Office of Chief Counsel
Internal Revenue Service
Memorandum

Number: 200620023

Release Date: 5/19/2006
CC:PSI:
POSTS-161891-05

UILC: 41.52-03, 41.55-05, 41.55-06

date: February 14, 2006

to: Patricia E kuehl, Technical Guidance Coordinator (AP)

from: Arthur Lee Keenan, Technical Advisor (LM:PFTG:8)
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subject: I.R.C. § 41 Credit for Increasing Research Activities:
Treatment of Receipts Attributable to Intra-Group Transfers

This memorandum responds to requests for assistance concerning numerous return examinations and claims for refund pending in the Large and Mid-Size Business Division (hereinafter "LMSB") and Appeals on the above-referenced issue. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

ISSUE

Whether, under the facts and circumstances described, a taxpayer may exclude receipts from its foreign subsidiaries when computing gross receipts for purposes of determining the base amount under I.R.C. § 41(c).

CONCLUSION

Under the facts and circumstances described, a taxpayer may not exclude receipts from its foreign subsidiaries when computing gross receipts for purposes of determining the base amount under I.R.C. § 41(c).

FACTS

There are numerous examinations pending in LMSB and Appeals involving the above-referenced issue. The typical fact pattern is as follows:

The taxpayer (hereinafter "Taxpayer") is a domestic corporation. Taxpayer owns more than fifty percent of certain foreign subsidiaries for purposes of I.R.C. § 1563(a)(1). Taxpayer performed research. In addition to research, Taxpayer manufactured product and sold some of that product to its foreign subsidiaries. Taxpayer also developed and subsequently licensed intangibles to its foreign subsidiaries for which it was paid royalties.

On its income tax returns for the years in issue, 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 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 subsidiaries in determining gross receipts.

LAW AND ANALYSIS

I.R.C. § 41 (hereinafter "research credit")[1] was originally enacted as part of the Economic Recovery Tax Act of 1981 (hereinafter "the 1981 Act") to provide a credit against tax to serve as an incentive to taxpayers to conduct certain types of research activities. When the research credit was enacted in 1981, it was computed by multiplying the research credit rate by the excess of the taxpayer's current year qualified research expenses (hereinafter "QREs") over the average of the taxpayer's QREs for the preceding three years.

As originally enacted in 1981, the research credit provisions contained special rules to prevent its manipulation. One of these rules, I.R.C. § 41(f)(1) (hereinafter "aggregation rule"), treats all members of a controlled group as a single taxpayer for purposes of computing the credit and allocates the credit to the members of the group based on the member's proportionate share of the increase in QREs giving rise to the credit.

The legislative history to 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

[1] The research credit provisions were enacted by § 221 of the Economic Recovery Tax Act of 1981, 1981-2 C.B. 256, 293, as I.R.C. § 44F. I.R.C. § 44F was redesignated as I.R.C. § 30 by § 471(c)(1) of the Deficit Reduction Act of 1984, 1984-3 (Vol. 1) C.B. 2, 334. I.R.C. § 30 was redesignated as I.R.C. § 41 by § 231(d)(2) of the Tax Reform Act of 1986, 1986-3 (Vol. 1) C.B. 2, 95.

prevent artificial increases in research expenditures by shifting expenditures among commonly controlled or otherwise related persons. H.R. Rep. No. 97-201, 1981-3 C.B. (Vol. 2) 364; S. Rep. No. 97-144, 1981-3 C.B. (Vol. 2) 442.

There is no special rule in the research credit provisions as enacted in 1981 (or as amended by the 1989 Act, infra), that addresses the treatment of transactions among members of the same controlled group of corporations or trades or businesses under common control. On May 17, 1989, however, 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. See Former Treas. Reg. § 1.41-6(e) (T.D. 8251, 54 F.R. 21203 (1989) (promulgated as Treas. Reg. § 1.41-8(e))).[2] Consistent with Congressional purpose, Treas. Reg. § 1.41-8(e) provided rules intended to prevent the shifting of research expenditures among 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 that generate research expenditures such as in-house research expenses and contract research expenses.

In late 1989, after the issuance of the aforementioned regulations, Congress made significant changes to the treatment of QREs in computing the base amount (f/k/a base period research expenses). Section 7110(b) of the Reconciliation Act of 1989 (hereinafter “the 1989 Act”) amended I.R.C. § 41(c) to provide a new method of computing the research credit for taxable years beginning after December 31, 1989. In revising the credit computation, Congress retained the incremental structure of the credit to maximize its efficacy. 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 in its gross receipts.

I.R.C. § 41(f), as amended by the 1989 Act, continues to provide special rules for computing the research credit. While the 1989 Act amendments did not change the aggregation requirement in I.R.C. § 41(f)(1), other rules in I.R.C. § 41(f) were revised to reflect the change in computation of the credit. These revised rules include the allocation rule in I.R.C. § 41(f)(1), the consistency requirement in I.R.C. § 41(c)(5)(A), the adjustment for acquisitions and dispositions rule in I.R.C. § 41(f)(3), and the short

[2] On May 24, 2005, the Service and Treasury issued temporary regulations for determining the amount of the research credit for a controlled group of corporations and trades or businesses under common control. These temporary regulations renumber the intra-group transaction rule of Treas. Reg. § 1.41-6(e) as Temp. Treas. Reg. § 1.41-6T(i), substantively without change.

taxable years rule in I.R.C. § 41(f)(4). Neither the 1989 Act's statutory language nor its legislative history indicates that Congress intended that intra-group transfers generating gross receipts be disregarded. In fact, 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)(6). I.R.C. § 41(c)(6) provides that in the case of a foreign corporation, there shall be taken into account only gross receipts that are effectively connected with the conduct of a trade or business within the United States.

On January 3, 2001, Treas. Reg. § 1.41-8 was amended and renumbered as Treas. Reg. § 1.41-6 by T.D. 8930, 66 F.R. 280 (January 3, 2001). On May 24, 2005, in T.D. 9205 (70 F.R. 29596), the Service and Treasury issued temporary regulations determining the amount of the research credit for a controlled group of corporations and trades or businesses under common control. See Temp. Treas. Reg. § 1.41-6T. Temp. Treas. Reg. § 1.41-6T renumbered Treas. Reg. § 1.41-6(e) as Temp. Treas. Reg. § 1.41-6T(i). Neither T.D. 8930 nor T.D. 9104 amended the intra-group transaction rule to make it applicable to gross receipts. The operative language of Temp. Treas. Reg. § 1.41-6T(i) remains substantively unchanged from that of former Treas. Reg. §§ 1.41-6(e) and 1.41-8(e). Accordingly, Temp. Treas. Reg. § 1.41-6T and former Treas. Reg. § 1.41-6(e) continue 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.

Under the foregoing facts and circumstances, it is not appropriate for Taxpayer to exclude these receipts from its foreign subsidiaries when computing gross receipts for purposes of determining its base amount under I.R.C. § 41(c).

As you know, the treatment of gross receipts attributable to intra-group transactions is on the 2005-06 Priority Guidance Plan. Please contact Brenda Stewart of this office at (202) 622-3120 if you have any further questions.

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