

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

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date: September 01, 2015

to:

Team Manager
Heavy Manufacturing & Pharmaceuticals
Territory 1
Boston, Massachusetts

from: Paul Colleran
Attorney (Boston)
(Large Business & International)

subject:

This memorandum responds to your request for assistance in reviewing a statement of work and direction to an outside expert. This advice may not be used or cited as precedent.

ISSUES

1. What is the appropriate direction to be provided to an expert in evaluating the reasonableness of compensation under I.R.C. §§ 162 and 174(a).
2. What amounts are to be included in compensation when testing for reasonableness of compensation under I.R.C. §§ 162 and 174(a).

CONCLUSIONS

1. There are different standards for determining the reasonableness of compensation under I.R.C. § 162 for deduction as an ordinary and necessary business expense from that under § 174 for treatment as a research or experimental expenditure. While the reasonableness of compensation under I.R.C. § 162 looks to all of the activities performed by an employee, the determination under I.R.C. § 174 is limited to the employee's research or experimental activities.
2. When evaluating the reasonableness of compensation, total compensation is the relevant measure. This includes taxable, non-taxable and deferred compensation.

FACTS

You are currently auditing _____, a _____, formerly known as _____, for its taxable years ended _____, elected to be taxed as a _____ corporation. _____ filed a consolidated Form 1120 Federal income tax return for each of the years at issue.

_____ wholly owns _____ (EIN: _____), a

_____ which in turn wholly owns _____ (EIN: _____), a _____ Corporation. Both _____ and _____ elected to be treated as disregarded entities, with their items of income and expense being reported on the _____ Forms 1120 for the years at issue.

_____ is wholly owned by _____, a _____ limited liability company. _____ is wholly owned by _____.

During the years at issue _____ was the chief executive officer (CEO) and President of: (1) _____; (2) _____; (3) _____; and (4) _____. Collectively the four entities are referred to as the "Company Group". The Company Group _____ You have determined that _____ controls directly and indirectly

_____ entered into an employment agreement ("employment agreement") effective as of _____ with _____. The employment agreement called for _____ to serve as the CEO and President of: (1) _____; (2) _____; (3) _____; _____;

and (4) . (Employment agreement, Article 1 Position)
The employment agreement provides that :

... shall have primary responsibility for the strategic direction of the Company Group and shall advise and make recommendations to the Board on such matters as acquisitions, disposition and financing, shall have primary responsibility for the Company Group's relationship with its suppliers, customers and lenders, and shall oversee the other officers and employees of the Company Group.

(Employment agreement, Article 2 Duties).

The employment agreement allows to devote as much time as he wants to another business, , which is not a part of the Company Group. The employment agreement provides:

The foregoing does not preclude [] (i) from devoting such time and attention as he deems appropriate to manage the business and affairs of , a , and its future subsidiaries (collectively "

) in connection with its business of , , as defined herein (collectively, the "Products"), in countries located outside of North America ...

(Employment Agreement, Article 3 Exclusive Service)

The employment agreement is effective from through which includes the periods at issue. (Employment Agreement, Article 4 Terms of Employment).

annual base salary under the employment agreement is . The base annual salary is increased on of each year in an amount no less than the percentage change in the annual cost of living over the prior year. (Employment Agreement, Article 5.1 Compensation and Benefits, Base Salary).

The employment agreement also provides for annual bonuses to be paid to . The bonus provision of the employment agreement provides:

With respect to the fiscal year ending , and each fiscal year thereafter, [] shall be entitled to an annual cash performance bonus ("Annual Bonus") based on the Adjusted EBITDA . . . that is earned by the Company Group.

(Employment Agreement, Article 5.2, Compensation and Benefits, Bonuses).

The employment agreement also provides for additional benefits for

The additional benefits provision of the employment agreement provides:

[] will be eligible to participate in the Company's employee benefit plans of general application as they may be established and modified from time to time, including plans relating to pension, thrift, profit sharing, life, health, disability, accident and dental insurance, education or other retirement programs, and any other similar plans or programs that the Company has adopted or may adopt for the benefit of its similarly situated employees . . . The Benefits shall include and [Key Executive] shall also be entitled to an automobile for use during the Initial Term or any Renewal Term of this Agreement and the Company shall pay all expenses (including insurance, taxes and fuel) in connection therewith; providing that, the aggregate expenditure by the Company pursuant to this sentence for any fiscal year shall not exceed \$.

