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**R & D**

Across all industries, U.S. controlled group members often exchange employees' time and expertise with other controlled group members (both domestic and foreign). Unique transactions may take place among these entities, specifically with respect to the performance of and payment for research activities. This article considers some challenging questions these transactions may pose, with a focus on which member of the controlled group is permitted to claim amounts as qualifying research expenses (QREs) for the research credit.

## Whose Qualifying Research Expense Is It, Anyway?

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**I**n general, all members of a group under common control are treated as a single taxpayer for purposes of computing the research credit<sup>1</sup>; the members of a controlled group must compute a credit as if the mem-

bers were a single taxpayer and then allocate the credit among the members.

Because of the single taxpayer rule, transfers between members of the group are "generally disregarded," as stated in Regulations Section 1.41-6(i)(1).

Despite these general principles, it is still important to determine the qualifying research expenses (QREs) of each member. The allocation of the group credit among the members is based on their proportionate share of the QREs of the group.<sup>2</sup>

With the single taxpayer rule, the question becomes: Who is entitled to the QREs if one member of a controlled group is performing research on behalf of another member of the group? Would QREs be considered wages or contract research expenses?

Reg. Section 1.41-6(i)(2) addresses these questions and states that:

<sup>2</sup> See Section 41(f)(1). The provisions of this section have been modified under the provisions of the American Taxpayer Relief Act of 2012 (ATRA) (Pub. L. No. 112-240), which is effective for tax years beginning after Dec. 31, 2011. The modification is such that the group credit allocation must be made strictly in proportion to the QREs of each member for the credit year. Prior to enactment of ATRA, a complex group credit allocation was required in which the group credit was compared to the sum of stand-alone credits, and the allocation of any excess group credit was determined in accordance with each member's proportionate share of QREs. See Notice 2013-20 for IRS guidance in regard to the allocation modifications made under ATRA.

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[I]f one member of a group performs qualified research on behalf of another member, the member performing the research shall include in its QREs any in-house research expenses for that work [i.e., wage payments and direct supply costs] and shall not treat any amount received or accrued as funding the research.<sup>3</sup> Conversely, the member for whom the research is performed shall not treat any part of any amount paid or incurred as a contract research expense.

Thus, the member whose employee performs the research can claim the QRE, and the member on whose behalf the research is being performed cannot treat the expense as a contract research expense.

Treatment as a “contract research expense” is important because, generally, only 65 percent of a contract research expense is a QRE. Reg. Section 1.41-2(e) defines contract research expenses as “expenses paid or incurred in carrying on a trade or business to any person other than an employee of the taxpayer for the performance on behalf of the taxpayer.” If contract research expenses are incurred by a member of the controlled group contracting with an entity outside the controlled group in carrying on the member’s trade or business, the expenses would be subject to the 65 percent limit.

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Intragroup contract research expenses, meanwhile, are addressed by Reg. Section 1.41-6(i)(3). Because of the rules in Reg. Section 1.41-6(i)(2), a payment from one member of a group to another wouldn’t be subject to the 65 percent limit. This treatment of intragroup contract research applies even if the member receiving the payments and conducting the research isn’t in a trade or business, or is in a trade or business different from the paying member’s trade or business. The regulations state that when the intragroup rule applies, “the member performing the research shall be treated as carrying on any trade or business carried on by the member on whose behalf the research is performed.” Thus, these intragroup expenses cannot be contract research expenses.

Determining on which entity’s behalf the research is being performed requires reference to Reg. Section 1.41-2(e)(3), which sets forth the rule that the entity on whose behalf research is performed is the entity that retains substantial rights to the research. Though Reg.

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<sup>3</sup> Funding comes into play if the entity making wage payments to the worker is reimbursed for those costs by the entity on whose behalf the research is performed. Generally, funded research isn’t qualified research. Section 41(d)(4)(H). When the payments are made within the group, however, this clause of the regulation makes clear that such reimbursements aren’t to be taken into account due to the single taxpayer rule, so the analysis of which entity can claim the QREs isn’t affected by the existence of an intragroup reimbursement.

