

INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

05/02/2003

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Index (UIL) No.: 41.55-05, 41.56-09
CASE MIS No.: TAM-127892-03/CC:PSI:B07

Taxpayer's Name:

Taxpayer's Address:

Taxpayer's Identification No:

Years Involved:

Date of Conference:

LEGEND:

Taxpayer:

EIN:

Parent:

EIN:

Corporation A:

EIN:

Corporation B:

Corporation C:

Corporation D:

Corporation E:

Year:

Date 1:

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Date 2:

Date 3:

Date 4:

Date 5:

ISSUES:

(1) Can Taxpayer include qualified research expenses paid or incurred by Corporation D and Corporation D Subsidiaries for the period Date 1 through Date 3 for purposes of computing its research credit for its taxable year ended Date 5?

(2) How should Taxpayer compute its research credit for its taxable year ended Date 5?

CONCLUSIONS:

(1) Taxpayer cannot include any of the qualified research expenses paid or incurred by Corporation D and Corporation D Subsidiaries for the period Date 1 through Date 3 for purposes of computing its research credit for its taxable year ended Date 5.

(2) Taxpayer should compute its research credit for its taxable year ended Date 5 on an aggregate basis, including the following: (a) 100 percent of the qualified research expenses paid or incurred by Corporation A for the period Date 1 through Date 3 and Corporation A's average annual gross receipts for the four taxable years preceding the credit year; (b) all of the qualified research expenses paid or incurred by Corporation D and Corporation D Subsidiaries for the short taxable year from Date 4 through Date 5, and Corporation D and Corporation D Subsidiaries' average annual gross receipts for the four taxable years preceding the credit year; and (c) all of the qualified research expenses paid or incurred by Corporation A Subsidiaries for the full taxable year from Date 1 through Date 5 and Corporation A Subsidiaries' average annual gross receipts for the four taxable years preceding the credit year.

FACTS:

Prior to Date 3, Corporation A was the common parent of a consolidated group of corporations. The Corporation A consolidated group was a calendar year taxpayer. Corporation A wholly owned more than domestic subsidiaries, including lower-tier subsidiaries (hereinafter Corporation A Subsidiaries). Prior to Date 3, Corporation D was a member of the Corporation B consolidated group of corporations. The Corporation B consolidated group was also a calendar year taxpayer. Corporation C was a wholly-owned subsidiary of Corporation B. Corporation D was a wholly-owned subsidiary of Corporation C. Corporation D owned many domestic subsidiaries,

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including Corporation E.

On Date 2, Corporation C was liquidated into Corporation B in a complete liquidation to which section 332 of the Internal Revenue Code (hereinafter, the Code) applied, with the consequence that after this liquidation Corporation B directly owned 100 percent of the stock of Corporation D. Corporation E was then liquidated into Corporation D in a complete liquidation under section 332, a transaction to which section 381(c)(4) and (c)(5) of the Code applied. All remaining subsidiaries of Corporation D are hereinafter referred to as Corporation D Subsidiaries.

On Date 3 (the day after Date 2), Corporation B distributed all of the Corporation D stock to Corporation B shareholders in a distribution to which section 355 of the Code applied. Immediately after the section 355 distribution of Corporation D stock to the Corporation B shareholders, Corporation A merged with and into Corporation D in a statutory merger under section 368(a)(1)(A) of the Code. As a result of the merger, Corporation D either directly or indirectly owned 100 percent of the outstanding stock of the Corporation A Subsidiaries. In consideration for the merger, the Corporation A shareholders received more than 50 percent of the outstanding stock of Corporation D. As a result, the Corporation A shareholders obtained a majority interest in Corporation D. The merger of Corporation A with and into Corporation D qualified as a reverse acquisition as defined in Treas. Reg. § 1.1502-75(d)(3). Immediately following the merger, Corporation D changed its name to Parent (the same name as Corporation A).

On its consolidated return for the taxable year beginning on Date 1 and ending on Date 5, Taxpayer (consisting, on Date 5, of Parent (f/k/a Corporation D) as the common parent, Corporation D Subsidiaries, and Corporation A Subsidiaries) elected to claim the alternative incremental research credit under section 41(c)(4) of the Code. When computing its section 41 credit for increasing research activities for the taxable year ended Date 5, Taxpayer included in its aggregate credit year qualified research expenses amounts paid or incurred by Corporation D and Corporation D Subsidiaries for the period Date 1 through Date 3.¹

LAW:

Section 41 provides a nonrefundable income tax credit for qualified research expenses (QREs) 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

¹ This technical advice memorandum only addresses issues related 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). Also, we express or imply no opinion on the allocation of the group credit among members of the controlled group under Prop. Treas. Reg. § 1.41-6.

