Tax Considerations for High Tech Start-Ups

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This outline and presentation provides an overview to various tax rules and issues that a start-up company in a high technology industry should consider. It begins with a chart noting key activities of a high tech company and the tax rules that present opportunities and potential problems. Following the chart are brief summaries of many of the tax provisions noted in the chart. Each summary is designed to provide an introduction to the basics of the rules and a sampling of the possible issues.

Activities—Opportunities—Cautions

The chart below lists a sampling of the tax opportunities and cautions for various activities of a high technology company. Each of the opportunities and cautions noted in **bold** are further explained in the remainder of this outline.

Activity	Opportunities	Cautions
Choice of entity	See later charts on pros and cons of different **entity choices**.	
Raising capital for a high tech venture	• **IRC §1202** allows non-corporate shareholders to exclude 50% of gain from disposition of qualified small business stock (QSBS) held over 5 years. • **IRC §1045** allows for deferral if §1202 gain is rolled over.	• Have the shareholders (IRC §351) or partners (IRC §721) contributed property? (**What is property?**)
Location decisions	• Most states and some cities and counties offer a variety of **tax incentives**. These may include research tax credits, training credits, special tax breaks for locating in an enterprise zone, sales tax exemptions for manufacturing and R&D equipment and lower capital gains tax rates. • A physical location in a state typically results in sales and use tax collection obligations and income tax liabilities. Strategic location of sales, distribution, R&D, and training facilities can lower tax liabilities and compliance costs. In addition, attention must be paid to where employees (and perhaps agents) are located, number of days attendance at trade shows (many states specify a minimum number of days that is below the nexus threshold), and location of property (for example, software leased to a Texas customer creates a physical presence for the lessor).	• What constitutes a physical presence and what is the minimum allowable contact under P.L. 86-272 to avoid a taxable presence (or **nexus**) in a jurisdiction can vary from state to state and court decisions have not been consistent. It is important to carefully review the law in any state in which the company has employees, assets and/or operations or plans to have such factors, in order to determine tax obligations and liabilities. Failure to do this can result in significant retroactive assessments of taxes plus penalties.

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Activity	Opportunities	Cautions
Start-up phase	• Need to distinguish between §195, §162, and **§174** expenditures.	• Potential for personal holding company tax under IRC §541, et. seq., if closely-held and start-up funds are generating interest income. • Potential to fail to meet the **IRC §1202** QSBS definition. • Special rules apply for calculating the federal research tax credit under **IRC §41**.
R&D activities	• **IRC §174** allows for research and experimental expenditures to be expensed. Alternatively, taxpayer may elect to capitalize R&E and then amortize it when first realize benefits from the R&E. • Taxpayer may be entitled to federal (**IRC §41**) and state research tax credits.	• Not all expenditures or activities qualify for the **IRC §41** research tax credit. Federal research tax credit is not permanent. • If third parties used, need to distinguish between **IRC §174** expenditures and acquisition of assets.
Profiting from R&D	• Individual transferring patent may be able to obtain capital gain treatment under **IRC §1235**.	• Need to determine **type of income**: sale of goods, license, services, other, so can determine tax treatment/consequences. • **State nexus issues** for both income and sales/use tax purposes. Need to review rules in any state in which taxpayer has customers, licenses, employees, or property. • Might the collapsible corporation rules of IRC §341 apply? [See *Computer Sciences Corp.*, 63 T.C. 327 (1974) and other cases]
Acquiring technology	• Need to consider application of **IRC §174, §41, §167(f), and §197.**	• If third party was hired, need to determine whether payments are deductible under **IRC §174** (and whether 65% are eligible for the **IRC §41** credit), or whether considered to have acquired an asset.
Selling technology	• Individual transferring patent may be able to obtain capital gain treatment under **IRC §1235.**	• Law not clear as to whether the technology may qualify as a §1221 or §1231 asset. • Sales tax may be owed on transfer of intangibles – varies by state and by transfer technique.
Dealing with emerging issues	• Involvement with industry associations can be beneficial.	• New issues continue to emerge as federal and state governments re-evaluate nexus, what goes into state apportionment formulas, definition of tangible property, how to deal with electronic commerce, and more. • Need to keep up to date.

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Choice of Entity

Generally, the process of deciding on a business entity form for a high technology company is similar to that of other businesses. Thus, the basic advantages and disadvantages of corporations, subchapter S corporations, limited liability companies (LLCs), partnerships and sole proprietorships are pertinent to selecting the high technology company's form. Discussed here are specific considerations that may be unique to a high technology business.

A. The Corporate Form

Listed in the chart below are the advantages and disadvantages of a high technology business operating as a regular ("C") corporation. Advantages and disadvantages that are not unique to high technology businesses are not listed. Certain items mentioned in the chart are further explained afterwards.

Advantages	Disadvantages
• Corporate stock and stock options can be used as non-cash employee compensation.	• Where intangible property is contributed in exchange for stock, issues can arise under §351 as to whether the property qualifies for deferred gain or loss treatment.
• Corporate stock can be used for volume discounts and other purposes, thus saving cash.	• A closely-held corporation with R&D funds invested prior to use and prior to significant sales may meet the definition of a personal holding company (PHC) and be subject to the PHC tax.
• Preferable form for many types of financing.	• There is no flow through of losses and credits to owners that will likely be unusable to the corporation in its early years. Such losses may be larger for a high technology company relative to other companies.
• Stock issued by the entity should meet the definition of qualified small business stock under §1202 thus enabling non-corporate shareholders to exclude 50 percent of any gain from income if the stock is held over 5 years. In addition, §1045 allows for rollover of gain from QSBS for timely reinvestments in other QSBS.	• If the entity were the target of a takeover or acquisition, the resulting gain would be subject to double taxation and the loss and credit carryforward limitations of Sections 382 and 383 would apply.
• Stock issued by the entity may meet the definition of §1244 stock thus entitling individuals to treat up to $50,000 of their loss ($100,000 if filing a joint return) as ordinary, rather than as capital.	

B. Other Entity Forms

Listed in the chart below are the advantages and disadvantages of a high technology business operating as a subchapter S corporation, partnership, LLC, or sole proprietorship. Advantages and disadvantages that are not unique to high technology businesses are not listed.

Advantages	Disadvantages
• The PHC tax problem noted above for regular corporations is avoided.[1]	• The 50 percent gain exclusion rule of §1202 is only available to holders of stock in a C corporation.
• A partnership or sole proprietorship is less costly to form relative to a corporation. Thus, more cash is preserved for R&D in the start-up phase.	• The ordinary loss rule of §1244 is only available to individual shareholders of a C or S corporation.[2]
• Losses and credits, such as the research credit of §41, can pass through and be used by owners which may allow for an immediate tax benefit rather than being carried forward by a corporation.[3] However, owners of passthrough entities must consider loss and credit limitation rules, including the passive activity rules of §469.	• The possibilities of using S corporation stock in lieu of cash for expenses and of issuing additional stock as a financing technique are limited due to the restrictions for S corporations on the number and type of shareholders and by the requirement to have one class of stock.[4]
• The possibility that intangible property is really a service only causes a tax effects to the partner contributing such property/services. Others contributing property will still get the tax-deferred benefits of §721.	• Interests in partnerships and LLCs are not convenient forms for compensating employees.
• If the entity were the target of a takeover or acquisition, the resulting gain would only be subject to a single layer of tax. In addition, the loss and credit carryforward limitations of Sections 382 and 383 would not apply; losses and credits are passed through to owners.	• Owners of a passthrough entity may not be viewed as entitled to §174 benefits.

[1] Passive investment income can be a problem for an S corporation that has subchapter C earnings and profits (see I.R.C. § 1362(d)(3)). However, this problem is not addressed in the discussion of choice of entity because the discussion focuses on new entities.

[2] The ordinary loss treatment available under I.R.C. § 1244 is also available where stock is issued to a partnership, but only to partners who are individuals. I.R.C. §1244(a). See Treas. Reg. § 1.1244(d)-2(a) for guidance on determining how much of a shareholder's basis in S corporation stock qualifies for I.R.C. § 1244 treatment. Note that if an S corporation owns stock in a small business corporation and sells it at a loss, the loss is not considered an I.R.C. § 1244 loss when it flows through to the S corporation shareholders. TAM 91-30-003 (Mar. 25, 1991) and Rath v. Commissioner, 101 T.C. 196 (1993).

[3] Limitations exist for owners of passthrough entities; see I.R.C. § 41(g) and later discussion in this article.

[4] An S corporation could use stock appreciation rights or phantom stock plans, but they would not derive the same benefits as use of stock of a regular corporation. See Treas. Reg. § 1.1361-1(b)(3). Also see Treas. Reg. § 1.1361-1(l) (T.D. 8419, 1992) for circumstances where an S corporation could have classes of stock with differing voting rights, but still be considered as having one class of stock if all stock has identical rights to distribution and liquidation proceeds.

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What is Property under IRC §351 and §721?

• Issue/concern: High tech corporations may receive intangible property, such as know-how, in exchange for stock. Issues raised by such contributions include:

a) Is the item transferred to the corporation "property" for §351 purposes or is it services?

b) What is the value of any intangible property transferred in (such property is usually more difficult to value than tangible property)?

Similar issues exist under §721 for property transferred to a partnership in exchange for an interest in the partnership. In *U.S. v. Stafford*, 727 F.2d 1043 (11th Cir. 1984), fn. 9, the court implies that cases under §351 can be used in resolving issues under §721.

