Office of Chief Counsel
Internal Revenue Service

memorandum

CC:WR:RMD:[redacted]:TL-N-4668-00
[redacted]

date: September 18, 2000

to: Examination District, Rocky Mountain District, [redacted]
Office
Attention: [redacted]

from: [redacted]
Special Litigation Assistant

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subject: **Request for legal advice in CEP case**
Taxpayer: [redacted]
Tax Years: [redacted] **through** [redacted]

On August 4, 2000, we received your request for legal advice on the application of I.R.C. 174 and the related Treasury Regulations.

DISCLOSURE STATEMENT

This advice constitutes return information subject to I.R.C. § 6103. This advice contains confidential information subject to attorney-client and deliberative process privileges and if prepared in contemplation of litigation, subject to the attorney work product privilege. Accordingly, the Examination or Appeals recipient of this document may provide it only to those persons whose official tax administration duties with respect to this case require such disclosure. In no event may this document be provided to Examination, Appeals, or other persons beyond those specifically indicated in this statement. This advice may not be disclosed to taxpayers or their representatives.

This advice is not binding on Examination or Appeals and is not a final case determination. Such advice is advisory and does not resolve Service position on an issue or provide the basis for closing a case. The determination of the Service in the case is to be made through the exercise of the independent judgment of the office with jurisdiction over the case.

FACTS

[redacted] graduated with a Bachelor degree from [redacted] and an MBA degree from the [redacted]. He initially went into business running a small

[redacted] plant. In [redacted], he formed a joint venture to produce [redacted] containers. [redacted] and [redacted] founded a [redacted] products company in [redacted]. In [redacted], [redacted] incorporated [redacted] which developed and produced more than [redacted] different types of foam packaging products including the [redacted] container. [redacted] sold his interest in [redacted] and in [redacted], he entered the [redacted] business by founding [redacted] and purchasing [redacted]'s [redacted] division. Subsequent purchases of [redacted]'s [redacted] and [redacted] businesses, [redacted]'s [redacted] business, and additional acquisitions along with joint ventures with [redacted] have made [redacted] chemical company.

[redacted] entered the [redacted] business in [redacted] with the purchase of the [redacted] division of the [redacted]. In [redacted], [redacted] acquired [redacted]'s [redacted] business and contracted to purchase [redacted]'s converted products and specialty [redacted] divisions. [redacted] doubled in size in [redacted] with the $[redacted] acquisition of [redacted] and a $[redacted] dollar acquisition of [redacted]'s [redacted] business. Combined revenues of [redacted] exceeded $[redacted] in [redacted].

At the beginning of [redacted], [redacted] held an interest in [redacted] major corporate groups with each group filing a separate consolidated return. The [redacted] major groups included [redacted]. On [redacted], [redacted] transferred all of the stock of its subsidiaries to [redacted] in an I.R.C. § 368(a)(1)(A) reorganization and then liquidated, terminating its corporate existence. On [redacted], [redacted] and its subsidiary became subsidiaries of [redacted] in an I.R.C. § 368(a)(1)(A) reorganization. On [redacted], [redacted] changed its name to [redacted]. On [redacted], [redacted] and its subsidiaries became subsidiaries of "[redacted]" and qualified to file a consolidated federal income tax return with [redacted].[1]

In [redacted], [redacted] purchased all of the stock of [redacted], a Texas chemical

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[1]By [redacted], various corporate operations controlled by [redacted] and headquartered in [redacted] employed over [redacted] employees scattered throughout [redacted] locations in [redacted] countries.

manufacturer, and then renamed it [redacted]. [redacted] had previously filed a consolidated federal income tax return as the parent corporation of a consolidated group. At the time of its acquisition, [redacted] had two major projects underway in [redacted], [redacted]:

1. the construction of a [redacted] plant costing $[redacted]; and,
2. the $[redacted] expansion of an existing [redacted] plant.

[redacted] has advised the audit team that it will soon file a refund claim in the approximate amount of $[redacted] for its tax years [redacted] through [redacted] asking for the allowance of previously unclaimed amounts for research and development expenses under I.R.C. § 174. [redacted] has indicated that a portion of these previously unclaimed expenses will relate to the [redacted] projects acquired with [redacted]. In the consolidated corporate income tax returns filed by [redacted] for the tax years [redacted] and [redacted], the taxpayer claimed deductions under I.R.C. § 174 in the amounts of $[redacted] and $[redacted], respectively. The audit team understands that the claimed amounts do not relate to the [redacted] projects.

