



Coordinated Issue Utilities Industry Membership Payments made to Industry-Created Research Organizations (Effective: July 1, 1993)

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ISSUE

Whether membership payments, or any portion thereof, made to non-profit organizations which are funded by members of a specific industry constitute "contract research expenses" for purposes of computing the research credit under section 41 of the Internal Revenue Code.[1]

CONCLUSION

To the extent that the membership payments paid to non-profit organizations are used for qualified research, such payments constitute amounts paid or incurred to any person (other than an employee of the taxpayer) for qualified research. Accordingly, 65% of that portion of the membership payments made by members of such non-profit organizations that is allocable to qualified research will be treated as contract research expenses under section 41.

FACTS

Several industry groups have formed separate non-profit corporations to promote, engage in, conduct and sponsor research and development with respect to their respective industry products and matters directly or indirectly related thereto. Typically these industry-created research organizations are granted recognition of exemption from Federal income taxes under I.R.C. Sec. 501(c)(3). These non-profit organizations are intended to provide a medium through which all members of the industry can sponsor industry-related research in both the pure and applied sciences.

These non-profit organizations also prepare and disseminate information and data with respect to such research. The management of these industry research entities is usually handled by a Board of Directors and several advisory committees. Industry members are represented in the advisory committees and assist in identifying the research and development needs of the industry.

These industry non-profit research organizations typically make the results of their research and other information available to the public on a nondiscriminatory basis. After request and payment of a nominal fee, anyone may obtain this information. Dissemination of such information is made through published research reports, meetings, workshops, seminars, news releases, motion picture films, a monthly periodical and by other means. In addition, inventions and computer codes resulting from the research activities of these entities are available to the public under licensing arrangements with such entities.

These entities are usually structured as membership organizations with no outstanding shares of capital stock. Persons, firms, government agencies or corporations committed to a national program for research and development in the membership organization's particular industry are eligible for membership.

These industry-related research organizations finance their research and development programs, program management expenses, and other expenses from membership payments made by its members. The Board of Directors bases the amount of a member's payment upon either a fixed fee and/or a formula that uses specific member data.

The membership agreement between these non-profit organizations and their members typically states that the organization will conduct its activities and operations for some or all of the following

purposes:

1. To promote, engage in, conduct and sponsor research and development with respect to industry products and all activities directly or indirectly related thereto;
2. To provide a medium through which investor-owned, government-owned and cooperative-owned entities and all other persons interested in the industry can sponsor industry research and development for the public benefit;
3. To promote, engage in, and conduct research in both the pure and applied sciences for the advancement and betterment in the public service of industry products;
4. To sponsor scientific research and development with respect to industry-related matters with a view towards providing economical, reliable service to customers and minimal adverse environmental effects;
5. To seek and ascertain, through scientific research and development, solutions to environmental problems related to industry operations;
6. To discover, devise, develop, invent and create, through study and research, the methods and means to improve industry-related products;
7. To undertake, conduct, engage in or direct research and development activities for the discovery or improvement of new or more efficient forms of industry products, including new or more efficient uses of industry products by the public;
8. To discover and develop, through scientific study and research, ways and means to protect, conserve and maximize the efficient utilization of finite natural resources used in industry operations;
9. To provide a medium for coordination and cooperation and for the exchange of information for all organizations and persons, public or private, concerned with industry scientific research and development; and
10. To ascertain, prepare and disseminate information and data with respect to scientific research and development activities in the industry.

The membership agreement typically states that in consideration for the financial support, encouragement and participation of the member signing the agreement, the non-profit organization shall:

conduct during the term of this Agreement, for the benefit of the member and other members, and for the public benefit, a program of research and related activities consistent with the purposes of and approved by its Board of Directors and shall provide, from time to time, to the member and to others, analyses and reports documenting the plans, progress and results of the activities and operations of the non-profit organization.

These industry-related non-profit research organizations do very little research themselves but instead enter into contracts with outside third-party research firms. The payments made to these research firms are categorized into research projects. The research projects are generally large in scope and may involve a number of individual third-party contracts. A significant portion of the industry-related research organization's expenditures relate to these research contracts.

The other large category of expenditures incurred by these non-profit organizations relate to nonqualified expenses, including but not limited to, general and administrative costs, training costs and market research costs.