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taxpayer's QREs for the taxable year over its base amount, and (2) twenty percent of the taxpayer's basic research expenses. I.R.C. § 41(a).

For taxable years beginning after June 30, 1996, a taxpayer may elect to determine its research credit under the alternative incremental research credit rules of section 41(c)(4). If properly elected, the alternative incremental research credit for taxable years beginning after June 30, 1996, and before July 1, 1999, is equal to the sum of the following amounts:

- (i) 1.65 percent of so much of the QREs for the taxable year as exceeds 1 percent of the average annual gross receipts for the 4 taxable years preceding the credit year but does not exceed 1.5 percent of such average,
- (ii) 2.2 percent of so much of the QREs for the taxable year as exceeds 1.5 percent of the average annual gross receipts for the 4 taxable years preceding the credit year but does not exceed 2 percent of such average, and
- (iii) 2.75 percent of so much of the QREs for the taxable year as exceeds 2 percent of the average annual gross receipts for the 4 taxable years preceding the credit year.

I.R.C. § 41(c)(4)(A).

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. Section 41(f)(5) provides that the term "controlled group of corporations" has the same meaning given to such term by section 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). Section 1563(a)(1) provides that a controlled group of corporations includes a parent-subsidary controlled group. A parent-subsidary controlled group is one or more chains of corporations connected through stock ownership with a common parent corporation if the percentage of ownership requirements in section 1563(a)(1)(A) and (B) are met with respect to each corporation in the group. See I.R.C. § 1563(a)(1).

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 QREs paid or incurred by the taxpayer during periods before such acquisition shall be increased by so much of such expenses

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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 taxpayer, 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). Treas. Reg. § 1.41-7(b) also provides that an “acquisition” includes an incorporation or a liquidation.

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 a trade or business (or separate unit).

Section 41(f)(4) provides that in the case of any short taxable year, QREs 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)² provides, in relevant

² Treas. Reg. § 1.41-3(b) was amended by T.D. 8930 (2001-5 I.R.B. 433) to reflect the changes to the computation of the research credit made by the Revenue Reconciliation Act of 1989, and was applicable for taxable years beginning on or after January 3, 2001. Treasury and the Service reconsidered T.D. 8930 and on December 26, 2001, issued new proposed regulations (66 F.R. 66,362, 2002-4 I.R.B. 404), amending the effective date to December 26, 2001. The new proposed regulations retain the special rules for short taxable years contained in Treas. Reg. § 1.41-3(b) of T.D. 8930. Although these rules are applicable for taxable years after the year at issue here, no inference should be drawn from the applicability date concerning the application of section 41 to the expenditures paid or incurred before the applicability date.

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part, the following rules:

(1) Short credit year. 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) Short taxable year preceding credit year. 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.

Treas. Reg. § 1.1502-76(b)(1)(i) provides that a consolidated return must include the common parent's items of 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 (including the consolidated return of another group).

Treas. Reg. § 1.1502-76(b)(1)(ii)(A)(1) generally 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 corporation's change in status. Treas. Reg. § 1.1502-76(b)(1)(ii)(B) provides that if, on the day a corporation's status as a member changes, a transaction occurs that is properly allocable to the portion of the corporation's day after it ceases to be a member, the corporation (and all related persons) must treat the transaction as occurring at the beginning of the following day.

Treas. Reg. § 1.1502-76(b)(2)(i) generally provides that the returns for the years that end and begin with a corporation becoming (or ceasing) to be a member are separate tax years and are subject to the rules of the Code applicable to short periods. Treas. Reg. § 1.1502-76(b)(2)(ii) provides that although the periods ending and beginning with a corporation's change in status are different tax years, items (other than extraordinary items) may be ratably allocated between the periods if the corporation is not required to change its annual accounting period or its method of accounting as a result of its change in status and the corporation makes an irrevocable ratable allocation election.

