**Office of Chief Counsel**
**Internal Revenue Service**
# memorandum

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to: Keith G. Medleau
Senior Counsel (Seattle, Group 2)
(Large Business & International)

Joseph R. Worst
Attorney, (Seattle, Group 2)
(Large Business & International)

from: Peter C. Friedman
Senior Technician Reviewer, Branch 6
Office of Associate Chief Counsel
(Passthroughs & Special Industries)

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subject: Request for Advice---

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Taxpayer =

Act =

Process =

Years =

Year 1 =

Year 2 =

Year 3 =

Year 4 =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Oxidant =

Laboratory =

Pilot Project =

Technology =

Conversion =

Accounting Firm =

LLC =

Company 1 =

Company 2 =

Company 3 =

Company 4 =

Company 5 =

a% =

$A =

$B =

$C =

$D =

$E$ =

$F =

ISSUES

1. Whether certain expenditures in tax Years 1, 2 and 3 incurred by Taxpayer in connection with a potential Process plant qualify as research and experimental expenditures deductible under § 174(a), or are precluded from being deductible under § 174(d) as exploration expenditures and instead deductible under § 617.

2. Whether the expenditures qualify for the § 41 research credit.

CONCLUSIONS

1. The expenditures incurred by Taxpayer are exploration expenditures under § 174(d) and, thus, are not deductible as research and experimental expenditures under § 174(a). The exploration expenditures are deductible under § 617 if Taxpayer makes an election pursuant to § 617(a)(2) and the regulations thereunder.

2. The expenditures do not qualify for the § 41 research credit.

FACTS

Taxpayer is a corporation that was created by the Act. Taxpayer owns land under which lie coal deposits. According to Taxpayer's protest, these coal deposits are located

In Years, Taxpayer began looking into the potential development of a Process plant to extract the coal from its land. Process is

In Year 1, Taxpayer teamed up with Laboratory, a government research agency, to assist with this endeavor. The Laboratory Statement of Work (SOW) included three

tasks: (1) site selection, site characterization, preliminary environmental hazard identification, assessment, and recommendations; (2) site development planning; and (3) project management activities. The SOW also stated that successful completion of the first two tasks would contribute to Taxpayer's ability to successfully field a test burn and start toward Pilot Project, and assist in the engineering design and execution of Process pilot.

On Date 1, Taxpayer created a disregarded entity, LLC, which then entered into a partnership with Company 1. Company 1 is a Process developer and holds the certain geographical rights to the Company 2 Technology under license from Company 2. The Company 2 Technology is described on Company 2's website as the "

" The purpose of the partnership was to carry out the Process project.

Taxpayer also contracted with two other parties regarding the potential Pilot plant. On Date 2, Taxpayer contracted with Company 3 as a consultant for the Process project. The contract provides for Company 3 consulting services involving the exploration and development of coal resources on Taxpayer's land. Taxpayer's protest notes that Company 3 also conducted a geological mapping project, a two-phase core-drilling program in Years 2 and 3, and a 2D seismic survey in Years 3 and 4.

Taxpayer also entered into a contract with Company 4 on Date 3, for Company 4 to do geophysical surveys. According to Taxpayer's protest, Company 4 also conducted seismic testing in the bores drilled by Company 3.

Neither the Company 4 nor Company 3 contracts include any language or provision regarding Process, research Company 4 or Company 3 is to conduct, nor alternatives to consider to resolve any uncertainties with respect to the Process project.

Taxpayer's expenses relating to the Company 3 and Company 4 contracts make up about a% of the total contract expenses Taxpayer incurred in tax Years 2,3 and 4 all of which Taxpayer considers research and experimental expenditures under § 174 and qualified research under § 41.[1] Taxpayer claimed § 174 deductions for Process related expenditures in the amounts of $A, $B, and $C on its tax returns for the Years 2, and 4, respectively. Taxpayer claimed § 41 research credits in the amounts of $D and $E on its Year 2, 3 and 4 tax returns, respectively.

Taxpayer hired Accounting Firm to analyze its costs related to the Process project to determine their eligibility for § 41 research credits and § 174 research and experimental expenditure deductions. As part of Accounting Firm's analysis, Research Tax Credit Study Project Questionnaire and Contract Research Analysis forms were completed for

[1] To the extent Taxpayer is allowed a research credit under I.R.C. § 41, research expenses cannot be deducted under § 174. I.R.C. § 280C(c)(1).

