Coordinated Issue All Industries Qualifying Wages under Section 41 in Determining the Tax Credit for Increasing Research Activities (Rev 2/16/99)

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ISSUE

Whether contributions to a deferred compensation plan arrangement under I.R.C. § 401(k) on behalf of an employee who engages in qualified research are qualified research expenses under I.R.C. § 41(b).[1]

CONCLUSION

No. The tax credit for increasing research activities under I.R.C. § 41 is calculated on the increase in the taxpayer's "qualified research expenses", which includes wages paid or incurred to an employee for providing qualified services. In defining qualified research expenses to include wages for qualified services, I.R.C. § 41(b)(2)(D)(i) specifies that the "term wages has the meaning given such term under I.R.C. § 3401(a)." The term wages, as defined under I.R.C. § 3401(a), specifically excludes employee and employer contributions to tax-qualified trusts. Accordingly, since these contributions to tax-qualified trusts do not constitute "wages", these payments are not qualified research expenses and cannot be used in calculating the tax credit under Section 41.

FACTS

The Taxpayer develops, manufactures, and sells computer equipment. The employees working in the Taxpayer's Research Department engage in research that would constitute "qualified research" under I.R.C. § 41(d).

To provide for its employees' retirement, the Taxpayer maintains a qualified deferred compensation plan (the "Plan") under I.R.C. § 401. The Plan incorporates a trust satisfying the requirements of I.R.C. § 401(a), making it tax-exempt under I.R.C. § 501(a). The Plan also includes a qualified cash or deferred compensation arrangement meeting the requirements of I.R.C. § 401(k). Under the Plan's deferred compensation arrangement, eligible employees may elect to receive cash or have the Taxpayer contribute up to 10 percent of their compensation to the Plan's trust ("elective contributions"). Certain eligible employees elected to defer their compensation and make elective contributions. The Plan also permits the Taxpayer to contribute an amount for each employee in addition to the employees' elective contributions. Consequently, the Taxpayer contributes an additional amount for each dollar deferred by its employees ("matching contributions").

In computing the credit for increasing research under I.R.C. § 41(a), the Taxpayer treats both the elective contributions and the matching contributions as qualified research expenses.

LAW AND ANALYSIS

A credit against tax for increasing research activities is provided under I.R.C. § 41(a). This incremental credit equals the sum of 20 percent of the excess of the taxpayer's "qualified research expenses" for the taxable year over a base amount plus 20 percent of the taxpayer's basic research payments.[2] I.R.C. § 41(a). The term "qualified research expenses" is generally defined as the sum

of both the taxpayer's "in-house research expenses" and contract research expenses that are paid or incurred during the taxable year in carrying on the taxpayer's business. I.R.C. § 41(b). "In-house research expenses" include "any wages paid or incurred to an employee for qualified services performed by such employee."[3] I.R.C. § 41(b)(2)(A)(i). The term "wages" under I.R.C. § 41 "has the meaning given such term by section 3401(a)." I.R.C. § 41(b)(2)(D)(i). Accordingly, the critical issue is whether the elective or matching contributions to the Plan constitute "wages" under I.R.C. § 3401(a). Unless these contributions constitute wages, they are not qualified research expenses and cannot be used in determining the tax credit under I.R.C. § 41.

The term "wages" is defined under I.R.C. § 3401(a) for purposes of Chapter 24, concerning the collection of income tax at the source of wages. "Wages" generally includes all remuneration for services performed by an employee for his employer, including the cash value of all remuneration not paid in cash. I.R.C. § 3401(a). Specifically excluded from the definition of "wages", however, are payments made on behalf of an employee to a trust under I.R.C. § 401(a), which is tax-exempt under I.R.C. § 501(a), at the time the payments are made. I.R.C. § 3401(a)(12)(A). A qualified cash or deferred arrangement is defined by I.R.C. § 401(k)(2)(A), in part, as an arrangement under which a covered employee may elect to have the employer make payments as contributions to a trust under the plan on behalf of the employee. Similarly, I.R.C. § 401(m)(4) defines a matching contribution as any employer contribution made to a defined contribution plan on behalf of an employee on account of an employee's elective deferral. Thus, the employees' elective contribution and the Taxpayer's matching contributions are payments made on behalf of an employee to a qualified trust and do not constitute wages under I.R.C. § 3401(a). Because these contributions do not constitute wages under I.R.C. § 3401(a), the contributions do not qualify as "qualified research expenses" for the purposes of determining the credit for increasing research activities.[4]

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1. The credit for increasing research activities was initially enacted as section 44F pursuant to section 221 of the Economic Recovery Tax Act of 1981, 1981-2 C.B. 256, 293. Section 44F was redesignated as section 30 pursuant to section 471(c)(1) of the Deficit Reduction Act of 1984, 1984-3 (Vol. 1) C.B. 2, 334. Section 231 (d)(2) of the Tax Reform Act of 1986, (Vol 1) C.B. 2, 95, amended the research credit provisions and redesignated section 30 as section 41.
2. Section 38 of the Code allows a general business credit equal to the sum of the taxpayer's business credit carry forwards, current year business credit, and business credit carrybacks. The research credit under section 41(a) is one of twelve current year business credits. I.R.C. section 38(b)(4).
3. The term "qualified services" defined under section 41(d)(2)(B), is comprised of other terms, such as "qualified research," which is defined under section 41 d). The meaning of these terms is not directly relevant to the resolution of the issues presented in this paper and will not be addressed.
4. The Tax Court has construed the term wages under section 41 to have the same meaning as wages in I.R.C. section 3401(a). **See Apple Computer, Inc. v. Commissioner**, 98 T.C. 232 (1992), **acq**., 1992-2 C.B. 1; **Sun Microsystems, Inc. v. Commissioner**, T.C. Memo. 1995-69. See also the legislative history to the Economic Recovery Tax Act, H. Rept. 97-201 (1981). 1981-2 C.B. 352, 361.

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