Section 1.41-6(i)(2) specifically states that the QREs wouldn’t be treated as contract research QREs, in evaluating the “on behalf of” criteria, it is relevant to review any agreement that may exist between the two controlled group members to determine which member retains substantial rights in the research and thus which member the research is being performed “on behalf of.”

Such a review should look not only at formal written agreements pertaining to specific projects but also to any corporate documents pertaining to delegation of authority and agency within the group. A review of less formal arrangements, even if not in writing, may also be beneficial.

Applying the regulations discussed above, if a controlled group has two members in the U.S. and Member 1 performs qualified research on behalf of Member 2, then Member 1 would clearly be entitled to claim that qualified research as wage QREs. However, if a controlled group has one member in the U.S. and a foreign parent, there may be other factors to take into consideration, as illustrated by the following three examples.

### Example 1

A foreign parent company funds the qualifying research activities of its U.S. subsidiary. The arrangement provides for the U.S. subsidiary to receive reimbursement from its foreign parent company for its qualifying research activities.

In this fact pattern, the research activity (which is otherwise qualifying) occurs within the U.S., and the wages of the employees are paid or incurred by the U.S. subsidiary. Therefore, the U.S. subsidiary would be entitled to the amounts incurred in conducting the research, and the amount received from the foreign parent would be disregarded as transfers between members of the group under Reg. Section 1.41-6(i)(2).

The result would be the same regardless of whether the U.S. subsidiary retains any rights to the research it conducts.

### Example 2

A U.S. subsidiary has a foreign parent. The foreign parent sends certain employees from its location overseas to work in the U.S., performing qualifying research activity at the U.S. subsidiary’s facilities in support of the U.S. subsidiary’s projects. The employees are paid directly by the U.S. subsidiary and are considered U.S. employees. As U.S. employees, the workers would receive a Form W-2 reporting their wages.

In this fact pattern, the research being performed would be on behalf of the U.S. subsidiary. The U.S. subsidiary would be entitled to claim amounts paid to the employees as wage QREs.

### Example 3

Assume the same facts as Example 2, except that instead of the employees from the foreign parent becoming U.S. employees, the foreign parent pays the employees directly and invoices the U.S. subsidiary to recoup the cost. The U.S. subsidiary reimburses the foreign parent for the temporary work assistance.

The qualifying research is being performed in the U.S. on behalf of the U.S. entity; however, it is being performed by the foreign parent and paid for by the foreign parent. Intragroup transactions, including the reimbursement by the U.S. subsidiary for the foreign parent's expenses, are disregarded under Section 41. Therefore, any such QREs would be QREs of the foreign parent.

The QREs of the foreign parent are taken into account in the computation of the group credit, and a portion would be allocated to the foreign parent. However, if the foreign parent isn't a U.S. taxpayer, its allocated credit would provide no U.S. income tax benefit.

### What About the 'Single Taxpayer' Concept?

Under Section 41(f)(1) and, as previously mentioned, under Reg. Section 1.41-6(b)(1), all members of a controlled group, which includes a "group under common control," are treated as a single taxpayer. The term "controlled group" for research tax credit purposes is defined under Section 41(f)(5)—it applies the same meaning given to controlled group by Section 1563(a), although the Section 41(f)(5) definition substitutes the Section 1563(a)(1) ownership threshold of "80 percent or more" with a "more than 50 percent" threshold.<sup>4</sup> Section 1563(a) defines a controlled group as any group that is: (1) a parent-subsidiary controlled group; (2) a brother-sister controlled group; or (3) a combination of (1) and (2).<sup>5</sup>

A foreign corporation can be in a controlled group with a U.S. entity. Section 1563(b) discusses "component members" of a controlled group, and, among other things, provides that a foreign corporation would be excluded from being a component member, but conditions the exclusion on the foreign corporation being a member of the controlled group in the first place. In any case, Section 1563(b) is disregarded in "determining whether a corporation is included in a controlled group of corporations," according to Reg. Section 1.1563-1(a)(1)(ii).<sup>6</sup>

Further, Technical Advice Memorandum 8643006 discusses this discrepancy, concluding that a corporation can be a member of a controlled group of corporations and yet be an excluded member if it comes within the purview of Section 1563(b)(2). Nonetheless, such a corporation is still a member of a "controlled group of corporations" within the meaning of Section 1563(a) for purposes of Section 41(f)(5).

