Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:FSH:MAN:2:TL-N-1520-01
PLDarcy

date:

to: Territory Manager, Natural Resources
Attn: Mr. Martin Ray

LMSB Office of Pre-Filing and Technical Guidance
Attn: David Bernard, Technical Advisor (Research Credit)

from: Area Counsel (Financial Services & Healthcare) (Area 1 - Manhattan)

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subject: [redacted]
Taxable Years Ended [redacted] through [redacted]
U.I.L. Nos. 41.51-02 and 41.51-09

This memorandum responds to your request for assistance with respect to [redacted]'s section 41 credit computation for the taxable years ended [redacted] through [redacted]. Specifically, you asked us if [redacted]'s depreciation expenses, general and administrative ("GA") expenses, employee benefits excluded from the section 3401(a) definition of wages ("Employee Benefits"), and travel and entertainment expenses may be treated as qualified research expenses ("QREs") pursuant to the provisions of section 41(b) if they relate to a "self-constructed supply." Additionally, you asked our advice on whether [redacted] is entitled to include in its section 41 credit computation, other expenses relating to a "self-constructed supply," which may not otherwise be treated as QREs. The advice rendered in this memorandum is conditioned on the accuracy of the facts presented to us. This advice is subject to National Office review. We will contact you within two weeks of the date of this memorandum to discuss the National Office's comments, if any, about this advice. This memorandum should not be cited as precedent.

ISSUES

1. Whether [redacted]'s depreciation expenses, GA expenses, Employee Benefits, and travel and entertainment expenses may be treated as QREs because they relate to a "self-constructed supply."

2. Whether other expenses of [redacted] which may not otherwise be treated as QREs pursuant to the provisions of section 41(b), can nevertheless be treated QREs because they relate to a "self-constructed supply."

CONCLUSION

[redacted] may not treat depreciation expenses, GA expenses, Employee Benefits, and travel and entertainment expenses as QREs. Furthermore, the fact that these expenses (or other non qualifying expenses) may relate to a "self-constructed supply" used in qualified research[1] does not permit [redacted] to treat them as QREs.

FACTS

The Large and Mid-Size Business Operating Division (Natural Resources) is currently auditing the [redacted] through [redacted] taxable years of [redacted], a manufacturer of pharmaceutical products. In [redacted], [redacted] began to build a plant to manufacture branded drugs in [redacted], California (hereinafter the "[redacted] Plant"). For a period of time, [redacted] used the [redacted] Plant to produce experimental drugs for clinical trials mandated by the Food Drug and Administration. These clinical trials occur prior to the commercial production of the drug, and the Examination Team has concluded that these clinical trials constitute qualified research within the meaning of section 41(d).[2]

At the [redacted] Plant, [redacted] manufactured sufficient quantities of the experimental drug to conduct the clinical trials. [redacted] argues that these experimental drug samples are "self-constructed supplies" that meet the definition of a supply set forth in section 41(b)(2)(C). [redacted] therefore treated every cost related to the production of the experimental drug samples as a QRE. [redacted]'s position on this issue is attached hereto as Exhibit A. The costs that [redacted] has treated as QREs include the following expenses related to the production of the experimental drug samples: depreciation expenses, GA expenses, Employee Benefits, and travel and entertainment services purchased from outside vendors.

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[1] This memorandum does not address whether the activities in question constitute "qualified research" as defined in section 41(d).

[2] Supra n.1.

[redacted] incurred a myriad of other costs related to the production of the experimental drug samples. We conclude that [redacted]'s "self-constructed supply" theory lacks merit. That is, we conclude that only costs specifically defined as QREs under the provisions of section 41(b) can be included in [redacted]'s section 41 credit computation. The fact that a non qualifying cost relates to the production of a "self-constructed supply" does not make that non qualifying expense a QRE. We therefore find it unnecessary to address every cost claimed by [redacted] as a QRE and will focus our analysis on the depreciation expenses, GA expenses, Employee Benefits, and travel and entertainment claimed as QREs by [redacted]. However, upon your request, we will gladly provide you advice on whether any specific cost claimed by [redacted] is a QRE as defined under the provisions of section 41(b).

APPLICABLE LAW

Section 41 allows taxpayers a credit against tax for increasing research activities. Generally, the credit is an incremental credit equal to the sum of 20 percent of the excess (if any) of the taxpayer's QREs for the taxable year over the base amount, and 20 percent of the taxpayer's basic research payments determined under section 41(e)(1)(A)[3]. Section 41(b)(1) defines QREs as the sum of (1) "in-house research expenses" and (2) "contract research expenses."