LAW AND ANALYSIS

The Economic Recovery Tax Act of 1981 established a tax credit for certain categories of expenses paid or incurred by a Taxpayer in the process of conducting "qualified research". Generally, for taxable years beginning before January 1, 1990, section 41 provided a credit against tax in an amount equal to a certain percentage of the excess (if any) of (1) the qualified research expenses for the taxable years, over (2) the base period research expenses. Except for certain tax years which require special treatment, the base period research expenses equal the average of the qualified research expenses incurred in the three years immediately preceding the year in which the credit is claimed. For taxable years beginning after December 31, 1989, the credit is equal to 20 percent of the excess of the taxpayer's qualified research expenses over a fixed base amount.

Section 41(b)(1) defines the term "qualified research expenses" as the sum of the amount paid by the taxpayer for "in-house research expenses" and "contract research expenses" during the taxable year in carrying on a trade or business. Section 41(b)(2) defines the term "in-house research expenses" to include wages paid or incurred to an employee for qualified services performed by such employee, and amounts paid or incurred for supplies used in the conduct of qualified research. Section 41(b)(3) and Treas. Reg. Sec. 1.41-2(e) define the term "contract research expenses" as 65% of any amount paid or incurred, in carrying on a trade or business, to any person (other than an employee of the taxpayer) for the performance, on behalf of the taxpayer, of qualified research or services which, if performed by the taxpayer, would constitute qualified services. However, where the contract calls for services other than qualified research or qualified services, only 65% of the portion of the amount paid or incurred for qualified research or services is a contract research expense. Treas. Reg. Sec. 1.41-2(e)(1). Under the regulations, an expense is paid or incurred for the performance of qualified research only to the extent it is paid or incurred pursuant to an agreement "that -- (i) Is entered into prior to the performance of the qualified research, (ii) Provides that research be performed on behalf of the taxpayer, and (iii) Requires the taxpayer to bear the expense even if the research is not successful". Treas. Reg. Sec. 1.41-2(e)(2). The determination of whether payments from a taxpayer to another person constitute contract expenditures for research to be conducted on behalf of the taxpayer depends on all the facts and circumstances of the particular research arrangement. H.R. Rep. No. 97-201, 97th Cong. 1st Sess. 119 (1981); See also, Joint Committee on Taxation, General Explanation of the Economic Recovery Tax Act of 1981, p. 128.[1]

For taxable years beginning before January 1, 1986, the term "qualified research" has the same meaning as the term "research or experimental" has under section 174, with some exceptions not relevant here. The term "research or experimental expenditures," as used in section 174, means expenditures incurred in connection with the taxpayer's trade or business which represent research and development costs in the experimental or laboratory sense. The term includes generally all such experimental or laboratory costs incident to the development or improvement of an experimental or pilot model, a plant process, a product, a formula, an invention, or similar property.

For taxable years beginning after December 31, 1985, the term "qualified research" means research, with respect to which expenditures may be treated as expenses under section 174, which is undertaken for the purpose of discovering information that is technological in nature and the application of which is intended to be useful in the development of a new or improved business component of the taxpayer. Further, substantially all of the activities of the research must constitute elements of a process of experimentation for a purpose described in section 41(d)(3). See Section 41(d)(1). However, the term "qualified research" does not include any activity described in Section 41(d)(4).

In order to determine what portion of a member's payments (dues) paid to the industry research organization qualify for the section 41 research credit, the organization's expenditures must be reviewed.

The following activities are not qualified research:

Literature Reviews. Projects may contain payments for work involved with surveys of books, periodicals, etc., that pertain to research matters. These Expenditures are usually incurred early in the project and typically before any true laboratory or experimental work is performed. Because section 174 requires that qualifying expenditures be for research in the "laboratory or experimental sense," literature reviews accomplished prior to and/or outside the laboratory do not qualify as section 174 expenditures. This determination also prevents these types of expenditures from qualifying as section 41 expenditures.

Technology Transfers. These expenditures are associated with workshops, seminars and training sessions in which the organization attempts to pass on the technology and/or knowledge acquired through its various projects. It also includes the publication and dissemination of any handbooks or manuals explaining research and its results. Again, these expenditures are incurred outside the laboratory and, in any event, they are made after the research had been completed. Consequently, these costs are not qualified expenditures under section 174 or section 41.