• Guidance on "property":

a) Whether intangibles other than patent rights qualify as property is to be determined on a case-by-case basis.

b) A patent right transferred to a corporation is considered property for §351 purposes. [§1.351-1(a)(2)]

c) The IRS has held that the term property includes "secret processes and formulas" per §§861(a)(4) and 862(a)(4) and other secret information as to devices or process, whether or not a patent has been applied for. The item should be something that is subject to legal protection against unauthorized disclosure and use. Recording the idea on paper does not alone make it property. [Rev. Rul. 64-56, 1964-1 (Part 1) C.B. 133, 134.]

d) If an item is not subject to protection from unauthorized use and rights to use under the law, it will likely not be viewed as property. [Rev. Rul. 79-288, 1979-2 C.B. 139.]

e) Where a transfer involves all substantial rights in the property, it will likely be viewed as a transfer of property under §351. [Rev. Rul. 64-56, 1964-1 (Part 1) C.B. 133, 135; *amplified by* Rev. Rul. 71-564, 1971-2 C.B. 179.] The IRS has ruled that to constitute a sale or exchange, all substantial rights to the patent must be granted to the corporation.[5] However, in *E.I. Du Pont de Nemours and Company v. U.S.*, 471 F.2d 1211 (Ct. Cl. 1973), the court held that a non-exclusive license under a patent to manufacture, use and sell a particular product was property for §351 purposes even though the transferor kept certain rights in the patent. The IRS argued that a transaction must qualify as a "sale or exchange" in order to be considered a "transfer" of property "in exchange" for §351 purposes. The court pointed out, however, that §351 is not involved with "true severance of control and true flow of gain." The sale or exchange language pertinent for capital gains transactions stresses a complete disposition by the taxpayer. On the other hand, §351 is "grounded in the taxpayer's continuance in control." The court ruled that the concept of sale and exchange is not relevant under §351. After reaching this conclusion, the court ruled that a non-exclusive license of "substantial value" which was "commonly thought of in the commercial world as a positive

[5] Rev. Rul. 69-156, 1969-1 C.B. 101, the ruling makes reference to I.R.C. § 1235 to determine whether all substantial rights to the patent were transferred. Also see Rev. Proc. 83-59, 1983-2 C.B. 575.

business asset" constituted property under §351.[6] Similarly, in another case, the court stated that the term property "encompasses whatever may be transferred."[7]

f) Case law has also addressed whether the item transferred to an entity in exchange for an ownership interest in the entity must constitute an enforceable property right. For example, a letter of intent was held to constitute property even though it was not legally enforceable.[8] The court pointed out that unpatented know-how, even though not enforceable, could be considered to be property, as could an exclusive right to use a trade secret.[9] Generally, if the item transferred encompasses a "sufficient bundle of rights" it is likely to be viewed as constituting property.[10]

- Services: If the item was developed solely for the corporation, the stock received may be viewed as provided for services. The IRS provides an example where a taxpayer was viewed as receiving payment for services for a plan he developed for selling insurance. If services are to be performed in connection with a transfer of property, the services are merely ancillary to the transfer, and consideration is received for both, §351 treatment can still result for the property. Whether services are considered ancillary and subsidiary to a transfer of property is a question of fact.[11]

  Also relevant in distinguishing a property contribution from the contribution of services is the content of any agreements related to the "transferor's" activities. For example, if the "transferor" is under an agreement with the transferee entity to perform services, the contribution of the results of such services in exchange for an interest in the entity will likely be viewed as given for payment for the services, and taxable to the recipient ("transferor"). If instead, the transferor works on his own behalf and then contributes the results of his activities to the entity, such contribution will likely not be viewed as for services.[12]

  Finally, even if the transferor contributes property in exchange for an interest in a corporation or partnership entity, it must be established that the interest is transferred in exchange for the property, and not for services, or some combination of property and services.[13]

- Advance Rulings: Procedures exist whereby taxpayers may obtain advance rulings from the IRS under §351. Rulings may also be obtained as to whether a transfer of software is a transfer of property under §351.[14]

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[6] IRS reaction to the *Du Pont* case: Although in GCM 36,922 (11/16/76) the Chief Counsel recommended that Rev. Rul. 64-56, *supra*, be modified and Rev. Rul. 69-156, *supra*, be revoked, in light of the decision in the *Du Pont* case, such actions were never taken. Also see GCM 37,178 (6/2477) and 38,114 (9/27/79).

[7] *Stafford*, *supra*, referring to *Hempt Bros., Inc. v. U.S.*, 453 F.Supp. 1172, 1175 (M.D. Pa 1973), *aff'd*, 490 F.2d 1172 (3d Cir.), *cert. denied*, 419 U.S. 826 (1974).

[8] *Stafford*, *supra*.

[9] *Id*. at 1052, with reference to Rev. Rul. 64-56, *supra*, Rev. Rul. 71-564, 1971-2 C.B. 179, and Rev. Rul. 70-45, 1970-1 C.B. 17.

[10] *Stafford*, *supra*, at 1052.

[11] See Rev. Rul. 64-56, *supra*, and cases cited therein.

[12] See Stafford, *supra*, at 1050.

[13] For example, in Stafford, *supra*, at 1054, after concluding that the letter of intent constituted property, the court noted that it must still determine whether the partnership issued Stafford an interest in the partnership as compensation for services to be rendered, or for contributing the letter of intent, or both.

[14] Rev. Proc. 74-36, 1974-2 C.B. 491 and Rev. Proc. 69-19, 1969-1 C.B. 301. The procedures for obtaining rulings under I.R.C. § 351 are at Rev. Proc. 83-59, 1983-2 C.B. 575.

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<u>Example</u>: Carol has been working on developing a new device to treat cancer patients. Abe and B Corporation are interested in this idea and want to enter into a corporate venture with Carol. Abe contributes equipment and facilities worth $350,000 with an adjusted basis of $80,000 and B Corporation contributes $350,000 of cash. Carol contributes all rights to her idea and her written plans (not yet patented). The three parties intend to become equal shareholders of the corporation. It is critical, particularly to Abe and Carol, that Carol be viewed as contributing property, rather than services. If Carol is viewed as really contributing her services of developing her idea, then she has not contributed property. Consequently, Abe and B Corporation, who contributed property, are not in control of the corporation immediately after their contributions because they do not have an 80% or greater interest. Abe would recognize a gain of $270,000 upon contribution of his appreciated property ($350,000 value of stock received less $80,000 basis of property contributed). In addition, Carol would have compensation income from the receipt of stock for her services.

Should Carol's contribution be viewed as services, the shareholders could still qualify for §351 tax-deferred treatment if Carol also contributes a sufficient amount of property that clearly meets the definition of property, such as tangible property or cash. The IRS has indicated that if at least 10% of what Carol receives was matched by a contribution of property, she will count as one of the shareholders who contributed property and the 80% control requirement of §351 will be satisfied. For example, because Carol is to receive stock worth $350,000, if she gives cash or other property worth $35,000, she should be viewed as contributing sufficient property to be included in the group used to measure control.[15]

If there is any doubt as to whether or not Carol has contributed property, the parties should consider obtaining a ruling from the IRS or having Carol contribute at least $35,000 of property for which no question exists that it qualifies as property.

If the parties had instead formed a partnership, Abe would benefit from the tax-free (tax-deferred) rule of §721 that, unlike §351, does not have an 80% or more control requirement for those contributing property. Carol would still have compensation should she be deemed to have received an interest in the partnership for contribution of services.

[15] "When a person transfers property to a corporation in exchange for stock or securities of such corporation and the primary purpose of the transfer is to qualify under section 351 of the Code the exchanges of property by other persons transferring property, the property transferred will not be considered to be of relatively small value, within the meaning of section 1.351-1(a)(1)(ii) of the regulations, if the fair market value of the property transferred is equal to, or in excess of, 10 percent of the fair market value of the stock and securities already owned (or to be received for services) by such person." Rev. Proc. 77-37, 1977-2 C.B. 568, 570, § 3.07.

IRC §1202 and §1045—Qualified Small Business Stock

Basics of the 50% Gain Exclusion Rule

- Provides a 50% gain exclusion for non-corporate shareholders where the qualified small business stock (QSBS) was held over 5 years prior to the sale or exchange. Caveats:

  a) The aggregate amount of gain eligible for the exclusion for the tax year with respect to stock of a corporation is not to exceed the greater of, A) $10 million less the aggregate amount of eligible gain taken into account under §1202 in prior tax years for such corporation, or B) 10 times the aggregate adjusted bases of QSBS issued by the corporation and disposed of by the taxpayer during the tax year.

  b) Per §57(a)(7), 42% of the excluded gain is a preference item for alternative minimum tax (AMT) purposes (thus, for taxpayers in AMT, only 29% of the gain is excluded). If the holding period of the stock begins after December 31, 2000, 28% of the excluded gain is an AMT add-back.

- Eligible stock—must be originally issued after August 10, 1993 at a time when the corporation is a qualified small business. The shareholder must acquire the stock at original issue (with limited exceptions). The stock must be issued for money or other property (other than stock) or as compensation for services (other than services performed as an underwriter). Redemption rules exist which may prevent certain stock from being qualified.

- Qualified small business—a domestic C corporation where aggregate gross assets at all times after August 10, 1993 and immediately after the stock issuance does not exceed $50 million. Aggregate gross assets = cash + aggregate adjusted bases of other property held by the corporation. Where property was contributed to the corporation in a transaction, such as §351, where the corporation's basis is determined with reference to the contributor's basis, the basis of the property is treated as equaling its fair market value at the time of contribution in measuring the corporation's aggregate gross assets (§1202(d)(2)). A high technology corporation can slow down the pace at which it approaches the $50 million asset threshold by expensing its R&E under §174(a) rather than capitalizing it.[16]

- The corporation must agree to submit reports to the IRS and shareholders as required by the IRS.

- Active business requirement—stock is only QSBS if during substantially all of the taxpayer's holding period, the corporation met the active business requirement and was an eligible C corporation. The active business requirement is met where at least 80% (by value) of the corporation's assets (including intangible assets) are used in the active conduct of one or more qualified trades or businesses. If a corporation is engaged in start-up activities (per §195(c)(1)(A)), activities that result in incurring R&E expenditures under §174, or activities with respect to in-house research expenses (as defined at §41(b)(4)), the assets used are treated as used in the active conduct of a qualified trade or business. For purposes of this rule, it does not matter whether the corporation has gross income from the activities.

  Assets held for the "reasonably required working capital needs" of a qualified trade or business are treated as used in the active conduct of a qualified trade or business. Assets held for investment that are reasonably expected to be used within two years to finance R&E in a qualified trade or business or increases in working capital needs of such a business are treated as used in the active conduct of a trade or business. After a corporation is over two years old, it may not have over 50% of its assets qualify as used in the active conduct of a qualified trade or business under the working capital or investment asset exceptions. Any rights to software that produces active business computer software royalties (as defined at §543(d)(1)) are treated as an asset used in the active conduct of a trade or business. If the

[16] However, other tax rules may lead to better results if the company capitalizes its R&E expenditures. For example, if the state in which the company operates in does not allow for a full net operating loss (NOL) carryover, §174(b) capitalization would be preferable. Also, if an ownership change is contemplated sometime in the future and NOLs are being generated, the §174(b) capitalization method would be preferable to keep the NOL amount smaller.