[redacted] has hired [redacted] to prepare a study to identify previously unclaimed research and development expenditures which might qualify for deduction under I.R.C. § 174. [redacted] has identified expenses of $[redacted] on the [redacted] plant and $[redacted] on the [redacted] plant which it claims will qualify for deduction. [redacted] has indicated it will not claim an I.R.C. § 41(e) credit which would have to satisfy requirements beyond those found in section 174. Amounts which [redacted] claims will qualify consist largely of payments to outside contractors but include a small amount of internal labor costs incurred by [redacted].

In the [redacted] study, the accountants concluded that when [redacted] acquired [redacted], that it in some way waived performance guarantees from contractors building the [redacted] plant and the [redacted] plant. The [redacted] study concludes that this undocumented waiver converts the construction of the plants into construction at the risk of the owner within the meaning of Treas. Reg. § 1.174-2(b)(3) so that [redacted] can claim deductions under I.R.C. § 174 for the construction costs. [redacted] claims the waivers occurred when [redacted] elected to forgo a series of performance tests specified in the contracts because of cost overruns on those contracts. These tests would have verified that the plants would operate according to specifications of producing the end product at stated quantities and quality.

You ask us to review contracts with [redacted] and with [redacted] to determine whether the risk shifted to [redacted] within the meaning of Treas. Reg. § 1.174-2(b)(3), and if so when. You have asked the taxpayer for documentation of [redacted]'s waiver of the performance tests but you have not yet received anything from the taxpayer.

You ask us to review three specific contracts with [redacted], with [redacted] and with [redacted] to determine whether they contain performance guarantees. [redacted] asserts they do not.

You also ask us to assist you in determining when [redacted] placed the [redacted] plant and the [redacted] plant in service.

You provided excerpts from the contracts with [redacted] and with [redacted]. As you noted in your memorandum, you have requested documentation to show what risk transfer occurred and when. We do not believe we have adequate documentation to provide a complete answer to your question. However, we will provide a general reaction and then invite you to seek further advice once you have obtained additional information.

It appears that after [redacted] acquired [redacted] it continued with the contracts for the construction of the [redacted] and [redacted] plants. However, both plants had gone significantly over budget.[2] Under the contracts, [redacted] would operate the plants for a period of time before proceeding with performance tests. [redacted] had to pay for the costs of the initial performance tests and the contractors had to take care of fixing any problems. The contracts permitted [redacted] to just accept the operating plants and forego the performance tests. [redacted] chose to do that. However, no evidence exists of any real transfer of risk. These plants dealt with an already established technology. The engineers and contractors who built the plants had to come up with the engineering plans to build the plants but in discussions with the audit team, the engineers agreed that this process was essentially the same as what other chemical plants go through in their periodic renovations and updating. The engineers had to do some unique engineering work

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[2] Taxpayer employees claim this occurred because [redacted] had wasted too much time; the contract with [redacted] provided for payment at an hourly rate plus expenses. [redacted] has pending litigation to resolve the dispute with [redacted].

in developing the [redacted] plant to a size [redacted] larger than any existing plant but they still relied on existing research and development for their plant design. The contract with [redacted] notes that they would build the plant according to [redacted] process-design and they would rely on the research, development and other proprietary information already developed by [redacted].

The contract with [redacted] dealt with a licensing of [redacted]'s [redacted] technology. It did not provide for development of new technology but for licensing of existing technology.

LEGAL DISCUSSION

In the taxpayer arguments for allowance of deductions under I.R.C. § 174, the taxpayer appears to rely on a strained interpretation of Treas. Reg. § 1.174-3(b)(3) and (4) which provide, in relevant part, as follows:

> (3) If expenditures for research or experimentation are incurred in connection with the construction or manufacture of depreciable property by another, they are deductible under section 174(a) only if made upon the taxpayer's order and at his risk. No deduction will be allowed (i) if the taxpayer purchases another's product under a performance guarantee (whether express, implied, or imposed by local law) unless the guarantee is limited, to engineering specifications or otherwise, in such a way that economic utility is not taken into account; or (ii) for any part of the purchase price of a product in regular production. For example, if a taxpayer orders a specially-built automatic milling machine under a guarantee that the machine will be capable of producing a given number of units per hour, no portion of the expenditure is deductible since none of it is made at the taxpayer's risk. Similarly, no deductible expense is incurred if a taxpayer enters into a contract for the construction of a new type of chemical processing plant under a turn-key contract guaranteeing a given annual production and a given consumption of raw material and fuel per unit. On the other hand if the contract contained no guarantee of quality of production and of quantity of units in relation to consumption of raw material and fuel, and if real doubt existed as to the capabilities of the process, expenses for research or experimentation under the contract are

at the taxpayer's risk and are deductible under section 174(a). However, see subparagraph (4) of this paragraph.

