Intragroup Transactions Under the Proposed Research Credit Regs

By Keith Jordan and David Culp


Keith Jordan


David Culp

Keith Jordan is a senior manager in the income tax and accounting group and David Culp is a director in the passthroughs group of KPMG LLP's Washington National Tax practice.

Jordan and Culp examine proposed regulations on the computation of the research credit and identify some practical considerations for taxpayers. Controlled groups with foreign members should take heed because compliance may be burdensome and, perhaps more importantly, the regulations may reduce the amount of research credits available to them.

The information herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser. This article represents the views of the authors only and does not necessarily represent the views or professional advice of KPMG.

On December 12, 2013, the IRS issued proposed regulations regarding the computation of the research credit for a controlled group that includes one or more foreign corporations that derive foreign-source gross receipts. The proposed regulations address whether a controlled group can exclude from its credit calculation gross receipts resulting from an intragroup transaction that involves the same property or services that a foreign group member ultimately sells to a person outside the group. There are practical considerations taxpayers should take into account when assessing the effect that these regulations may have on their research credit calculation. In the authors' view, as a practical matter, taxpayers fitting the profile targeted by the regulations would be likely to face enormous complexities in computing their research credit.

A. Background

The research credit is a tax incentive that encourages taxpayers to perform qualified research and development activities within the United States. All members of a controlled group of taxpayers — corporations, partnerships, trusts, estates, and sole proprietorships — must together compute the credit as if they are a single taxpayer. That group credit is then allocated to each member of the controlled group based on each member's contribution of qualified research expenses (QREs).

There are two methods for calculating the research credit — the traditional method and the alternative simplified credit (ASC) method. Each method gives taxpayers a credit equal to a percentage (20 percent for the traditional method, 14 percent for the ASC method) of their QRE for a given tax year in excess of a calculated limitation referred to as the base amount.

Under the traditional method, the base amount is determined in part by reference to the gross receipts of the taxpayer in tax years before the year it is claiming the research credit (credit year). That includes gross receipts for the taxpayer's previous four tax years (current period) and the gross receipts of the taxpayer during a period referred to as the base period. The tax years in a taxpayer's base period may vary depending on the particular facts; however, that time frame is typically defined as the tax years beginning after December 31, 1983, and before January 1, 1989.[1] Because a taxpayer's activity in the base period is compared with its activity during the current period when determining its available research credit, taxpayers are required to calculate amounts, including gross receipts, determined for the base period in a manner consistent with their determination of those amounts for the current period.[2]

For example, assume a taxpayer acquires another entity in a particular tax year and includes QREs for

---

[1] Section 41(c)(3). Start-up companies will use a different base period that will look to years in the late 1990s at the earliest; the gross receipts of the company are still an important part of start-up companies' traditional credit computation.

[2] Reg. section 1.41-3(d).

that entity's operations in its current-year research credit calculation. Even though that entity was unaffiliated with the taxpayer before the credit year, the taxpayer generally would be required to include the gross receipts of the newly acquired entity in its gross receipts calculation for both the current period and the base period when determining its research credit. That is done to ensure an apples-to-apples comparison of the current period and the base period of the taxpayer, which now includes the newly acquired entity.[3]

To compute a taxpayer's gross receipts for its credit calculation under the traditional method, section 41(c)(7) only requires a foreign corporation to count gross receipts that are effectively connected with the conduct of a trade or business in the United States, the Commonwealth of Puerto Rico, or another U.S. possession. Also, because a controlled group of taxpayers is required to calculate the research credit as a single-taxpayer group, transactions between members of the controlled group are generally disregarded.[4]

In 2006 IRS examiners took the position (in non-precedential published guidance) that a U.S. taxpayer in a controlled group with a more-than-50-percent-owned controlled foreign corporation should include gross receipts for sales from the U.S. taxpayer to the CFC in calculating its research credit.[5] However, in 2010 a federal district court held that the IRS could not enforce that position and that the law allows a controlled group to exclude all intragroup gross receipts in computing its research credit.[6] After that court decision, the IRS generally stopped enforcing its 2006 position and began working with Treasury to develop regulations regarding the issue.