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Treas. Reg. § 1.1502-75(d)(3)(i) provides, in part, that if a corporation (the first corporation) or any member of a group of which the first corporation is the common parent acquires substantially all the assets of the second corporation in exchange, in whole or in part, for stock of the first corporation, and the shareholders (immediately before the acquisition) of the second corporation, as a result of owning stock of the second corporation, own (immediately after the acquisition) more than 50 percent of the fair market value of the outstanding stock of the first corporation, then any group of which the first corporation was the common parent immediately before the acquisition shall cease to exist as of the date of the acquisition, and any group of which the second corporation was the common parent immediately before the acquisition shall be treated as remaining in existence (with the first corporation becoming the common parent of the group).

Treas. Reg. § 1.1502-75(d)(3)(v) provides, in pertinent part, that if, in a transaction described in § 1.1502-75(d)(3)(i), the first corporation files a consolidated return for the first taxable year ending after the date of acquisition, then –

(a) The first corporation, and each corporation which, immediately before the acquisition, is a member of the group of which the first corporation is the common parent, shall close its taxable year as of the date of acquisition, and each such corporation shall, immediately after the acquisition, change to the taxable year of the second corporation, and

(b) If the acquisition is a transaction described in section 381(a)(2), then for purposes of section 381. . . .

(2) The second corporation shall not close its taxable year merely because of such acquisition, and all taxable years ending on or before the date of acquisition, of the second corporation and each corporation which, immediately before the acquisition, is a member of any group of which the second corporation is the common parent, shall be treated as taxable years of the acquiring corporation.

ANALYSIS:

The computation of the research credit for a controlled group of corporations is governed by the rules of section 41(c) and (f) and its underlying regulations. The consolidated return regulations under section 1502 provide the rules in order that the tax liability of an affiliated group of corporations filing a consolidated return, can be returned, determined, computed, assessed, collected, and adjusted, in such manner as to clearly reflect the income tax liability and the factors necessary for the determination of such liability.

On Date 3, Corporation A merged with and into Corporation D in a statutory merger under section 368(a)(1)(A). It is clear that under general corporate principles,

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Corporation D is the acquiring entity. In a statutory merger, the assets and liabilities of Corporation A (the disappearing corporation) pass to Corporation D (the surviving entity) by operation of law. See Doloboff and Wilcox, 771-2nd T.M., Corporate Acquisitions -- (A), (B), and (C) Reorganizations. Corporation D absorbs the corporate enterprise of Corporation A, with the result that Corporation D (the acquiring corporation) steps into the shoes of Corporation A (the disappearing corporation) as to its assets and liabilities. See Bittker and Eustice, Federal Income Taxation of Corporations and Shareholders, ¶ 12.22[1] (7th Ed. 2000).

The issue is whether the consolidated return regulations mandate a different result, that is, whether the consolidated return regulations require that Corporation A be treated as the acquiring entity for purposes of section 41(f)(3).³ Neither section 41(f)(3) nor the consolidated return regulations provide special rules for determining the research credit when there is an acquisition or disposition involving a consolidated group.

For certain limited purposes, the consolidated return regulations under Treas. Reg. § 1.1502-75(d)(3) provide that the larger corporation is the “acquiring” corporation. The larger corporation is treated as the “acquiring corporation” with respect to the continuation of the group rules, the determination of taxable years of the group (and its members), and with respect to determining taxable years under section 381 (carryovers of attributes in certain corporate acquisitions). Treas. Reg. § 1.1502-75(d)(3)(v). This substance over form determination is limited solely to the issues set out under this provision of the regulations. The consolidated return regulations do not extend this substance over form treatment to other provisions of the Code. The consolidated return regulations are silent as to the determination of the credit under section 41. Thus, treatment of Corporation A as the “acquiring” entity for purposes of determining the research credit is neither required nor authorized by the consolidated return regulations (including the reverse acquisition rules).

Upon the merger of Corporation A into Corporation D, the shareholders of Corporation A received more than 50 percent of the fair market value of the outstanding stock of Corporation D. Under the consolidated return regulations in effect in Year, the Corporation A consolidated return group remained in existence after the merger and Corporation D (renamed Parent) became the common parent of the Corporation A consolidated return group.⁴ Treas. Reg. § 1.1502-75(d)(3)(i). Corporation D

³ The Taxpayer has advanced several arguments in support of its position. Some of these arguments are discussed herein.

