OFFICE OF
CHIEF COUNSEL

**DEPARTMENT OF THE TREASURY**
**INTERNAL REVENUE SERVICE**
**WASHINGTON, D.C. 20224**
November 5, 1999

Number: **200006023**
Release Date: 2/11/2000 CC:DOM:FS:P&SI

UILC: 41.00-00

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR ASSISTANT REGIONAL COUNSEL (LC), SOUTHEAST REGION

FROM: Assistant Chief Counsel (Field Service)
CC:DOM:FS

SUBJECT: Research Credit

This Field Service Advice responds to your memorandum dated July 21, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

**LEGEND:**

T =
U =

**ISSUE:**

Whether for the taxable year 1985 T is entitled to the research credit for expenses related to the creation of internal use software.

**CONCLUSION:**

Based on the information provided, T has not demonstrated that it is entitled to the research credit for the taxable year 1985.

**FACTS:**

In 1985, T developed a software system for its mainframe computer. The program was developed and written internally. T engaged U to write and test certain programs that allowed entry to and exit from the data base and were essential to the overall operation of the computer application. T claims that it is entitled to the

research credit for expenses associated with the development of the software system.

**LAW AND ANALYSIS:**

Overview

A taxpayer is allowed a credit against tax for qualified research expenses paid or incurred in carrying on a trade or business of the taxpayer. I.R.C. §§ 38(a); 41(a). The research credit was added to the Internal Revenue Code by the Economic Recovery Tax Act of 1981 and was codified as section 44F. The credit was subsequently amended by the Tax Reform Act of 1984 and was redesignated as section 30. The Tax Reform Act of 1986 redesignated the credit as section 41. Because the relevant section for the year at issue, 1985, is section 30, this advice will refer to section 30, notwithstanding the subsequent recodification.

For 1985, the amount of the credit is equal to a percentage of the excess of the taxpayer's qualified research expenses for the taxable year over the base period research expenses. I.R.C. § 30(a). The term "qualified research expenses" means the sum of in-house research expenses and contract research expenses which are paid or incurred by the taxpayer during the taxable year in carrying on any trade or business of the taxpayer. I.R.C. § 30(b)(1). In-house research expenses means any wages paid or incurred to an employee for qualified services, any amount paid or incurred for supplies used in the conduct of the qualified research, and any amount paid or incurred to another person for the right to use personal property in the conduct of qualified research. I.R.C. § 30(b)(2)(A). Qualified services means services consisting of engaging in qualified research or engaging in the direct supervision or direct support of research activities which constitute qualified research. I.R.C. § 30(b)(2)(B). Contract research expenses means 65 percent of any amount paid or incurred by the taxpayer to any person, other than an employee of the taxpayer, for qualified research. I.R.C. § 30(b)(3)(A).

Credits are a matter of legislative grace, and taxpayers bear the burden of proving that they are entitled to the credit. McDonald v. Commissioner, T.C. Memo. 1995-503. See also Interstate Transit Lines v. Commissioner, 319 U.S. 590, 593 (1943); Segel v. Commissioner, 89 T.C. 816, 842 (1987).

Wages as Qualified Research Expenses

For wages to constitute qualified research expense, we look to the statute, the regulations, and the legislative history. First, the wage expenses must have been incurred by the taxpayer in carrying on its trade or business. I.R.C. § 30(b)(1).

In addition, to constitute a qualified research expense, the wages must have been paid or incurred for qualified services performed by such employee in conducting qualified research. I.R.C. § 30(b)(2)(A)(i). Qualified services means services consisting of engaging in qualified research or engaging in the direct supervision or direct support of research activities which constitute qualified research. I.R.C. § 30(b)(2)(B). With certain exceptions not applicable under the given facts, qualified research had the same meaning as the term "research or experimental" had under section 174.[1] I.R.C. § 30(d).[2] While section 174 does not define "research or experimental expenditures," the regulations provide--

> The term "research or experimental expenditures", as used in section 174, means expenditures incurred in connection with the taxpayer's trade or business which represent research and development costs in the experimental or laboratory sense. The term includes generally all such costs incident to the development of an experimental or pilot model, a plant process, a product, a formula, an invention, or similar property, and the improvement of already existing property of the type mentioned. The term does not include expenditures such as those for the ordinary testing or inspection of materials or products for quality control or those for efficiency surveys, management studies, consumer surveys, advertising, or promotions. However, the term includes the costs of obtaining a patent, such as attorneys' fees expended in making and perfecting a patent application. On the other hand, the term does not include the costs of acquiring another's patent, model, production or process, nor does it include expenditures paid or incurred for research in connection with literary, historical, or similar projects.

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[1] Under section 174, a taxpayer may treat research or experimental expenditures which are paid or incurred by it during the taxable year in connection with its trade or business as expenses which are not chargeable to the capital account. I.R.C. § 174(a)(1). A taxpayer is generally allowed the election of either currently deducting its research and experimental expenditures or amortizing those expenditures over a period of not less than 60 months. I.R.C. §§ 174(a)(1), (b)(1); Treas. Reg. § 1.174-1. Research expenses which are neither treated as expenses nor deferred and amortized must be charged to the capital account. Treas. Reg. § 1.174-1.

