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 AREA COUNSEL
(FINANCIAL SERVICES) CC:LM:F

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

SUBJECT: Computation of the Research Credit under Section 41 of the Internal Revenue Code

This Chief Counsel Advice responds to your memorandum dated February 29 [sic], 2002. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

Taxpayer:
TIN:
Parent:
Corporation:
Date 1:
Date 2:
Date 3:
Date 4:
Date 5:
Date 6:
Date 7:
Date 8:
Date 9:
Date 10:

ISSUES

(1) Whether Taxpayer should include 100 percent of Corporation's base year qualified research expenses, base year gross receipts, and average annual gross receipts for the four taxable years preceding Taxpayer's credit year in computing its base amount.

(2) Whether Taxpayer should include all of the qualified research expenditures paid or incurred by Corporation for the period Date 3 through Date 6 (the period before Corporation became a member of Taxpayer's consolidated group) in computing its research credit for the taxable year ended Date 10.

(3) Whether Taxpayer may claim a current deduction under section 174 for the qualified research expenditures paid or incurred by Corporation for the period Date 3 through Date 6 (the period before Corporation became a member of Taxpayer's consolidated group).

CONCLUSIONS

(1) Taxpayer should include 100 percent of Corporation's base year qualified research expenses, base year gross receipts, and average annual gross receipts for the four taxable years preceding Taxpayer's credit year in computing its base amount because Parent's acquisition of 100 percent of Corporation's outstanding stock and Corporation's subsequent merger into Parent constitutes the acquisition of a major portion of a trade or business for purposes of section 41(f)(3)(A).

(2) Taxpayer should include all of the qualified research expenditures paid or incurred by Corporation for the period Date 3 through Date 6 (the period before Corporation became a member of Taxpayer's consolidated group) in computing its research credit for the taxable year ended Date 10 because Parent's acquisition of 100 percent of Corporation's outstanding stock and Corporation's subsequent merger into Parent constitutes the acquisition of a major portion of a trade or business for purposes of section 41(f)(3)(A).

(3) Taxpayer may not claim a current deduction under section 174 for the qualified research expenditures paid or incurred by Corporation for the period Date 3 through Date 6 (the period before Corporation became a member of Taxpayer's consolidated group).

FACTS

Parent is the common parent of the Taxpayer consolidated group. Taxpayer is a controlled group of corporations under section 41(f) using a calendar year for tax purposes. For all relevant periods, Taxpayer filed a Form 1120, U.S. Corporation Income Tax Return, including all members of Taxpayer's consolidated return group.

Prior to Date 7, Corporation was a stand-alone corporation using a fiscal year ending on the last Saturday of Date 1. Prior to its acquisition, Corporation filed a Form 1120, U.S. Corporation Income Tax Return, for the full taxable year beginning on Date 2 and ending on Date 4. Corporation's next taxable year began the next day on Date 5.

On Date 6, Parent acquired 100 percent of the outstanding stock of Corporation in a transaction purported to qualify as a tax-free reorganization under section 368(a)(1)(B). Accordingly, Corporation was a wholly-owned subsidiary of Parent and a member of Taxpayer's consolidated return group from Date 7 to Date 8 for Taxpayer's taxable year beginning on Date 3 and ending on Date 10. On Date 9 (the day after Date 8), Corporation was merged into Parent in a transaction purported to qualify as a tax-free reorganization under section 368(a)(1)(A).

Corporation filed a return for the short taxable year beginning on Date 5 and ending on Date 6 (the day before Date 7). Taxpayer filed a Form 1120, U.S. Corporation Income Tax Return, for the taxable year beginning on Date 3 and ending on Date 10, including all members of Taxpayer's consolidated return group.[1]

LAW

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 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). Section 41(c)(2) provides that in no event shall the base amount be less than 50 percent of the qualified research expenses for the credit year.

Section 41(f)(1)(A)(i) provides that in determining the amount of the credit under section 41 all members of the same controlled group of corporations shall be treated as a single taxpayer. Prop. Treas. Reg. § 1.41-8(a)(1)[2] 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.

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[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).

[2] 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.

Section 41(f)(5) provides that the term "controlled group of corporations" 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 section 1563(a)(4) and (e)(3)(C). I.R.C. § 41(f)(5)(A) and (B). Section 1563(a)(1) provides that a controlled group of corporations includes a parent-subsidiary controlled group. A parent-subsidiary controlled group is:

> 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.