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corporation is an SSBIC (specialized small business investment company), the active business requirement is waived.

The corporation fails the active business requirement if over 10% of the value of its assets consist of stock or securities in other corporations that are not subsidiaries. The corporation fails the active business requirement if over 10% of the total value of its assets is real property not used in the active conduct of a qualified trade or business.

A qualified trade or business is generally a manufacturing, sales or research operation. Ineligible businesses include services (for example, law, health, and accounting), banking, insurance, financing, farming, extraction, hotels, and restaurants.

Rollover of Gain from Sale of QSBS

- IRC §1045 added by the Taxpayer Relief Act of 1997 allows individuals to roll over their QSBS gain if certain requirements are satisfied. Non-corporate taxpayers who sell QSBS owned for over six months and who purchase other QSBS within 60 days, may elect to defer recognition of any gain if the replacement stock meets the active business requirement under §1202 for the six months following the purchase. The cost of the new stock must be at least equal to the amount realized on the old stock in order to defer the entire realized gain. This deferral provision is effective for sales after August 5, 1997.
- Election procedure—see Rev. Proc. 98-48, 1998-38 I.R.B. __.

Cautions

- IRC §1202 is quite detailed and should be carefully reviewed before advising a corporation as to whether or not the stock it issues qualifies as QSBS.
- Check if the shareholder's state has a similar gain exclusion and whether the QSBS requirements include that so much business activity occurs within the state.
- Shareholders investing in a QSBS should be warned that certain events could cause the stock to lose its character as such.
- Employees receiving stock options in a qualified small business will likely want some protection that they will be able to exercise their options when the corporation still qualifies as a qualified small business (assets do not yet exceed $50 million).
- Be sure to consider the interaction of AMT and capital gains rates and netting in determining the benefits to be derived under §1202.

Tax Incentives

High technology businesses typically involve high-paying jobs. Cities, counties and states often seek these types of enterprises to locate in their area. Thus, various tax incentives exist that business owners and their tax advisers should investigate, seek out and utilize, such as research tax credits and sales tax exemptions for manufacturing and R&D equipment. Some states also have enterprise zones that entitle companies located in them to special tax breaks such as on sales tax and income tax credits. While location decisions involve much more than tax considerations, the availability of special tax incentives should not be overlooked as they may help maintain the company's cash.

Basics of IRC §174

- General rule: R&E incurred in connection with a trade or business is treated as current deductions. Note the "in connection with" language, which differs from the §162 "carrying on" language. In *Snow v. Comm'r.*, 416 U.S. 500 (1974), the Court held that the "in connection with " language allows a taxpayer to deduct R&E expenditures before they are carrying on a business. However, the taxpayer must be engaged in a trade or business at some time—there must be some actual and honest objective of making a profit. [*Brown v. Comm'r.*, 58 T.C.M. (CCH) 850 (1989).]

- Election to capitalize R&E: If a taxpayer does not want to currently expense its R&E expenditures, it may elect to instead capitalize them and then begin to amortize them when it first realizes benefits from the expenditures. The amortization period under §174(b) may be no shorter than 60 months. If the R&E results in an item that is depreciable under §167, that life is used. For example, if a software developer has capitalized its R&E (software development costs), the amortizable life is under §167(f)—36 months. [§1.167(a)-14(b)(1) and §1.174-4(a)(4)]

- §174(a) versus (b): Expensing under §174(a) and capitalizing/amortizing under §174(b) are considered methods of accounting. A taxpayer may adopt §174(a) without IRS permission if it expenses R&E in the first year in which it incurs R&E. To adopt the capitalization method of §174(b), special election procedures must be followed (§1.174-4). To change from one method to another (whether for all projects or for a new project), see the procedures under §1.174-3 and §1.174-4. Most changes from §174(a) to §174(b) or vice versa can be made under the automatic change procedures of Rev. Proc. 99-49, 1999-52 I.R.B. 725.

- AMT: If an individual incurs R&E and uses the §174(a) expensing method and does not materially participate in the activity that generated the R&E, the R&E must be capitalized and amortized over 10 years for AMT purposes. Such an individual should consider a §59(e) election to use the same treatment for regular tax purposes for all or part of the §174(a) expenditures. A §59(e) is also available to other taxpayers who use the §174(a) expensing method. The election would apply only for the R&E expenditures designated for the election for the year; such expenditures would be amortized over 10 years and the taxpayer's method remains §174(a) for future years.

- Definition of R&E (§1.174-2(a)): R&D costs incurred in the experimental or laboratory sense, for activities intended to discover information that would eliminate uncertainty concerning the development or improvement of a product. Uncertainty exists if information available to the taxpayer does not establish the capability or method for developing or improving the product or the appropriate design of the product. You are to look to the nature of the activity, not to the nature of the product or improvement being developed. R&E for tax purposes (but not for GAAP purposes) includes the costs of obtaining a patent on the taxpayer's R&E. Depreciable property is not a §174 expenditure, but the depreciation on equipment used in R&E does fall under §174 (§174(c) and §1.174-2(b)(1).

- Relationship to other IRC provisions:
  - §174 expenditures are excluded from §263A.
  - Start-up expenditures under §195 specifically exclude §174 expenditures. [§195(c)(1)]
  - Not all expenditures that fall under §174 as research or experimental (R&E) qualify for the §41 credit for increasing research activities.

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- Software development costs: Rev. Proc. 2000-50 provides that "all of the costs properly attributable to the development of software" may be accounted for similarly to §174 expenditures thereby allowing the taxpayer (1) to currently expense the costs, or (2) to elect to amortize them over 60 months from the date the development is completed in accordance with rules similar to §174(b), or under the 167(f) depreciation rule (36 months) starting with the date the software is placed in service. Thus, this Rev. Proc. does not state that software development costs are §174 costs, just that they may use that accounting treatment. This distinction is particularly relevant for the research tax credit because one of the requirements for "qualified research" is that the expenditures fall under §174 (see *Norwest v. Comm'r.*, 110 T.C. No. 34 (1998)).

- R&E performed by a third party: The taxpayer will need to determine if it acquired completed R&E (an asset) or if it, in effect, incurred the R&E (such that §174 would apply). The distinguishing factor is who bears the risk of the R&E. If it is the taxpayer, the payments to the third party should qualify as R&E (assuming all other requirements were satisfied). [§1.174-2(b)(3) and TAM 9449003]

Basics of the Federal Research Tax Credit (IRC §41)

The federal research tax credit was created in 1981 to address declining spending on research activities (IRC §41, *Credit for increasing research activities*). Congress viewed a tax credit for increased research spending as a way to help companies overcome the reluctance to devote scarce resources for uncertain rewards. The credit was set to expire in 1985 so that Congress could evaluate its efficiency.[17] On June 30, 1999, the research credit expired for the tenth time since it first expired in 1985. The temporary reinstatements of this credit have often been retroactive, but once, the credit was allowed to lapse for a one-year period (July 1, 1995 to June 30, 1996). In December 1999, the credit was extended to June 30, 2004. There are active discussions in the 107th Congress, supported by President Bush, to make the credit permanent as part of a 2001 tax package. The revenue cost of permanency may be an issue though.

In 1986, substantial changes were made to the research credit because Congress believed that the definition of research that qualifies for the credit had been applied too broadly. To tighten up the definition of "qualified research," additional requirements were created and new terminology added to §41. In addition, limitations were placed on the availability of the credit for costs of developing internal-use software. Proposed regulations were not issued to address the revised definition of qualified research until December 1998 and were quite controversial in how they interpret the legislative language. Also, in late 1996, proposed regulations were issued on internal-use software.[18] The passage of more than a decade since the §41 modifications has led to the inevitable result that court cases have beat out regulations as a source of guidance on "qualified research."

Why the Credit Exists

The federal research tax credit was created in 1981 and was intended to:

- encourage businesses to incur costs for research projects despite the reluctance owing to uncertain rewards and significant costs.
- serve as an incentive to stimulate productivity to lead to greater private activity in research.
- address the decline in R&D activities in the U.S. that adversely affects economic growth and competitiveness in world markets.
- encourage taxpayers to conduct research in the U.S.

Instead of applying to all research, the credit only applies to limited specified expenses of "qualified research" that exceed a base amount. The rationale for the incremental nature of the credit was to not reward research that would have been done anyway (represented by the "base amount"). The credit was limited to direct wage, supply and contract research expenses because Congress viewed these principal types of research expenditures as distinctly reflecting the extent of increased activities.

Operation of the Credit

- Formula: The credit is computed on Form 6765. The calculation itself is relatively straightforward. The problems in dealing with the credit are with the numerous definitions, lack of guidance, and recordkeeping. The formula per §41(a):

  20% x [QRE less base amount] + 20% x basic research payments[19]

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[17] General Explanation of the Economic Recovery Tax Act of 1981, prepared by the staff of the Joint Committee on Taxation, pages 119 to 120.

[18] REG-209494-90 (12/31/96).

[19] Basic research payments are explained at §41(e) and basically pertain to certain payments made a corporation to universities and other qualified research organizations.

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- <u>AIRC</u>: The Small Business Jobs Protection Act of 1996 added an alternative incremental research credit (AIRC) that a taxpayer could irrevocably elect to use in place of the regular credit. This credit benefits taxpayers who do not have adequate records to compute a base year (perhaps due to an acquisition), or who obtain a regular credit of zero due to the special features of that credit, such as how it factors in a taxpayer's "research intensity" for prior years (percentage of QRE to gross receipts).

- <u>Definitions for the regular credit</u>:

  a) QRE = Qualified Research Expenses = total of,

  In-house research expenses (wages per §3401(a) + supplies)[20]

  + 65% of contract research expenses[21]

  [The above must be incurred for "qualified research."]

  b) Qualified Research per §41(d) means research—
  - that falls under §174;
  - which is undertaken to discover information (i) which is technological in nature, and (ii) the application of which is intended to be useful in the development of a new or improved business component of the taxpayer; and
  - substantially all of the activities of which constitute elements of a process of experimentation for a purpose that relates to a new or improved function, performance, or reliability or quality. [Note: certain purposes do not qualify—those that relate to style, taste, cosmetic, or seasonal design factors.]