Years 2 and 3. Accounting Firm concluded that Taxpayer's costs were more likely than not eligible for both §§ 41 and 174 treatment.

On Date 4, Company 2 provided a recent update regarding the status of the Process project in a memorandum that gives the results of the site selection phase of the project. The memo goes in depth about the site selection process, which focused on the geology, hydrology, and rock mechanics assessment of the target Pilot area. of the memo states that the site-selection process determination by Company 2 was based on whether a candidate site was suitable for the application of Technology and for the potential development of a commercial scale Process plant.

**Law and Analysis**

**Issue 1: Whether certain expenditures in tax years 2, 3 and 4 incurred by Taxpayer in connection with a potential Process plant qualify as research and experimental expenditures deductible under § 174(a), or are precluded from such deduction under § 174(d) as exploration expenditures (and instead deductible under § 617 if Taxpayer so elects).**

Section 174(a) provides that a taxpayer may treat research or experimental expenditures paid or incurred by the taxpayer during the taxable year in connection with its trade or business as a deduction rather than chargeable to a capital account.

Treas. Reg. § 1.174-2(a)(1) provides that the term "research or experimental expenditures," as used in § 174, means expenditures incurred in connection with the taxpayer's trade or business which represent research and experimental costs in the experimental or laboratory sense. The term generally includes all such costs incident to the development or improvement of a product. Expenditures represent research and experimental costs in the experimental or laboratory sense if they are for activities intended to discover information that would eliminate uncertainty concerning the development or improvement of a product. Uncertainty exists if the information available to the taxpayer does not establish the capability or method for developing or improving the product or the appropriate design of the product. Whether expenditures qualify as research or experimental expenditures depends on the nature of the activity to which the expenditures relate, not the nature of the product or improvement being developed or the level of technological advancement the product or improvement represents.

Treas. Reg. § 1.174-2(a)(2) provides that for purposes of Treas. Reg. § 1.174-2, the term "product" includes any pilot model, process, formula, invention, technique, patent, or similar property, and includes products to be used by the taxpayer in its trade or business as well as products to be held for sale, lease, or license.

Treas. Reg. § 1.174-2(a)(8) provides, in part, that the provisions of Treas. Reg. § 1.174-2 apply not only to costs paid or incurred by the taxpayer for research or

experimentation undertaken directly by the taxpayer but also to expenditures paid or incurred for research or experimentation carried on in its behalf by another person or organization.

Section 174(d), however, provides that § 174 shall not apply to any expenditure paid or incurred for the purpose of ascertaining the existence, location, extent, or quality of any deposit of ore or other mineral (including oil and gas). Treas. Reg. § 1.174-2(c) repeats the language of § 174(d) and cross-references §§ 617 and 263.

There are at least four sub-issues related to the primary issue above: (a) whether the activities of Company 3 and Company 4 should be viewed as independent activities or as part of Taxpayer's overall Process project in determining whether the expenditures are exploration expenditures under § 174(d); (b) whether Taxpayer's secondary purpose of collecting data to refine its knowledge as to the extent or quality of known coal deposits causes its costs to be exploration expenditures under § 174(d); (c) if Taxpayer's contract costs to Company 3 and Company 4 are exploration costs under § 174(d), whether they are deductible under § 617; and (e) if so, whether the statutory notice of deficiency (SNOD) adjustments should include such deductions absent a § 617 election by Taxpayer.

We now address those sub-issues as follows:

**(a) Whether the activities of Company 3 and Company 4 should be viewed as independent activities or as part of Taxpayer's overall Process project in determining whether the expenditures are exploration expenditures under § 174(d).**

Taxpayer claims that it cannot separate its exploration costs from its overall project because the two are intertwined. In other words, Taxpayer argues that it only contracted with Company 3 and Company 4 to conduct the drilling and surveying in connection with Taxpayer's Process project. The logic of Taxpayer's argument seems to be that since the goal of the Process project was to develop a commercial Process plant and to improve the Process process, all steps Taxpayer took to accomplish those goals are incidental to such development or improvement. As such, it asserts that contract expenses paid to Company 3 and Company 4 are deductible as research and experimental expenditures under § 174(a).

