DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
CHIEF COUNSEL

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INTERNAL REVENUE SERVICE NATIONAL OFFICE LEGAL ADVICE

MEMORANDUM FOR ASSOCIATE AREA COUNSEL (LMSB) CC:LM:RFPH:CHI:2

FROM: Associate Chief Counsel
(Passthroughs and Special Industries) CC:PSI

SUBJECT: Credit for Increasing Research Activities under Section 41 of the Internal Revenue Code

This Chief Counsel Advice responds to your memorandum dated January 30, 2002. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

Taxpayer:
TIN:
Date 1:
Date 2:
Date 3:

ISSUES

(1) Whether Taxpayer, a domestic corporation, and its majority-owned foreign subsidiaries should be treated as a single taxpayer under I.R.C. §§ 41(f)(1)(A)(i), 41(f)(5), and 1563(a) as members of the same controlled group of corporations if the foreign subsidiaries were excluded members of that controlled group of corporations under section 1563(b)(2)(C).

(2) Whether Taxpayer should exclude the sales to its foreign subsidiaries when computing gross receipts for purposes of determining its base amount under section 41(c).

CONCLUSIONS

(1) Taxpayer, a domestic corporation, and its majority-owned foreign subsidiaries should be treated as a single taxpayer under sections 41(f)(1)(A)(i), 41(f)(5), and 1563(a) because they were members of the same controlled group of corporations

even if the foreign subsidiaries were excluded members of that controlled group of corporations.

(2) Given the particular facts and circumstances of this case, Taxpayer should exclude the sales to its majority-owned foreign subsidiaries when computing gross receipts for purposes of determining its base amount under section 41(c). For the years at issue, Taxpayer should consistently exclude such sales from gross receipts for purposes of both the fixed-base percentage and the average annual gross receipts for the four taxable years preceding the credit year.

FACTS

Taxpayer is a domestic corporation. Taxpayer owned more than fifty percent of certain foreign subsidiaries for purposes of section 1563(a)(1). Taxpayer performed research. Taxpayer, however, did not perform research for or on behalf of the foreign subsidiaries, nor did the foreign subsidiaries perform research for or on behalf of Taxpayer. In addition to research, Taxpayer manufactured product and sold some of that product to the foreign subsidiaries. The foreign subsidiaries did not have gross receipts that were effectively connected with the conduct of a trade or business within the United States.

In its income tax returns for Date 1, Date 2, and Date 3, Taxpayer included all sales to the foreign subsidiaries in its gross receipts for purposes of determining the average annual gross receipts and the aggregate gross receipts under section 41(c). Taxpayer later increased the amount of its credit and filed an informal claim for refund. In computing the base amount and determining the increased amount of its credit for the three years, Taxpayer excluded all sales to its foreign subsidiaries in its gross receipts and all of the foreign subsidiaries' gross receipts.[1]

LAW AND ANALYSIS

I. Foreign Members of a Controlled Group of Corporations and Single Taxpayer Treatment

Section 41 provides a non-refundable income tax credit for qualified research expenses paid or incurred by a taxpayer during the taxable year. Under the general rule, the research credit is equal to the sum of (1) twenty percent of the excess (if any) of the taxpayer's qualified research expenses for the taxable year over its base amount and (2) twenty percent of the taxpayer's basic research expenses. I.R.C. § 41(a). The base amount is computed by multiplying the taxpayer's fixed-base percentage by its average annual gross receipts for the four taxable years

[1] This Chief Counsel Advice addresses issues related only to the computation of the research credit under section 41(c). We express or imply no opinion as to whether Taxpayer has satisfied the requirements for qualified research under section 41(b) and (d).

preceding the taxable year for which the credit is being determined. I.R.C. § 41(c)(1). A taxpayer's fixed-base percentage is the percentage that the aggregate qualified research expenses 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. I.R.C. § 41(c)(3)(A). Treas. Reg. § 1.41-3(c)(1) defines gross receipts 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 (e.g., revenues derived from the sale of inventory before reduction for cost of goods sold).[2]

Section 41(f) provides that:

> (1) 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 shares of the qualified research expenses and basic research payments giving rise to the credit.

Prop. Treas. Reg. § 1.41-8(a)(1)[3] provides that in determining the amount of research credit allowed with respect to a trade or business that at the end of its taxable year is a member of a controlled group of corporations, all members of the group are treated as a single taxpayer.