  - Certain activities are specifically excluded from qualifying for the credit (§41(d)(4) & §1.41-4(c)):
    - Research after commercial production;
    - Adaptation of existing business components;
    - Duplication of existing business component from examination of the business component or from plans or publicly available information;[22]
    - Survey, studies, and data collections;
    - Software developed primarily for internal use by the taxpayer other than for use in an activity constituting qualified research or a production process, or as specified in regulations;[23]
    - Research conducted outside the United States, Puerto Rico or a U.S. possession;
    - Research in the social sciences, arts, or humanities;[24] or
    - Research to the extent it is funded by any grant, contract or by some other person, including a governmental entity.[25]

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[20] See §1.41-2(b), (c), and (d). Wages can include the spread from the exercise of non-qualified stock options. *Apple Computer*, 98 TC 232 (1992); acq. 1992-31 I.R.B. 4. Wages can also include the spread resulting from disqualifying dispositions of incentive stock options (ISO). *Sun Microsystems Inc. v. Comm'r.*, T.C. Memo 1995-69, acq, 1997-2 C.B. 1.

[21] See §1.41-2(e).

[22] In TAM 9346006 (8/13/93), the IRS held that research with respect to the development of generic drugs was not qualified research because of the exclusion for duplication procedures. Also see FSA 1999-1023.

[23] See *United Stationers, Inc. v. U.S.*, 99-1 USTC ¶50,136, 82 AFTR2d 98-7488 (7th Cir.), *cert. denied* S.Ct. Dkt. No. 98-1870 (6/21/99); *Norwest Corp., et al. v. Comm'r.*, 110 T.C. 454 (1998); §1.41-4(c)(6); and Notice 87-12, 1987-1 C.B. 432.

[24] See *TSR, Inc. and Subs. v. Commissioner*, 96 T.C. 903 (1991).

[25] Guidance on the meaning of "funded research" can be found at TAM 9410007 (Nov. 30, 1993), *Fairchild Industries v. Comm'r.*, 95-2 USTC ¶50,633, 76 AFTR2d ¶95-5683 (Fed. Cir. 1995), *rev'g* 94-1 USTC ¶50,164 (Ct. Cls.) and *Lockheed*

c) Base Amount—see examples below.

- Special rules for start-up companies: QRE must be paid or incurred in carrying on a trade or business. A special rule at §41(b)(4) allows certain startup ventures to disregard this "carrying on" requirement for in-house research expenses (wages and supplies). Thus, a start-up may not include contract research expenses in calculating the research credit. Special rules also apply to start-up companies in computing their base amount. [§41(c)(3)(B)]

- Prevention of double benefit: To help pay for renewal of the credit and to prevent a double benefit for R&E expenditures (deduction and credit), §280C(c) requires taxpayers to reduce their §174 amount by the amount of the research credit, or to instead elect to take a reduced credit.

Example: Corporation with has a marginal tax rate of 34%, QRE of $16,000 and a credit of $1,600. It must reduce its R&E deduction by $1,600. If instead, the corporation elects to take a reduced credit:

1st - compute §41 credit [$1,600]

2nd - multiply credit by 35% [$560]

3rd - reduce credit by amount from step 2 [$1,040]

Credit Calculation Examples

1. Standard Credit Calculation: Disk Drive, Inc. (DD) - a publicly-traded corporation that designs and manufactures disk drives for personal computers.

Research credit data:

Year	Gross Receipts (GR)	Qualified Research Exp. (QRE)
1984	$28,000,000	$3,000,000
1985	$32,000,000	$4,200,000
1986	$31,000,000	$5,000,000
1987	$34,000,000	$6,200,000
1988	$43,000,000	$6,800,000
[1989 – 1995 – information omitted]		
1996	$48,000,000	$8,400,000
1997	$60,000,000	$10,200,000
1998	$68,000,000	$11,000,000
1999	$76,000,000	$12,000,000
2000	$80,000,000	$10,000,000

Research Credit Calculation for DD:

Step 1 - determine the fixed base percentage:

$$\text{Fixed base percentage} = \frac{\text{total qualified research expenses 1984 - 1988}}{\text{total gross receipts 1984 - 1988}}$$

$$= \frac{\$3{,}000{,}000 + 4{,}200{,}000 + 5{,}000{,}000 + \$6{,}200{,}000 + 6{,}800{,}000}{\$28{,}000{,}000 + 32{,}000{,}000 + 31{,}000{,}000 + 34{,}000{,}000 + 43{,}000{,}000}$$

$$= \underline{\$25{,}200{,}000}$$

Martin Corp., et al v. U.S., 82 AFTR2d 98-7141, 98-2 USTC ¶50,887 (Fed Cls). *Fairchild* case: "inquiry turns on who bears the research costs upon failure, not on whether the researcher is likely to succeed in performing the project."

$168,000,000 = 15.00%

Because 15.00% is below the maximum fixed base percentage of 16%, 15.00% is used.

Step 2 - determine base amount:

Base amount = fixed base % X average annual gross receipts of DD for the four preceding tax years

Average annual gross receipts from 1996 to 1999 =

[$48,000,000 + 60,000,000 + 68,000,000 + 76,000,000] ÷ 4 = $63,000,000

Base amount = 15.00% x $63,000,000 = $9,450,000

Minimum allowable base amount is 50% of the current year QRE:

50% x $10,000,000 = $5,000,000

Because $9,450,000 is greater than the minimum base amount, $9,450,000 must be used.

Step 3 - determine credit:

20% x [qualified research expense - base amount] + 20% of basic research payments

20% x [$10,000,000 - $9,450,000] + 20% x $0 = **$110,000**

Thus, the $10,000,000 of 2000 QRE generated a $110,000 credit (1.10% of QRE).

Per IRC §280C(c), DD must reduce its R & E expense deduction on its 2000 return by $110,000 (the amount of the credit), or, it may chose instead to take a reduced credit and not change its R & E deduction. Note that DD would have had a higher credit if its 2000 research expenses were greater, its base years' research expenses were less, its base years' gross receipts were more, and/or its gross receipts in the prior four years was less.

2. *Start-up company:* ABC Corporation was formed in 1999 and had the following revenue and expenses:

	1999	2000
Sales revenue	$20,000	$45,000
Interest income	$1,000	$1,000
Section 174 expenses	$35,000	$55,000
QRE	$22,000	$39,000

2000 research credit calculation:

Step 1: Fixed base percentage = 3%

Step 2: Base amount = 3% x $\frac{(\$20,000 + \$45,000)}{2}$ = $975

Minimum base amount = 50% of 2000 QRE = $19,500

Step 3: Credit =

20% x [$39,000 - $19,500] = $3,900

or, ABC may elect to take a reduced research credit:

$3,900 x 35% = $1,365

Credit = $3,900 - $1,365 = $2,535

Thus, ABC obtained a credit equal to 6.5% of its QRE ($2,535 ÷ $39,000). This is the maximum credit amount available.

If ABC does not elect to take a reduced research credit, it must reduce its §174 amount by $3,900.

3. Alternative Incremental Credit: Example: Research credit data for T Corporation:

Year	Gross Receipts (GR)	Qualified Research Exp. (QRE)
1984	$ 28,000,000	$ 4,400,000
1985	$ 30,000,000	$ 6,300,000
1986	$ 31,000,000	$ 6,400,000
1987	$ 31,000,000	$ 7,200,000
1988	$ 32,000,000	$ 7,600,000
1989	$ 42,000,000	$ 8,800,000
1990	$ 56,000,000	$ 8,900,000
1991	$ 68,000,000	$ 9,000,000
1992	$ 81,000,000	$10,000,000
1993	$ 99,000,000	$11,000,000
1994	$117,000,000	$12,000,000
1995	$122,000,000	$13,000,000
1996	$134,000,000	$14,000,000
1997	$156,000,000	$16,000,000

1) Determine fixed base percentage:

= $\frac{\text{total QRE 1984 - 1988}}{\text{total gross receipts 1984 – 1988}}$ = $\frac{\$31,900,000}{\$152,000,000}$ = 20.99%

Because 20.99% is above the maximum fixed base percentage of 16%, 16.00% is used.

2) Determine the base amount:

= fixed base percentage x average annual GR for the 4 preceding tax years

= 16.00% x $118,000,000 = $18,880,000

Minimum allowable base amount is 50% of the current year QRE:

$16,000,000 x 50% = $8,000,000

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Because $18,880,000 > the minimum base amount, $18,880,000 must be used.

3) Determine the credit amount:

20% x [$16,000,000 - $18,880,000] + 20% x $0 = $0

Thus, the $16,000,000 of QRE generates no research tax credit for 1997.

Alternative incremental credit calculation:

Preliminary amounts needed:

1% x $118,000,000 = $1,180,000
1.5% x $118,000,000 = $1,770,000
2% x $118,000,000 = $2,360,000

Calculation - credit equals the sum of the following amounts:*

(a) QRE in excess of	$1,180,000, but not in excess of
	$1,770,000
	$ 590,000
	x 1.65%
	$ 9,735
(b) QRE in excess of	$1,770,000, but not in excess of
	$2,360,000
	$ 590,000
	x 2.2%
	$ 12,980
(c) QRE in excess of	$ 2,360,000
	$16,000,000
	$13,640,000
	x 2.75%
	$ 375,000

Total = **$397,815**

* The Tax Relief Extension Act of 1999 (P.L. 106-170) increased each of the three percentages used to compute the AIRC by one percentage point (to 2.65, 3.2, and 3.75) effective for tax years beginning after June 30, 1999.

Selected Issues

1. The credit has expired 10 times since it was first enacted in 1981 – should it be made permanent?

2. Should the base period (1984 – 1988) be updated? Should the 50% minimum base rule be repealed?
   - Basically, a credit is generated if current QRE exceeds research intensity (QRE/GR) for base period (capped at 16%) applied to average gross receipts for the prior 4 years.

- However, the base amount cannot be less than 50% of current year QRE. This serves as a cap on the credit (basically limits it to 10% of QRE – which is then further reduced to 6.5% by §280C(c)). This 50% base rule serves to limit the credit for companies with a large increase in QRE over the base amount.

  Example: Base amount = $10
  Current QRE = $20
  Credit = 20% x $10 = $2

  Modification: Base amount = $10
  Current QRE = $30
  Credit = 20% x $15 = $3 (so additional $10 of current QRE only generated $1 of credit --- 10%, not 20%)

- A 1995 GAO study found that almost 60% of corporations were subject to the 50% minimum base rule. *Query*: Is the incremental nature of the credit being carried out if almost 60% of firms, in effect, calculate the research tax credit at 10% of current year QRE?