B. Proposed Regulations

The proposed regulations would require a controlled group to include the gross receipts from an intragroup sale of tangible or intangible property or services in its research credit calculation if the controlled group has a foreign corporation that sells the same, or a modified version of the same, property or services that it purchased from a U.S. member to a third party in a transaction that is not effectively connected with the conduct of a trade or business in the United States, Puerto Rico, or other U.S. possession (qualified transaction).[7]

For example, if a U.S. parent has gross receipts from selling goods to its foreign corporate subsidiary, and the subsidiary sells those goods to a third party in a qualified transaction, the U.S. parent must include the gross receipts from that sale in its research credit calculation.

The preamble to the proposed regulations explains that the IRS and Treasury believe that a complete exclusion of gross receipts in that situation distorts the base amount and therefore distorts the amount of credit that Congress intended to allow.

In addition, the proposed regulations provide that the sales from the intragroup transaction are counted in determining gross receipts in the tax year in which the foreign corporate member engages in the qualified transaction with the external party.[8]

For example, assume a U.S. member of a controlled group of taxpayers sells goods to a foreign corporate member of the controlled group in year 1. In year 2, that foreign member sells the goods it purchased from the U.S. member to a third party in a qualified transaction. To calculate the group's research credit, the U.S. member would include in its determination of gross receipts for year 2 the amounts received from the foreign corporate member in the year 1 transaction.

If there are multiple intragroup transactions for the same tangible or intangible property or service that is eventually sold outside the group in a qualified transaction, the proposed regulations only require the counting of gross receipts from the last intragroup transaction giving rise to gross receipts not excluded by section 41(c)(7). For convenience, we will refer to those gross receipts as includable gross receipts — that is, the gross receipts a standalone company would recognize in that transaction. The preamble states that in those situations, it would be inappropriate to overstate gross receipts and potentially reduce the research credit available to a controlled group by taking into account the transfer of a single piece of property more than once.[9]

The proposed regulations provide several examples that highlight the proper treatment of multiple intragroup transactions, including those between two foreign members of the group before

---

[3]The base amount for the ASC method is determined by analyzing a taxpayer's QRE in the three years before the credit year and does not include a taxpayer's gross receipts in the calculation.

[4]Reg. section 1.41-6(i).

[5]ILM 200620023.

[6]*Procter & Gamble Co. v. United States*, 733 F. Supp.2d 857 (S.D. Ohio 2010). *See also Hewlett-Packard Co. v. Commissioner*, 139 T.C. 255 (2012).

[7]Prop. reg. section 1.41-6(i)(2).

[8]Prop. reg. section 1.41-6(i)(2)(ii).

[9]In fact, depending on the circumstances, including gross receipts from multiple sales could increase the credit. In either case, counting multiple sales would be inconsistent with the single-taxpayer principle.

the sale outside the group. In one example, D, F1, and F2 are members of the same controlled group. D is a domestic corporation, and F1 and F2 are foreign corporations that do not conduct a trade or business within the United States, Puerto Rico, or any U.S. possession. In year 1, D sells Product A to F1 for $8. In year 2, F1 sells Product A to F2 for $9, and F2 sells Product A to an unrelated third-party customer for $10. Both D's sale to F1 and F1's sale to F2 are intragroup transactions involving Product A that precede F2's external transaction involving Product A. Further, the $10 that F2 receives from its sale of Product A outside the group is not effectively connected with a trade or business within the United States, Puerto Rico, or any other U.S. possession. Accordingly, under the general rule of these proposed regulations, the group should include gross receipts from one of the intragroup transactions in its research credit computation. F1's sale of Product A to F2 was the most recent intragroup transaction preceding the qualified transaction; however, it did not produce gross receipts that are effectively connected with the conduct of a trade or business within the United States, Puerto Rico, or any other U.S. possession. Therefore, the amounts from that sale are excluded under section 41(c)(7) and should not be taken into account in determining the group's research credit. Rather, D would include the $8 it received from its transaction with F1 in its gross receipts amount for year 2 (the year the external qualified transaction took place) because the transfer from D to F1 is the last intragroup transaction giving rise to includable gross receipts.[10]

