it re-enacts a statutory provision without change. See e.g., Lorillard v. Pons, 434 U.S. 575, 580 (1978).

- After referring to the I.R.C. § 41(f)(1) aggregation rules, the Conference Report for the 1989 Act states in the very next paragraph: "In addition, the bill provides that a foreign affiliate's gross receipts which are not effectively connected with the conduct of a trade or business in the United States do not enter into the computation of the credit." H.R. Conf. Rep. No. 101-386 at 542. This quote suggests that Congress was aware of the interplay between the single taxpayer concept and the fact that some controlled groups include foreign affiliates, which further supports the position that intra-group transactions with foreign affiliates should be disregarded like any other intra-group transfer or a transfer between divisions/branches of the same legal entity.

Compliance does not dispute that, in computing the research credit for a controlled group, Congress intended that the gross receipts of the members of the group should be aggregated under the single taxpayer computation of I.R.C. § 41(f)(1). However, Compliance does not believe that Congress intended that the intra-group transaction rule contained in Treas. Reg. § 1.41-6(i) was intended to apply to gross receipts. The legislative history to the 1981 Act discusses this rule in relation to intercompany charges

for the right to use personal property in the conduct of research and contracts for research between the taxpayer and a person whose research expenditures are aggregated with the taxpayer.

Compliance does not believe that the doctrine of legislative re-enactment applies to the intra-group transaction rule contained in Treas. Reg. § 1.41-6(i). The legislative history quoted in the Taxpayers' position relates to a specific provision in the statute dealing with acquisitions and dispositions of major portions of a trade or business in I.R.C. § 41(f)(3), not the intra-group transaction regulation. Further, Compliance believes that because the regulation does not reflect the legislative changes that pre-dated the 1989 Act changes, there can be no legislative re-enactment of the intra-group transaction rule. See § 231(e) of the Tax Reform Act of 1986 (the 1986 Act) amending I.R.C. § 41(b)(2)(A)(iii). Prior to amendment, I.R.C. § 41(b)(2)(A)(iii) included amounts paid to another person for the right to use personal property in the conduct of qualified research as an in-house research expenditure. The 1986 Act revised this provision to treat amounts paid for the right to use computers in qualified research as eligible in-house research expenditures. Treas. Reg. § 1.41-6(i)(4) has never been amended to reflect this change in the law.

As can be seen, both Compliance and taxpayers rely on statements in various parts of the legislative history to support their positions. Compliance relies primarily on the legislative history of the 1981 Act and the legislative intent of the aggregation rules. In contrast, taxpayers point to the legislative history of the 1989 Act to support the position that the relevant legislative history refers to gross receipts as well as expenditures.

B. The Regulations

The relevance that an administrative interpretation, such as a regulation, has to the interpretation of a statute can be summarized as follows: "[If a court determines that] Congress has directly spoken to the precise question at issue, that is the end of the matter; for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress." Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc., 467 U.S. 837, 842-43 (1984). If, however, the agency's statutory interpretation "fills a gap or defines a term in a way that is reasonable in light of the legislature's revealed design, we give [that] judgment 'controlling weight.'" NationsBank v. Variable Annuity Life Ins. Co., 513 U.S. 251, 257 (1995) (quoting Chevron, 467 U.S. at 844).

Where a statute's plain terms admit of two or more reasonable ordinary usages, the Government's choice of one of them is entitled to deference. See, e.g., Verizon Communications Inc. v. FCC, 535 U.S. 467 (2002).

The general rule for administrative interpretations by a governmental agency, such as the IRS or Treasury, of a statute is as follows:

> In determining whether an agency's regulation complies with its [C]ongressional mandate, [courts] look to see whether the regulation harmonizes with the plain language of the statute, its origin, and its purpose. So long as the regulation bears a fair relationship to the language of the statute, reflects the views of those who sought its enactment, and matches the purpose they articulated, it will merit deference.

Connecticut General Life Ins. Co. v. Comm'r, 177 F.3d 136, 143 (3rd Cir. 1999) (quoting Sekula v. FDIC, 39 F.3d 448 (3rd. Cir. 1994).