Prop. Treas. Reg. § 1.41-8 provides guidance on how a controlled group of corporations should compute its research credit. 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. The controlled group's credit year qualified research expenses are the aggregate of each member's credit year qualified research expenses.

Prop. Treas. Reg. § 1.41-8(c)(1) provides that the credit allowable to a member of a controlled group of corporations or of a group of trades or businesses under common control is that member's share of the aggregate credit computed as of the end of such member's taxable year. In computing the aggregate credit in the case of a group whose members have different taxable years, a member shall generally treat the taxable year of another member that ends with or within the credit year of the computing member as the credit year of that other member. In computing the aggregate base amount, the gross receipts taken into account with respect to another member shall include that other member's gross receipts for the four taxable years of that other member preceding the credit year of that other member.

Section 41(f)(3)(A) provides that if, after December 31, 1983, a taxpayer acquires the major portion of a trade or business of another person (hereinafter in this paragraph referred to as the "predecessor") or the major portion of a separate unit of a trade or business of a predecessor, then, for purposes of applying this section

for any taxable year ending after such acquisition, the amount of qualified research expenses paid or incurred by the taxpayer during periods before such acquisition shall be increased by so much of such expenses paid or incurred by the predecessor with respect to the acquired trade or business as is attributable to the portion of such trade or business or separate unit acquired by the taxpayers, and the gross receipts of the taxpayer for such periods shall be increased by so much of the gross receipts of such predecessor with respect to the acquired trade or business as is attributable to such portion.

Treas. Reg. § 1.41-7(b) provides that, for the meaning of "acquisition," "separate unit," and "major portion," see Treas. Reg. § 1.52-2(b). In addition, Treas. Reg. § 1.41-(b) provides that an "acquisition" includes an incorporation or a liquidation. The regulations under section 41 do not provide any further clarification or examples of what constitutes an acquisition.

Treas. Reg. § 1.52-2(b)(1)(i) provides in part that the term "acquisition" includes a lease agreement if the effect of the lease is to transfer the major portion of the trade or business or of a separate unit of the trade or business for the period of the lease. Treas. Reg. § 1.52-2(b)(1)(ii) provides that neither the major portion of a trade or business nor the major portion of a separate unit of a trade or business is acquired merely by acquiring physical assets. The acquisition must transfer a viable trade or business.

Treas. Reg. § 1.52-2(b)(2)(i) provides that a separate unit is a segment of a trade or business capable of operating as a self-sustaining enterprise with minor adjustments. The allocation of a portion of the goodwill of a trade or business to one of its segments is a strong indication that that segment is a separate unit. Treas. Reg. § 1.52-2(b)(2)(ii) provides several examples illustrating the acquisition of a separate unit of a trade or business.

Treas. Reg. § 1.52-2(b)(3) provides that all the facts and circumstances surrounding the transaction shall be taken into account in determining what constitutes a major portion of trade or business (or separate unit).

Section 41(f)(4) provides that in the case of any short taxable year, qualified research expenses and gross receipts shall be annualized in such circumstances and under such methods as the Secretary may prescribe by regulation. Treas. Reg. § 1.41-3(b)[3] provides the following rules:

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[3] Treas. Reg. § 1.41-3(b) 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. However, the new proposed regulations retain the special rules for short taxable years contained in Treas. Reg. § 1.41-3(b) of T.D. 8930.

(1) If a credit year is a short taxable year, then the base amount determined under section 41(c)(1) (but not section 41(c)(2)) shall be modified by multiplying that amount by the number of months in the short taxable year and dividing the result by 12.

(2) If one or more of the four taxable years preceding the credit year is a short taxable year, then the gross receipts for such year are deemed to be equal to the gross receipts actually derived in that year multiplied by 12 and divided by the number of months in that year.

(3) No adjustment shall be made on account of a short taxable year to the computation of a taxpayer's fixed-base percentage.

Treas. Reg. § 1.1502-76(b)(1)(i) provides that a consolidated return must include the common parent's income, gain, deduction, loss, and credit for the entire consolidated return year, and each subsidiary's items for the portion of the year for which it is a member. If the consolidated return includes the items of a corporation for only a portion of its tax year, items for the portion of the year not included in the consolidated return must be included in a separate return.