- Additional issues with the current base: (1) provides little incentive for companies, such as defense firms, with QRE in the base period that is unrealistically high for them today; (2) doesn't reward companies that have become more efficient in their R&D activities; and (3) incentive is diminished if company has changed its business focus such that it doesn't make sense to devote the same percentage of GR to R&D as in the base period (such as a company that has added new lines of business in the finance area).

3. The credit cannot be used to reduce AMT and is not a refundable credit.

4. There is much dispute as to what constitutes *qualified research*.

Recent cases involving a research credit claimed for internal-use software (which must cross more hurdles than other types of research) has raised some issues as to the meaning of QRE. A few courts have taken a very narrow interpretation of "discovering information that is technological in nature." For example, in *Norwest Corp. v. Commissioner*, 110 T.C. 454 (1998), a case involving internal-use software, the court stated: "The fact that the information is new to the taxpayer, but not new to others, is not sufficient for such information to come within the meaning of discovery for purposes of this test. The purpose of the R&E credit was to stimulate capital formation and improve the U.S. economy—not merely the taxpayer's business."[26]

Issues: Did Congress intend for the research credit to only be available where the taxpayer can show that it discovered something that was new to everyone? Did Congress intend that software development would have to expand or refine the field of computer science, or somehow go beyond the preexisting knowledge of the principles of computer science? If yes, who is to determine if this level of discovery has been achieved? The legislative history to §41(d) states that the "determination of whether the research is undertaken for the purpose of discovering information that is technological in nature depends on whether the process of experimentation utilized in the research fundamentally relies on principles of the physical or biological sciences, engineering, or computer science[27]—in which case

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[26] Similarly, see *United Stationers, Inc.*, 82 AFTR2d 98-7488, 99-1 USTC ¶50,136 (7th Cir.), *cert. denied* S.Ct. Dkt. No. 98-1870 (6/21/99).

[27] This quote includes the following footnote: "Research does not rely on the principles of computer science merely because a computer is employed. Research may be treated as undertaken to discover information that is technological in nature, however, if the research is intended to expand or refine existing principles of computer science."

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the information is deemed technological in nature—or on other principles, such as those of economics—in which case the information is not be treated as technological in nature."[28]

Does this language imply a separate discovery test, or does the "deemed" language mean that if the research is in an appropriate field, it is deemed technological in nature (which along with the other requirements and limitations of §41, arguably causes the credit to be allowed only for appropriate expenses and research activities)? Given that many software processes are protected by trade secret, how can a taxpayer know if they have expanded the field of computer science?

Also, from what perspective is the court's "discovery test" statement about the need for qualified research to stimulate capital formation and improve the U.S. economy to be applied? Arguably, the economy is improved by streamlined financial transactions. Witness the growth of Internet-based financial transactions (such as home banking and stock trading) and suggestions by governments for increased use of technology for transfers of funds to and from the government (such as EFT for tax deposits).

In contrast, a 2000 District Court case held that there was no separate "discovery test." In *Tax and Accounting Software Corporation v. U.S.*, 86 AFTR2d 2000-5752, 2000-2 USTC ¶50,672 (ND OK 2000) (appeal pending in the 10th Circuit), a case involving commercial software, the court found that the "discovering information that is technological in nature" test was satisfied. Per the court, the courts in *United Stationers* and *Norwest* "erroneously tried to divide this requirement into two tests with the first being whether the taxpayer's actions can be considered a 'discovery' in the scientific sense." Per the court, the "emphasis should be on whether the information qualifies as being 'technological in nature' (the Technology Test), not whether the work could be considered a revolutionary discovery in the scientific sense." Based on its reading of the TRA'86 legislative history, the court did not see a reason to put a "scientific" spin on the word "discovery" when the intent of the requirement was to distinguish between technologically-based information and non-technologically-based information. The term "discovery" could also mean "detect," unearth" and "learn."

The court also looked to the conference committee report to the Tax and Trade Relief Extension Act of 1998 (P.L. 105-277) where Congress stated that evolutionary research activities could qualify for the credit. Per the court, evolutionary research is not 'revolutionary research." "[Evolutionary research] suggests to the Court a pattern of research that is unfolding in a series of events rather than something that is a radical change from the norm." In short, per the court, the "purpose of the 'technology' requirement of section 41 is to eliminate the 'soft sciences' from contention for the credit, not to focus on the word 'discovery.'"

Update: In the preamble to the final §41 regulations issued in January 2001 (T.D. 8930), Treasury notes the *Norwest* and *United Stationers* cases, but does not mention the *TAASC* case. On January 31, 2001, Treasury Secretary O'Neill announced that Treasury was delaying the effective date of the final regulations and reopening the comment period.[29]

5. Are in-house patent counsel wages a QRE?

In FSA 200131007, the Service ruled that wages of in-house patent counsel did not constitute qualified research expenditures for the research credit. Taxpayer provides telecommunications products and services. In-house patent counsel gets involved from the point at which an engineer creates a written disclosure of an idea. Taxpayer's Patent Department includes attorneys, agents, engineers, illustrators and coordinators (clerical support). All, but the coordinators have technical degrees.

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[28] General Explanation of the Tax Reform Act of 1986, prepared by the staff of the Joint Committee on Taxation, page 133.

[29] Treasury press release of January 31, 2001, PO-18; http://www.treas.gov/press/releases/po18.htm. Per Notice 2001-19, 2001-10 I.R.B. __, comments are requested by April 2, 2001.

To qualify for the credit, the wages paid to Patent Department personnel must meet the definition of "qualified services" under §41(b)(2)(B) and §1.41-2(c). Such services must provided for engaging in qualified research or engaging in direct supervision or support of research activities that constitute qualified research. Determination of qualified services is to consider the activities performed, rather than job titles.

The IRS stated that the work of patent personnel was not for direct engagement in qualified research because the work did not involve discovery of technological information or a process of experimentation. The fact that the patent personnel may have interacted with researchers to determine whether something is patentable or how distinct the research outcome must be for it to be patentable did not rise to the level of direct research. In addition, the patent personnel's work was not direct supervision of qualified research because it did not involve day-to-day supervision or first-line management of qualified research.

Finally, the IRS did not find that patent personnel work was in direct support of qualified research. While clerical work to prepare research reports and compile data may be direct support, the work of the patent personnel was not seen as crucial to the research.

The IRS took an interesting interpretation of the meaning of qualified support by implying that work is in direct support of research if failure to the do the work would impede the research.

> "Taxpayer correctly notes that activities in direct support of research include typing reports, cleaning equipment, compiling data, and machining parts so that without such activities, the research could not be completed. See Treas. Reg. section 1.41-2(c)(3)(ii). Thus, the failure of a secretary to type a report describing laboratory results derived from qualified research may impede the research, particularly to the extent such report would document the requisite process of experimentation. Similarly, the failure of a clerk to compile research data may delay if not suspend the research.
>
> Conversely, the failure of a Patent Coordinator to prepare a monthly report on Patent Department activities, or to ensure that patent docketing procedures are followed, may impede the operations of the Patent Department but not the progress of Taxpayer's researchers. Similarly, the failure of a Patent Attorney to determine if the product under development may potentially infringe upon an existing patent will only temporarily curtail product development in the same way the failure of a payroll employee to cut a salary check only may delay the research phase to the extent Taxpayer's overall business activities are affected. In short, the activities of the Patent Department are intended to facilitate, streamline and validate the research efforts and end products of Taxpayer's inventors and engineers. The Patent Department will perform all necessary tasks to achieve this end but such activities alone do not contribute to the efforts underlying the research or support the research."

Observations: The issue presented in this FSA is a longstanding one. It would seem arguable that where the patent personnel work very closely with researchers to guide documentation and perhaps even the direction of the research, it would be in direct support of that research. After all, if the research yields something already patentable, it won't be useful to the taxpayer. Also, some research needs to be patented in order to be useful to the taxpayer. One might also argue that because the §1.174-2 regulations so clearly state that costs to obtain patents on research qualify as R&E expenditures under §174, that Congress would have specifically excluded such activities under §41(e) if they did not want them to qualify for the research tax credit. On the other hand, arguments can also certainly be made that the attorneys aren't conducting research or enabling it to occur and thus, are not performing qualified services. This remains an unclear area under §41 since FSAs are not binding authority.

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6. What are supplies?

§41(b)(2)(C): "The term 'supplies' means any tangible property other than – (i) land or improvements to land, and (ii) property of a character subject to the allowance for depreciation."

Some of the issues raised by this definition:

a. If the taxpayer incurs costs to dispose of supplies, is that part of the cost of the supply? Is it a QRE paid in direct support of research? (See FSA 200103010.)

b. What is the difference between contract research expenses and supplies when a third party creates the supply? (See *Lockheed Martin Corp. v. U.S.*, 87 AFTR2d 2001-1799 (Fed. Cls. 2001).)

c. If the taxpayer creates the supply, such as a chemical, itself, what costs are considered QRE? Can overhead costs be included?

d. If the supply is of a type of property, such an engine that is destroyed in the research testing, that would be depreciable in some taxpayer's hands, is it a QRE?

7. How much documentation is needed? The final regulations under §41 provide that taxpayers must prepare "documentation before or during the early stages of the research project, that describes the principal questions to be answered and the information the taxpayer seeks to obtain to satisfy the requirements of [§1.41-4(a)(3) – "discovering information], and retains that documentation on paper or electronically" as prescribed in regulations or other administrative guidance. The taxpayer must also satisfy the recordkeeping requirement of §6001.[30]

Consideration should also be given to that fact that QRE must be of a type that qualifies, such as wages, and incurred in an activity or project that qualifies (research that meets the requirements of §174 and is technological in nature and is not an excluded activity under §41(d)(4)). Thus, in addition to tracking dollar amounts, information on the nature of the projects or activities to which the costs relate must also be collected. Terminology should also be evaluated. For example, certain job titles and account names may unnecessarily lead to problems during an audit by the Service. Labeling a worker as an administrative assistant when that person's primary job is to document research activities in a lab will lead to unnecessary scrutiny by the Service.