(Employment Agreement, Article 5.3, Compensation and Benefits, Expenses).

The employment agreement also provides that

will reimburse for all reasonable and necessary expenses incurred in connection with its business. (Employment agreement, Article 5.4, Compensation and Benefits, Expenses)

The employment agreement recites that the execution of the employment agreement is contemplated by the Employment Term Sheet dated as of ("Employment Term Sheet"). The Employment Term Sheet contains many of the same terms in the Employment Agreement.

also received equity in . The Employment Term Sheet provides for equity to as follows:

shall issue to Executive 50,000 Units of 50,000 Units of and 100,000 Units of (collectively the " "). The Units will be entitled to participate, on a pro rata basis in accordance with such units, in all distributions of in excess of US pursuant to Sections 3.2 and 8.3 of the Agreement. The Units will be entitled to participate, on a pro rata basis in accordance with such units, in all distributions of in excess of pursuant to

Sections 3.2 and 8.3 of the Agreement. The Units will be entitled to participate, on a pro rata basis in accordance with such units, in all distributions of in excess of pursuant to Sections 3.2 and 8.3 of the Agreement. If Executive is terminated for Cause or Executive resigns without Good Reason prior to the 5th anniversary of the Closing, then shall have the option to purchase all of the Units for \$1.00.

(Employment Term Sheet, VIII. Incentive Equity)

issued Forms W-2 to for the calendar years reporting gross wages and other compensation in the following amounts:

Calendar year:	Gross Wages and other compensation
	\$
	\$
	\$

paid annual bonuses to (which were included in the gross wages reported above) based on the adjusted "EBITDA" of the Company Group determined pursuant to Article 5.3 of the Employment Agreement in the following amounts:

Tax Year:	Bonus Paid
	\$
	\$
	\$

is claiming that 60% of the gross wages and other compensation reported on the Forms W-2 issued to is includable as QREs in the computation of the research credit for each of the years at issue.

You have decided to retain an outside expert to opine on the reasonableness of the compensation paid to under §§ 162(a) and 174. You have asked us to review the proposed statement of work for the expert and the charge for the expert.¹

¹ We are not addressing herein whether the taxpayer performed qualified research within the meaning of I.R.C. § 41(d) and whether services constitute the performance of qualified services within the meaning of I.R.C. § 41(b)(2)(B). These determinations should be made by the revenue agent and engineer assigned to the case.

LAW AND ANALYSIS

There are different standards for determining the reasonableness of compensation under I.R.C. § 162 for deduction as an ordinary and necessary business expense from that under § 174 for treatment as a research or experimental expenditure. We will begin our discussion with the standards under I.R.C. § 162 and then address the requirements for compensation to be treated as a research or experimental expenditure under I.R.C. § 174.

Reasonable Compensation under IRC § 162(a)

Internal Revenue Code § 162 (a)(1)² limits a corporation's deduction for salaries or other compensation to a "reasonable allowance for salaries or other compensation for personal services actually rendered."

Treas. Reg. § 1.162-7(a) provides the test of deductibility of compensation payments is "whether they are reasonable and are in fact payments purely for services."

Treas. Reg. § 1.162-7(b)(1) provides that "[a]n ostensible salary paid by a corporation may be a distribution of a dividend of stock" in the case of amounts paid in excess of reasonable compensation to an owner-employee.

Treas. Reg. § 1.162-7(b)(3) explains that "reasonable and true compensation is only such amount as would ordinarily be paid for like services by like enterprises under like circumstances." The circumstances to be considered are those which exist "at the date when the contract for services was made, not those existing at the date when the contract is questioned." Id.

The "tax liability of the recipient of an amount ostensibly paid to him as compensation, but not allowed to be deducted as such by the payor, will depend upon the circumstances of each case." Treas. Reg. § 1.162-8. Payments to an owner-employee which are in excess of reasonable compensation for services rendered may be treated as a distribution to said owner-employee. Id.

Treas. Reg. § 1.62-9 provides that bonuses to employees will constitute allowable deductions from gross income when such payments are made in good faith and as additional compensation for the services actually rendered by the employees, provided such payments, when added to the stipulated salaries, do not exceed a reasonable compensation for the services rendered. It is immaterial whether such bonuses are paid in cash or in kind or partly in cash and partly in kind. Donations made to employees and others, which do not have in them the element of compensation or which are in excess of reasonable compensation for services, are not deductible from gross income.