Foreign Research. Some projects may be contracted with some foreign entities where the work is performed outside the United States. In addition, some of domestic entities contracted with, in turn, may subcontract with foreign entities who perform research outside the United States. Section 41(d)(4)(F) states that qualifying research does not include research conducted outside the United States. Thus, any expenditures associated with work conducted outside the United States would be disallowed.

Demonstration or Adaptation of Existing Technology. Certain projects or portions of projects may be found to contain expenditures relating to work that used existing technology. The purpose behind these types of costs is not the discovery of new knowledge, but merely the attempt to show how previously acquired knowledge could be commercially exploited and/or used in the industry. Some projects may involve costs in the construction of commercial-size facilities whose technological feasibility has been previously established by test, prototype and/or large scale facilities. Generally, these types of costs are related to the implementation of a full-scale (commercial-size) operation of a previously tested (proven) process, with only the risk of economic success in doubt. See PLR 7948031 which states that these types of expenditures "are not embraced by the definition of research and experimental expenditures contained in section 1.174-2(a) of the regulations." Accordingly, any expenditures found to have been incurred in the planning, development or actual construction of a demonstration facility would be deemed not to qualify for the R&E credit permitted by section 41. In addition, any project expenditures that are determined to be solely for adapting existing technology to the particular needs of the industry would be similarly disallowed.

Software Costs. In General, software costs are to be reviewed for purposes of section 174 in the same manner as any other research costs. See section 1.174-2(a)(5) of the proposed Income Tax Regulations and Notice 87-12, 1987-1 C.B. 432.

Trouble Shooting, Quality Control. As noted previously, section 174 and section 41 require that expenditures be in the experimental or laboratory sense. Ordinary testing does not qualify. Some of the projects or contracts may involve work that would best be classified as debugging. These types of costs come after the technology has been established and are primarily incurred when relatively minor problems have occurred. As these expenditures are not connected with or in the nature of laboratory or experimental work, they would be disallowed.

Market or Economic Survey. Projects that are associated with "equipment or processes" will generally include a contract for a survey as to the marketability or commercial feasibility of the new or improved equipment/process. Since these contracts do not reflect expenditures for research in the "laboratory or experimental sense" and actually arise after the development of the technology, the expenditures are not qualifying expenditures under section 41.

Non R & E Data Collections. Similar to literature reviews, these data collections typically are undertaken prior to the decision to perform any laboratory or experimental work and are not related to any research work actually underway. The value or benefit of such data collections are to assist management in its decisions as to future research endeavors. Again, since such costs are not for research in the "laboratory or experimental sense," they are deemed to be non-qualifying expenditures for purposes of section 41.

Generally, a research organization's general and administrative costs are not qualified research expenditures; however, costs for services which, if performed by employees of the member(s), would constitute qualified services within the meaning of section 41(b)(2)B, are contract research expenses. See regulations 1.41-2(e)(1)(ii).

CONCLUSION

Based on the facts and circumstances encountered, members may treat a portion of their membership payments as contract research expenses. Pursuant to Treas. Reg. Sec. 1.41-2(e)(1), only that portion of the membership payments allocable to qualified research may be treated as contract research expenses. The Service will treat as qualified research expenses that portion of a

member's membership payments which bears same proportionate relation to the member's total membership payments as the research organization's total research expenditures for qualified research with respect to the member bear to such organization's total expenditures. Because this portion is a contract research expense, it is subject to the 65% limitation of section 41(b)(3)(A). For example, if it is determined that fifty percent of the expenditures of the research organization would have qualified as contract research expenses if they had been incurred directly by the member, then fifty percent of that member's membership payment would be treated as contract research expenses by the member.

1. In enacting the research credit, the Conference Committee adopted the House version of section 44F. See H.R. Conf. Rep. No. 215, 97th Cong., 1st Sess. 223, 1981-2 C.B 481, 495-96. The House, however, did not issue a report for the bill that contained the version of section 44F actually enacted. The House report that is frequently cited as part of the legislative history for the 1981 Act, H.R. Rep. No-97-201, supra, actually relates to a bill that was introduced in the House, but was never passed. The House did not issue a report for the bill that was eventually accepted by the conference Committee. The Joint Committee Explanation, or "Blue Book" is the most authoritative legislative history available.

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