⁴ The argument has been made that the provisions of Treas. Reg. § 1.1502-76(b) (and Example 2 thereunder) require that Corporation A be treated as the substantive common parent and that Corporation D be treated as the common parent in form only. As stated above, Corporation D becomes the common parent of the Corporation A group upon the merger of Corporation A into Corporation D. See Treas. Reg. § 1.1502-75(d)(3). Treas. Reg. § 1.1502-76(b) merely provides rules for

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Subsidiaries became members of the Corporation A consolidated return group at the end of the day on Date 3.

Because the Corporation A consolidated return group remained in existence after the merger of Corporation A with and into Corporation D, the Corporation A consolidated return group (that is, the Taxpayer consolidated group) has a full taxable year beginning on Date 1 and ending on Date 5. Treas. Reg. § 1.1502-75(d)(3)(i). Corporation A Subsidiaries have a full taxable year beginning on Date 1 and ending on Date 5. Treas. Reg. § 1.1502-75(d)(3)(v)(b). Corporation A has a short taxable year beginning on Date 1 and ending on Date 3 (when it merged out of existence). Corporation D and Corporation D Subsidiaries have two short taxable years, a short taxable year beginning on Date 1 and ending on Date 3 and a short taxable year beginning on Date 4 and ending on Date 5. Treas. Reg. § 1.1502-75(d)(3)(v)(a).

Taxpayer is a controlled group of corporations for purposes of section 41(f)(1) consisting at the end of its full taxable year on Date 5 of Parent (f/k/a Corporation D) as the common parent, Corporation D Subsidiaries, and Corporation A Subsidiaries. All members of the Taxpayer controlled group should be treated as a single taxpayer for purposes of computing the research credit under section 41(f)(1). When the Taxpayer controlled group computes its credit year QREs under the alternative incremental research credit rules of section 41(c)(4), it should aggregate each member's credit year QREs. Further, the Taxpayer controlled group should aggregate each member's average annual gross receipts for the four taxable years preceding the credit year. I.R.C. § 41(f)(1).

The Taxpayer controlled group should compute its aggregate research credit, including the following:

Corporation A

We have determined that the merger of Corporation A with and into Corporation D under section 368(a)(1)(A) constitutes the acquisition of a major portion of a trade or business by Corporation D for purposes of section 41(f)(3)(A). In other words, Corporation D "acquired" Corporation A for purposes of section 41(f)(3)(A). See Treas. Reg. § 1.52-2(b)(1)(i) and (ii) (providing that an acquisition must transfer a viable trade or business).

For its taxable year ended Date 5, Taxpayer should include in its aggregate computation 100 percent of the QREs paid or incurred by Corporation A for the period Date 1 through Date 3 (the period prior to the acquisition) and Corporation A's average

determining the items of income, gain, loss, deduction, and credit of the common parent and each member to be included in the consolidated return. These rules do not change the determination that Corporation D is the common parent for purposes of the consolidated return regulations.

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annual gross receipts for the four taxable years preceding the credit year.

Corporation D and Corporation D Subsidiaries

Taxpayer cannot include any of the QREs paid or incurred by Corporation D and Corporation D Subsidiaries for the short taxable year from Date 1 through Date 3. Rather, Taxpayer should include in its aggregate computation only the QREs paid or incurred by Corporation D and Corporation D Subsidiaries for the short taxable year from Date 4 through Date 5, and Corporation D and Corporation D Subsidiaries' average annual gross receipts for the four taxable years preceding the credit year, using the short taxable year rules of Treas. Reg. § 1.41-3(b). Because Corporation D's and Corporation D Subsidiaries' first taxable year preceding the credit year is a short taxable year beginning on Date 1 and ending on Date 3, Taxpayer should multiply each of Corporation D's and Corporation D Subsidiaries' gross receipts for that short taxable year by twelve and divide the result by the number of months in that short taxable year. See Treas. Reg. § 1.41-3(b)(2). Then, because the credit year beginning on Date 4 and ending on Date 5, is a short taxable year, Taxpayer should multiply each of Corporation D's and Corporation D Subsidiaries' average annual gross receipts for the four taxable years preceding the credit year by the number of months in the short taxable year and divide the result by twelve. See Treas. Reg. § 1.41-3(b)(1).

Corporation A Subsidiaries

Taxpayer should include in its aggregate computation all of the QREs paid or incurred by Corporation A Subsidiaries for the full taxable year from Date 1 through Date 5. Taxpayer should also include Corporation A Subsidiaries' average annual gross receipts for the four taxable years preceding the credit year.

CAVEAT

A copy of this technical advice memorandum is to be given to the taxpayer. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.