However, this argument is refuted by Rev. Ruls. 74-67 and 75-122. Rev. Rul. 74-67, 1974-1 C.B. 63, involved a taxpayer engaged primarily in the business of exploring, developing, and producing minerals. The taxpayer began a project in which it delineated the size and grade of the ore body by using conventional drilling methods and perfecting a new hydraulic mining method. The project included the drilling of holes for three purposes: (1) for maximum coverage of geologic information; (2) for testing the new hydraulic mining method; and (3) for optimum production with the new mining method. The Service held the costs incurred for the first purpose were mining

exploration expenditures subject to the provisions of § 615[2] or 617, while the costs incurred for the second and third purposes were research and experimental expenditures subject to § 174.

In Rev. Rul. 75-122, 1975-1 C.B. 87, the Service considered the costs incurred by a mining company: (1) in determining the location and quality of a mineral deposit that previously had not been commercially exploited; (2) in driving shafts, drifts, cross-cuts, and for other production facilities that were not limited to use in developing prototype mining equipment and perfecting a new metallurgical process; and (3) at the research laboratory that were directly related to the development of prototype mining equipment and the perfecting of new metallurgical processes. The Service held the first type of costs were exploration expenditures under § 617, the second type of costs were mine development expenses under § 616, and the third type of costs were research or experimental expenditures within the meaning of Treas. Reg. § 1.174-2(a)(1) and may be deducted under § 174(a).

Implicit in these holdings is that, when a taxpayer is involved in a project that includes discrete activities, the taxpayer's purpose for each activity must be analyzed in determining whether the expenses relating to that activity qualify as research or experimental expenditures within the meaning of Treas. Reg. § 1.174-2(a)(1).

The revenue rulings' analyses provide a strong argument that the expenditures at issue are exploration costs under § 174(d). The revenue rulings were issued more than forty years ago and have not been revoked or superseded. During that time, no court has cited them and only a few pieces of administrative guidance have discussed them.[3] There has been a revision to Treas. Reg. § 1.174-2 since the issuance of the revenue rulings that is relevant.[4] In T.D. 8562, a definition for "research or experimental expenditures" was added. The last sentence of the regulation notes that the determination of "whether expenditures qualify as research or experimental expenditures depends on the nature of the activity to which the expenditures relate, not the nature of the product or improvement being developed." This sentence suggests that the determination of whether expenditures can be deducted under § 174(a) is made upon looking at the purpose of each independent activity as opposed to the purpose of the entire project to which the activity relates. In other words, the regulation validates the analyses in Rev. Ruls. 74-67 and 75-122.

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[2] Section 615 (Pre-1970 Exploration Expenditures) was repealed by the Tax Reform Act of 1976 and replaced by former § 617(i). Former § 617(i) was repealed by Sec. 11801(a)(27) of the Omnibus Budget Reconciliation Act of 1990. See 1991-2 C.B. 481, 538.

[3] Rev. Rul. 74-67 has only been cited by Rev. Rul. 75-122, a 1981 PLR, and a 1993 field service advisory. Rev. Rul. 75-122 has been cited by two nondocketed service advice reviews and three field service advisories, with the most recent informal administrative guidance issued in 2001.

[4] Treas. Reg. § 1.174-2 has also been revised in T.D. 8131 (issued on March 30, 1987) and T.D. 9680 (issued on July 21, 2014). The revisions in those regulations are not relevant to this case.

**(b) Whether Taxpayer's secondary purpose of collecting data to improve Taxpayer's knowledge as to the extent or quality of its known coal deposits causes its costs to be exploration expenditures under § 174(d).**

Section 174(d) provides that § 174 "shall not apply to any expenditures paid or incurred for *the* purpose of ascertaining the existence, location, extent, or quality of any deposit or other mineral." (emphasis added). The ambiguous part of § 174(d) is whether "the" indicates that the subsection only applies if a taxpayer's sole purpose of an expenditure paid or incurred is ascertaining, location, extent, or quality of any deposit of ore or other mineral, or it applies if such purpose is merely one of the taxpayer's purposes for the expenditure.

Taxpayer's argues that its primary purpose, which it asserts was to eliminate or reduce technical uncertainty incident to the design or development of the Process process, is what is relevant under § 174. Although Taxpayer notes multiple times that it knew of the coal deposits, it admits that a secondary consequence of collecting data was to improve its knowledge as to the extent or quality of the known coal deposits. Taxpayer goes on to argue, however, that the Service is focusing on this secondary consequence instead of its primary motivation.

Whether and to what extent tax deductions shall be allowed depends upon legislative grace. New Colonial Ice Co. v. Helvering, 292 U.S. 435, 440 (1934). A taxpayer seeking a deduction must be able to point to a statute and show that it comes within its terms. Id. As a general matter, provisions providing special tax deductions are strictly construed. General Securities Co. v. Commissioner, 123 F.2d 192, 194 (10th Cir. 1941) (citing Helvering v. Northwest Steel Rolling Mills Inc., 311 U.S. 46, 49 (1940)).