The adviser should also consider what documents the IRS might ask to examine during an audit and be sure the documentation is not confusing. For example, the IRS might ask for job descriptions and employee performance review files from the personnel office, as well as contracts that support contract research expenses. In addition, the IRS may ask for organizational charts, accounting manuals, copyright and patent applications, minutes of various meetings where R&D projects were discussed, and progress reports.[31]

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[30] Reg. §1.41-4(d) of T.D. 8930, January 3, 2001. On January 31, 2001, Treasury Secretary O'Neill announced that Treasury was delaying the effective date of the final regulations and reopening the comment period. Treasury press release of January 31, 2001, PO-18; http://www.treas.gov/press/releases/po18.htm. Per Notice 2001-19, 2001-10 I.R.B. __, comments are requested by April 2, 2001.

[31] In 1995, David W. Bernard, IRS National Issue Specialist for the Research Credit, released his recommended audit plan for the research tax credit. While the plan is not binding on examiners, it presents a good overview to how the IRS will likely verify the research credit and can be helpful in setting up adequate recordkeeping and documentation prior to the filing of each tax return. Distributed at Mr. Bernard's presentation on "R&E Documentation" at the 11th Annual High Technology Tax Institute, San Jose, Nov. 14, 1995. Available from Lexis: *Full Text: IRS Specialist's Paper on Audit Plan For Research Tax Credit*, Tax Notes Today, 95 TNT 225-40 (Nov. 17, 1995).

8. Relative to the standard research tax credit, the AIRC rates are arguably still too low.

9. Is a maximum of 6.5% credit on a subset of §174 expenditures the appropriate incentive? Because a company may not receive all of the return from its research investment, but will instead share some of it with society, there is justification for public support of such research. *Query*: How much? Also, since many countries are seeking U.S. R&D activities and offer a variety of incentives, what is the appropriate incentive to keep the R&D in the U.S.?

Has the Research Tax Credit Accomplished its Policy Goals?

Both government and private studies have shown that the research tax credit has had an impact on the amount of research conducted. A 1989 General Accounting Office (GAO) report, "The Research Tax Credit Has Stimulated Some Additional Research Spending," stated that the research credit "raised corporate spending on R&E above the level that otherwise would have been achieved."[32] This study, based on a sample of 800 corporations and economic models, concluded that the credit "stimulated between $1 billion and $2.5 billion of additional spending for the 5 years 1981 through 1985." Such an increase represented an increase of 15 cents to 36 cents for every dollar of foregone tax revenue due to the credit.[33]

A 1994 private study concluded that the GAO study underestimated the benefits of the research tax credit. This study estimated that the credit stimulated additional spending of about $2 billion per year with foregone tax revenues of about $1 billion per year.[34]

As noted in two government reports, studies of the research credit may not have captured its complete benefits because of the sometimes long lead times for research projects and changes made to the credit since 1981, particularly in 1989.[35] A 1993 report noted that the 1989 changes likely increased the credit's incentive effect "substantially" and may have increased the credit's impact "beyond what is shown by the existing data."[36]

The California Research Tax Credit

- R&T §17052.12 and §23609.
- California Form 3523.
- Permanent provision in California law.
- Similar to the federal credit at IRC §41 except that an 15% rate is used instead of a 20% rate, IRC §41(a)(2) regarding payments to qualified organizations for basic research only applies to

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[32] "The Research Tax Credit Has Stimulated Some Additional Research Spending," by GAO, GAO/GGD-89-114, Sept. 1989, pg. 22.

[33] 1989 GAO report, *supra*, pg. 22.

[34] "R&D Tax Policy During the 1980s: Success or Failure," by Bronwyn H. Hall, National Bureau of Economic Research, Reprint No. 1872, April 1994, pg. 29. The author also noted that the investment incentives of the research tax credit should also consider the interaction of the foreign tax credit and the AMT. Pgs. 28 - 30.

[35] Prior to the 1989 changes to the research tax credit, the amount of the credit was based on a rolling base period of research expenditures. There was some disincentive built into such a system because more dollars spent on research today would result in a smaller credit in future years. "The R&D Tax Credit: An Evaluation of Evidence On Its Effectiveness," A Staff Study prepared for the use of the Joint Economic Committee, 8/23/85, page 4., also noted that the temporary nature of the credit "has detracted from its effectiveness" (pg. 1).

[36] "The R&D Tax Credit: An Evaluation of Evidence On Its Effectiveness," A Staff Study prepared for the use of the Joint Economic Committee, 8/23/85, page 1 and Congressional Research Service Issue Brief "The Research and Experimentation Tax Credit," by D. Brumbaugh, November 17, 1993.

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corporations and is a 24% rate for corporations (rather than the 20% rate allowed for the federal research credit).

- California conforms to the federal definition of QRE.
- Qualified research includes only research performed in California

- Gross receipts used for the credit calculation only includes receipts from sales that are delivered or shipped to a purchaser in California ("throwback" sales are not included).

Potential for Capital Gain Income from Transfer of a Patent (IRC §1235)

Basics:

- Allows for certain transfers of patents to be treated as if a capital asset were sold or exchanged. Thus, the transferor can obtain the benefit of the lower capital gains tax rates.

- Purposes—a) to allow professionals, as well as amateur inventors an opportunity to enjoy capital gain treatment for their royalties, and b) to allow for capital gain treatment even if payments by the transferee are payable periodically or contingent on the productivity or use of the patent. [*Blake v. Comm'r.*, 80-1 USTC ¶9247 (6th Cir.)]

- Must be a transfer of property consisting of all substantial rights to a patent, or an undivided interest which includes a part of all such rights.

- It does not matter that payments are payable periodically over a period of time that corresponds with the transferee's use of the patent, or is contingent on the productivity, use, or disposition of the property transferred.

- Patent refers to a patent granted under Title 35 of the U.S. Code or any foreign patent granting rights similar to those of a U.S. patent. "It is not necessary that the patent or patent application for the invention be in existence if the requirements of section 1235 are otherwise met." [§1.1235-2(a)]

- The transfer must be by the "holder". A "holder" is any individual whose efforts created the patent, or any other individual who acquired his interest in the patent in exchange for consideration in money or money's worth paid to such creator prior to actual reduction to practice of the invention covered by the patent, if such individual is neither a) the creator's employer, nor b) related to the creator (per §1235(d)).

- Two-prong inquiry—1) what does the holder have left after the transfer? If he retains any substantial rights to the patent, he has not transferred enough. 2) if the transferor has no substantial rights left, then examine what was actually relinquished - should be the monopoly rights to the patent. [*Blake*, *supra*, quoting *Fawick v. Comm'r.*, 436 F.2d 655, 662, 71-1 USTC ¶9147 (6th Cir.)]

- Be sure to review the §1235 regulations and court cases for details of definitions.

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Type of Revenue: Focus on Software Revenue Recognition and Characterization

a. Nature of Revenue

For some high technology companies, such as software development, it may not be easy to tell if the revenue received is from services, rent or sale of goods. Also, it may be possible to structure some transactions for the optimal tax result.

Example: AB Corporation, a subchapter S corporation, developed software to aid doctors in tracking medications used by patients. AB has determined that it can market this software in the following ways:

i) By licensing it to doctors and entering an agreement to provide technical support and updates.

ii) By having a doctor's office access the software by dialing in to AB's computer system and running the program on an as needed basis with AB charging for the connect time. AB believes there is a business benefit of having customers dial in to access the software in that it will be easier for AB to update the software and allow for access to the most current medication data.

iii) By including an on-line connection feature with the software and giving the software away for free. AB would then charge customers for connect charges to access AB's medical library database and for technical support.

AB must determine its type of revenue under each scenario (sale of goods, royalties, service income) and what the tax consequences are of each to AB and its customers. AB should also consider tax planning considerations in selecting its revenue technique. For example, if AB will be collecting advance payments from customers, AB may prefer to utilize a revenue stream that constitutes services income, adopt the accrual method, and defer the payments by adopting the deferral technique of Rev. Proc. 71-21.

b. Tax Consequences of Character of Income

For federal income tax purposes, distinction between a sale, a license, a lease and the provision of services can be relevant in the following contexts (only federal domestic tax issues are discussed):

(1) Character of the resulting income: If the transferred item is a capital asset that is sold, capital gain will result; if it is not a capital asset, or is licensed, ordinary income will result. It is also important to distinguish what has been transferred: an intangible, such as a copyright, or a copyrighted item. For certain transfers of a patent, special capital gain treatment of §1235, *Sale or exchange of patents,* may be available.

(2) Timing of income recognition: If the transferred item is licensed, income is likely earned by an accrual basis taxpayer ratably over the license period; if the item is sold, income is recognized upon sale, unless the installment method applies.[37]

(3) Passive versus active income: Under some tax provisions, royalty income from licensing can produce adverse tax consequences such as personal holding company status, passive investment income of an S corporation, or possibly constitute income from a passive activity under §469.

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[37] Whether the installment sale method of §453 can apply to payments received over more than one tax year for the transfer of software depends on whether the item transferred is considered inventory or dealer property in which case the installment sale method is not allowed.

c. Sale versus Lease versus License

- Rev. Rul. 55-540, 1955-2 C.B. 39[38]—For tax purposes, whether a transaction is a lease or a sale depends on the intent of the parties as evidenced by the terms of the transaction. A transaction will most likely be classified as a sale if one or more of the following conditions exists:

  a) A portion of each periodic payment made by the customer is specifically to acquire an equity interest in the property.

  b) The customer will acquire title to the property once they make a stated amount of payments.

  c) The total amount to be paid by the customer for a relatively short period of use is an "inordinately" large proportion of the total amount to be paid to obtain title to the property.

  d) The periodic payments materially exceed the fair rental value.

  e) The agreement includes a purchase option that allows the customer to obtain the property for a nominal amount relative to the total amount of periodic payments to be made.

  f) A portion of each periodic payment made by the customer is designated as interest.

  A transaction may be classified as a sale even if title does not transfer, provided at least one of the above factors is present.

- TAM 9231002—The IRS applied Rev. Rul. 55-540 (and other guidance) to hold that updates for off-the-shelf software should be treated as goods, rather than as services. The Service also held that the deferral provisions of §1.451-5 could apply to the amount received in advance for the maintenance agreement (to provide updates).

  Example: Taxpayer receives $100x for a five-year extended maintenance contract and reports $20x income per year for financial reporting purposes. Under §1.451-5, taxpayer would generally report the $100x in year 3. However, since $20x is reported for books each year, taxpayer's deferrals for tax purposes may not be greater than the book deferrals, thus the taxpayer would report $20x in both years 1 and 2 of the contract and $60x in year 3.

