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OFFICE OF
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR AREA COUNSEL, FINANCIAL SERVICES AND
HEALTHCARE CC:LM:FSH

FROM: ASSOCIATE CHIEF COUNSEL (PASSTHROUGHS AND
SPECIAL INDUSTRIES) CC:PSI

SUBJECT: CREDIT FOR INCREASING RESEARCH ACTIVITIES

This Chief Counsel Advice responds to your memorandum dated August 14, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

Taxpayer:

Research Buildings: Taxpayer's research buildings located in

Year 1: Taxable year ended

Year 2: Taxable year ended

Year 3: Taxable year ended

ISSUE

Whether certain amounts incurred by Taxpayer for utilities used in the Research Buildings are qualified research expenses under section 41.

CONCLUSION

None of the amounts incurred by Taxpayer for utilities used in the Research Buildings are qualified research expenses under section 41 because Taxpayer has not established that the special character of the qualified research required additional extraordinary expenditures for utilities.

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FACTS

Taxpayer is currently under examination for Year 1, Year 2, and Year 3. One issue is Taxpayer's computation of the credit for increasing research activities under section 41. For each year under examination, Taxpayer's per square foot utilities expenses in the Research Buildings exceeded the per square foot utilities expenses in its buildings where qualified research was not performed (Non-Research Buildings). In computing the credit, Taxpayer included certain amounts incurred for utilities used in the Research Buildings. Taxpayer used the following methodology to determine those amounts:

Step 1: Taxpayer determined its utilities expenses per square foot in the Non-Research Buildings.

Step 2: Taxpayer determined its utilities expenses per square foot in the Research Buildings.

Step 3: Taxpayer subtracted the per square foot utilities expenses for the Non-Research Buildings from the per square foot utilities expenses for the Research Buildings.

Step 4: Taxpayer multiplied the difference by the number of square feet in the Research Buildings to determine the utilities expenses for the Research Buildings included as qualified research expenses.

In sum, Taxpayer treated the additional per square foot utilities expenses for the Research Buildings as qualified research expenses eligible for the credit under section 41.

LAW

Section 41(a) provides that the research credit for the taxable year is an amount equal to the sum of (1) 20 percent of the excess (if any) of (A) the qualified research expenses for the taxable year, over (B) the base amount, and (2) 20 percent of the basic research payments determined under section 41(e)(1)(A).

Section 41(b)(1) defines the term "qualified research expenses" to mean the sum of the following amounts that are paid or incurred by the taxpayer during the taxable year in carrying on any trade or business of the taxpayer: (A) in-house research expenses, and (B) contract research expenses.

Section 41(b)(2)(A)(ii) provides that the term "in-house research expenses" includes any amount paid or incurred for supplies used in the conduct of qualified research.

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Section 41(b)(2)(C) defines the term "supplies" to mean any tangible property other than (i) land or improvements to land, and (ii) property of a character subject to the allowance for depreciation.

Treas. Reg. § 1.41-2(b)(1) of the Income Tax Regulations provides that expenditures for supplies or for the use of personal property that are indirect research expenditures or general and administrative expenses do not qualify as in-house research expenses.

Treas. Reg. § 1.41-2(b)(2)(i) 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.

Treas. Reg. § 1.41-2(b)(2)(ii) provides that 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.

H.R. Rep. No. 97-201, at 116-18 (1981), provides an extensive discussion of in-house research expenses:

The first category of in-house research expenditures qualifying for the new credit consists of wages paid or incurred to an employee for qualified services performed by such employee.

. . . .

As a general rule, wages enter into the credit computation only to the extent paid for that portion of the services performed by an employee of the taxpayer which is performed in conducting research (as defined above). For example, if an employee spends part of his or her time during the year conducting research, part of the time engaged in production or marketing activities, and part of the time providing general or administrative services, only the amount of wages actually paid for services performed in conducting research enters into the credit computation. The allocation of wages between conducting research and other services is to be made in a consistent manner, in

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accordance with Treasury regulations, on the basis of time or other appropriate factors.