Treas. Reg. § 1.41-3(c): This provision is cited by Compliance in support of the position that the term "gross receipts" is broadly defined as "the total amount, as determined under the taxpayer's method of accounting**,** derived by the taxpayer from *all* its activities and from *all* sources . . . ." Treas. Reg. § 1.41-3(c)(1) (emphasis added).

Treas. Reg. § 1.41-3(c)(2) provides for only six exceptions to gross receipts: **(i)** returns or allowances; **(ii)** receipts from the sale or exchange of capital assets; (**iii)** repayments of loans or similar instruments; **(iv)** receipts from a sale or exchange not in the ordinary course of business; **(v)** amounts received with respect to sales tax or other similar state and local taxes; and **(vi)** amounts received by a taxpayer in a taxable year that precedes the first taxable year in which the taxpayer derives more than $25,000 in gross receipts other than specifically defined investment income.

Treas. Reg. § 1.41-6T(b): It is taxpayers' position that Treas. Reg. § 1.41-6T(b) specifically confirms that I.R.C. § 41(f)(1) applies to aggregate gross receipts. The regulatory provision states that:

> Computation of the group credit--(1) In general**.** 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. All members of a controlled group must use the same method of computation, either the method described in section 41(a) or the alternative incremental research credit (AIRC) method described in section 41(c)(4), or the alternative simplified credit (ASC) method described in section 41(c)(5), in computing the group credit for a credit year.

Treas. Reg. § 1.41-6T(b)(1).

In addition, taxpayers assert that the regulations include an example of a company that is required to combine expenditures *and* receipts in determining if it is a start-up company. See Treas. Reg. § 1.41-6(b)(2)(ii). In this example, three companies are members of the same controlled group of corporations, one of which would have been considered a start-up company because it had no gross receipts in the specified year,

one of which would have been a start-up because it had no qualified research in the specified year and the last of which had no qualified research or gross receipts in the specified year. Because § 41(f) treats the three companies as a single taxpayer, the example holds that the start-up company is *not* treated as a start-up. Id.

Finally, Treas. Reg. § 1.41-6(i)(1) details the application of the aggregation rule for transactions between group members. This provision states that "for purposes of determining the research credit, transfers between members of the group are generally disregarded."

In contrast, Compliance agrees that Treas. Reg. § 1.41-6(b) requires aggregation of both QREs and gross receipts but differs in how this is done and whether Treas. Reg. § 1.41-6(i) applies to gross receipts. Compliance suggests that all of the examples in the legislative history and the regulations dealing with controlled groups compute the research credit by adding the total QREs and gross receipts of each member of the group and that Treas. Reg. § 1.41-6(i) applies only to determine the eligible QREs of each member.

Preambles: While not binding authority, preambles frequently express the intended effect of a regulation and may be helpful in interpreting ambiguous statements in regulations. See Connecticut General Life Ins. Co., 177 F.3d at 145-46; Armco, Inc. v. Comm'r, 87 T.C. 865, 868 (1986).

For this issue, excerpts from the following preambles are relevant:

- 2001 Final Regulations —"Several commentators objected to the definition of gross receipts in the proposed regulations. Referring to the inclusion in a House Budget Report of the term sales growth as an apparent short-hand reference to an increase in gross receipts, some commentators argued that gross receipts should be limited to income from sales. See H.R. Rep. No. 101-247, at 1200 (1989). *In determining its research budget, however, a business may take into account any expected income stream, regardless of whether or not the income is derived from sales or from other active business activities.* Moreover, many businesses do not generate any income in the form of sales. Accordingly, the final regulations do not adopt this suggestion. The final regulations also do not adopt suggestions that the definition of gross receipts be narrowed to exclude those items not directly related to the conduct of the taxpayer's trade or business. *As noted above, any expected income stream may be taken into account in determining a business' research budget, regardless of the source of the income. Moreover, IRS and Treasury believe that a subjective narrowing of the term gross receipts, as suggested by these commentators, could leave the definition of the term, and thus the computation of the base amount, vulnerable to manipulation*." T.D. 8930 (emphasis added).