- *Grodt & McKay Realty v. Comm'r.*, 77 T.C. 1221 (1981)—8 factors:

  (i) Whether legal title passes;

  (ii) How the parties treat the transaction;

  (iii) Whether an equity was acquired in the property;

  (iv) Whether the contract creates a present obligation on the seller to execute and deliver a deed and a present obligation on the purchaser to make payments;

  (v) Whether the right of possession is vested in the purchaser;

  (vi) Which party pays the property taxes;

  (vii) Which party bears the risk of loss or damage to the property; and

  (viii) Which party receives the profits from the operation and sale of the property.

- Sale - transfer of title, or transfer of benefits and burdens of ownership may be sufficient. Seller gives up all substantial rights.

d. International Tax Provisions

Final regulations providing guidance on the classification of revenues from transactions involving computer programs under certain international provisions of the Code were issued at §1.861-18 (T.D. 8785; 10/2/98; replacing proposed regulations at REG-251520-96; 11/13/96). The rules contained in

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[38] Also see Rev. Rul. 75-21, 1975-1 C.B. 715.

these regulations enable taxpayers to categorize transactions involving computer programs as being either: sales, licenses, leases, the provision of services, the provision of know-how, or some combination of these transactions. The regulations only apply for purposes of IRC §§861 through 999, 367, 404A, 482, 551, 679, 1059A, 1441 through 1465, 1491 through 1494, 842 and 845 (to the extent involving a foreign person) and for transfers to foreign trusts not covered by section 679.[39] The regulations are effective for contracts entered into on or after December 1, 1998; elective transition rules are provided at §1.861-18(i)(2).[40]

The chart below summarizes the six types of transactions described in the regulations. The regulations contain 18 examples to help illustrate their application; these examples are referenced in the chart.

Transaction	Regulation §1.861-18
Transfer where transferee (TE) acquires one or more of the following rights: (i) to make copies of CP to distribute to the public by sale or other transfer of ownership, or by rental, lease or lending; (ii) to prepare derivative CP based upon the copyrighted CP; (iii) to make a public performance of the CP; or (iv) to publicly display the CP. CP = computer program[41]	Transfer of © rights, that is either: (1) a sale or exchange of property (©) - if, based on the facts and circumstances, all substantial rights in the © have been transferred (per the principles of §1222 and §1235, as well as case law (even cases not specifically addressing §1222 and §1235)); [Income to be sourced per §865(a), (c), (d), (e), or (h) as appropriate.] [Example 5] or (2) a license of a © generating royalty income - if not all substantial rights have been transferred. [Income to be sourced per §861(a)(4) or §862(a)(4) as appropriate.] [Examples 6 and 8] © = copyright

[39] §1.861-18(a)(1).

[40] §1.861-18 (i).

[41] Per §1.861-18(a)(3), a computer program is defined as a "set of statements or instructions to be used directly or indirectly in a computer in order to bring about a certain result." A computer program includes "any media, user manuals, documentation, data base or similar item if the media, user manuals, documentation, data base or similar item is incidental to the operation of the computer program."

Transaction	Regulation §1.861-18
TE acquires copy of CP, but does not acquire any of the rights (i) - (iv) listed above (or only acquires a de minimis grant of such rights), and either no services or a de minimis amount of services are involved, or a de minimis amount of know-how is involved.	Transfer of copyrighted article,[42] that is either: (3) a sale or exchange of a copyrighted article if the benefits and burdens of ownership have been transferred; [Income to be sourced per §861(a)(6), §862(a)(6) §863, §865(a), (b), (c), or (e), as appropriate.] [Examples 1, 2, 7, 9, 10, 11, 13, 14, 17, and 18] or (4) a lease of a copyrighted article (generating rental income), if insufficient benefits and burdens of ownership have been transferred. [Income to be sourced per §861(a)(4) or §862(a)(4), as appropriate.] [Examples 3, 4, and 12]
Provision of services for the development or modification of a CP. Provision of services is to be distinguished from other transactions by considering "all the facts and circumstances of the transaction, including, as appropriate, the intent of the parties (as evidenced by their agreement and conduct) as to which party is to own the copyright rights in the computer program and how the risks of loss are allocated between the parties." [§1.861-18(d)]	(5) Provision of services. [Example 15]
Provision of information with respect to a CP that: 1) relates to computer programming techniques; 2) is furnished under conditions preventing unauthorized disclosure; and 3) is considered property subject to trade secret protection.	(6) Provision of know-how relating to computer programming techniques. [Example 16]
Transaction involving more than one category above.	Treat as separate transactions, with appropriate provisions applied to each transaction. "However, any transaction that is de minimis, taking into account the overall transaction and the surrounding facts and circumstances, shall not be treated as a separate transaction, but as part of another transaction."[43]

Additional Points:

[42] Per §1.861-18(c)(3), "copyrighted article" includes "a copy of a computer program from which the work can be perceived, reproduced, or otherwise communicated, either directly or with the aid of a machine or device. The copy of the program may be fixed in the magnetic medium of a floppy disk, or in the main memory or hard drive of a computer, or in any other medium."

[43] §1.861-18(b)(2).

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- Consideration of special features of computer programs—per §1.961-18(f)(3), consideration of special characteristics of computer programs may need to be considered, such as the ability to make perfect copies at minimal cost. For example, if a program deactivates itself after a specified time period, such a feature is generally the equivalent of returning the program after such time period.
- Regs override—the form and wording used by the parties and the classification under copyright law do not control the classification for tax purposes.
- Accounting method changes—automatic consent is granted to change a method of accounting to comply with §1.861-18. See §1.861-18(j) and (k).
- Definition of a computer—the final regulations do not define "computer" because the definition of software used in the regulations is based on copyright law which does not define "computer."

Items Not Addressed:

- The Service will continue to consider whether the characterization principles of §1.861-18 should apply to other provisions of the Code.
- The Service may consider whether to apply the principles of §1.861-18 to other types of transactions, such as transfers of other types of digitized information; this would be a separate guidance project.

e. Additional Guidance and Considerations

- **Rev. Proc. 71-21**—Allows an accrual method taxpayer to defer recognition of prepaid service revenue provided all services are to be provided by the end of the next tax year.
- **Rev. Rul. 69-314**—Taxpayer, a boat builder, had contracts with the government under which the government retained a portion of the total contract price. A portion of the retainage was released to the taxpayer when each boat was completed and the balance when all boats were delivered. The Service held that all events that fix the taxpayer's right to receive part of the retainage do not occur until each boat is accepted and for the final retainage amount, when all boats are accepted. Some taxpayers have applied the logic of this ruling to software developers who do not earn development fees until certain milestones are attained. The 1999 IRS/Treasury Business Plan included "Guidance under sections 446 and 451 regarding the accrual acceptance method." It is likely that this guidance will modify or limit the application of Rev. Rul. 69-314.
- **§458 and Video Game Cartridges**: In TAM 9730006 the Service held that a video game cartridge qualified as a "record" per §458 and §1.458-1(b)(3) because its pre-recorded sound was a "relatively substantial and an integral part" of the item and sufficiently material compared to the non-audio components of the cartridge. Thus, a taxpayer who distributes such games could elect to exclude from gross income amounts returned within a specified time after year-end. Unfortunately for the taxpayer in the TAM, it had not properly elected to use the §458 method and had not actually used it. Thus, the Service required it to use the normal accrual method, rather than the §458 method.
- **Financial Reporting**—Tax practitioners should know how the software developer is reporting revenue for financial reporting purposes under SOP 97-2 in order to better understand the nature of the transactions and to identify book-tax (Schedule M-1) differences.

Introduction to Nexus (State Tax Considerations)

What is Nexus?

Sufficient *nexus* must exist in order for a state to subject a vendor to tax, as well as sales and use tax collection obligations. Nexus may be thought of as a connection between the vendor and state such that subjecting the vendor to the state's sales tax rules is neither unfair to the vendor nor harmful to interstate commerce. These two requirements of fairness to the vendor and no impediment to interstate commerce stem from the U.S. Constitution—respectively, from the Due Process Clause and the Commerce Clause. Both of these requirements must be satisfied before a state may impose sales and use tax collection responsibilities on a vendor. These constitutional provisions are explained below, along with an overview of the *Quill* case which provides the current state of the law as to how these rules apply in determining whether a state may impose sales and use tax collection obligations on a remote (non-physically present) vendor.

Due Process Clause

The 14th Amendment to the U.S. Constitution provides: "No State shall make or enforce any law which shall abridge the privileges or immunities of citizens of the United States; nor shall any State deprive any person of life, liberty, or property, without due process of law; nor deny to any person within its jurisdiction the equal protection of the laws." The Due Process Clause requires "some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax."[44] "The simple but controlling question is whether the state has given anything for which it can ask return."[45] The due process requirement ensures fairness to a vendor by ensuring that it has some minimal contact with the state before subjecting it to state laws.

Unlike the Commerce Clause (discussed next), the Due Process Clause does not give Congress any power to enact a law that would modify or violate the due process standard.

Commerce Clause

Article I, Section 8, Clause 3 of the U.S. Constitution provides: "The Congress shall have power ... to regulate commerce with foreign nations, and among the several States, and with the Indian tribes."

Courts often refer to the "dormant" or "negative" Commerce Clause because the above statement does not specifically limit state activities; instead, it just grants power to Congress to regulate commerce. In applying the dormant Commerce Clause, the courts consider the purpose served by the Commerce Clause and "whether action taken by state or local authorities unduly threatens the values the Commerce Clause was intended to serve."[46] Unlike the Due Process Clause that focuses on fairness to a specific person, the Commerce Clause focuses on the effect of state regulation on the national economy. That is, will imposition of the state's law on interstate vendors impede interstate commerce? Courts have applied a four-part test to determine if a state's law can survive a Commerce Clause challenge. To survive the challenge, the tax must[47]

1) be applied to an activity with a *substantial nexus* with the taxing state (explained below),
2) be fairly apportioned (only one state imposes the tax and it reasonably reflects the activity within that state),

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[44] *Miller Brothers Co. v. Maryland*, 347 U.S. 340, 345 (1954).

[45] *National Bellas Hess, Inc. v. Dept. of Rev.*, 386 U.S. 756 (1967).

[46] *Wardair Canada v. Florida Dept. of Revenue*, 477 U.S. 1 (1986).

[47] *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977).

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3) not discriminate against interstate commerce (for example, the tax rate is the same as for instate purchases), and

4) be fairly related to the services provided by the state (ensures that a "State's tax burden is not placed upon persons who do not benefit from services provided by the State"[48]).

