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WNTS Insight*

Focusing on the impact of emerging developments

In this Issue

Since 2005, the IRS Priority Guidance Plan (commonly known as the business plan) has included the following item: "Guidance under section 41 regarding whether the gross receipts component of the research credit computation for a controlled group under section 41(f) includes gross receipts from transactions between group members."

This important issue affects both taxpayers with research credit cases pending in IRS Appeals and the many taxpayers deciding whether to elect the new alternative simplified research credit (ASC) instead of the regular credit. Electing the ASC would provide certainty, but perhaps at the cost of reduced benefits. Whether intercompany payments are included in the gross receipts calculation is one of the key factors in deciding whether to elect the ASC.

The issue has been complicated by two chief counsel advice (CCA) memorandums issued by the IRS: one in 2002 concluding that such gross receipts should be excluded, and the other in 2006 concluding the exact opposite -- that they should be included.

We understand the IRS is in the process of issuing Appeals Settlement Guidelines under which taxpayers would concede 50 percent of the issue -- the IRS essentially would split the difference between the conflicting CCAs.

Background

Since the research credit was enacted in 1981, the computational rules have required a "single taxpayer" approach, intended to prevent artificial shifting of expenditures among related companies. The single taxpayer concept always has included domestic members of a taxpayer's consolidated group, as well as CFCs.

In 1989, the computational rules were changed to include the taxpayer's gross receipts, in addition to expenditures, in the calculation of the

credit's base amount.

Under final regulations issued in 2001, gross receipts are defined as "the total amount, as determined under the taxpayer's method of accounting, derived by the taxpayer from all its activities and from all sources (e.g., revenues derived from the sale of inventory before reduction for cost of goods sold)."

In a well-reasoned CCA issued in 2002, the IRS said taxpayers could exclude from the calculation of gross receipts payments -- items such as royalties and sales proceeds -- from CFCs since those entities are part of the "single taxpayer." Taxpayers agreed with this CCA.

During 2005, under the American Jobs Creation Act of 2004, taxpayers repatriated billions of dollars from their CFCs under section 965 (so-called Homeland Dividends). Under the 2002 CCA, section 965 dividends could be excluded from the gross receipts calculation.

In 2006, however, the IRS reversed course. In another CCA, the IRS concluded -- but based on sketchy facts and unclear reasoning -- that receipts from CFCs, which would include section 965 dividends, should be included in the gross receipts portion of the regular research credit computation.

The IRS Large and Midsize Business Division has been following the 2006 CCA. Some affected taxpayers have taken their cases to IRS Appeals, which now is offering taxpayers 50 percent of this issue to resolve their cases.

Why Is the 2002 CCA the Better Analysis?

The 2002 CCA and the 2006 CCA take opposite positions. There is no way to reconcile the two: Intercompany receipts should be either excluded or included from the gross receipts calculation as a pure question of law.

Observation: A comparison of the statutory and regulatory arguments of taxpayers and the IRS indicates that the IRS's reliance on the 2006 CCA is misplaced -- the 2002 CCA is far more persuasive. The IRS does not try to explain why the reasoning of the 2006 CCA is superior to that of the 2002 CCA; in fact, the 2006 CCA does not mention the 2002 CCA.

The key provision is section 41(f)(1), which states that, in determining the amount of the credit, "all members of the same controlled group of corporations shall be treated as a *single taxpayer….*" (emphasis added).

The IRS nevertheless argues that section 41(c)(7), which provides two exclusions from gross receipts, does not exclude gross receipts from affiliates. But that section cannot override the single-taxpayer approach of section 41(f)(1). Indeed, without application of that provision to gross receipts, there would be *no* statutory provision requiring group members to combine gross receipts.

Also, the IRS itself has issued regulations interpreting two other Code sections (sections 263A and 448) as requiring aggregation of gross receipts. The regulations under both sections exclude payments between controlled group members.

Finally, the IRS argues that because the title of section 41(f)(1) -- "Aggregation of expenditures" -- was not changed when the statute was amended in 1989, the provision should not apply to the calculation of receipts in the absence of specific legislative history so indicating. But the Supreme Court has held that statutory headings "cannot limit the plain meaning of the text."

Reg. sec. 1.41-6(b) provides that "the group credit is computed by applying all of the section 41 computational rules on an aggregate basis." One of those computational rules, as noted above, requires the determination of gross receipts. Further, Reg. sec. 1.41-6(i)(1), like the regulations under sections 263A and 448, provides that "because all members of a group under common control are treated as a single taxpayer for purposes of determining the group credit, transfers between members of the group are generally disregarded."

In short, the legislative and regulatory aspects of this issue support the conclusions reached in the 2002 CCA.

What to Do Next?

While it certainly would be preferable from a taxpayer's perspective for

the IRS simply to follow the 2002 CCA, the anticipated final Appeals settlement guideline -- splitting the difference between the two CCAs -- would be an improvement over an earlier 65-percent taxpayer concession offer and would allow taxpayers with research credit cases pending in Appeals to make an informed decision about whether to accept the IRS offer.

Meanwhile, the IRS continues working on regulations on the intra-controlled-group gross receipts issue (as the business plan indicates), but when this guidance will be issued remains uncertain.

Therefore, since the IRS still has not issued regulations on the gross receipts issue, taxpayers that are considering whether to choose the ASC in lieu of the regular credit may wish to look to the IRS's Appeals Settlement Guideline for assistance.

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