Section 42(b)(2) defines in-house research expenses as:

(i) any "wages" paid or incurred to an employee for "qualified services" performed by such employee; and

(ii) any amount paid or incurred for "supplies" used in the conduct of "qualified research."[4]

Section 41(b)(3) defines "contract research expenses" as 65 percent of any amount paid or incurred by the taxpayer to any person (other than an employee of the taxpayer) for qualified

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[3] Under section 41(c)(2), however, the minimum base amount is 50 percent of the credit year qualified research expenses.

[4] Section 42(b)(2)(A)(iii) allows certain amounts paid or incurred to another person for the right to use computers in the conduct of qualified research. [redacted] has not claimed any such expenses in the production of the experimental drug samples. Thus, section 41(b)(2)(A)(iii) is not pertinent to this discussion.

research. If an expense is not set forth in sections 42(b)(2)(i), 42(b)(2)(ii) or 41(b)(3), [redacted] may not claim the expense as a QRE.

A. Wages

The first category of in-house research expenditures eligible for the section 41 credit consists of amounts paid or incurred for qualified wages. For purposes of section 41, the term wages means wages as defined in section 3401(a) for income tax withholding purposes. I.R.C. § 41(b)(2)(D)(i). Thus, amounts of compensation which are not subject to withholding, such as certain fringe benefits, do not enter into the credit computation even though paid for research services performed by an employee. Wages paid to or incurred for an employee constitute in-house research expenses only to the extent the wages were paid or incurred for "qualified services" performed by the employee. Treas. Reg. § 1.41-2(d)(1).

The term "qualified services" means services consisting of:

(1) engaging in qualified research;

(2) direct supervision of research activities which constitute qualified research; or

(3) direct support of research activities which constitute qualified research.

I.R.C. § 41(b)(2)(B).

The term "engaging in qualified research" means the actual conduct of qualified research (as in the case of a scientist conducting laboratory experiments). Treas. Reg. § 1.41-2(c)(1). The term "direct supervision" means the immediate supervision (first-line management) of qualified research (as in the case of a research scientist who directly supervises laboratory experiments, but who may not actually perform experiments). "Direct supervision" does not include supervision by a higher-level manager to whom first-line managers report, even if that manager is a qualified research scientist. Treas. Reg. § 1.41-2(c)(2). The term "direct support" means services in the direct support of either persons engaging in the actual conduct of qualified research or persons who are directly supervising persons engaging in the actual conduct of qualified research. This would include the services of a machinist for machining a

part of an experimental model used in qualified research.[5] Treas. Reg. § 1.41-2(c)(3). Direct support of research does not include GA services, or other services only indirectly of benefit to research activities.[6] Treas. Reg. § 1.41-2(c)(3)(emphasis added). This is true whether GA personnel are part of the research department or in a separate department. Treas. Reg. § 1.41-2(c)(3).

B. Supplies

A taxpayer may claim the section 41 credit for amounts it paid or incurred for supplies used in the conduct of qualified research. The term "supply" means any tangible property other than (1) land or improvements to land, and (2) property of a character subject to the allowance for depreciation. I.R.C. § 41(b)(2)(C). Supplies are used in the conduct of qualified research if they are used in the performance of "qualified services" by an employee of the taxpayer. I.R.C. § 1.41-2(b)(1). To be a QRE, a supply must be directly related to the performance of "qualified services." Expenses for property used in general and administrative activities are not QREs. Id.[7] Accordingly, for the purposes of section 41, a "supply" is non-depreciable tangible property acquired by the taxpayer that is used in the taxpayer's conduct of qualified research. Lockheed Martin Corp. v. United States, 87 A.F.T.R.2d, ¶ 2001-812 (Ct. Cl. 2001).

C. Contract Research

A taxpayer may claim the section 41 credit for "contract research expenses." Section 41(b)(3) defines contract research expenses as 65 percent of any amount paid or incurred by the taxpayer to any person (other than an employee of the taxpayer)

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[5] Other examples of direct support of research would include the services of (1) a secretary typing reports describing laboratory results derived from qualified research; (2) a laboratory worker for cleaning equipment used in qualified research; and (3) a clerk for compiling research data. Treas. Reg. § 1.41-2(c)(3).

[6] Services of payroll personnel in preparing salary checks of laboratory scientists, of an accountant for accounting for research expenses, of a janitor for general cleaning of a research laboratory, or of officers engaged in supervising financial or personnel matters do not qualify as direct support of research. Treas. Reg. § 1.41-2(c)(3).

[7] The only exception is for extraordinary utilities expenditures.

for qualified research. Section 41(d) defines qualified research as research:

(A) with respect to which expenditures may be treated as expenses under section 174,

(B) which is undertaken for the purpose of discovering information-

(i) which is technological in nature, and

(ii) the application of which is intended to be useful in the development of a new or improved business component of the taxpayer, and

(C) substantially all of the activities of which constitute elements of a process of experimentation for a purpose described in section 41(d)(3). Section 41(d)(3)(3) states that the research must relate to (i) a new or improved function, (ii) performance, or (iii) reliability or quality.

