Office of Chief Counsel
Internal Revenue Service

memorandum

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date:

to: LMSB Office of Pre-Filing and Technical Guidance
Attn: David Bernard, Technical Advisor (Research Credit)

from: LMSB Area Counsel, Financial Services and Healthcare (LM:FSH:MAN)

subject: [redacted]
Tax Years: [redacted] through [redacted]

Treatment of Costs Attributable to Pilot Unit Construction Under I.R.C. § 174 and Treas. Reg. § 1.174-2

U.I.L. Nos. 41.50-00, 174.00-00

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INTRODUCTION

This memorandum is in response to your request for advice dated May 11, 2000, and is subject to National Office review and approval. Accordingly, the advice herein stated should be considered preliminary, and should not be acted upon until we contact you concerning National Office comments. We will so contact you within two weeks of the date of this memorandum.

FACTS

For the tax years in issue, [redacted] through [redacted], [redacted] was the common parent of an affiliated group of corporations (hereinafter "Taxpayer") and filed consolidated U.S. Corporate Income Tax Returns (Forms 1120) with its affiliates. During these years, Taxpayer incurred costs in connection with the construction of several pilot units. Specifically, Taxpayer's costs were incurred for the component material, labor and other elements involved in the construction of these pilot units to be used in Taxpayer's trade or business for the manufacturing of products by Taxpayer for its customers. Taxpayer and the Service agree that no portion of the costs incurred with respect to these pilot units was for activities intended to discover information that would eliminate uncertainty concerning the development or improvement of these pilot units. Taxpayer and the Service further agree that these pilot units are property of a character subject to an allowance for depreciation.

On its Forms 1120 for the years in issue, Taxpayer fully deducted the entire costs attributable to the construction of these pilot units as research and experimentation expenditures under Internal Revenue Code section 174.

ISSUE

May Taxpayer's entire costs attributable to the construction of these pilot units be treated as deductible research and experimentation expenditures under section 174?

CONCLUSION

Taxpayer's entire costs attributable to the construction of these pilot units, which is property of a character subject to an allowance for depreciation, may not be treated as deductible research and experimentation expenditures under section 174, because the costs are solely for the component material, labor and other elements involved in their construction.

However, any such allowances for depreciation are considered as research and experimental expenditures, for purposes of section 174, to the extent that the property to which the allowances relate is used in connection with research or experimentation.[1]

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[1] The issue of whether the Taxpayer is entitled to allowances for depreciation during these years, as well as the issue of whether the pilot units were used in connection with research or experimentation, is beyond the scope of this memorandum. If advice is sought on these issues, please contact the attorney

LAW

Section 174(a) provides that a taxpayer may treat research or experimental expenditures which are paid or incurred by him during the taxable year in connection with his trade or business as expenses which are not chargeable to capital account. The expenditures so treated shall be allowed as a deduction. Section 174(c) provides, in relevant part, that section 174 will not apply to any expenditure for the acquisition or improvement of land, or for the acquisition or improvement of property to be used in connection with the research or experimentation and of a character that is subject to the allowance under section 167 (relating to allowance for depreciation, etc.).

Section 1.174-2(b) of the Income Tax Regulations ("Regulations") contains rules relating to certain expenditures with respect to land and other property. Section 1.174-2(b)(1) of the Regulations provides that expenditures by the taxpayer for the acquisition or improvement of land, or for the acquisition or improvement of property which is subject to an allowance for depreciation under section 167, are not deductible under section 174, irrespective of the fact that the property or improvements may be used by the taxpayer in connection with research or experimentation. However, allowances for depreciation of property are considered as research or experimental expenditures, for purposes of section 174, to the extent that the property to which the allowances relate is used in connection with research or experimentation.

Section 1.174-2(b)(2) of the Regulations provides, in relevant part, that expenditures for research or experimentation which result, as an end product of the research or experimentation, in depreciable property to be used in the taxpayer's trade or business may, subject to the limitations of section 1.174-2(b)(4) of the Regulations, be allowable as a current expense deduction under section 174(a).

Section 1.174-2(b)(4) of the Regulations provides that the deductions referred to in sections 1.174-2(b)(2) and (3) of the Regulations for expenditures in connection with the acquisition or production of depreciable property to be used in the taxpayer's trade or business are limited to amounts expended for research or experimentation. Thus, amounts expended for research or experimentation do not include the costs of the component materials of the depreciable property, the costs of labor or other elements involved in its construction and installation, or costs attributable to the acquisition or improvement of the property. For example, a taxpayer undertakes to develop a new machine for use in his business. He expends $30,000 on the project of which $10,000 represents the actual costs of material,

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assigned to this matter.

labor, etc., to construct the machine, and $20,000 represents research costs which are not attributable to the machine itself. Under section 174(a) the taxpayer would be permitted to deduct the $20,000 as expenses not chargeable to capital account, but the $10,000 must be charged to the asset account (the machine).