Section 41(f)(5)(A) provides that the term "controlled group of corporations" has the same meaning given to such term by section 1563(a), except that "more than 50 percent" shall be substituted for "at least 80 percent" each place it appears in section 1563(a)(1). Section 1563(a)(1) provides that a controlled group of corporations includes a parent-subsidiary controlled group. A parent-subsidiary controlled group is:

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[2] Treas. Reg. § 1.41-3(c) was amended by T.D. 8930 and is applicable for taxable years beginning on or after January 3, 2001. The Service and Treasury have reconsidered T.D. 8930 and on December 26, 2001, issued new proposed regulations (66 F.R. 66,362, 2002-4 I.R.B. 404). See Notice 2001-19. The new proposed regulations retain the definition of gross receipts contained in § 1.41-3(c)(1) of T.D. 8930.

[3] Prop. Treas. Reg. § 1.41-8 refers to the proposed amendments to the Income Tax Regulations relating to the aggregation and allocation of the research credit published in the Federal Register on January 4, 2000. See 65 F.R. 258.

> 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.

Id.

Section 1561 imposes limitations on certain multiple tax benefits for component members of a controlled group of corporations. Section 1563(a) defines a controlled group and section 1563(b) defines a component member of that controlled group. Under section 1563(b), a component member is a member that is not treated as an excluded member under section 1563(b)(2). Section 1563(b)(2)(C) provides that a corporation which is a member of a controlled group of corporations on December 31 of any taxable year shall be treated as an excluded member of such group for the taxable year including such December 31 if such corporation is a foreign corporation subject to tax under section 881 for such taxable year. Section 881 imposes a tax on the income of foreign corporations to the extent the amount received is not effectively connected with the conduct of a trade or business in the United States.

In this case, Taxpayer and its foreign subsidiaries were members of the same controlled group of corporations because Taxpayer owned more than fifty percent of the foreign subsidiaries for purposes of section 1563(a)(1). Moreover, the foreign subsidiaries were excluded members (and therefore not component members) of the controlled group because they did not have income effectively connected with the conduct of a trade or business within the United States under section 1563(b)(2)(C).

The fact that the foreign subsidiaries were not “component” members of the controlled group of corporations under section 1563(b)(2)(C) does not prevent the foreign subsidiaries from being “members” of the controlled group under section 1563(a). The term “component” member for purposes of section 1563(b) merely defines a particular type of member. A controlled group may include corporations that are component members and corporations that are excluded members (and therefore not component members). I.R.C. § 1563(a). A corporation may be a member of a controlled group for purposes of section 1563(a), but may not be a component member for purposes of section 1561.

This conclusion is consistent with the language in section 41(f)(5). In defining controlled group, section 41(f)(5) refers to the meaning of controlled group under section 1563(a). Section 41(f)(5) does not refer to the component member provisions under section 1563(b). Therefore, section 41(f)(1)(A) and (f)(5) should be construed to apply to a controlled group that may include a foreign corporation, even though the foreign corporation may not be a component member.

As so construed, we conclude that the majority-owned foreign subsidiaries in this case should be viewed as members of the same controlled group of corporations under sections 41(f)(1)(A) and 1563(a). As members of the same controlled group, Taxpayer and its foreign subsidiaries should be treated as a single taxpayer for purposes of determining the amount of the research credit. I.R.C. § 41(f)(1)(A).

II. Gross Receipts and Intra-Group Transactions

The aggregation of expenditures provisions in section 41(f) were originally enacted and designated I.R.C. § 44F(f) by the Economic Recovery Tax Act of 1981, Pub. L. No. 98-34, § 221, 95 Stat. 172, 241-47 (1981). Section 44F was redesignated I.R.C. § 30 by the Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 471(c), 98 Stat. 494, 826, 831-32 (1984). Section 30 was amended and redesignated section 41 by the Tax Reform Act of 1986, Pub. L. No. 99-514, § 231, 100 Stat. 2085, 2173-2180 (1986). Section 44F(f) provided as follows:

> (1) 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.

When Congress enacted section 44F(f), the calculation of the research credit did not involve gross receipts. Instead, the focus was on expenditures. Section 44F(a) allowed a credit against the tax imposed for the taxable year in an amount equal to 25 percent of the excess (if any) of (1) the qualified research expenses for the taxable year, over (2) the base period research expenses. Section 44F(c)(1) defined base period research expenses as the average of the qualified research expenses for each year in the base period. Section 44F(c)(2) defined base period as the 3 taxable years immediately preceding the taxable year for which the determination is being made.

Accordingly, in enacting section 44F(f), Congress sought to prevent the manipulation of only expenditures within a controlled group. H.R. Rep. No. 97-201 at 109 (1981). Congress provided 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.
>
> Under the provision, all qualified research expenditures of all corporations that are members of a "controlled group of corporations" are treated as if made by one taxpayer... Any research credit earned by a controlled group, computed pursuant to this aggregation rule, is to be apportioned among members of the group on the basis of their proportionate share of the increase in aggregate qualified research expenditures giving rise to the credit.