ANALYSIS

Taxpayers may incur a wide variety of costs while conducting research, but the provisions of section 41(b) specifically define what expenses constitute QREs. To be claimed as a QRE, an expense must be defined under the provisions of section 41(b).[8]

[redacted] has treated all costs related to its manufacture of experimental drug samples for clinical trials as QREs. [redacted] argues that all costs related to the manufacture of the experimental drug samples are amounts "paid or incurred for supplies used in the conduct of qualified research" pursuant to section 41(b)(2)(A)(ii), and thus are QREs. As an example, [redacted] has claimed depreciation expenses, GA expenses, Employee Benefits, and travel and entertainment expenses as QREs because these expenses supposedly relate to a "self-constructed supply" (the experimental drug samples produced by [redacted]).

As a threshold matter, these expenses are not by themselves QREs. Depreciation is not a wage, supply, or contract research expense as defined in sections 41(b)(2)(D)(i) and 41(b)(2)(C). GA expenses are explicitly excluded from the section 41 credit computation by Treasury Regulation § 1.41-2(b)(1), and, in any

[8] Additionally, section 41(d)(4) sets forth specific expenses which are not credit eligible.

event, wages paid to [redacted]'s general and administrative staff are not for the performance of qualified services as defined in section 41(b). Section 41(b)(2)(D)(i) precludes [redacted] from including Employee Benefits in its section 41 computation. Finally, travel and entertainment services do not meet the section 41(d) definition of qualified research and, therefore, the cost of these services cannot be claimed as QREs pursuant to section 41(b)(3).

[redacted] does not appear to argue that these expenses by themselves qualify for the section 41 credit. Instead, [redacted] argues that all costs related to its manufacture of a "self constructed supply" are amounts "paid or incurred for supplies used in the conduct of qualified research" pursuant to section 41(b)(2)(A)(ii), and thus are QREs. However, this argument ignores the plain language of section 41 and defies logic.

Depreciation expenses, GA expenses, Employee Benefits, and travel and entertainment expenses are simply not supplies and labeling them costs related to a "self constructed supply" does not make them supplies. When [redacted] depreciates property used in the production of the experimental drug samples, it incurs a depreciation expense, it does not incur a cost for a supply (i.e., an amount paid or incurred for tangible property other than (1) land or improvements to land, and (2) property of a character subject to the allowance for depreciation). I.R.C. § 41(b)(2)(C)). [redacted]'s general and administrative staff are clearly not supplies. Since the general and administrative staff are not engaged in the performance of qualified services, supra, the cost of any supplies used by [redacted]'s general and administrative staff are not credit-eligible. Thus, when [redacted] incurs GA wage or GA supply expense, it is not incurring an expense for a supply under section 41(b)(2)(C).

Section 41(b)(2)(D)(i) prohibits [redacted] from claiming Employee Benefits as QREs. When [redacted] purchases travel and entertainment services from an outside vendor, as is the case here, [redacted] is not incurring a "contract research expense" under section 41(b). When [redacted] purchases travel and entertainment services it is not paying or incurring an expense for non-depreciable tangible property used in qualified research. Therefore, [redacted] is not incurring an expenditure for a supply.

[redacted] also absorbed a myriad of other costs as costs related to a "self-constructed supply." These costs include the following items:

Payroll Taxes
Real Estate Expense
Relocation Allowance
Relocation Management Service
Employment Agencies
Pre-employment Expense
Medical
Employee Relations
Catering
Food Supplies
Rental Equipment
Miscellaneous Taxes
Cellular Telephone Services
Telecommunications
Printing Services
Environmental & Other Studies
Professional Dues & Memberships
Business Meals
Interview Expenses
Recruiting Expenses
Training Programs
Accounting Services
Quality Assurance.

The analysis of these expenditures, or any other expenditure, is the same as the analysis used in our discussion of the depreciation expenses, GA expenses, Employee Benefits, and travel and entertainment expenses. If the expense claimed by [redacted] is not a permitted QRE under the provisions of section 42(b), [redacted] cannot claim the expense in its section 41 credit. The fact that [redacted] labels an expense as a cost related to a "self constructed supply" cannot convert an otherwise disallowed expense into a QRE.

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. If you have any questions regarding the above, please contact Paul Darcy of this office at (212) 264-5473 x256.

ROLAND BARRAL
Area Counsel

By: _____
PAUL L. DARCY
Senior Attorney
(LMSB)

Exhibit A

The following is a typed copy of the contents of a memo sent by [redacted], to support his position to use full-absorption costing as the qualified research expense of self-constructed supplies used in qualified research activities. The memo is dated [redacted]. The "From:" line is blank; however, the top lines of pages 2 and 3 show "[redacted]," which indicates that the memo may have originated at an accounting or legal firm.