Additionally, Private Letter Ruling 8914026 also supports the same conclusion: For purposes of Section 41(f)(5), a corporation can be considered an excluded member of a controlled group under Section 1563(b) and still be a member of a controlled group of corporations within the meaning of Section 1563(a) (as well as a member of a controlled group of corporations for research credit purposes).

<sup>4</sup> Under Section 41(f)(5), Sections 1563(a)(4) and (e)(3)(c) are specifically excluded from the definition of controlled group members for research tax credit purposes.

<sup>5</sup> Section 41(f)(1)(B) and Reg. Section 1.52-1(b) set similar standards for entities that aren't corporations, i.e., partnerships, trusts, estates and sole proprietorships.

<sup>6</sup> T.D. 9522, 76 FR 19907 (April 11, 2011). An example in the regulation makes it clear that even though a corporation is an "excluded member," it is still a member of the controlled group under Section 1563(a).

### What Expenses Would Be Claimed as QREs?

Section 41(b)(2)(D) defines the "wage amount paid in calculating wage QRE" as wages defined under Section 3401(a). In short, such wages would be all remuneration for services performed by an employee for an employer that are subject to withholding. Accordingly, this amount is generally an employee's federal W-2, box 1, wage amount.

### Is All Hope Lost if the Research Activity Is Sourced to the Foreign Member?

If, after applying the applicable regulations to the specific fact pattern of the controlled group, it is then determined that the QREs would be sourced to the foreign member and therefore unable to be claimed for U.S. federal research tax credit purposes, there may still be a benefit for the group as a whole if the QREs can be claimed under a research tax credit regime in the country of the foreign parent.

Though the basic definition of research and development is similar in most countries, there are variations in country-specific taxation legislation and incentive regimes. Unlike the U.S., some countries allow a taxpayer to claim expenses incurred for research activities conducted overseas. Some foreign parents that send employees to the U.S. to perform research activities on behalf of U.S. subsidiaries may be able to claim the expenses incurred for those activities for tax credits in their home countries.

### Why Are the Controlled Group And Credit Allocation Rules So Complex?

The controlled group member determination for research tax credit purposes is just one of the complexities resulting from the antiquated research credit law. In 1981, when the credit was enacted, the single taxpayer concept was included in Section 41(f) to prevent any taxpayer claiming more than the appropriate share of credit. Thus, the definition of "single taxpayer" necessitated defining a controlled group.

As was the practice for many other areas of the code, the controlled group rules of Section 1563 were viewed (with modification to the ownership percentage) as the common ground on which to determine controlled group members for research tax credit purposes. However, in practice, because controlled groups often consist of one or more consolidated groups and involve partnerships, foreign members, acquisitions, dispositions and other complicating structures and transactions, the complexities of defining a controlled group for research credit purposes quickly spiraled upward.

Adding to this, the Internal Revenue Service Office of Chief Counsel issued conflicting informal advice with regard to intercompany sales and the inclusion<sup>7</sup> and exclusion<sup>8</sup> of amounts in the gross receipts calculation under the traditional method.

Further, the regulations in effect since 2006 required a controlled group to allocate the group credit in a burdensome two-step procedure necessitating computing

<sup>7</sup> CCA 200620023.

<sup>8</sup> CCA 200233011.

the credit under both the traditional and alternative simplified credit method for each member of the controlled group (and on a group-level basis). When this procedure was first proposed by the IRS, KPMG tax professionals spoke at an IRS-Treasury hearing in opposition to the two-step allocation method, and sup-

ported a simpler method, similar to what has now become the rule in tax years beginning after 2011.<sup>9</sup>

It appears that there has been movement toward simplifying the credit allocation process; however, a lot remains to be seen in regard to other updates to the credit law—the advent of cloud computing, permanent in-statement of the credit, abolishment of the traditional method and increase in credit percentage, among other things.

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<sup>9</sup> See Notice 2013-20 for a description of new allocation method.