**Office of Chief Counsel**
**Internal Revenue Service**
# Memorandum

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to: Senior Team Coordinator
( )

from:
(Large Business & International)

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subject: Acquiring Corporation's Use of Target's Pre-Acquisition Qualified Research Expenses

This memorandum responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Parent =
Target =
Date 1 =
Date 2 =
Date 3 =
Date 4 =
Year 1 =
Year 2 =
x =
y

ISSUE

Whether Parent can include the qualified research expenditures (QREs) paid or incurred by Target for the period Date 2 through Date 3 (the short period before Target

was acquired) in computing Parent's research credit under I.R.C. § 41 for the Year 1 taxable year.

CONCLUSION

Parent cannot include the QREs paid or incurred by Target for the period Date 2 through Date 3 in computing the research credit on Parent's consolidated income tax return for the Year 1 taxable year.

FACTS

This issue arose following the acquisition of Target by Parent in Year 1. Parent is the parent of a consolidated group (Parent and Subsidiaries), and files a consolidated federal income tax return for a taxable year ending on December 31st. Before it was acquired by Parent, Target was a publicly traded corporation and the parent of a consolidated group (Target and Subsidiaries). Prior to the acquisition, Target also filed a consolidated federal tax return for a taxable year ending on December 31st.

Parent acquired 100% of Target in Date 1, pursuant to a tender offer and short form merger. Target filed a short period return for the period beginning Date 2 and ending on Date 3. Parent filed a consolidated return for all of Year 1. The Target consolidated group was included in Parent's Year 1 consolidated return for the period Date 4 to December 31st.

Parent uses the alternative simplified credit provided in section 41(c)(5) to determine its research credit. Both Parent and Target claimed a research credit for Year 1. Both Parent (on its full year return) and Target (on its short period return) took into account in computing the research credit (QREs) paid or incurred by Target for the period Date 2 to Date 3 (the pre-acquisition period). Parent included qualified research expenses incurred by Target from the period Date 2 to Date 3 in the amount of $x in the qualified research expenses it reported on its Year 1 consolidated return.[1]

[1] Target reported a somewhat smaller amount of qualified research expenses, $y, on its short period return. We understand that the expenses were for the same research, and that discrepancy between $x and $y is currently under examination.

LAW AND ANALYSIS

Section 41(a)(1) provides, in part, that the research credit for the taxable year is an amount equal to the sum of 20 percent of the excess (if any) of the QREs for the taxable year over the base amount.

Section 41(b)(1) provides that the term "qualified research expenses" means the sum of the in-house research expenses and contract research expenses that are paid or incurred by the taxpayer during the taxable year in carrying on any trade or business of the taxpayer.

Section 41(c)(5) provides that a taxpayer may elect to determine a research credit equal to 14 percent of the excess of the QREs for the taxable year over 50 percent of the average qualified research expenses for the 3 taxable years preceding the taxable year for which the credit is being determined.

Treas. Reg. 1.41-9T, applicable to the year at issue, provided that at the election of the taxpayer, the credit determined under section 41(a)(1) equals the amount determined under section 41(c)(5), and included rules for making the election, and other special rules.

Section 41(f)(1)(A) provides that in determining the amount of the credit (i) all members of the same controlled group of corporations shall be treated as a single taxpayer, and (ii) the credit allowable to each member shall be its proportionate share of the QREs.

Section 1.41-(b)(1) provides that all members of a controlled group are treated as a single taxpayer for purposes of computing the research credit. The group credit is computed by applying all of the section 41 computational rules on an aggregate basis.

Section 41(f)(5) provides that the term "controlled group of corporations" has the same meaning given to such term by section 1563(a), except that "more than 50 percent" shall be substituted for "at least 80 percent" each place it appears in section 1563(a)(1), and the determination shall be made without regard to section 1563(a)(4) and section 1563(e)(3)(C).

Section 1563(a)(1) provides that the term "controlled group of corporations" means any group of one or more chains of corporations connected through stock ownership with a common parent corporation if (A) stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote or at least 80 percent of the total value of shares of all classes of stock of each of the corporations, except the common parent corporation, is owned by one or more of the other corporations; and (B) the common parent corporation owns stock possessing at least 80

percent of the total combined voting power of all classes of stock entitled to vote or at least 80 percent of the total value of shares of all classes of stock of at least one of the other corporations, excluding, in computing such voting power or value, stock owned directly by such other corporations.

