Office of Chief Counsel
Internal Revenue Service

memorandum

CC:[redacted]:TL-N-2986-99
[redacted]

date: October 1, 1999

to: [redacted]
Team Coordinator
Examination Division, [redacted]

from: [redacted]
Attorney

subject: [redacted]; Research credit and Section 174 deductions on depreciable property

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The analysis contained in this request is not binding on Examination or Appeals and is not a final case determination. It does not represent the position of Chief Counsel or the Internal Revenue Service on any issue and does not provide the basis for closing a case. The determination of the Service in the case is to be made through the exercise of the independent judgment of the office with jurisdiction over the case.

The attached document contains my suggestions for a Notice of Proposed Adjustment. As we discussed, it expands on the position in the draft you sent me on September 15, 1999.

By: /s/
[redacted]
Attorney

[redacted] PROGRAM
RESEARCH CREDITS & DEDUCTIONS
ON DEPRECIABLE PROPERTY

I. ISSUES:

Is [redacted] entitled to treat the costs of material and labor used in the construction of test articles and [redacted] #1 as "research and experimental expenditures" (within the meaning of I.R.C. § 174) and "qualified research expenditures" (within the meaning of I.R.C. § 41)?

II. FACTS:

On [redacted], the [redacted] Board of Directors agreed that upon execution of a firm definitive contract with [redacted] for the purchase of Model [redacted], the company would proceed with the [redacted] program.

Beginning in [redacted], certain articles (rigs) were constructed for the purpose of testing the design and materials used in producing the [redacted]. The test articles were subsequently used after [redacted] certification to test new designs and materials to be used in future models. The items at issue here are the [redacted] and the [redacted] (hereinafter referred to as the "test articles").

[redacted] (referred to hereinafter as "[redacted] #1") was built for [redacted], which still uses it as a demonstration [redacted]. This [redacted] was completed in [redacted] and was used to conduct some of the tests required for [redacted].

For book purposes, the costs of the [redacted] and the [redacted] were initially captured in a Construction In Process (CIP) account. Once an article was ready for use, the costs were transferred and capitalized as "Program Equipment" and depreciated. On its original [redacted] and [redacted] tax returns, [redacted]'s tax treatment was identical to its book treatment; it did not make a Schedule M adjustment. In [redacted], [redacted] amended its [redacted] and [redacted] returns, and deducted the [redacted] and the [redacted] costs pursuant to Section 174. On its [redacted] return, [redacted] deducted the test article costs.

For book purposes, [redacted] capitalized the costs of [redacted] #1 incurred from [redacted] through [redacted], and began depreciating the costs in [redacted]. It appears that on its [redacted] and [redacted] tax returns, [redacted] deducted all or part of the capitalized costs through a [redacted] Schedule M adjustment. Hereinafter, [redacted] #1, the [redacted] and the [redacted] are referred to as the "Equipment."

III. LAW

Excerpts from Section 174 (Research and Experimental Expenditures)

(C) LAND AND OTHER PROPERTY.--This section shall not apply to any expenditure . . . for the acquisition or improvement of property to be used in connection with the research or experimentation and of a character which is subject to the allowance under section 167 (relating to allowance for depreciation, etc.) . . . ; but for purposes of this section allowances under section 167 . . . shall be considered as expenditures.

Excerpts from Treasury Regulation § 1.174-2

(b) Certain expenditures with respect to land and other property. (1) Expenditures by the taxpayer . . . 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. . . . If any part of the cost of acquisition or improvement of depreciable property is attributable to research or experimentation (whether made by the taxpayer or another), see subparagraphs (2), (3), and (4) of this paragraph.

(2) 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 subparagraph (4) of this paragraph, be allowable as a current expense deduction under section 174(a). Such expenditures cannot be amortized under section 174(b) except to the extent provided in paragraph (a)(4) of § 1.174-4.

(4) The deductions referred to in subparagraphs (2) and (3) of this paragraph 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. For the purpose of the preceding sentence, 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, 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).

Excerpts from Section 41 (Research Activities)

(b)(1) QUALIFIED RESEARCH EXPENSES.--The term "qualified research expenses" means the sum of the following amounts which are paid or incurred by the taxpayer during the taxable year in carrying on any trade or business of the taxpayer--

(A) in-house research expenses, and

(B) contract research expenses.

(2) IN-HOUSE RESEARCH EXPENSES.--

(A) IN GENERAL.--The term "in-house research expenses" means--
(i) any wages paid or incurred to an employee for qualified services performed by such employee,

(ii) any amount paid or incurred for supplies used in the conduct of qualified research . . .

(B) QUALIFIED SERVICES.--The term "qualified services" means services consisting of--

(i) engaging in qualified research, or

(ii) engaging in the direct supervision or direct support of research activities which constitute qualified research.

* * *

(C) SUPPLIES.--The term "supplies" means any tangible property other than--

(i) land or improvements to land, and

(ii) property of a character subject to the allowance for depreciation.

* * *

(d)Qualified Research Defined. - For purposes of this section-

(1) In General.-The term "qualified research" means research-

(A) with respect to which expenditures may be treated as expenses under section 174.

* * *

IV. DISCUSSION

A. Introduction:

Property of a character which is subject to the allowance for depreciation is not eligible for current deduction under Section 174. I.R.C. § 174(c). If a cost cannot be treated as an expense for purposes of Section 174, then it is not "qualified research" for purposes of the research credit. I.R.C. § 41(d)(1)(A). Therefore, if the Equipment is "property of a character which is subject to the allowance for depreciation", the costs of the Equipment are not deductible under section 174 and are not included in the research credit computation.

