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Treatment of Intra-Group Transactions under the Proposed Research Credit Regulations

Recently proposed regulations address how the research credit calculation takes into account transactions between members of a controlled group that involve property or services, which a foreign corporation group member ultimately sells outside the group. This article reviews the proposed regulations and highlights the complexities involved with implementing the regulations.

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On December 12, 2013, the IRS filed proposed regulations dealing with the computation of the research credit for a controlled group that includes one or more foreign corporations that derive foreign-source gross receipts. Specifically, these proposed regulations address whether a controlled group can exclude from its credit calculation gross receipts resulting from an intra-group transaction that involves the same property or services that a foreign corporation group member ultimately sells to a person outside the group.

The following article provides an in-depth discussion of these proposed regulations and some practical considerations for taxpayers to take into account when assessing the effect these regulations may have on their current research credit calculation. It is the authors' view that, as a practical matter, taxpayers fitting the target profile of these regulations would be likely to face enormous complexities in computing their research credit.

Background

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

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Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended (the "Code") or the applicable regulations promulgated pursuant to the Code (the "regulations").

There are currently two methodologies for taxpayers to use in calculating the research credit, the "traditional methodology" and the Alternative Simplified Credit ("ASC") methodology. Each method provides taxpayers with a credit equal to a certain percentage (20 percent for the traditional method, 14 percent for the ASC) 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 prior to the year it is claiming the research credit ("credit year"). This includes gross receipts for the taxpayer's previous four tax years ("current period") as well as the gross receipts of the taxpayer during a period referred to as the "base period." The tax years included in a taxpayer's base period may vary depending on its particular facts; however, this timeframe is typically defined as the tax years beginning after December 31, 1983, and before January 1, 1989.[1] Since a taxpayer's activity in the base period is used as a comparison to its current activity in determining a taxpayer's available research credit, taxpayers are required to determine amounts, including gross receipts, included for the base period in a manner consistent with their determination of those amounts for the current years.[2]

For example, assume a taxpayer acquires another entity in a particular tax year and includes QRE related to that entity's operations in the taxpayer's current year research credit calculation. Even though the acquired entity was not affiliated with the taxpayer prior to the credit year, the taxpayer would generally be required to include the gross receipts of the newly acquired entity in its gross receipts calculation for the current period as well as the base period when determining its research credit. This is done to ensure an apples-to-apples comparison is made between the current period and the base period of the taxpayer, which now includes the newly acquired entity.[3]

To calculate a taxpayer's gross receipts to be included in its credit calculation under the traditional methodology, section 41(c)(7) requires a foreign corporation, in computing its research credit, to count only gross

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

2 Section 1.41-3(d).

3 The base amount for the ASC methodology is determined by analyzing a taxpayer's QRE spend in the three years prior to the credit year and does not consider a taxpayer's gross receipts in the calculation.

receipts that are effectively connected with the conduct of a trade or business in the United States, the Commonwealth of Puerto Rico, or other U.S. possessions (the "United States or its possessions"). In addition, because a controlled group of taxpayers is required to calculate the research credit as a single-taxpayer group, the regulations generally disregard transactions between members of the controlled group.[4]

In 2006, IRS examiners took the position in non-precedential published guidance that a U.S. taxpayer that is in a controlled group with a more-than-50 percent-owned controlled foreign corporation ("CFC") should include gross receipts related to 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 this position, and that the law allows a controlled group to exclude all intra-group gross receipts in computing its research credit.[6] After this 2010 decision, the IRS generally stopped enforcing the 2006 position taken by IRS Examination and turned to work with Treasury on developing regulations to address the issue.

Proposed Regulations

The December 2013 proposed regulations would require a controlled group to include the gross receipts from an intra-group 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 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 or its possessions ("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 its sale to the foreign subsidiary 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 this

4 Section 1.41-6(i).
5 C.C.A. 200620023 (Feb. 14, 2006).
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 Proposed section 1.41-6(i)(2).

situation distorts the base amount, and thus distorts the amount of credit that Congress intended to be allowed.