The proposed regulations note that the statutory rules excluding gross receipts from foreign third-party sales apply only to a foreign corporation and not to a foreign partnership. For example, if there is a sale of goods by a U.S. parent to a foreign partnership, followed by a sale to a foreign corporate member and then a sale to an unrelated person in a qualified transaction, the foreign partnership is not allowed to exclude the gross receipts. The proposed regulations explain that in that situation, the controlled group needs to recognize the foreign partnership's gross receipts, because the sale to the foreign parent by the U.S. parent was the last intragroup transaction giving rise to includable gross receipts before the sale outside the group.[11]

Finally, the preamble to the proposed regulations states that a taxpayer needs to apply the new rules regarding intragroup gross receipts to all earlier years that are relevant in determining the taxpayer's base amount used to compute the research credit for the current year, and should disregard the law that was in effect for those years. That requirement is provided to maintain consistency when determining and comparing the activities conducted by the taxpayer in the current and base periods.

C. Taxpayer Considerations

The preamble states that outside of the adjustment for gross receipts for the intragroup transactions described above, the regulations would continue to respect the rule that transfers between members of a controlled group are disregarded when determining the research credit of the controlled group. However, the implementation of that particular exclusion from the general rule could prove problematic for many taxpayers when calculating the research credit. Some of the potential pitfalls are discussed below.

1. Administratively burdensome. The proposed regulations would require taxpayers in a controlled group that includes foreign members to track the sales cycle of all property or services sold by U.S. members of the group to foreign members of the group.[12] The sales cycle includes not only the initial sales from the U.S. member to the foreign member but also all subsequent sales of the property or services between members, as well as the final sale of the property or services to a third party outside the group. That tracking is required to confirm the sales amount of the last intragroup transaction that gives rise to includable gross receipts, as well as the timing of the inclusion of those gross receipts in the research credit calculation.

The effort required to trace the sales cycle of various products sold from the United States to foreign members and ultimately to the final third party may create undue stress in the credit calculation process. Compliance would require increased communication among all members of the controlled group and a level of insight into one another's sales activities that may not have existed. It may also require the development of additional tracking and reporting capabilities so that the specific product or services provided in the initial sale from the U.S. member can be tracked through to the final sale of the product or services outside the group. The

[10]Prop. reg. section 1.41-6(i)(2)(iv), Example 3.

[11]Prop. reg. section 1.41-6(i)(2)(iv), Example 4.

[12]While sales from U.S. members to foreign members will likely be the transactions most commonly affected by the proposed regulations, the coverage is not limited to sales from U.S.-based members (for example, sales from a foreign partnership within the controlled group to another foreign member would also need to be tracked).

process required to track those specific items may prove extremely complex or virtually impossible to implement.

For example, consider a foreign corporate member that purchases goods that it modifies and ultimately sells to non-U.S. third parties. If it purchases similar raw materials or products from multiple sources, including a U.S. member of its controlled group, as well as individuals outside of the group, the group will then be required to track the sales activity of the products purchased from the U.S. member to determine the appropriate timing and amount of gross receipts associated with that intragroup transaction that must now be included in its research credit calculation.

The complexities of tracking the specific product received from the U.S. member are further compounded for industries, such as chemical manufacturing, in which the raw products purchased from the various vendors are mixed together as part of the foreign member's production process before the foreign member sells the product outside the group or transfers it to another member of the group for further processing. In that situation, it may be infeasible to accurately determine the amount of U.S.-based product that is ultimately sold or transferred, or the timing of that sale or transfer.

Finally, even if taxpayers eventually identify or develop ways to track the sales activities, the data required to track and accurately report that activity for prior years may no longer be available, especially if taxpayers are trying to find base-period information dating back to the mid-1980s. That becomes even more burdensome for acquisitive taxpayers, considering that the consistency rules require the gross receipts of the acquired entity to be included in the taxpayer's credit calculation. Gaining access to historical records and data for acquired entities often proves to be a difficult task. That difficultly is amplified if the acquirer must also determine the specific foreign sales activity of the acquired entity and its previously related foreign members.[13]

Note that the proposed regulations would also apply when there is a sale of services to a third party following an intragroup transfer of those services. The complexities of tracking intragroup movements of goods would be compounded when dealing with sales of services.

That compliance burden would have no utility other than in determining the research credit.