Treasury Regulation § 1.174-2(b)(1) provides "property which is subject to an allowance for depreciation" is not eligible for deduction under Section 174.

B. Property of a Character Subject to the Allowance for Depreciation

A depreciation deduction is allowed for the exhaustion, wear and tear, and obsolescence of property used in a trade or business. I.R.C. § 167(a). In the context of former section 168(c)(ACRS), the term "property of a character subject to the allowance for depreciation" meant subject to exhaustion, wear and tear, or obsolescence. Simon v. Commissioner, 103 T.C. 247, 260 (1994) (court reviewed), aff'd. 68 F.3d 41 (2nd Cir. 1995), nonacq. 1996-29 I.R.B. 4 (musical instruments were eligible for the deduction when they were used by professional musicians in their trade, and such use resulted in wear and tear); Arkla, Inc. v. United States, 37 F.3d 621, 624-25 (Fed. Cir. 1994) (cushion gas, which does not decay or deteriorate, is not subject to exhaustion, wear and tear, or obsolescence, and therefore is not depreciable property); Noyce v. Commissioner, 97 T.C. 670, 688-90 (1991) (section 168 deduction allowed to corporate executive for personal airplane used for business travel).

If [redacted] was entitled to claim depreciation on the Equipment, but failed to do so, the Equipment was "property of a character subject to the allowance for depreciation." Arkla, Inc. v. United States, 37 F.3d 621, 624-25 (Fed. Cir. 1994) (court held that for purposes of section 168(c) [which contains the identical term], it was irrelevant whether the taxpayer had claimed a depreciation allowance.); Twentieth Century-Fox Film Corp. v. Commissioner, 372 F. 2d 281 (2d Cir. 1967), aff'g. 45 T.C. 137 (1965) (where transferor did not depreciate film, court examined record to determine if he was entitled to claim depreciation; he was, so property was of a character which is subject to the allowance for depreciation provided in section 167).

The nature of the Equipment, the uses to which [redacted] applied it, [redacted]'s treatment of the Equipment for book purposes, and [redacted]'s

initial treatment of the equipment for tax purposes are all indications that Equipment was subject to exhaustion, wear and tear, and obsolescence. It is clear that [redacted] was entitled to claim depreciation on the Equipment, and that the Equipment was therefore property "of a character which is subject to the allowance under section 167" and "property of a character subject to the allowance for depreciation".

C. Section 174:

As explained above, the Equipment was property "of a character which is subject to the allowance under section 167." Therefore, [redacted] is not entitled to claim a current deduction for the cost of the Equipment. [redacted] is entitled to claim a current deduction for only the depreciation on the Equipment.

These rules are clearly explained in the legislative history of section 41, which states:

> The cost of land and the full cost of depreciable or depletable property are expressly excluded from section 174 elections (sec. 174(c)); that is, the full cost of a research building or of <u>equipment used for research cannot be deducted</u> in one year.
>
> * * *
>
> However, the amounts which can be expensed or amortized under section 174 include amounts for depreciation or depletion with respect to depreciable or depletable property used for research activities. (Sec. 174(c); Treas. Reg. § 1.174-2(b)).

Sen. Rep. No. 97-144, 97th Cong. 1st Sess., 1981-2 C.B. 412, 438 (emphasis added).

There does not appear to be any reasonable argument supporting the deduction of the full costs of the Equipment under Section 174.

D. Section 41:

Just as the cost of the Equipment is not a research and experimental expenditure qualifying for immediate deduction under Section 174, it is not qualified research for purposes of Section 41.

First, as noted above, because the cost is not currently deductible as research under section 174, it is not a qualified research expenditure. I.R.C. § 41((d)(1)(A). Moreover, the cost cannot be treated as a supply within the meaning of Section 41 because the Equipment is "property of a character subject to the allowance for depreciation". I.R.C. § 41(b)(2)(C)(ii).

The legislative history of section 41 demonstrates that actual depreciation is not the proper test. Section 41(b)(2)(C)(ii) originated with provisions contained in House Bill, H.R. 4242, which Congress enacted without change.[1] Sec. 221(a), Pub. L. No. 97-34, 97th Cong., 1st Sess. (Aug. 13, 1981), 1981-2 C.B. 293. The House Committee Report, commenting on language which was identical to the language of the eventual statute, stated:

> Property which is of a character subject to the allowance for depreciation <u>is not eligible for the credit whether or not amounts of depreciation are deductible during the year and whether or not the cost of such property can be expensed</u>.

H. Rep. No. 201, 97th Cong. 1st Sess. 109, 118 (1981), 1981-2 C.B. 352, 361 (emphasis added).

The phrase "whether or not the cost of such property can be expensed" reflects Congress' intent to preclude expenditures for property of a character subject to depreciation from treatment as QRE whether or not the depreciation on the items was actually claimed.

TAXPAYER'S POSITION

Unknown.

CONCLUSION

The Equipment is property of a character subject to the allowance for depreciation. Therefore, [redacted] is not entitled to treat the costs of constructing these assets as "research and experimental expenditures" (within the meaning of I.R.C. § 174) or "qualified research expenditures" (within the meaning of I.R.C. § 41).

[1] The bill originally recommended by the Senate Finance Committee, H.J. Res. 266, S. Rep. No. 144, 97th Cong., 1st Sess. (1981) did not allow a credit for "supplies." The Senate then conformed its bill with the House bill's provisions concerning supplies. 127 Cong. Rec. S8488 (July 27, 1981).