Subject: R&E Credit Cost of Supplies

Issue

What is the cost of supplies used in the conduct of qualified research under section 41(b)(2)(A)(ii) of the Code in the case of self-constructed assets, such as prototypes and test samples?

Discussion

Definition of "Supplies"

For purposes of the section 41 research credit, "qualified research expenses" include "any amount paid or incurred for supplies used in the conduct of research." I.R.C. sec. 41(b)(2)(A)(ii). "Supplies" are defined as "any tangible property" other than land or improvements to land and property of a character subject to the allowance for depreciation. The Regulations provide that supplies are used in the conduct of qualified research "if they are used in the performance of qualified services." Regs. sec. 1.41-2(b)(1).

In the course of a development project, researchers often use prototypes or test samples to test their design concepts. Therefore, such prototypes or samples meet the definition of "supplies used in the conduct of research."

Cost of Supplies

Prototypes and samples can be obtained in several ways. They can be purchased from a third party; they can be purchased from an affiliate or other related party; or they can be constructed by the taxpayer. In the case of a prototype unit or test sample purchased from a third party, it is apparent that the amount paid or incurred is the purchase price. For instance, a taxpayer might design the concept for a new engine part and order such a

part from a third-party manufacturer, to be fabricated by it in accordance with the taxpayer's design. If the taxpayer uses the part to test its design concept in an otherwise qualifying activity, the price paid to the manufacturer would be the amount paid or incurred for a qualified supply.

If, instead, the taxpayer purchased the above part from a person controlled by, or under common control with, the taxpayer, the Regulations provide a special rule. In that situation, the amount paid or incurred to another member of a controlled group is 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 supply. Regs. sec. 1.41-8(e)(5).

Finally, if the above part were self-constructed by the taxpayer, the question arises as to the appropriate "amounts paid or incurred" for the part. Under GAAP, the historical cost of a self-constructed asset includes "the costs necessarily incurred to bring it to the condition and location necessary for its intended use." FASB Statement No. 34, para. 6. This includes the allocation of depreciation, interest and other indirect costs. *Id.* Similarly, the cost of a capital asset for tax purposes has been determined to include all such capitalizable costs. E.g., Commissioner v. Idaho Power Co., 418 U.S. 1 (1974) (construction-related depreciation must be included in cost of constructed asset). In Idaho Power, the Supreme Court specifically addressed the issue of allocation of indirect costs to a self-constructed asset in a case in which, as here, the applicable statutory language included "any amount paid" (section 263(a)(1) provided "any amount paid out," while the provision here in question, section 41(b)(2)(ii), provides "any amount paid or incurred").

Thus, the clear rule for both GAAP and tax purposes is that the amount paid for a self-constructed asset is the fully-absorbed cost, including allocations of indirect costs. ("The general proposition that good accounting practice requires capitalization of the cost of acquiring a capital asset is not seriously open to question." Idaho Power, 418 U.S. at 11, n.8.) Accordingly, the reference in Code section 41(b)(2)(ii) to "any amount paid or incurred" for a supply is, by longstanding rule of law and professional practice, a reference to the fully-absorbed cost of the supply that was constructed by the taxpayer.

Consistency of Supply Costs

Any reading other than one in accordance with the normal GAAP and tax notions of the cost of a supply would raise considerable consistency issues between the treatment of taxpayers constructing their own supplies and those purchasing the supplies. The researcher in the first example above, purchasing an engine part prototype from a third-party, would have a cost

equal to its purchase price. That purchase price would include the manufacturer's direct and indirect costs, as well as a profit margin. A researcher that produces its own supplies would be limited only to direct costs.

"Indirect Research Expenses"

Section 1.41-2(b)(1) 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." But this provision is inapposite. The issue is the "amount paid or incurred for" supplies of the research that *do* qualify, that is, supplies actually used in the conduct of research. Supplies that are "indirect research expenses," such as payroll department supply costs allocable to lab personnel performing research, do not qualify under this provision. The proper cost of a supply actually used in the conduct of research, however, includes all the costs of constructing that supply, not because the costs are "research expenses," but because they are the cost of a supply used in research.

Conclusion

The issue is the appropriate calculation of "amounts paid or incurred" for a supply used in the conduct of research. The tax law, and accounting standards, clearly interpret that phrase to mean the fully-absorbed cost of self-constructed assets. Those costs are costs of the asset, not "research expenditures" as such. Prototypes and test samples constructed by the taxpayer and used in qualifying activities are appropriately considered supplies used in the conduct of the research, and therefore, their fully absorbed costs qualify as amounts paid or incurred under section 41(b)(2)(ii).