2. Distortion of gross receipts. The traditional method for calculating the research credit requires a comparison of a taxpayer's current QREs and overall gross receipts with those of the taxpayer in the base period. Under that method, a taxpayer's ratio of R&D spending to its overall sales in the current period generally must exceed that of the base period for the taxpayer to receive a research credit. That comparison is designed to encourage increased growth in R&D activities and to reward taxpayers that show more dedication in their R&D efforts as their organization continues to grow. A consistent determination of a taxpayer's activities in the current period and base period is required to provide the most accurate comparison between the two periods. A shift or adjustment in the reporting of any of the amounts in the credit calculation (for example, a change in the timing or amount of gross receipts that are included) that is inconsistently reflected in the reporting for the other amounts could have a dramatic effect on a taxpayer's research credit calculation.

The requirement that gross receipts for specific intragroup transactions not be recognized in a group's credit calculation until the time of the sale outside the group could potentially distort gross receipts between years. Depending on the sales cycle of a particular product, the proposed rule could result in the gross receipts for a particular transaction not being included in the group's credit calculation until several years after the product is sold by the U.S. member. That may create abnormal results and an inconsistent matching of the taxpayer's R&D and sales activities.

For example, assume a U.S. member of a controlled group sells all of its products to a foreign corporate member in year 1. The U.S. member would not include any gross receipts for the transaction in the group's research credit calculation until the foreign corporate member sells those items to a third party in a qualified transaction — even if multiple years pass before the qualified transaction takes place. Further, consider the same example but in year 2, due to an adjustment in business operations, the U.S. member discontinues its sales of products to the foreign member and starts selling its products exclusively to U.S.-based third parties. If the foreign corporate member sells to a third party all of the products it purchased from the U.S. member in a qualified transaction in year 2, the U.S. member would be required to include all of its sales for both year 1 and year 2 as gross receipts in year 2. That shift in sales activities between years potentially creates an improper matching of the taxpayer's R&D and sales activities when determining its

[13]The single-taxpayer requirement for determining the research credit of a taxpayer that is a member of a controlled group means that the credit amount can be influenced by the gross receipts of group members that do not themselves have any qualified research expenses. Thus, the proposed regulation would impose its compliance requirements on entities that may have no interest in what the group credit amount is.

research credit and could result in unintended fluctuations in the taxpayer's research credit from year to year.

There is a risk of further distortion in the credit calculation if the taxpayer does not have the data available to accurately or consistently apply the requirements of the proposed regulations when determining its base-period gross receipts. As described above, under the traditional method, a taxpayer's current QRE-to-gross receipts ratio must exceed the base-period ratio for the taxpayer to be eligible for the research credit. Based on the mechanics of the calculation, an increase in the gross receipts for either period will result in a reduction to that period's QRE-to-gross receipts ratio. Therefore, an increase in current-period gross receipts without a commensurate increase in the gross receipts of the base period will likely result in a decrease to the taxpayer's research credit.

Unless taxpayers are granted some mechanism for relief when the taxpayer's data for the base period limits its ability to accurately calculate its gross receipts, the proposed regulations may generate significant increases to a taxpayer's current-period gross receipts, with a limited effect on its base-period gross receipts. That could inadvertently create an unwarranted reduction in many taxpayers' research credit amounts.

The preamble to the proposed regulations states that the IRS and Treasury recognize that accounting for intragroup transactions in prior years presents a unique burden to taxpayers. It also states that the proposed regulations are intended to capture some measure of intragroup gross receipts and are not intended to preclude research credit claims for taxpayers that do not have adequate information in their books and records for the base years. Therefore, the preamble requests comments from the public on the need for and formulation of a special rule or safe harbor to allow taxpayers to comply with the newly proposed intragroup gross receipts rules.

Although the IRS and Treasury have acknowledged the issues taxpayers might face when applying the proposed regulations to activities conducted in prior years, they have provided no resolution. Further, the request for comments or feedback from taxpayers suggests that the agencies do not have an adequate solution to the problem and have unduly placed the burden on taxpayers to develop a viable alternative that works for everyone. A safe harbor presumably would enable some taxpayers to only roughly comply with the requirement to restate intragroup gross receipts. It is difficult to see how rough justice is fair to taxpayers that have sufficient information to comply fully with the requirements and, as a result of the new regulations, would be allowed a smaller credit than under existing law. Rough justice also seems incompatible with the goal of the regulations to avoid distortion of the amount of the credit Congress presumably intended to allow.