- 2004 Final Regulations — “These final regulations retain the broad definition of gross receipts contained in T.D. 8930. In response to Notice 2001-19, a number of commentators reiterated earlier comments that this definition was overly broad. As stated in the preamble to the 2001 proposed regulations, *the Treasury Department and the IRS continue to believe that the definition of gross receipts should be construed broadly,* and, accordingly, no change has been made in these final regulations to the definition contained in T.D. 8930." T.D. 9104, 2004-1 C.B. 406 (emphasis added).

C. The Double Counting Issue

Taxpayers raise the double counting issue to demonstrate that, if they are required to report transfers between related entities as gross receipts for purposes of computing the base amount under I.R.C. § 41(c), then there is the possibility that there would be double counting of gross receipts from the controlled group’s sale of the same property. Following is an analysis of the possibility for double counting of receipts in two situations (wholly domestic and domestic/foreign):

1.) Wholly Domestic Situation

Example 1-- P, a U.S. corporation, owns 100 percent of the stock of S, also a U.S. corporation. P and S do not file consolidated returns. P manufactures property having a cost of $90, which P sells to S for $100. S later resells the property outside the PS controlled group for $110.

Because P and S are treated as a single taxpayer under I.R.C. § 41(f)(1)(A)(i), the group credit is calculated by applying all of the I.R.C. § 41 computational rules on an aggregate basis. One issue in applying such rules is whether, on the above set of facts, the PS group has gross receipts of $210 ($100 on P's sale to S + $110 on S's sale of the same property to an unrelated party) or gross receipts of only $110 (represented by the amount S realized on its sale of the property to an unrelated party).

Taxpayers argue that the correct result is $110 and not $210 since, if gross receipts were determined to be $210, there would be a double counting of the receipts of the group’s sale of the same property. This result is reached by disregarding the intra-group sale. Taxpayers maintain that this is the simplest and most straightforward method to calculate gross receipts, and the only method consistent with the statutory language, its underlying purpose, and the regulations. Taxpayers reason that true gross receipts can only arise when a sale is made to a third party.

2.) Domestic/Foreign Situation

Example 2 -- Intra-Group Export Sales -- P, a U.S. corporation, owns 100 percent of the stock of FS, a Country X corporation. FS is not engaged in a U.S. trade or business. P

manufactures goods for $90, which P sells to FS for $100. FS later resells the goods to the public for $110.

Here, again, taxpayers argue the proper method for calculating gross receipts is to disregard the intra-group sale. Nonetheless, taxpayers recognize that, if the gross receipts realized by P on its sale to FS are excluded from the computation of gross receipts, *no gross receipts from the sale of the goods sold by P to FS will ever be reflected in the group's gross receipts*. Such would be the result, because under I.R.C. § 41(c)(7), the gross receipts of FS are not counted since FS is not engaged in a U.S. trade or business. Taxpayers understand the Service might find this situation troubling, however, they maintain this concern does not warrant treating intra-group transactions as creating gross receipts.

D. Additional Arguments Raised by Taxpayers

During the course of the Appeals process, taxpayers have raised two additional arguments, which are addressed below. Compliance's position regarding the arguments raised is also summarized below**.**

1.) Legislative Re-enactment Doctrine Argument

It is taxpayers' position that the legislative reenactment doctrine supports their argument that Treas. Reg. § 1.41-6(i)(1) governs the issue of determining gross receipts from intra-group transactions. According to taxpayers:

- The Conference Report for the 1989 Act states that "[t]he *rules relating to aggregation of related persons* and changes in business ownership are the same as under present law, with the modification that when a business changes hands, qualified research expenses and gross receipts for periods prior to the change of ownership are treated as transferred with the trade or business which gave rise to the expenditures and receipts for purposes of recomputing the taxpayer's fixed-base percentage." H.R. Conf. Rep. No. 101-386 at 542 (1989) (emphasis added).

- This quote demonstrates that, when Congress added gross receipts to the credit calculation formula, it determined that changes to the statutory rules governing changes in business ownership under I.R.C. § 41(f)(3) were required, but there was no need to alter the existing single taxpayer rule under I.R.C. § 41(f)(1). This rule had already been clarified by regulation to require that intra-group transfers be disregarded, and -- under the legislative re-enactment doctrine -- Congress is presumed to be aware of administrative interpretations and to adopt those interpretations when it re-enacts a statutory provision without change. See e.g., Lorillard, 434 U.S. 575 at 580.