Based on these basic rules of statutory construction for deductions, Taxpayer's costs are subject to § 174(d) even if Taxpayer can demonstrate that the expenditures otherwise meet the requirements of § 174(a) and the regulations thereunder. Given that § 174(a) should be strictly construed, it follows that the exclusion in § 174(d) be interpreted broadly. The language of § 174(d) supports such a broad reading because it applies to "any" expenditures for the purpose of exploration. Had Congress intended the § 174(d) exclusion to apply narrowly, as Taxpayer suggests, it could have used "those," or similar limiting language, to describe the expenditures to which § 174(d) applies. Moreover, a strict reading of § 174(d) in the context of § 174 suggests that if "any" expenditure is paid or incurred for "the" purpose of ascertaining the existence, location, extent, or quality of any deposit of ore or other mineral, then it does not matter how important that purpose is relative to any purpose for the expense. In such case, the taxpayer is not entitled to a deduction for the expense as a research and experimental expenditure.

The legislative history to § 174 supports this interpretation. The committee reports (H. Rept. 83-1337 (1954), p. 28; S. Rept. 83-1622 (1954), p. 33), which accompany H.R. 8300, the Internal Revenue Code, explain that exploration expenditures are not

deductible as research and experimental expenditures under § 174 because they are "presently provided for under other provisions."[5] Congress clearly recognized that a different regime applies to exploration expenditures. If Congress did not add subsection (d) to § 174, taxpayers may have tried to take two deductions for one expenditure, e.g., under both §§ 174 and 617. But see Charles Ilfeld Co. v. Hernandez, 292 U.S. 62, 68 (1934) (stating that absent the Code or regulations that specifically authorize it, taxpayers are not allowed the practical equivalent of a double deduction). Thus, regardless of a taxpayer's intent, the legislative history provides that if expenses qualify as exploration expenses under § 617, or are otherwise provided for, they cannot qualify as research and experimental expenditures under § 174(a).

Taxpayer's argument that its alleged primary purpose is more important than its secondary purpose for purposes of § 174(d) is without merit. Congress enacted § 174 as a part of the Internal Revenue Code of 1954. Since then, Congress has amended § 174 numerous times without ever changing the language of § 174(d). See, e.g., Omnibus Budget Reconciliation Act of 1989, Public Law 101-239, 103 Stat. 2489 (adding I.R.C. § 174(e) and redesignating what used to be § 174(e) as § 174(f)); The Tax Reform Act of 1986, Public Law 99-514, 100 Stat. 2085 (amending what is currently in § 174(f)(2)). Congress could have clarified § 174(d) so that it only applies if a taxpayer's "principal purpose," "significant purpose," or "primary purpose" is for exploration, which is language Congress has used in other Code sections. See, e.g., §§ 357(b)(1) (use of principal purpose); 6662(d)(2)(C)(ii) (use of significant purpose); and 502(a) (use of primary purpose). The fact that Congress has not amended the language of § 174(d) since it was enacted in 1954 and the legislative history to § 174(d) makes it clear that § 174(d) takes precedence over the other requirements of § 174. Accordingly, Taxpayer's expenses incurred in its Process project cannot be deducted as research and experimental expenditures under § 174(a) because they are exploration costs under § 174(d).

**(c) If Taxpayer's contract costs to Company 3 and Company 4 are exploration costs under § 174(d), whether the costs are deductible under § 617.**

Section 617(a) provides, in part, that at the election of the taxpayer, expenditures paid or incurred during the taxable year for the purpose of ascertaining the existence, location, extent, or quality of any deposit of ore or other mineral, and paid or incurred before the beginning of the development stage of the mine, shall be allowed as a deduction in computing taxable income. In no case shall § 617(a) apply with respect to amounts paid or incurred for the purpose of ascertaining the existence, location, extent, or quality of any deposit of oil or gas or of any mineral with respect to which a deduction for percentage depletion is not allowable under § 613(a).

[5] Though not cited explicitly, the "other provisions" referenced in the legislative history are likely to §§ 263 and 617. See Treas. Reg. § 1.174-2(c).

Taxpayer's costs are mining exploration costs subject to § 617. Taxpayer does not disagree that the requirements in the first sentence of § 617(a) are met. However, it maintains that, under the last sentence of § 617(a), no deduction under § 617 is allowable because a deduction for percentage depletion is not available to Taxpayer under § 613.