In addition, the proposed regulations provide that the sales from the intra-group 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. For purposes of calculating 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 multiple intra-group transactions occur relating to the same tangible or intangible property or service that is eventually sold outside the group in a qualified transaction, the proposed regulations would require only the gross receipts from the last intra-group transaction giving rise to gross receipts that would not be excluded by section 41(c)(7) to be counted in the controlled group's research credit calculation. For convenience, we will refer to these as "includible" gross receipts, i.e., the gross receipts a stand-alone company would recognize in that transaction. The preamble states that, in these situations, it would not be appropriate 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 one time.[9]

The proposed regulations provide several examples to highlight the proper treatment in situations in which multiple intra-group transactions occur, including transactions between two foreign members of the group, prior to the sale outside the group. In one such 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 or its possessions. 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

8 Proposed 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, however, counting multiple sales would be inconsistent with the single taxpayer principle.

to an unrelated third-party customer for $10. Both D's sale to F1 and F1's sale to F2 are intra-group 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 or its possessions. Accordingly, the group should include gross receipts from one of the intra-group transactions in its research credit computation. F1's sale of Product A to F2 was the most recent intra-group 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 or its possessions. Thus, amounts arising from that sale are excluded under section 41(c)(7), and should not be taken into account in determining the group's research credit. Therefore, 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 intra-group transaction giving rise to includible 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 gross receipts of 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 to an unrelated person in a qualified transaction, the foreign partnership would not be entitled to exclude the gross receipts. The proposed regulations, in this situation, explain that the controlled group needs to recognize the foreign partnership's gross receipts, as it was the last intra-group transaction giving rise to includible gross receipts prior to the sale outside the group.[11]

Finally, the preamble to the proposed regulations states that a taxpayer needs to apply the new rules regarding intra-group gross receipts to all earlier years that are relevant to determining a taxpayer's base amount used to compute the research credit for the current year without regard to the law that was in effect for those prior years. This requirement ensures that consistency is maintained when determining and comparing the activities conducted by the taxpayer in the current and base periods.

[10] Proposed section 1.41-6(i)(2)(iv), Example 3.
[11] Proposed section 1.41-6(i)(2)(iv), Example 4.

Taxpayer Considerations

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

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] This includes not only the initial sales transaction 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 that property or services to a third party outside the group. This tracking is required to confirm the sales amount of the last intra-group transaction that gives rise to includible gross receipts, as well as the timing of when those gross receipts should be included in the research credit calculation.

The effort required to trace the sales cycle of various products sold from the U.S. to foreign members and ultimately to the final third party may create undue stress on the credit calculation process. Compliance would require increased communication between all members of the controlled group and a level of insight into each other's sales activities that may not have existed before. This 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 that product or service outside the group. The process involved to track these 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 other non-U.S. third parties. If it

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

purchases similar raw materials or products from multiple sources, including a U.S. member of its controlled group and individuals outside the group, the group would now be required to track the sales activity of the products specifically purchased from the U.S. member to determine the appropriate timing and amount of gross receipts associated with that intra-group 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 prior to selling the product outside the group or transferring it to another member of the group for further processing. In this situation, it may not be feasible to accurately determine the timing and amount of U.S.-based product that is ultimately sold or transferred.

Finally, even if taxpayers identify or develop ways to track these sales activities going forward, the data required to track and accurately report this activity for prior years may no longer be available, especially if the taxpayers are trying to identify base period information dating back to the mid-1980s. This becomes even more burdensome for acquisitive taxpayers, when 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. This 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 apply also when there is a sale of services to a third party following an intra-group transfer of such services. The complexities of tracking intra-group movements of goods would be compounded when dealing with sales of services.

This compliance burden would have no utility other than for purposes of determining the research credit.

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[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 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.

Distortion of Gross Receipts

The traditional method for calculating the research credit requires a comparison of a taxpayer's current R&D spend (QRE) and overall gross receipts to the taxpayer's level of QREs and overall gross receipts in the base period. Under this methodology, a taxpayer's ratio of R&D spend related to its overall sales in the current period generally must exceed that of the base period in order for the taxpayer to receive a research credit. This comparison is designed to encourage increased growth in R&D activities and to reward taxpayers that show increased levels of dedication in their R&D efforts as their organizations continue to grow. The consistent determination of a taxpayer's activities in the current period and base period is required in order to provide the most accurate comparison between the two periods. A shift or adjustment in the reporting of any of the amounts included in the credit calculation, for example a change in the timing or amount of gross receipts that are included, that is not consistently reflected in the reporting for the other amounts, could have a dramatic effect on a taxpayer's research credit calculation.

The rule that the gross receipts related to the specific intra-group transactions identified in these proposed regulations would not be recognized in the 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 the group's credit calculation until several years after the product is sold by the U.S. member. This may create abnormal results and an inconsistent matching of the taxpayer's actual R&D and sales activities.

For example, assume a U.S. member of a controlled group exclusively sells its products to a foreign corporate member in Year 1. This U.S. member would not include any gross receipts related to this transaction in the group's research credit calculation until the time in which the foreign corporate member sells those items to a third party in a qualified transaction. This is the case, 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 all the products it purchased from the U.S. member to a third party in a qualified transaction in Year 2, the U.S. member would be required to include all its sales for both Years 1 and 2 as gross receipts in Year 2. This shift in sales activities between years potentially creates an improper matching of the taxpayer's actual R&D and sales activities for purposes of the determining its research credit and could result in unintended fluctuations in the taxpayer's research credit year after year.