3. Effect on calculation methods. Under the traditional method of calculating the research credit, a taxpayer's base amount may not be less than 50 percent of the taxpayer's current-year QRE. Therefore, a taxpayer is limited to a maximum of 50 percent of its current-year QREs in applying the 20 percent credit, regardless of how much the current-period R&D activity exceeds that of the base period. For example, if a taxpayer's current-year QREs were $100, the maximum research credit available to the taxpayer would be $10 ($100 x 50 percent x 20 percent = $10). That is commonly referred to as the 50 percent limitation. If a taxpayer uses the 50 percent limitation, the base period and gross receipts analysis has no direct effect on its final research credit calculation. However, the taxpayer is still obligated to support its calculations under exam (that is, taxpayers must determine the applicable base-period amounts and current-period gross receipts to validate that their credit should be calculated using the 50 percent limitation).

As described above, ensuring the accuracy of the determination of a taxpayer's gross receipts to be included in its research credit calculation will be extremely difficult under the proposed regulations. Therefore, taxpayers may have difficulty demonstrating that they qualify for the 50 percent limitation, even if they have successfully supported that position in the past.

As discussed above, taxpayers have an alternative to the traditional method for calculating their research credit: the ASC method. That method is based purely on a taxpayer's R&D expenditures and does not require a taxpayer to determine gross receipts in calculating the research credit. Because the traditional and ASC methods are so different, there is no reason to presume that the credit a taxpayer can claim under one is remotely similar to the credit that would be allowed under the other. The accounting complexity that the proposed regulations would impose may encourage — or force — some taxpayers to begin using the ASC method when determining their research credit, even if they would otherwise be content to compute it under the traditional method.[14]

---

[14]Even taxpayers that use the ASC method for their federal research credit may not escape the requirements of the regulations in computing any state research credits. California, for example, has a research credit that generally follows federal principles but does not allow the ASC method. Determining

(Footnote continued on next page.)

The mechanics of the ASC method generally require a taxpayer to maintain consistent levels of R&D spending or continue to increase its R&D spending year over year in order to generate a research credit. Given the economic growth in various industries over the past few years, that dedication to R&D has been achievable for many taxpayers. A taxpayer that is unable to consistently maintain the required levels of R&D spending necessary to produce a research credit under the ASC method might still be able to take a credit under the traditional method. In the event a taxpayer must switch from the ASC to the traditional method, it will be required to confront the calculation complexities presented by the proposed regulations or risk losing the research credit incentive altogether.

D. Conclusion

The proposed regulations would expand the definition of gross receipts to include some sales from intragroup transactions when those same or modified goods (tangible or intangible) or services are sold to a third party in a transaction that is not effectively connected with the conduct of a trade or business in the United States, Puerto Rico, or other U.S. possession. The regulations would be a departure from the position — generally taken by most taxpayers and accepted by the IRS — that typically excludes gross receipts from all intragroup transactions. The single-taxpayer principle used to determine controlled group gross receipts — and the section 41(c)(7) rule — has been in effect since 1989 and has been respected by the courts. The adjustment in the credit calculation that would be required — because of the IRS's perception that the current accepted practice works a distortion of the research credit — may have a drastic effect on credit amounts received by taxpayers calculating their research credits under the traditional method. Also, the implementation of the proposed regulations will create considerable challenges for taxpayers in determining future research credit amounts. Some observers question not only the wisdom of imposing the changes, but also the authority of the IRS and Treasury to implement them without a more specific signal from Congress that the existing rules are deficient.

The proposed regulations would be effective for computing the research credit in tax years beginning on or after the date the final regulations are published. Therefore, for calendar-year taxpayers, the regs would be applicable no earlier than calendar year 2015. The IRS and Treasury requested comments on all aspects of the proposed regulations, and consideration will be given to all timely submitted comments before the regs are adopted as final. A public hearing on the proposed regulations is scheduled for April 23.

gross receipts is an important part of the California credit; a taxpayer might need to apply the rules about intragroup transactions in compliance with the California rules if the proposed regulations are adopted. Other states have their own credit rules, many of which also follow federal principles.