² All section references unless otherwise indicated are to the Internal Revenue Code of 1986 as in effect for the taxable periods at issue.

The determination of whether the payments to _____ were made with the intent to compensate for services is a factual question to be decided on the basis of the particular facts and circumstances of the case. Paula Construction Company v. Commissioner, 58 T.C. 1055, 1058 (1972). Each case turns on its own facts and circumstances. Because _____ was in control of the taxpayer's affairs, close scrutiny must be given to the relevant facts to determine whether so-called compensation is not in reality a distribution of profits in a manner calculated to avoid payment of income taxes. Botany Worsted Mills v. United States, 278 U.S. 282 (1929); Lowland v. Commissioner, 244 F.2d 450 (1957).

Many factors are relevant in determining the reasonableness of compensation, and no single factor is decisive. Charles Schneider & Co. v. Commissioner, 500 F.2d 148, 151-52 (8th Cir.1974), affg. T.C. Memo.1973-130; Mayson Manufacturing Co. v. Commissioner, 178 F.2d 115, 119 (6th Cir.1949). Case law has provided an extensive list of factors that bear on the determination of reasonableness. See e.g. Owensby & Kritikos, Inc. v. Commissioner, 819 F.2d 1315, 1323 (5th Cir. 1987) (where court employed a nine factor test). These factors include: (i) the employee's qualifications; (ii) the nature, extent and scope of the employee's work; (iii) the size and complexities of the business; (iv) a comparison of salaries paid with gross income and net income; (v) the prevailing general economic conditions; (vi) comparison of salaries with distributions to stockholders; (vii) the prevailing rates of compensation for comparable positions in comparable concerns; (viii) the salary policy of the taxpayer as to all employees;³ and (ix) the amount of compensation paid to the particular employee in previous years.⁴ Id.; see also Brewer Quality Homes, Inc. v. Commissioner, 122 F. App'x. 88, 91 (5th Cir. 2005).

The taxpayer bears the burden of establishing the elements of deductible compensation. Botany Worsted Mills v. United States, 278 U.S. 282, 289-90, 293 (1929); American Lithofold Corp. v. Commissioner, 55 T.C. 904, 917-18 (1971), acq. 1971-2 C.B. 1 (failed to establish exact nature of services and extend of services performed and that services were actually performed for the taxpayer).

It is reasonable to assume that reasonable compensation is only the amount that would ordinarily be paid for like services by like enterprises under like circumstances. Treas. Reg. §1.162-7(b)(2). Therefore, industry standards are important in determining whether compensation is reasonable. Charles Schneider & Co. v. Commissioner, 500

³ The Fifth Circuit in Owensby stated "this factor is significant because a key issue in this controversy [was] whether the entity as a whole pays top dollar to all of its employees, shareholder- and nonshareholder-employees alike." Owensby, 819 F.2d at 1323, 1329-30.

⁴ The amount of compensation paid to a particular employee in previous years is relevant only if an argument is made that the payments to said employee for the years at issue were made in recompense for underpayments in previous years. See Owensby, 819 F.2d at 1323.

F.2d 148, 154 (8th Cir. 1974), cert. denied, 420 U.S. 908 (1975) (payments were greatly disproportionate to payments to executives in industry); Avis Industrial Corp. v. Commissioner, T.C. Memo 1995-354; Escrow Connection v. Commissioner, T.C. Memo 1997-17 (compensation exceeded industry norm and amount paid to remaining 21 to 23 employees).

The outside expert should be directed to make the following determination with respect to the reasonable compensation for _____ services:

Determine the reasonable compensation for the services provided by _____ during the taxable years ended _____ to each of the following entities: (1) _____ ; (2) _____ : (3) _____ ;

and (4) _____. Your report should detail the services performed by _____ for each year for the respective entities.

The compensation amount you so determine must be both reasonable and in fact payment purely for services. Reasonable and true compensation is only such amount as would ordinarily be paid for like services by like enterprises under like circumstances. The circumstances to be considered are those which exist at the date when the contract for services was made.

You should consider the following factors in making your determination: (1) _____ qualifications, (2) the nature, extent and scope of work; (3) the size and complexities of the business, (4) a comparison of salaries paid with the gross income and the net income, (5) the prevailing general economic conditions, (6) comparison of salaries with distributions to stockholders, (7) the prevailing rates of compensation for comparable positions in comparable concerns, and (8) the salary policy of the taxpayer as to all employees.