Id. at 123.

In 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, Treas. Reg. § 1.41-8(e) provided rules intended to prevent the shifting of expenditures between members of a controlled group. 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." Treas. Reg. § 1.41-8(e)(2)-(5) provided clarifying rules on how controlled groups should treat specific types of intra-group transfers which generate expenditures such as in-house research expenses and contract research expenses. Treas. Reg. § 1.41-8 applied only to expenditures because at the time the regulations were issued the calculation of the research credit did not involve gross receipts.

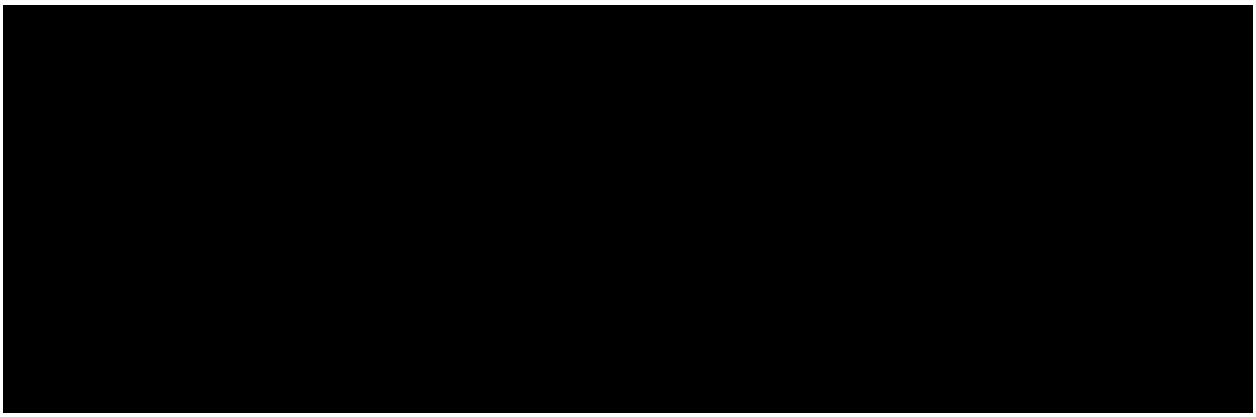
In the Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, § 7110, 103 Stat. 2106, 2323-26 (1989), Congress changed the calculation of the research credit making gross receipts an integral factor in determining the amount of the credit for taxable years beginning after December 31, 1989. See I.R.C. § 41(a), (c)(1), and (c)(3)(A). There is no indication in the legislative history that Congress intended for a controlled group of corporations to disregard automatically all intra-group sales when computing gross receipts. H.R. Rep. No. 101-247, 101st Cong., 1st Sess. 1198 (1989). To the contrary, Congress specifically indicated what gross receipts should be disregarded for purposes of determining the base amount under section 41(c) when it enacted section 41(c)(6). Section 41(c)(6) 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.

In 2000, Treas. Reg. § 1.41-8 was amended and renumbered by T.D. 8930 as Treas. Reg. § 1.41-6. Unlike other provisions of Treas. Reg. § 1.41-6, however, Treas. Reg. § 1.41-6(e) was not amended to reflect the effect of gross receipts on the research credit. The language in Treas. Reg. § 1.41-6(e) remains unchanged from that of former Treas. Reg. § 1.41-8(e). Accordingly, Treas. Reg. § 1.41-6(e) should continue to be interpreted as it was interpreted prior to the insertion of gross receipts into the calculation of the research credit. Section 41-6(e) requires a controlled group of corporations to disregard generally intra-group transfers with respect to research expenditures. Section 1.41-6(e)(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 section 41(c).

Prop. Treas. Reg. § 1.41-8 (relating to the aggregation and allocation of the research credit) provides guidance on how a controlled group of corporations should compute its research credit. Of relevance, when a controlled group computes its base amount, the controlled group must aggregate each member's base year qualified research expenses, base year gross receipts, and average annual gross receipts for the four years preceding the credit year. Id. Whether a controlled group of corporations may disregard intra-group sales when computing aggregate gross receipts for purposes of determining the base amount under section 41(c) will depend on the particular facts and circumstances of the controlled group. We have determined that given the particular facts and circumstances of this case that Taxpayer may exclude the sales to its foreign subsidiaries for purposes of determining its base amount under section 41(c). For the years at issue, Taxpayer should consistently exclude such sales from gross receipts for purposes of both the fixed-base percentage and the average annual gross receipts for the four taxable years preceding the credit year.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS



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Please call if you have any further questions.

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