Treas. Reg. § 1.1502-76(b)(1)(ii)(A) provides that a corporation becomes or ceases to be a member during a consolidated return year at the end of the day on which its status as a member changes and its tax year ends for all Federal income tax purposes at the end of that day. Appropriate adjustments must be made if another provision of the Code or regulations contemplates the event occurring before or after the subsidiary's change in status.

Treas. Reg. § 1.1502-76(b)(1)(ii)(B) provides that if, on the day a subsidiary's status changes, a transaction occurs that is properly allocable to the portion of the subsidiary's day after it ceases to be a member, the subsidiary (and all related persons) must treat the transaction as occurring at the beginning of the following day. A determination as to whether a transaction is properly allocable to the portion of the subsidiary's day after the event will be respected if it is reasonable and consistently applied by all affected persons.

ANALYSIS

Taxpayer is a controlled group of corporations for purposes of section 41(f)(1). Accordingly, all members of the controlled group should be treated as a single taxpayer for purposes of determining the amount of the research credit under section 41. I.R.C. § 41(f)(1)(A)(i) and Prop. Treas. Reg. § 1.41-8(a)(1). When the controlled group computes its base amount, the controlled group should 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. When the controlled group computes its credit year qualified research expenses,

the controlled group should aggregate each member's credit year qualified research expenses. Id.

Under the consolidated return regulations, Corporation became a member of the Taxpayer consolidated group of corporations at the end of the day on Date 6. Accordingly, Corporation's income, loss, deduction, and credit must be included in a separate return for the period Date 5 through Date 6 and on Taxpayer's consolidated return for the period Date 7 through Date 8. Treas. Reg. § 1.1502-76(b)(1). Corporation should calculate the research credit for the short period Date 5 through Date 6 using the short taxable year provisions in Treas. Reg. § 1.41-3(b).

Given the facts and circumstances of this case, we have determined that Parent has acquired a major portion of a trade or business for purposes of section 41(f)(3)(A). Treas. Reg. § 1.41-7(b). On Date 6, Parent acquired 100 percent of the outstanding stock of Corporation. On Date 9, Corporation was merged into Parent. Pursuant to the special rules in section 41(f)(3)(A), Taxpayer should include 100 percent of Corporation's base year qualified research expenses, base year gross receipts, and average annual gross receipts for the four taxable years preceding Taxpayer's credit year in computing its base amount. In addition, Taxpayer should include all of the qualified research expenditures paid or incurred by Corporation for the period Date 3 through Date 6 (the period before Corporation became a member of Taxpayer's controlled group of corporations) in computing its research credit for the taxable year ended Date 10.[4]

Taxpayer may not claim a current deduction for the qualified research expenditures paid or incurred by Corporation for the period Date 3 through Date 6 (the period before Corporation became a member of Taxpayer's consolidated group). If a proper election is made, section 174(a)(1) allows a taxpayer to treat research or experimental expenditures which are paid or incurred by a taxpayer during the taxable year as a deduction. The qualified research expenditures for the period Date 3 through Date 6 were paid or incurred by Corporation, not Taxpayer.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

The plain language of section 41(f)(3)(A) requires a controlled group of corporations, which has acquired a trade or business, to treat as transferred 100 percent of the acquired company's qualified research expenditures and base amount research expenditures and gross receipts for purposes of the computation

[4] The short taxable year provisions in Treas. Reg. § 1.41-3(b) do not apply to Taxpayer in this case because Taxpayer does not have a short taxable year. Rather, Taxpayer must compute the research credit for the full taxable year beginning on Date 3 and ending on Date 10.

of the research credit. This treatment is arguably inappropriate in the consolidated group setting where a corporation was a member of the group for only part of the common parent's taxable year. Under the consolidated return regulations, a subsidiary's items of income, gain, deduction, and credit are includible in the consolidated return only for the portion of the year it was a member of the group. Treas. Reg. 1.1502-76(b)(1)(i).

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Please call if you have any further questions.

Associate Chief Counsel
(Passthroughs and Special Industries)
By: LESLIE H. FINLOW
Chief, Branch 7
Associate Chief Counsel
(Passthroughs and Special Industries)