In evaluating the taxpayer's claim for deduction for compensation, total compensation must be considered. This includes all salary, bonuses, deferred compensation, fringe benefits (taxable and non-taxable) and other benefits. See Edwin's, Inc. v. U.S., 501 F.2d 675 (7th Cir. 1975) (holding deferred compensation, such as contributions to a pension plan must be considered in determining whether total compensation is reasonable); Brewer Quality Homes v. Commissioner, T.C. Memo 2003-200 aff'd without published opinion (5th Cir. 2004) ("if petitioner means to say that courts apply the reasonable compensation test to only 'cash compensation' then petitioner is wrong").

Credit for Increasing Research Activities under § 41

Section 41 allows taxpayers a credit against taxes for increasing research activities ("research credit"). In general, the research credit is an incremental credit equal to the sum of 20 percent of the excess (if any) of the taxpayer's qualified research expenses ("QREs") for the taxable year over the base amount. Section 41(a)(1).

To be eligible for the research credit under § 41(a)(1) a taxpayer must establish that it has performed "qualified research" during the year at issue. Section 41(d)(1). To be qualified research, the research must satisfy four requirements. First, to constitute qualified research, the expenditures connected with the research must be eligible for treatment as research or experimental expenditures pursuant to § 174. Section 41(d)(1)(A). Second, the research must be undertaken for the purpose of discovering information which is technological in nature. Section 41(d)(1)(B)(i). Third, the taxpayer must intend that the technological information to be discovered will be useful in the development of a new or improved business component of the taxpayer. Section 41(d)(1)(B)(ii). Fourth, substantially all of the research activities must constitute elements of a process of experimentation for a purpose relating to a new or improved function, performance, reliability or quality. Section 41(d)(1)(C),(d)(3). To be considered "qualified research," the taxpayer must establish that the activities performed satisfy all four tests. Section 41(d).

Once the taxpayer establishes that it has engaged in the performance of qualified research it must establish which costs attributable to the qualified research constitute QREs under § 41(b).

The term "qualified research expenses" means the sum of in-house research expenses and contract research expenses paid or incurred by the taxpayer. Section 41(b)(1). "In-house research expenses" include, in part, "any wages paid or incurred to an employee for qualified services performed by such employee." I.R.C. § 41(b)(2)(A)(i). The term "wages" has the meaning given such term by § 3401(a). Section 41(b)(2)(D)(i).

Section 41(b)(2)(B) provides that "qualified services" means services consisting of (i) engaging in qualified research, or (ii) engaging in the direct supervision or direct support of research activities which constitute qualified research.

The term "engaging in qualified research" as used in section 41(b)(2)(B) means the actual conduct of qualified research (as in a scientist conducting laboratory experiments). Treas. Reg. § 1.41-2(c)(1).

Direct supervision of qualified research means immediate supervision (first-line management) of qualified research (as in a research scientist who directly supervises laboratory research). Treas. Reg. § 1.41-2(c)(2). Direct supervision does not include supervision by a higher level manager to whom first-line managers report, even if the manager is a qualified research scientist. Id.

Treas. Reg. § 1.41-2(c)(3) defines "direct support" as services in the direct support of either (i) persons engaging in actual conduct of qualified research, or (ii) persons who are directly supervising persons engaging in the actual conduct of qualified research. "Direct support" does not include general administrative services, or other services only indirectly of benefit to research activities, such as the following: (i) services of payroll personnel in preparing salary checks of laboratory scientists; (ii) services of an accountant for accounting for research expenses; (iii) services of a janitor for general cleaning of a research laboratory; or (iv) services of officers engaged in supervising financial or personnel matters. Treas. Reg. § 1.41-2(c)(3).

If an employee has performed both qualified services and nonqualified services, only the amount of wages allocated to the performance of qualified services constitutes QREs. Treas. Reg. § 1.41-2(d)(1). All wages paid to an employee, however, are allocable to qualified services and constitute QREs if at least 80% of the employee's wages are attributable to qualified services for a taxable year. Treas. Reg. § 1.41-2(d)(2).

The amount of wages properly allocable to qualified services is determined by multiplying the total amount of wages paid to or incurred for the employee during the taxable year by the ratio of the total time actually spent by the employee in the performance of qualified services for the employer to the total time spent by the employee in the performance of all services for the employer during the taxable year. Treas. Reg. § 1.41-2(d)(1). Another allocation method may be used if the taxpayer demonstrates the alternative method is more appropriate. *Id.*

The IRS Engineer and Revenue Agent should determine whether the taxpayer performed qualified research within the meaning of § 41(d) and whether the activities performed by _____ constituted the performance of qualified services within the meaning of § 41(b)(2)(B).

