



# Coordinated Issue All Industries Credit for Increasing Research Activities - Extraordinary Expenditures for Utilities (Effective Date; May 9, 2006)

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## OVERVIEW

This Coordinated Issue Paper addresses whether amounts paid or incurred for utilities in buildings where qualified research is conducted are qualified research expenses as defined in I.R.C. § 41(b).

## ISSUE

Whether amounts incurred by X for utilities in buildings where qualified research was conducted are qualified research expenses as defined in I.R.C. § 41(b).

## CONCLUSION

None of the amounts incurred by X for utilities used in the buildings where qualified research was conducted are qualified research expenses under section 41 because X has not established that the special character of the qualified research required additional extraordinary expenditures for utilities under Treasury Regulation § 1.41-2(b)(2)(ii).

## FACTS

X's per square foot utilities expenses in buildings in which qualified research was conducted ("Research Buildings") exceeded the per square foot utilities expenses in buildings where qualified research was not performed ("Non-Research Buildings"). In computing the research credit, X included certain amounts incurred for utilities used in the Research Buildings. X used the following methodology to determine these amounts:

**Step 1:** X determined its utilities expenses per square foot in the Non-Research Buildings.

**Step 2:** X determined its utilities expenses per square foot in the Research Buildings.

**Step 3:** X subtracted the per square foot utilities expenses for the Non-Research Buildings from the per square foot utilities expenses for the Research Buildings.

**Step 4:** X multiplied the difference by the number of square feet in the Research Buildings to determine the utilities expenses for the Research Buildings included as qualified research expenses.

X treated the incremental cost of providing utilities to the Research Buildings over the corresponding costs of providing utilities to the Non-Research Buildings as qualified research expenses eligible for the credit under section 41.

## LAW

Section 41(a) provides a credit against tax for increasing research activities (research credit). The research credit is equal to the sum of (1) 20 percent of the excess of the taxpayer's qualified research expenses over its base amount, (2) 20 percent of the basic research payments determined under section 41(e)(1)(A), and (3) 20 percent of the amounts paid or incurred by the taxpayer in carrying on any trade or business of the taxpayer during the taxable year (including as contributions) to an energy research consortium.

Section 41(b)(1) defines the term "qualified research expenses" to include in-house research expenses and contract research expenses.

Section 41(b)(2)(A)(ii) provides that the term "in-house research expenses" includes, among other expenditures, any amount paid or incurred for supplies used in the conduct of qualified research.

Section 41(b)(2)(C) defines the term "supplies" to mean any tangible property other than (i) land or improvements to land, and (ii) property of a character subject to the allowance for depreciation.

Treas. Reg. § 1.41-2(b)(1) provides that expenditures for supplies or for the use of personal property that are indirect research expenditures or general and administrative expenses do not qualify as in-house research expenses.

Treas. Reg. § 1.41-2(b)(2)(i) provides that in general, amounts paid or incurred for utilities such as water, electricity, and natural gas used in the building in which qualified research is performed are treated as expenditures for general and administrative expenses.

Treas. Reg. § 1.41-2(b)(2)(ii) provides that to the extent the taxpayer can establish that the special character of the qualified research required additional extraordinary expenditures for utilities, the additional expenditures shall be treated as amounts paid or incurred for supplies used in the conduct of qualified research. For example, amounts paid for electricity used for general laboratory lighting are treated as general and administrative expenses, but amounts paid for electricity used in operating high energy equipment for qualified research (such as laser or nuclear research) may be treated as expenditures for supplies used in the conduct of qualified research to the extent the taxpayer can establish that the special character of the research required an extraordinary additional expenditure for electricity.

## **ANALYSIS**

Treas. Reg. § 1.41-2(b)(1) and (b)(2)(i) states the general rule that utilities expenses are treated as expenditures for general and administrative expenses and do not qualify as in-house research expenses. This provision is consistent with the legislative history of § 41. H.R. Rep. No. 97-201, at 118 (1981), states that "the credit is not available for expenditures for supplies ... if such expenditures constitute or are part of general and administrative costs or overhead costs (such as utilities)."

Treas. Reg. § 1.41-2(b)(2)(ii) provides the following example to illustrate the general rule: "[A]mounts paid for electricity used for general laboratory lighting are treated as general and administrative expenses ..."

Treas. Reg. § 1.41-2(b)(2)(ii) further provides for extraordinary expenditures a limited exception to the general rule. To qualify for this limited exception, a taxpayer must establish the following:

(1) that the qualified research is of a "special character," (2) that the special character of the qualified research "required" the utilities expenses, and (3) that the required utilities expenses are both "additional" and "extraordinary."

Treas. Reg. § 1.41-2(b)(2)(ii) provides the following example to illustrate this limited exception:

[A]mounts paid for electricity used in operating high energy equipment for qualified research (such as laser or nuclear research) may be treated as expenditures for supplies used in the conduct of qualified research to the extent the taxpayer can establish that the special character of the research required an extraordinary additional expenditure for electricity.

Thus, § 41 presumes that X's utilities expenses are general and administrative expenses not included in the computation of the credit, unless X can establish that the special character of the qualified research required additional extraordinary expenditures for utilities.

In this case, X presumes that any incremental costs of providing utilities to Research Buildings over

the corresponding costs of providing utilities to the Non-Research Buildings automatically qualify as additional extraordinary expenditures for utilities required by the special character of the qualified research and included in the computation of the credit. This presumption ignores any other factors that may contribute to the higher incremental costs of providing utilities to the Research Buildings. The burden is on X to establish that the qualified research is of a “special character,” that the special character of the qualified research “required” the utilities expenses, and that the required utilities expenses are both “additional” and “extraordinary.”

While these incremental costs may be considered as “additional” expenses for purposes of the credit, X has neither established that the incremental costs are “extraordinary” nor “required by the special character of the qualified research” to meet the limited exception under § 41. This ignores the explicit terms of the statute, the regulations, and the legislative history.

Because X has not established that the special character of the qualified research required additional extraordinary expenditures for utilities as required by Treas. Reg. § 1.41-2(b)(2)(ii), the amounts incurred by X for utilities used in the Research Buildings are treated as expenditures for general and administrative expenses under Treas. Reg. § 1.41-2(b)(2)(i). Expenditures for general and administrative expenses do not qualify as in-house research expenses under Treas. Reg. § 1.41-2(b)(1). Accordingly, the amounts incurred by X for utilities used in the Research Buildings are not qualified research expenses under § 41(b)(1) and are not eligible for the credit for increasing research activities under § 41.

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