. . . .

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.

Other in-house expenditures

General rules

The second category of in-house research expenditures eligible for the incremental credit consists of amounts paid or incurred for supplies used in the conduct of qualified research. The provision defines the term "supplies" to mean any tangible property other than (a) land or improvements to land or (b) property of a character subject to the allowance for depreciation. Property which is of a character subject to the depreciation allowance is not eligible for the credit whether or not amounts of depreciation are deductible during the year and whether or not the cost of such property can be "expensed."

The final category of in-house research expenditures eligible for the incremental credit consists of amounts paid or incurred for the right to use personal property in the conduct of qualified research, if such amounts are paid to a person other than the taxpayer. Intercompany charges for the right to use personal property in the conduct of research are not eligible for the credit.

Requirements for qualification

Determinations of whether and to what extent research expenditures of a taxpayer qualify under the second or third categories

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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.

ANALYSIS

Treas. Reg. § 1.41-2(b)(1) and (b)(2)(i) provides the general rule that utilities expenses are expenditures for general and administrative expenses and do not qualify as in-house research expenses. This provision is consistent with the legislative history of section 41. H.R. Rep. No. 97-201, at 118 (1981), states that “the credit is not available for expenditures for supplies . . . if such expenditures constitute or are part of general and administrative costs or overhead costs (such as utilities).”

Treas. Reg. § 1.41-2(b)(2)(ii) provides the following example to illustrate the general rule: “[A]mounts paid for electricity used for general laboratory lighting are treated as general and administrative expenses”

Treas. Reg. § 1.41-2(b)(2)(ii) further provides a limited exception to the general rule for extraordinary expenditures. To qualify for this limited exception, a taxpayer must establish the following:

- (1) that the qualified research is of a “special character,”
- (2) that the special character of the qualified research “required” the utilities expenses, and
- (3) that the required utilities expenses are both “additional” and “extraordinary.”

Treas. Reg. § 1.41-2(b)(2)(ii) provides the following example to illustrate this limited exception:

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[A]mounts 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.

The law presumes that Taxpayer's utilities expenses are general and administrative expenses not included in the computation of the credit, unless Taxpayer can establish that the special character of the qualified research required additional extraordinary expenditures for utilities.

In this case, Taxpayer presumes that any additional utilities expenses per square foot for the Research Buildings are automatically additional extraordinary expenditures for utilities required by the special character of the qualified research and included in the computation of the credit. Taxpayer may have established additional utilities expenses for the Research Buildings, but Taxpayer has not established that the additional utilities expenses were extraordinary or required by the special character of the qualified research. Instead, Taxpayer has adopted an arbitrary methodology that seeks to construe as qualifying supplies what would otherwise be nonqualifying expenses. This methodology ignores the explicit terms of the statute, the regulations, and the legislative history.

Because Taxpayer has not established that the special character of the qualified research required additional extraordinary expenditures for utilities as required by Treas. Reg. § 1.41-2(b)(2)(ii), the amounts incurred by Taxpayer for utilities used in the Research Buildings are treated as expenditures for general and administrative expenses under Treas. Reg. § 1.41-2(b)(2)(i). Expenditures for general and administrative expenses do not qualify as in-house research expenses under Treas. Reg. § 1.41-2(b)(1). Accordingly, the amounts incurred by Taxpayer for utilities used in the Research Buildings are not qualified research expenses under section 41(b)(1) and are not eligible for the credit for increasing research activities under section 41.¹

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

¹ This Field Service Advice addresses only the methodology used by Taxpayer to determine its utilities expenses for the Research Buildings included as qualified research expenses. We provide no opinion as to whether Taxpayer's activities at the Research Buildings constitute qualified research activities under section 41(d).

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Please call if you have any further questions.

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