Office of Chief Counsel
Internal Revenue Service

memorandum

CC:NER:PEN:PHI:TL-N-4551-00
RHGannon

date:

to: Internal Revenue Service
610 South Henderson Road,
King of Prussia, PA 19406

Attention: Walt Kirwan, Manager, Group 1677

from: District Counsel, Pennsylvania
Richard H. Gannon, Special Litigation Assistant

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ubject: [redacted]
Computation of Research Credit
Inclusion of Foreign Parent in Controlled Group

THIS DOCUMENT INCLUDES STATEMENTS SUBJECT TO THE ATTORNEY-CLIENT PRIVILEGE AND THE ATTORNEY WORK PRODUCT PRIVILEGE. THIS DOCUMENT SHOULD NOT BE DISCLOSED TO ANY ONE OUTSIDE IRS, INCLUDING THE TAXPAYER INVOLVED. LIMIT USE OF THIS DOCUMENT TO THOSE WITHIN THE SERVICE WORKING ON THIS CASE. THIS DOCUMENT CONTAINS "RETURN INFORMATION" AS THAT TERM IS DEFINED BY I.R.C. § 6103(b)(2) AND THE DISCLOSURE THEREOF IS PROHIBITED EXCEPT AS AUTHORIZED BY THE INTERNAL REVENUE CODE OF 1986.

In your memorandum of July 31, 2000, you requested assistance regarding the continuing viability of PLR 8643006. For the reasons set forth below, we believe that the cited ruling is technically correct. As also indicated, we believe that the facts, as represented to us, suggest some further lines of inquiry might be appropriate in this case.

FACTS:

[redacted] or the "taxpayer") is a wholly owned subsidiary of [redacted], a German corporation. Both [redacted] and [redacted] are engaged in the business of marketing and selling [redacted] in various parts of the world. In [redacted], [redacted] and [redacted] entered into a Research and Development Services Agreement (the "Agreement") whereby [redacted] agreed to provide services in connection with the design and development of [redacted] and the modification of existing [redacted] including the testing

thereof, together with other, related services, as requested by [redacted]. In return, [redacted] agreed to pay [redacted], on a monthly basis, the costs incurred by [redacted] in connection with any such work plus a [redacted]% margin. [redacted] was to retain all property rights arising from [redacted]'s performance under the Agreement. According to the file, [redacted] then licenses the rights so created from [redacted], on a nonexclusive basis, for use in its territory and pays a [redacted]% royalty for the privilege.

[redacted] claims the reimbursed costs in the calculation of the research credit provided by I.R.C. § 41, citing PLR 8643006 as authority for the proposition that [redacted] is an included member of [redacted]'s controlled group and, as such, the reimbursed costs incurred by [redacted] under the Agreement should be taken into account in calculating the § 41 credit to which [redacted] is entitled. As noted above, we agree.[1]

DISCUSSION AND LEGAL ANALYSIS:

I.R.C. § 41 provides for a credit of 20% of the excess of a taxpayer's qualified research expenses over its base amount. Its "base amount," defined in I.R.C. § 41(c), is the product of its "fixed base percentage" over its average annual gross receipts for the 4 taxable years preceding the year for which the credit is being claimed. In turn, the "fixed base percentage" is defined, in § 41(c)(3), as the ratio of its aggregate research expenditures for years beginning after 1983 and before 1989 over its aggregate gross receipts for the same period. If the taxpayer's first year for which it had both qualified research expenditures and gross receipts begins after 1983, and if the same taxpayer has less than 3 such years beginning after 1983 and before 1989, the taxpayer's fixed-base percentage is calculated by using the lengthy formula set forth in I.R.C. § 41(c)(3)(B) or the alternative formula described in I.R.C. § 41(c)(4).

The provision at issue here is I.R.C. § 41(f)(1), which requires that all members of a controlled group of corporations be treated as a single member, and in particular, § 41(f)(5), which provides that:

> The term "controlled group of corporations has the same meaning given to that term by section 1563(a)

with certain exceptions not relevant here. In turn, I.R.C. § 1563(a) provides that, "[f]or purposes of this part," a

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[1] In doing so, we express no opinion as to whether the research performed constitutes "qualified research" within the meaning of I.R.C. § 41(d).