(4) The deductions referred to in subparagraphs 2 and (3) of this paragraph for expenditures in connection with the acquisition or production of depreciable property to be used in the taxpayer's trade or business are limited to amounts expended for research or experimentation. . .

The taxpayer appears to argue that by waving the performance tests, the taxpayer assumed all risks that the plant could perform as specified in the contract. The taxpayer also appears to presume that most engineering costs under the contracts will qualify as research or experimentation; taxpayer's representatives, who include former Chief Counsel attorney [redacted], have told the audit team that the Chief Counsel office sets a very low standard for what qualifies as research and experimentation. Taxpayer's representatives appear to think that if they can show the taxpayer took on any risk of performance capabilities that the bulk of the engineering costs incurred in building the plant will automatically become deductible. We think the reasoning flawed.

By the time the taxpayer waived the performance tests, the taxpayer had possession of an operating plant and already knew how well the plant operated. The performance tests provided a mechanism the taxpayer could have used to get the plant up to specification if it had deficiencies. By the time the taxpayer waived the performance tests, no real doubt existed as to the capabilities of the plant.

That the taxpayer had a [redacted] plant [redacted] larger than any other [redacted] plant did not make all of the engineering costs deductible under I.R.C. § 174. If building a larger object always qualified as research or experimentation, then a contractor building a larger warehouse but of similar design to prior warehouses should receive a deduction for engineering and design costs. While building a larger building or a larger chemical plant requires new design work, the engineers in such situations do no real research or experimentation, they merely repeat what others have already done. See, Treas. Reg. § 1.174-2(a). In many respects, the taxpayer merely contracted for the use of others' patents and design work for a particular process; the Treasury Regulations specifically prohibit allowing deductions under I.R.C. § 174 in such situations. Treas. Reg. § 1.174-2(a)(3)(vi) While some experimentation might occur in the scaling up of the plant, only the costs of such

experimentation should qualify and not all of the design and engineering work. This case has some similarities to the case of Coors Porcelain Company v. Commissioner, 52 T.C. 682, 696-698 (1969), aff'd, 429 F.2d 1 (10th Cir. 1970). In that case the taxpayer modified a piece of manufacturing equipment but failed to show that the modifications qualified as experimental expenditures under I.R.C. § 174; the court denied the taxpayer's claimed deduction. [redacted] similarly contracted for modifications to the [redacted] plant which someone else had developed, but even if [redacted] had any risk in connection with those modifications, and we do not believe it did, [redacted] has failed to show how the costs of scaling up of the plant qualified as research or experimental expenditures. Based on the best information available to us, it does not even appear that [redacted] has yet tried to separately deal with what would qualify as scaling up costs in order to make an argument that such costs might separately qualify for deduction. Instead, [redacted] has asserted that most engineering costs associated with these plants qualify as costs of research and experimentation. Based on the evidence currently available to us, we think they do not.

We have reviewed the portions of the contract with [redacted] which you provided to us. It appears that sections 2.4 and 6.1 put the risks of any engineering designs on [redacted].

In the contract with [redacted], [redacted] agreed to provide a distributed control system for the [redacted] plant. Paragraph 6.3 of this contract contains a warranty from [redacted] that the provided equipment will meet specifications provided by the purchaser. Since the purchaser provided the specifications, it appears that the purchaser had the design risk in this contract. However, you must still answer the question of whether the design dealt with any research or experimentation. Nothing in the contract portions we reviewed suggests that this equipment involved any unique or experimental designs.

[redacted] agreed in its contract to provide a mixer/extruder system for the [redacted] plant. This contract clearly had performance standards built into it. See paragraphs 2.4 and 6.2. Accordingly, the design risks remained with [redacted].

We cannot answer your final question dealing with when the taxpayer placed the plant in service. We do not have enough facts to tell with any certainty. If you would like to provide us with more facts, we will provide further assistance.

CONCLUSION

We have provided you our preliminary impressions to the questions you posed in your request to us. As you develop additional facts, you may want to request additional assistance. We will provide this memorandum to the National Office for post-review. We will advise you of any additional suggestions we receive from the National Office of Chief Counsel.

If you have any further questions in this matter, please contact me at telephone number [redacted]

[redacted]

Special Litigation Assistant