Compliance Response: The legislative history to the 1989 Act provides that:

> The rules relating to *aggregation* of related persons and changes in business ownership *are the same as under present law*, with the modification that when a business changes hands, qualified research expenses and *gross receipts* for periods prior to the change of ownership are treated as transferred with the trade or business which gave rise to those expenditures and receipts for purposes of recomputing a taxpayer's fixed-base percentage.
>
> In addition, the bill provides that a foreign affiliate's *gross receipts* which are not effectively connected with the conduct of a trade or business in the United States do not enter the computation of the credit.

H.R. Rep. No. 101-247 at 1202-03 (1989) (emphasis added).

According to Compliance, in reality, the legislative history's statement that "[t]he rules relating to *aggregation* of related persons . . . are the same as under present law . . . ." supports Compliance's position. I.R.C. § 41(f)(1) was enacted to stop abuses relating to expenditures and, as stated in the legislative history, that law did *not* change.

Further, Compliance asserts neither the 1989 Act's language nor its legislative history indicates that Congress intended that intra-group transfers generating gross receipts be disregarded. In fact, the Congressional statements cited by taxpayers do not mention the elimination of any types of transactions. The legislative history only mentions aggregation. I.R.C. § 41(f)(1) is an anti-manipulation rule requiring a single group credit computation that aggregates QREs and gross receipts of all members of a controlled group and allocates the group credit among members of the group. Any interpretation of this rule should reflect the Congressional intent of preventing manipulation of the credit through expenditures.

Compliance also points out that the references to gross receipts speak only to adjustments to be made to gross receipts when a business changes hands (see I.R.C. § 41(f)(3)) and to non-recognition of a foreign affiliates gross receipts not effectively connected with a U.S. trade or business, the Commonwealth of Puerto Rico, or any possession of the U.S. (see I.R.C. § 41(c)(7)). Thus, the legislative history to the 1989 Act makes no mention of excluding gross receipts from intra-group transfers generally, nor does it support their exclusion. <u>See</u> H.R. Rep. No. 101-247 (1989).

Moreover, the legislative history to the 1981 Act includes rules under which "research *expenditures of the taxpayer are aggregated* with research expenditures of other persons for purposes of computing any allowable credit." S. Rep. 97-144 at 84 (1981) (emphasis added). In addition, the legislative history to the 1981 Act also requires that "*all qualified research expenditures of all corporations that are members of a controlled group of corporations are treated as if made by one taxpayer*." Id. (emphasis added).

2.) Regulation Re-Promulgation Argument

Taxpayers argue that Treas. Reg. § 1.41-6(i)(1), which expressly gives effect to the single taxpayer rule, requires the elimination of gross receipts received from affiliates in determining the research credit of the group.[7] According to taxpayers, the assertion that the regulatory rule disregarding intra-group transactions is inapplicable to gross receipts is incorrect, because Treas. Reg. § 1.41-6(i)(1) was re-promulgated in temporary form in 2005 and, yet again in final form, in 2006—well after the statutory changes to the research credit in 1989 made gross receipts a component in the research credit calculation. Therefore, taxpayers maintain that the re-promulgation of the regulation long after gross receipts became a component of the credit calculation removes any question that the single taxpayer rule applies to gross receipts as well as QREs. If the regulations were not intended to apply to gross receipts, the drafters would have had to include a provision excepting gross receipts from the regulatory provisions or reserving on the issue. There is no such provision.

Compliance Response: Taxpayers are incorrect when they claim that re-promulgation (re-numbering) of an unchanged regulation solely interpreting an unchanged portion of a statute also necessarily interprets portions of the statutory scheme that were changed after the initial promulgation of the regulation. When promulgated in 1989, the intra-group transaction rules were intended to address transactions involving QREs. The intra-group transaction rules do not address the treatment of gross receipts. The preamble to the regulations adopted in 1989 indicates that the final regulations do not reflect changes made by the Tax Reform Act of 1986. The rules in Treas. Reg. § 1.41-6(i) offer a regime for accounting for intra-group QREs. This regime is not applicable to gross receipts. Further, because these rules predate the 1989 Act, these rules do not reflect any change in the law made by the 1989 Act.