Section 613 provides an allowance for depletion based on the percentage of the gross income from "mining." Section 613(c)(4) provides a list of treatment processes considered as "mining," while § 613(c)(5) provides a list of treatment processes not considered as "mining" unless the process is otherwise provided for in § 613(c)(4).

Process is an activity that subsumes the coal extraction process – a mining activity. The definition of "mining" under § 613(c) includes the extraction of the ores or minerals from the ground.

**(d) If Taxpayer's costs are deductible under § 617, whether the statutory notice of deficiency (SNOD) adjustments should include the deduction or offset to Taxpayer's income absent Taxpayer affirmatively making the § 617 election.**

Taxpayer's costs meet all the eligibility requirements of § 617(a) to deduct the costs as mining exploration expenditures. The first clause of § 617(a), however, provides that the deduction is taken "[a]t the election of the taxpayer."[6] Thus, absent such election, the Service should not allow Taxpayer the § 617(a) deduction.

The SNOD should be revised to not allow Taxpayer any deduction or offset to income under § 617; but rather to provide in the explanatory language that the expenditures are deductible under § 617 if Taxpayer so elects. Thus, it would be Taxpayer's decision to determine when it will make the election to deduct the costs or to capitalize them. This recommendation conforms to the election requirement of § 617.

**(e) If Taxpayer seeks to elect § 617 treatment, whether such election would be timely.**

[6] It appears if a taxpayer does not make the election to deduct exploration mining expenditures under § 617, the expenditures would be capitalized under I.R.C. § 263. See Treas. Reg. § 1.174-2(c).

An additional sub-issue is whether, in the instant case, Taxpayer can make a timely § 617 election.

Section 6501(a) provides, in part, that except as otherwise provided in this section, the amount of any tax imposed by this title shall be assessed within 3 years after the return was filed.

Section 6501(c)(4) provides, in part, that where before the expiration of the time prescribed in this section for the assessment of any tax imposed by this title both the Secretary and the taxpayer have consented in writing to its assessment after such time, the tax may be assessed at any time prior to the expiration of the period agreed upon. The period so agreed upon may be extended by subsequent agreements in writing made before the expiration of the period previously agreed upon.

Section 6503(a)(1) provides, in part, that the running of the period of limitations provided in §§ 6501 or 6502 on the making of assessments shall (after the mailing of a notice under § 6212(a)) be suspended for the period during which the Secretary is prohibited from making the assessment and for 60 days thereafter.

Section 6511(c) provides, in part, that if an agreement under the provisions of § 6501(c)(4) extending the period for assessment of a tax imposed by this title is made within the period prescribed in subsection (a) for the filing of a claim or refund- (1) The period for filing claim for credit or refund shall not expire prior to 6 months after the expiration of the period within which an assessment may be made pursuant to the agreement or any extension thereof under § 6501(c)(4).

If the Service and taxpayer agree to a § 6501(c)(4) extension to the period for assessment, the period for filing a timely claim for credit or refund shall not expire prior to 6 months after the expiration of the agreement or any extension of time for which the Service may make the assessment. § 6511(c)(1). Pursuant to the issuance of a SNOD, § 6503(a)(1) suspends the period of limitations provided in § 6501 for the period of time the Secretary is prohibited from making the assessment, plus 60 days. The § 6501(c)(4) agreement to extend the period of limitations for assessment is a period of limitations within the meaning of § 6503.

If' the period for assessment provided in § 6501 is extended by the period of time for which assessment is prohibited, plus 60 days, the plain language of § 6511(c)(1) requires that the time to file a timely claim for credit or refund be extended by the same period of time. This extension will ensure the § 6511(c)(1) period to file a timely claim for credit or refund will not expire prior to 6 months after the expiration of the period for assessment provided in § 6501 thereby extending the time taxpayer has to make a timely election under § 617(a)(2)(B) to deduct its exploration expenditures.

**Issue 2: Whether the expenditures qualify for the § 41 research credit**

The expenditures incurred by Taxpayer are not R&E expenditures under § 174 but are mining exploration expenditures under § 174(d). Therefore, such expenditures do not qualify for the § 41 research credit as the requirements of § 41(d)(1)(A) have not been met. Consequently, we do not need to continue our analysis to determine whether any of the other elements of § 41(d) have been met as such an analysis would be irrelevant.

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

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]