[2] In the recodification of section 30 as section 41 under the Tax Reform Act of 1986, the definition of "qualified research" was amended to include requirements in addition to the requirement that the expenses qualify under section 174.

Treas. Reg. § 1.174-2(a)(1).

Except to the extent the expenditures are for the acquisition or improvement of land or depreciable property used in connection with the research or experimentation to which the taxpayer acquires rights of ownership, research or experimental expenditures include expenditures paid or incurred for research or experimentation carried on in the taxpayer's behalf by another person or organization. Treas. Reg. § 1.174-2(a)(2). In addition, section 174 only covers costs incurred in developing the concept of a product. Rev. Rul. 73-275, 1973-1 C.B. 134. It does not include expenditures for the acquisition or improvement of depreciable property. I.R.C. § 174(c); Treas. Reg. § 1.174-2(b). See also Mayrath v. Commissioner, 41 T.C. 582, 590 (1964), aff'd, 357 F.2d 209 (5th Cir. 1966) (regulatory definition of research or experimental expenditures is reasonable and consistent with the intent of the statute to limit deductions to those expenditures of an investigative nature expended in developing the concept of a model or product); Agro Science Co. v. Commissioner, T.C. Memo. 1989-687, aff'd, 927 F.2d 213 (5th Cir. 1991)[3] (contracts did not require the taxpayer to invent or design any product); Kollsman Instrument Corp. v. Commissioner, T.C. Memo. 1986-66, aff'd, 870 F.2d 89 (2d Cir. 1989) (contracts did not require the taxpayer to invent or design any product).

The United States Claims Court has provided some guidance for determining when expenditures associated with computer software come within the definition of "research or experimental expenditures." Specifically, the expenditures satisfy the definition only if new or significantly improved programs have been produced. Yellow Freight, Inc. v. United States, 24 Cl. Ct. 804, 809 (1992).

We also note that the legislative history provides that the research credit is not available for--

> expenditures such as the costs of routine or ordinary testing or inspection of materials or products for quality control; of efficiency surveys or management studies; of consumer surveys (including market research), advertising, or promotions (including market testing or development activities); or of routine data collection. Also, costs incurred in connection with routine, periodic, or cosmetic alterations or improvements (such as seasonal design or style changes) to existing business items, to production lines, or to other ongoing operations, or in connection with routine design of tools, jigs, molds, and dies, do not qualify as research expenditures under the definition in the provision.

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[3] Please note that the Fifth Circuit opinion has been withdrawn.

> The definition does not allow the new credit for such expenditures as the costs of copies of prototypes after construction and testing of the original model(s) have been completed; of pre-production planning and trial production runs; of engineering follow-through or trouble-shooting during production; or of adaptation of an existing capability to a particular requirement or customer's need as part of a continuing commercial activity. For example, the costs of adapting existing computer software programs to specific customer needs or uses, as well as the modifications of previously developed programs, are not eligible for the credit (regardless of how such costs are treated for purposes of sec. 174 deduction elections). [Underscoring supplied.]

H.R. Conf. Rep. No. 201, 97th Cong., 1st Sess. 38, 115 (1981), 1981-2 C.B. 352, 360. See also Joint Committee, 97th Cong., 1st Sess., General Explanation of the Economic Recovery Act of 1981, at 125.

Contract Research Expenses

The amounts paid or incurred by T to U may be used to compute the research credit only if they meet the requirements of contract research expenses. The term "contract research expenses" means 65 percent of any amount paid or incurred by the taxpayer to any person (other than an employee of the taxpayer) for qualified research. I.R.C. § 30(b)(3)(A).

Treas. Reg. § 1.41-2(e) addresses contract research expenses. Specifically, Treas. Reg. § 1.41-2(e)(2) provides:

> *Performance of qualified research*. An expense is paid or incurred for the performance of qualified research only to the extent that it is paid or incurred pursuant to an agreement that -
>
> (i) Is entered into prior to the performance of the qualified research,
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> (ii) Provides that research be performed on behalf of the taxpayer, and,
>
> (iii) Requires the taxpayer to bear the expense even if the research is not successful.
>
> If an expense is paid or incurred pursuant to an agreement under which payment is contingent on the success of the research, then the expense is considered paid for the product or result rather than the

> performance of the research, and the payment is not a contract research expense. The previous sentence applies only to the portion of a payment which is contingent on the success of the research.

Treas. Reg. § 1.41-2(e)(3) provides:

> *"On behalf of."* Qualified research is performed on behalf of the taxpayer if the taxpayer has a right to the research results. Qualified research can be performed on behalf of the taxpayer notwithstanding the fact that the taxpayer does not have exclusive rights to the research results.

Treas. Reg. § 1.41-2(e)(1) provides in part:

> Where the contract calls for services other than services described in this paragraph (e)(1), only 65 percent of the portion of the amount paid or incurred that is attributable to the services described in this paragraph (e)(1) is a contract research expense.

**CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:**

[redacted]

[redacted]

[redacted]

Please call if you have any further questions.

By: HARVE M. LEWIS
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