Research or Experimental Expenditures under § 174

As discussed above, to constitute qualified research, the expenditures connected with the research must be eligible for treatment as research or experimental expenditures pursuant to § 174. Section 41(d)(1)(A).

Section 174(a) provides that research or experimental expenditures paid or incurred during the taxable year in connection with a taxpayer's trade or business may be deducted currently rather than capitalized. Spellman v. Commissioner, 845 F.2d 148, 149 (7th Cir.1988), aff'd T.C. Memo.1986-403. The taxpayer must establish the right to treat expenditures as deductible expenses under § 174. Coors Porcelain Co. v. Commissioner, 52 T.C. 682, 697-698 (1969), aff'd, 429 F.2d 1 (10th Cir.1970) (holding that the taxpayer was not entitled to a deduction under § 174 because, in part, the

taxpayer did not prove that the expenditures met the definition of research and development under § 174).

Treas. Reg. § 1.174-2(a)(1) provides:

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 generally includes all such costs incident to the development or improvement of a product. The term includes the costs of obtaining a patent, such as attorneys' fees expended in making and perfecting a patent application.

The Tax Court gives the terms "experimental" and "laboratory" their plain and ordinary meanings. See, e.g., TSR, Inc. & Sub. v. Commissioner, 96 T.C. 903, 914 (1991). In TSR, the Tax Court concluded that according to the definition of those two terms in Webster's Third New International Dictionary, "Experimental" is defined as "relating to, or based on experience" and "Laboratory" is defined as "a place devoted to experimental study in any branch of natural science or to the application of scientific principles in testing and analysis." Id. The Tax Court has held further that "[t]he goal of the research must be scientifically reasonable. ... It requires some element of experimentation." Agro Science Co. v. Commissioner, T.C. Memo.1989-687, aff'd, 934 F.2d 573 (5th Cir.1991). Thus, the Tax Court has consistently held that research and development expenditures are generally those expenditures related to scientific and laboratory-based activities.

Expenditures may qualify as research and development expenses in "the experimental or laboratory sense" if they are incurred for activities to "eliminate uncertainty concerning the development or improvement of a product." Treas. Reg. § 1.174-2(a)(1). Uncertainty exists if the information available to the taxpayer does not establish the capability or method for developing or improving the product or the design of the product. Id. The taxpayer must perform activities intended to discover information not otherwise available regarding the capability of improving the product or for improving the design or development of the product. Id.

Section § 174(e) provides that the requirements of § 174 will only apply to research expenditures that are reasonable under the circumstances. Prior to the enactment of § 174(e), the Court in Driggs v. United States, 706 F. Supp. 20, 21-22 (N.D. Tex. 1989), held that § 174 did not impose a reasonableness standard and accordingly that all research or experimental expenditures which otherwise met the requirements of § 174 were deductible. Congress swiftly enacted § 174(e) to provide a rule contrary to the holding in Driggs and thus imposed a reasonableness requirement for § 174 research expenditures. H.R. Rep. No. 101-386, 1203 n.12 (1989) (Conf. Rep.); H.R. Rep. No. 101-247, 1203 n.12 (1989).

Congress intended the reasonableness requirement under § 174 “to be parallel to the reasonable allowance requirement for salaries and other compensation under section 162(a)(1), in that amounts supposedly paid for research may be recharacterized as disguised dividends, gifts, loans, or other similar payments.” See id. Congress did not intend “the reasonableness requirement under § 174 to be used to question whether or not research activities themselves are of a reasonable type or nature.” Id. Although the § 174(e) reasonableness test requires the application of the same factors as the § 162(a)(1) reasonableness test, the reasonableness inquiry under § 174 (e) is specific to the amount of research expenditures paid. See § 174(e); Treas. Reg. § 1.174-2(a)(9).

The requirements of § 174 only apply to research and experimental expenditures to the extent the amount thereof is reasonable under the circumstances. Treas. Reg. § 1.174-2(a)(9) provides:

Section 174 applies to a research or experimental expenditure only to the extent that the amount of the expenditure is reasonable under the circumstances. In general, the amount of an expenditure for research or experimental activities is reasonable if the amount would ordinarily be paid for like activities by like enterprises under like circumstances. Amounts supposedly paid for research that are not reasonable under the circumstances may be characterized as disguised dividends, gifts, loans, or similar payments.