ANALYSIS

The issue is whether Taxpayer's entire costs attributable to the construction of these pilot units constitute research and experimental expenditures under section 174. These costs do not escape the limitations imposed by sections 1.174-2(b)(2) and (4) of the Regulations because such property is of a character subject to an allowance for depreciation under section 167.

Section 174 provides that a taxpayer may treat research and experimental expenditures that are paid or incurred by him during the taxable year in connection with his trade or business as expenses that are not chargeable to capital account. Research and experimental expenditures are generally defined as expenditures incurred in connection with the taxpayer's trade or business which represent research and development costs in the experimental or laboratory sense but only so long as they are for activities intended to discover information that would eliminate uncertainty concerning the development or improvement of a product. Treas. Reg. § 1.174-2(a)(1). Uncertainty exists if the information available to the taxpayer does not establish the capability or method for developing or improving the product or the appropriate design of the product. Id.

Under certain circumstances, however, expenses attributable to research or experimentation undertaken either directly by the taxpayer or on behalf of the taxpayer by a third person will not be deductible under section 174, such as expenditures attributable to the acquisition or improvement of property which is subject to an allowance for depreciation under section 167. I.R.C. § 174(c). Section 1.174-2(b)(1) of the Regulations generally provides that a taxpayer's expenditures for the acquisition or improvement of property which is subject to an allowance for depreciation under section 167 are not deductible under section 174, irrespective of the fact that the property or improvements may be used by the taxpayer in connection with research or experimentation. Section 1.174-2(b)(2) of the Regulations provides, in relevant part, that expenditures for research or experimentation which result, as an end product of the research or experimentation, in depreciable property to be used in the taxpayer's trade or business may, subject to the limitations of section 1.174-2(b)(4) of the Regulations, be allowable as a current expense deduction under section 174(a). Section 1.174-2(b)(4) of the Regulations provides that the deductions referred to in sections 1.174-2(b)(2) and (3) of the Regulations for expenditures in connection with the acquisition or production of depreciable property to be used in the

taxpayer's trade or business are limited to amounts expended for research or experimentation and do not include the costs attributable to the construction of the property.

Two types of expense are implicated by these rules: (1) expense incurred for activities intended to discover information that would eliminate uncertainty concerning the development or improvement of a product (Treas. Reg. § 1.174-2(a)(1)); and (2) expense attributable to the component material, labor or other elements involved in the construction and installation of a product. The former type of expense, to the extent it can be traced to activities intended to discover information that would eliminate uncertainty concerning the development or improvement of a product, is deductible for purposes of section 174; the latter type of expense, to the extent it represents costs for the construction of a depreciable asset, is not deductible. Cf. Rev. Rul. 73-275, 1973-1 C.B. 134 (holding that costs attributable to the development and design of an automated manufacturing system, as distinguished from costs attributable to the production of the manufacturing system, are deductible under I.R.C. § 174).

Under the present facts, the expenditures in question are those attributable to the construction of these pilot units. The parties in this case agree that these pilot units are property of a character subject to an allowance for depreciation.

Section 1.174-2(b)(4) of the Regulations provides that the deductions referred to in sections 1.174-2(b)(2) and (3) of the Regulations for expenditures in connection with the acquisition or production of depreciable property to be used in the taxpayer's trade or business are limited to amounts expended for research or experimentation. Thus, amounts expended for research or experimentation do not include the costs of the component materials of the depreciable property, the costs of labor or other elements involved in its construction and installation, or costs attributable to the acquisition or improvement of the property. There is no question in this case that Taxpayer acquired or produced these pilot units for use in its trade or business. Therefore, Taxpayer's expenditures for the construction of the pilot units are not deductible as research and experimental expenditures under section 174 because they are related to depreciable property used in the manufacturing of products by Taxpayer for its customers. However, any allowances for depreciation are considered as research and experimental expenditures, for purposes of section 174, to the extent that the property to which the allowances relate is used in connection with research or experimentation. Treas. Reg. § 1.174-2(b).[2]

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[2] As discussed supra, the issue of whether the Taxpayer is entitled to allowances for depreciation during these years, as well as the issue of whether the pilot units were used in connection with research or experimentation, is beyond the scope

If you have any questions, please contact the undersigned at (212) 264-5473, extension 262.

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