"controlled group of corporations" includes a parent-subsidiary controlled group of the type present here. I.R.C. § 1563(b)(2)(C) excludes foreign corporations subject to tax under I.R.C. § 881 from the definition of a "component member of a controlled group." According to your memorandum, [redacted] is subject to tax under I.R.C. § 881, presumably because it derives income from U.S. sources which is not connected with a U.S. trade or business.[2]

PLR 8643006, dated July 23, 1986, dealt an analogous set of facts under former I.R.C. § 44F, now I.R.C. § 41. Under the ruling, the taxpayer in question sought to include research expenditures that had been reimbursed by a wholly-owned subsidiary of its foreign parent. According to the ruling, members of the same controlled group, as defined in I.R.C. § 1563(a), are to be treated as a single taxpayer. The ruling also emphasizes that I.R.C. § 1563(b)(2)(C), which excludes "foreign corporations which are subject to tax under section 881 from being a COMPONENT member of a controlled group of corporations" is not incorporated in the definition of "controlled group" set forth in I.R.C. § 1563(a).

We believe that PLR 8643006 accurately construes the provisions of I.R.C. §§ 1561 and 1563 cited above. § 1561 treats all "component members" of a "controlled group of corporations" as a single taxpayer for the purpose of applying the tax brackets and rates provided by I.R.C. § 11(b)(1). In turn, § 1563(a) defines "controlled group of corporations" while § 1563(b) defines "component member." The "excluded members" described in § 1563(b)(2) are excluded from the definition of "component member," but still remain members of a "controlled group" if they otherwise qualify as such.

In the context of the research credit provided by I.R.C. § 41, the inclusion of a foreign affiliate subject to tax under I.R.C. § 881 as a member of a controlled group is arguably incorrect as a matter of fiscal policy where, both as here and in PLR 8643006, it permits a foreign affiliate to pay for research conducted in the U.S. by a domestic affiliate while reaping the benefit of that research through the transfer of any intangible property created by the research abroad. This is especially egregious where, as here, the foreign affiliate is then permitted to charge the domestic affiliate conducting the research an apparently inflated royalty for the use of the intangible.

We believe it is important to segregate the allowance of the research credit for reimbursed costs from the possible payment of

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[2] "[R]oyalties for the use of patents, copyrights, secret processes and formulas, and other like property" are subject to tax under I.R.C. § 881(a). Treas. Reg. § 1.881-2(b).

an inflated royalty in this case. As noted above, PLR 8643006 appears to be correct as far as it goes, but nothing in the ruling or the Code itself justifies the charging of an inflated royalty. In fact, the provisions of I.R.C. § 482 and the regulations thereunder provide a highly sophisticated and specialized tool for testing the amount of the royalty to determine whether such a royalty would be justified if the parties had dealt with each other at arm's length.

We also note that, by its terms, the exclusion of § 881 reporting companies from the definition of "component member" would not present an insurmountable problem for those foreign parents that wished to abuse the system by reimbursing their domestic affiliates for research conducted on the parents' behalf. For example, the foreign parent could contract with a U.S. affiliate for the performance of the necessary research, reimburse the U.S. affiliate for its costs, and then transfer the resulting intangibles to a foreign subsidiary. If the parent had no U.S. income not connected with a U.S. trade or business it would not, by definition, be subject to tax under I.R.C. § 881 and would not be an excluded component member under I.R.C. § 1563(b)(2)(C).

The same result could be achieved through the use of a foreign partnership that operated a trade or business under common control with a domestic corporation. Under I.R.C. § 41 (f)(2)(B), all businesses, whether or not incorporated, are treated as a single taxpayer as long as they are under common control. See Treas. Reg. § 1.41-8(a).

The term "controlled group of corporations," as that term is defined by § 1563(a), is also used in I.R.C. § 414(b) to include all employees of member corporations for various purposes relating to qualified plans, including, for example, the minimum participation standards of I.R.C. § 410 and the minimum vesting standards of I.R.C. § 411. In this case, Treas. Reg. § 1.414(b)(1)(a) specifically provides that

> the term "members of a controlled group" means two or more corporations connected through stock ownership described in section 1563(a)(1), (2), or (3), whether or not such corporations are "component members of a controlled group" within meaning of section 1563(b).

Based on the foregoing, we believe that PLR 8643006 is correct, despite the fact that it permits a domestic taxpayer to benefit from the research credit while the intangible property created by the underlying research is transferred to and exploited by a foreign affiliate. We hasten to add, however, that this does

not condone the payment of greater than arm's length royalties for the use of those intangibles in the United States. That situation is governed by I.R.C. § 482 and, specifically, Treas. Reg. § 482-4.

CONCLUSION:

This concludes our advice and recommendation. Please feel free to call Special Litigation Assistant Richard H. Gannon at 215-597-3442 with any additional questions you may have. We are forwarding a copy of this advices to the Assistant Regional Counsel (Tax Litigation) and to the Office of Assistant Chief Counsel (APJP) (CC::PA:APJP) for mandatory ten day post review. Please refrain from discussing the issues raised by this memorandum until that review has been completed.

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