Section 1502 provides that the Secretary of Treasury shall prescribe such regulations as he may deem necessary in order that the tax liability of any affiliated group of corporations making a consolidated return and of each corporation in the group, both during and after the period of affiliation, may be returned, determined, computed, assessed, collected, and adjusted, in such manner as clearly to reflect the income tax liability and the various factors necessary for the determination of such liability, and in order to prevent avoidance of such tax liability. In carrying out the preceding sentence, the Secretary of Treasury may prescribe rules that are different from the provisions of chapter 1 that would apply if such corporations filed separate returns.

Section 1.1502-76(b)(1)(i) provides that a consolidated return must include the common parent's items of income, gain, deduction, loss, and credit for the entire consolidated return year, and each subsidiary's items for the portion of the year for which it is a member. If the consolidated return includes the items of a corporation for only a portion of its taxable year determined without taking this section into account, items for the portion of the year not included in the consolidated return must be included in a separate return (including the consolidated return of another group). The rules of this paragraph (b) must be applied to prevent the duplication or elimination of the corporation's items.

Section 1.1502-76(b)(1)(ii)(A)(1) provides that if a corporation, other than one described in paragraph(b)(1)(ii)(A)(2) of this section (concerning subchapter S corporations), becomes or ceases to be a member during a consolidated return year, it becomes or ceases to be a member at the end of the day on which its status as a member changes, and its taxable year ends for all Federal income tax purposes at the end of that day.

Section 1.1502-80(a) provides that the Internal Revenue Code, or other law, shall be applicable to the group to the extent the regulations do not exclude its application. To the extent not excluded, other rules operate in addition to, and may be modified by, these regulations.

The QREs at issue were paid or incurred between Date 2 and Date 3. For this period, Target was the common parent of its own consolidated group. When Parent acquired the stock of Target, Target's tax year ended for all federal income tax purposes. Section 1.1502-76(b)(1)(ii)(A). Target included the QREs it incurred between Date 2 and Date 3 in its own (short period) consolidated return. However, Parent also included these QREs paid or incurred by the Target group from Date 2 to Date 3 in Parent's (full year) consolidated return for Year 1.

Target's and Target subsidiaries' QREs from the period Date 2 through Date 3 are not includable in Parent's consolidated return for the tax year Year 1 because those QREs were not paid or incurred during the portion of Parent's tax year for which Target and its subsidiaries were members of the Parent consolidated group. To the contrary, these QREs were paid or incurred during the portion of the year in which Target was the common parent of its own group. Section 1.1502-76(b)(1)(i) is clear that the items described therein must be included only in the Target group's consolidated return for the short period beginning on Date 2 and ending on Date 3, and not in the Parent group's consolidated return for the tax year Year 1. Section 1.1502-76(b)(1)(i) is mandatorily applied to prevent duplication or elimination of items, and is explicitly clear that allowing multiple inclusions of an item is improper ("[t]he rules of [§ 1.1502-76(b)] *must* be applied to prevent the duplication or elimination of the corporation's items." (emphasis added). Recently, in TAM 201034017 the Service reached the same conclusion on similar facts.

Congress made a technical amendment to the special rules for acquisitions and dispositions in section 41(f)(3) in section 301(b) of the American Taxpayer Relief Act of 2012,[2] effective for taxable years beginning after December 31, 2011. The purpose of the amendment was to ensure that when a business changes hands, the disposing business entity receives the research credit for expenses incurred prior to the date of a change in ownership. Joint Comm. on Taxation, General Explanation of Tax Legislation Enacted in the 112th Congress, at 140-41 (Comm. Print 2013) ("General Explanation"). Section 41(b) indicates that QREs are amounts paid or incurred by the taxpayer claiming a deduction. According to the General Explanation, "[QREs] paid or incurred by the disposing taxpayer in a taxable year that includes or ends with a change in ownership are treated as current year qualified research expenses of the disposing taxpayer and such expenses are not treated as current year qualified research expenses of the acquiring taxpayer." Id. at 141.

[2] Pub. L. No. 112–240.

The 2012 amendment does not support the position that before its amendment, the special rule for acquisitions in section 41(f)(3) permitted a disposing taxpayer to treat expenses paid or incurred before an acquisition as QREs on its final return, and an acquiring taxpayer to treats those expenses as current year QREs for a taxable year that includes the acquisition.

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Please call ( if you have any further questions.

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