To establish which costs constitute qualified research expenses under § 41(b) requires a determination as to whether research costs may be treated as expenses under § 174, which includes the application of the reasonableness requirement under § 174(e) as to research expenses paid. The Tax Court in Norwest Corp. & Subs, v. Commissioner, 110 T.C. 454, 491 (1998) stated:

The phrase “the research expenditures may be treated as expenses under section 174” is meant to require the taxpayer to satisfy all the elements for a deduction under § 174. The legislative history of § 41 supports this requirement. See H. Conf. Rept. 99-841 (Vol.II), supra at II-71, 1986-3 C.B. (Vol.4) at 71 (“the conference agreement limits research expenditures eligible for the incremental credit to ‘research or experimental expenditures’ eligible for expensing under section 174. Under the conference agreement, research satisfying the section 174 expensing definition is eligible for the credit”).

Furthermore, the Tax Court in Union Carbide stated:

Petitioner cannot avoid the restrictions of section 174 by arguing that section 174 is relevant only for determining whether activities constitute qualified research and has no bearing on whether the costs of those activities may be QREs. See Norwest Corp. & Subs. v. Commissioner,

110 T.C. at 491; H. Conf. Rept. 99-841 (Vol.II), supra at II-71, 1986-3 C.B. (Vol.4) at 71 (“the conference agreement limits research expenditures eligible for the incremental credit to ‘research or experimental expenditures’ eligible for expensing under section 174.”).

Union Carbide Corp. and Subs. v. Commissioner, T.C. Memo. 2009-50, 114 (2009).

Accordingly, a taxpayer may not claim an amount of an employee's salary representing research expenses as QREs pursuant to § 41 when the value of the research services performed by the employee is worth less than the amount of the payment made for the research services. See § 174(e); Treas. Reg. § 1.174-2(a)(9); Norwest Corp. & Subs. v. Commissioner, 110 T.C. 454, 491 (1998); Union Carbide Corp., T.C. Memo. 2009-50 at 114. Additionally, any amounts paid for research services that are not reasonable under like circumstances may be recharacterized according to their substance. See id.

The outside expert should be directed to make the following determination with respect to the reasonable compensation for _____ research or experimental services:

Determine the reasonable compensation for the research or experimental services provided by _____ during the taxable years ended _____ and _____ to each of the following entities: (1) _____ ; (2) _____ ; (3) _____ ; and (4) _____. Your report should detail the research or experimental services performed by _____ for each year to the respective entities.

Research or experimental services are research and development services in the experimental or laboratory sense. The terms “experimental” and “laboratory” are given their plain and ordinary meanings. Experimental is defined as relating to or based on experience and laboratory is defined as a place devoted to experimental study in any branch of natural science or to the application of scientific principles in testing and analysis. The term research or experimental generally includes all services incident to the development or improvement of a product. The term includes the services of obtaining a patent.

Research or experimental services are activities intended to eliminate uncertainty concerning the development or improvement of a product. Uncertainty exists if the information available to the taxpayer does not establish the capability or method for developing or improving the product or the design of the product. Research or experimental services are activities intended to discover information not otherwise available regarding the capability of improving the product or for improving the

design or development of the product.

The compensation for research or experimental services is reasonable if the amount would ordinarily be paid for like activities by like enterprises under like circumstances.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

We recommend that the expert interview _____ to determine the nature of the services he performed for each of the entities for the years at issue. The expert should detail in his report the various types of services that _____ performed and the percentage of his time that he devoted to each activity. The expert's report should also detail the percentage of time, activities and allocation of compensation for each of the entities that _____ was employed by.

The IRS Engineer and Revenue Agent should evaluate the various services performed by _____ and determine what percentage of _____ time if any _____ devoted to the performance of qualified services within with meaning of § 41(b)(2)(B). This determination along with the findings of the outside expert on the reasonableness of _____ compensation for research or experimental services would serve as the basis of any adjustment for the research credit.

We have coordinated this advice with Roger Kave of the General Business Credit IPN.

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call (617) 788-0804 if you have any further questions.

MICHAEL P. CORRADO
Area Counsel
(Heavy Manufacturing & Pharmaceuticals)

By: _____
Paul Colleran
Attorney (Boston)
(Large Business & International)