In addition, there is 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 these 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 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 result in a reduction to the taxpayer's current period QRE-to-gross receipts ratio without a comparable reduction to its base period ratio. Without an offsetting reduction to the base period ratio, this reduction in the current period ratio will likely result in a decrease to the taxpayer's research credit.

Unless taxpayers are granted some mechanism for relief in situations in which the taxpayer's data for the base period limits its ability to accurately reflect the impact that this proposed change would have on its base period calculations, these proposed regulations may generate significant increases to a taxpayer's current period gross receipts with a limited effect on its base period gross receipts. This 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 intra-group transactions in prior years presents a unique burden to taxpayers. The IRS and Treasury also state that the proposed regulations are intended to capture some measure of intra-group 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. Thus, the preamble encourages and 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 intra-group gross receipts rules.

Although the IRS and Treasury have acknowledged the issue taxpayers might face when applying these 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 government currently does not have an adequate solution for resolving this issue. It also unduly places the burden on taxpayers to develop a viable alternative that works for everyone. A safe harbor presumably would enable some taxpayers to comply with only rough precision to the requirement to restate intra-group 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 would be allowed a smaller credit than under current law. Rough justice also seems incompatible with the goal of these regulations to avoid distortion of the amount of credit determined under the rules Congress presumably intended to apply.

Effect on Calculation Methodologies

Under the traditional method, a taxpayer's base amount (credit limitation 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 QRE for purposes of 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 tax credit available to the taxpayer would be $10 ($100 x 50% x 20% = $10). This 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 their final research credit calculation. However, the taxpayer is still obligated to support its calculations under exam (i.e., taxpayers must determine the applicable base period amounts and current period gross receipts to validate that their credit should be calculated using this 50 percent limitation).

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

Taxpayers have an alternative to the traditional method for calculating their research credit, the ASC methodology. This methodology is based purely on a taxpayer's R&D expenditures and does not require a taxpayer to determine gross receipts for purposes of calculating the research credit. Because the traditional and ASC methodologies are so different, there is no reason to presume that the credit a taxpayer can claim under one is remotely similar to the amount of 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 methodology for purposes of determining their research credit, even if they would otherwise be content to compute their research credit under the traditional method.[14]

The mechanics of the ASC methodology generally require a taxpayer to maintain consistent levels of R&D spend or continue to increase its R&D spend year over year in order to generate a research credit. Given the economic growth in various industries over the past few years, this dedication to R&D has been achievable for many taxpayers. A taxpayer that is unable to consistently maintain the required levels of R&D spend necessary to produce a research credit under the ASC methodology 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 these proposed regulations or risk losing the research credit incentive altogether.

Conclusion

The proposed regulations would expand the definition of gross receipts to include certain sales from intra-group 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 or its possessions. These regulations would be a departure from the position generally taken by most taxpayers and currently accepted by the IRS, which typically excludes gross receipts from all intra-group transactions. The single-taxpayer principle used to determine controlled group gross receipts—and the section 41(c)(7) rule—have been in effect since 1989 and have been

[14] However, even taxpayers that use the ASC for their federal research credit may not escape the requirements of these 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 methodology. Determining gross receipts is an important part of the California credit; a taxpayer might need to apply the rules about intra-group transactions on a California basis if the regulations are adopted. Other states have their own credit rules, many of which also follow federal principles.

respected by the courts. The adjustment in the credit calculation that would be required by the IRS's perception that the current, accepted practice works a distortion of the research credit may have a drastic impact on credit amounts received by taxpayers currently calculating their research credits under the traditional methodology. In addition, the implementation of these proposed regulations would impose considerable challenges to taxpayers when determining future research credit amounts. Some observers question not only the wisdom of imposing these changes, but also the authority of the IRS and Treasury to implement them without a more specific signal from Congress that the current rules are somehow deficient.

These regulations are proposed to be effective for purposes of computing the research credit for tax years beginning on or after the date the final regulations are published. Thus for calendar year taxpayers, these regulations would be applicable no earlier than calendar year 2015. The IRS and Treasury have requested comments on all aspects of these proposed regulations. Consideration will be given to all comments that are timely submitted before these proposed regulations are adopted as final regulations. Comments on the proposed regulations must be received by March 13, 2014. In addition, a public hearing on the proposed regulations is scheduled for April 23, 2014.

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