On May 17, 1989, the Service and Treasury issued regulations for determining the amount of the research credit for a controlled group of corporations. See Treas. Reg. § 1.41-8, T.D. 8251 (1989). Consistent with Congressional purpose, former Treas. Reg. § 1.41-8(e) provided rules intended to prevent the manipulation of the research credit by the shifting of *expenditures* between members of a controlled group. Then, in late 1989, after issuance of the aforementioned regulations, Congress changed the calculation of the research credit making gross receipts an integral factor in determining the amount of the credit for taxable years beginning after December 31, 1989. See I.R.C. §§ 41(a), 41 (c)(1) and (c)(3)(A). Former Treas. Reg. § 1.41-8(e)(1) provided the general rule that "[b]ecause all members of a group under common control are treated as a single taxpayer for purposes of determining the research credit, transfers between members of the group are generally disregarded." Former § 1.41-8(e)(2)-(5) provided clarifying rules on how controlled groups should treat specific types of intra-group transfers which generate *QREs* such as in-house research expenses, contract research expenses, lease payments and supplies. These rules prevent

[7] This provision states that: “[b]ecause all members of a group under common control are treated as a single taxpayer for purposes of determining the research credit, transfers between members of the group are generally disregarded.” Treas. Reg. § 1.41-6(i)(1).

artificial increases in QREs by eliminating the possibility of inflating QREs with profit factors and multiple accounting for the same research activities. Although this provision has been renumbered as Treas. Reg. § 1.41-6(i), the language remains unchanged from that of former Treas. Reg. § 1.41-8(e). Accordingly, Treas. Reg. § 1.41-6(i) requires a controlled group of corporations to disregard generally intra-group transfers with respect to QREs. Treas. Reg. § 1.41-6(i)(1) does not allow a controlled group of corporations to disregard automatically all intra-group sales when computing gross receipts for purposes of determining the base amount under I.R.C. § 41(c).

Treas. Reg. § 1.41-6(i) should continue to be interpreted as it was interpreted prior to the insertion of gross receipts into the calculation of the research credit. There was no reason to change the language of Treas. Reg. § 1.41-6(i) to exclude "gross receipts" because I.R.C. § 41(c)(7) and Treas. Reg. § 1.41-3(c) adequately define what should be included in or excluded from gross receipts. If the Service had wanted to exclude intra-company gross receipts from the definition of "gross receipts," it would have done so in Treas. Reg. § 1.41-3(c), which defines gross receipts and lists the only six exclusions therefrom.

The Service and Treasury have not issued interpretive rules addressing the treatment of gross receipts in a controlled group; the only existing interpretation of the controlled group rules pertains to legislation not including gross receipts in the research credit computation. See Treas. Reg. § 1.41-6. Accordingly, any attempt to invoke the intra-group transaction provisions of Treas. Reg. § 1.41-6(i) for taxable periods subsequent to a material change in the interpreted provision fails as a matter of law. See, e.g., Lockheed Martin v. United States, 42 Fed. Cl. 485, 495 (1998), rev'd on other grounds, 210 F.3d 1366 (Fed. Cir. 2000) (holding that former Treas. Reg. § 1.41-5, addressing the research credit funding exclusion under pre-1986 law, was valid for post-1986 taxable periods, as Congress reenacted the research credit funding provisions, after the regulation was promulgated, *without change*).

The rules in Treas. Reg. § 1.41-6 do not eliminate intra-group gross receipts. Even under the rules of Treas. Reg. § 1.41-6(i), intra-group transactions are not fully disregarded. The rules provide a regime to determine which member of the group is eligible to treat an expenditure as a QRE and what amount constitutes a QRE.

SETTLEMENT GUIDELINES:

As noted above, the issue addressed in these settlement guidelines is a legal issue involving the interpretation of two key I.R.C. provisions: I.R.C. §§ 41(c)(7) and 41(f)(1). In arriving at a proposed settlement offer, Appeals evaluated the taxpayers' as well as the Government's hazards of litigation.

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