Unlike the Due Process Clause, the Commerce Clause allows Congress to regulate interstate commerce, including passing a law that would burden such commerce.

Quill Corporation v. North Dakota[49]—Application of Due Process and Commerce Clauses Today

The *Quill* case involved a seller of office equipment and supplies (Quill), a Delaware corporation, with offices and warehouses in Illinois, California, and Georgia. Quill did not have any property or employees in North Dakota. Quill sold office supplies and equipment to customers in North Dakota. Quill mailed catalogs to these customers and advertised in national magazines. Under North Dakota law, Quill was required to collect use tax on its sales made to North Dakota customers because Quill was engaged in regular solicitation of customers in the state. Quill challenged the North Dakota law as violating both the Due Process and the Commerce Clauses of the U.S. Constitution.

The U.S. Supreme Court had previously addressed the "minimum connection" requirement of the Due Process Clause in 1967 in *National Bellas Hess v. Department of Revenue of Illinois*.[50] In that case, the Court ruled that some type of minimum contact was necessary for a state to tax an out-of-state business. The necessary minimum contact existed if the out-of-state company had a sales office or sales personnel in the state.

In *Quill*, North Dakota challenged the 1967 ruling as being out of date with today's ways of conducting business. Today, a company doesn't need a salesperson in a state to obtain a sale. Instead, a catalog and a mail-order sales system can be just as successful for a company. The taxing authority in North Dakota pointed out that $1 million of Quill's $200 million of sales were to 3,000 customers in North Dakota. Quill was also the sixth largest supplier of office supplies in the state. North Dakota also argued that it had created an economic climate that helped Quill's sales, that it maintained a legal infrastructure to protect the market, and that it had to dispose of 24 tons of catalogs and other mail that Quill sent into the state each year. Per North Dakota, all of this created the requisite minimum connection to enable it to collect use tax from Quill without violating the Due Process Clause.

North Dakota was partially successful in its argument that the *Bellas Hess* nexus standards for sales and use tax purposes were outdated. The Court stated that its earlier tests were too formalistic and that for due process purposes, it would be more appropriate to not focus on physical presence, but to instead look at whether the company's contacts with the state make it reasonable for the state to require the company to collect use tax. The Court stated that if an out-of-state business purposefully avails itself of the benefits of an economic market in the state, it need not have a physical presence in the state to be subject to tax collection requirements in the state.

Despite the Court's relaxation of the due process physical presence requirement, the Court stated that North Dakota's enforcement of the tax against Quill was an unconstitutional burden on interstate commerce in violation of the Commerce Clause. However, the Court pointed out that because the Constitution gives Congress the right to regulate interstate commerce, Congress could provide a mechanism to allow states to collect sales and use tax from an interstate mail-order business that was not physically present in the state, without violating the Commerce Clause.

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[48] *Goldberg v. Sweet*, 488 U.S. 252, 267 (1989).

[49] *Quill Corporation v. North Dakota*, 504 U.S. 298 (1992).

[50] *National Bella Hess .v Department of Revenue of Illinois*, 386 U.S. 753 (1967).

Substantial Nexus

"Substantial nexus" which serves as a key indicator that a state's law does not burden interstate commerce requires that the vendor have a physical presence in the state. The extent of the required level of physical presence has been the subject of litigation over many years and no bright line test exists. The substantial nexus requirement has also raised issues as to whether an affiliate of a vendor (such as a parent corporation of a subsidiary) or a third party can create a physical presence for the vendor. These issues are briefly explained below.

Extent of physical presence required for substantial nexus: In one case, twelve trips by employees into the state over three years was held to constitute a substantial physical presence[51] In contrast, in another case, one salesperson visiting the state during the year, about 21 days of customer training, about 180 transactions totaling approximately $385,000 of income over a 4-year period, and ownership of two computers leased to a customer in the state, was found to not constitute a substantial nexus. However, that decision was overturned on appeal.[52] Additional activities that have been found not to constitute a substantial nexus include electronic signals of a telephone call,[53] a few software diskettes,[54] and an airplane flying over a state.[55]

Some states have provided some guidance as to whether an activity constitutes a substantial nexus with the state. For example, in 1997 California amended a regulation to provide that use of a computer server on the Internet to create or maintain a web site would not be treated as a factor in determining if a vendor had a substantial nexus in California.[56] The federal Internet Tax Freedom Act (ITFA) takes the position that a "web presence" is not sufficient to establish nexus. The ITFA imposes a three-year moratorium on certain taxes including "discriminatory taxes" imposed on e-commerce. A discriminatory tax includes one under which the sole ability to access a site on a remote seller's out-of-state computer server is considered a factor in determining a remote seller's tax collection obligation.

Attribution nexus: Generally, states have been unsuccessful in attributing nexus of a commonly controlled corporation to another corporation. Courts have "relied upon the fundamental principle of corporate law that the parent corporation and its subsidiary are to be treated as separate and distinct legal persons in the absence of a showing that corporate assets have been intermingled, that the formalities of separate corporate procedure have been ignored, or where the corporation is inadequately financed."[57] Minimal interaction between the entities has generally been ignored. For example, occasional returns of merchandise purchased from one affiliate to the other and distribution of a minimal amount of catalogs by the related affiliate were not found to create substantial nexus.[58]

Use of separate legal entities has been employed by some Internet businesses today to avoid the need to collect use tax. For example, while Barnes & Noble has physical locations in many states, its Internet business operates as a separate legal entity and thus only has substantial nexus where the "dot.com" operation has a physical location.

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[51] *Orvis v. Tax Appeals Tribunal of the State of New York* and *Vermont Information Processing Inc. v. Tax Appeals Tribunal*, 654 N.E.2d 954 (N.Y. Ct. App. 1995), cert. denied, 516 U.S. 989 (1995).

[52] *Care Computer Systems, Inv. v. Arizona Dept. of Revenue*, 1 CA-TX 98-0003 (7/25/00), rev'g Dkt. No. 1049-93-S (4/4/95).

[53] *Goldberg v. Sweet*, 488 U.S. 252 (1989).

[54] *Quill Corporation v. North Dakota*, 504 U.S. 298 (1992).

[55] *United Air Lines, inc. v. Mahin*, 410 U.S. 623, 631 (1973).

[56] Revenue & Taxation Regulation 1684.

[57] *Current, Inc. v. SBE*, 24 Cal. App 4th 382, 29 Cal Rptr.2d 407 (Ct. Appeal 1994). Similarly, see *SFA Folio Collections, Inc. v. Bannon*, 585 A.2d 666 (Conn. 1991), cert. denied, 501 U.S. 1223 (1991), *SFA Folio Collections v. Tracy*, 652 N.E.2d 693 (SCt Ohio 1995), and *Bloomingdale's v. Dept. of Revenue*, 567 A.2d 773 (1989), aff'd without opinion 591 A.2d 1047 (Penn. 1991), cert. denied, 504 U.S. 955 (1992).

[58] *Supra*.

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Nexus through agents: In *Scripto, Inc. v. Carson*, 362 U.S. 207 (1960), a Georgia vendor had no property or operations in Florida. S did, though, have ten commissioned salespeople (contractors) in Florida. The court held that such continuous solicitation in Florida was sufficient to constitute "substantial nexus" such that S was obligated to collect Florida use tax on its sales in that state. Also, the court did not find that the legal distinction between an employee and an independent contractor affected its conclusion. "To permit such formal 'contractual shifts' to make a constitutional difference would open the gates to a stampede of tax avoidance. ... The test is simply the nature and extent of the activities of [Scripto] in Florida."

Cases involving agency nexus have been dependent on the exact relationship between the parties and the specific state law. For example, in *Scholastic Book Clubs, Inc. v. State Board of Equalization*,[59] the court found that S's use of teachers and librarians to solicit book orders created sufficient nexus with California such that S had to collect use tax from California customers. The court found that the relationship between S and the teachers was similar to that in *Scripto*.[60] In contrast, in at least two cases with similar facts, the vendor was found not to have substantial nexus with the state and thus, the state could not impose use tax collection responsibilities on the vendor.[61]

Another type of "discriminatory tax" that the ITFA prohibits during its three-year moratorium, is one imposed on the premise that a provider of Internet access or online services is deemed to be the agent of a remote seller for determining tax collection obligations solely as a result of "(I) the display of a remote seller's information or content on the out-of-state computer server of a provider of Internet access service or online services; or (II) the processing of orders through the out-of-state computer server of a provider of Internet access service or online services."

Sales Tax Nexus versus Income Tax Nexus

When a state seeks to impose an income tax on a multistate business, it faces the same constitutional constraints as exist for sales tax purposes. However, with respect to income taxes applied to sales of tangible personal property, Congress exercised its authority under the Commerce Clause to provide minimum standards that must be met for a state to impose a net income tax on the operations of a remote vendor by enacting Public Law 86-272 in 1959. This law prohibits a state from taxing a foreign corporation's net income derived from activities within the state if those activities consist merely of solicitation of orders for the sale of tangible personal property that are approved, filled, and shipped from outside the state. P.L. 86-272 is of more limited use today due to the increased sales of intangible property and services that are not covered by this law. With the expected increase in the delivery of digitized products over the Internet, P.L. 86-272 will become even less useful. When P.L. 86-272 does not apply, a state's ability to assess income taxes upon a remote vendor depends on whether such imposition is within the standards of the Due Process and Commerce Clauses. Generally, the same nexus analysis is applied as for sales tax purposes. However, in *Geoffrey, Inc. v South Carolina Tax Commission*, the court held that G had the minimum connection with the state to be subject to tax there even though the only connection involved intangible property (thus, no physical presence). "We reject Geoffrey's claim that its intangible assets are located exclusively in Delaware. Accordingly, we find that Geoffrey's purposeful direction of activity toward South Carolina as well as its possessing intangible property here provide a definite link between South Carolina and the income derived by Geoffrey from the use of its trademarks and trade names in this State."[62]

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[59] *Scholastic Book Clubs, Inc. v. State Board of Equalization*, 207 Cal App 3d 734, 255 Cal Rptr 77 (CA Ct App, 1989).

[60] A similar result was found in *Scholastic Book Clubs, Inc.*, 920 P.2d 947 (S Ct. Ks 1996).

[61] *Pledger v. Troll Book Clubs, Inc.*, 871 S.W.2d 389 (S Ct. Ark. 1994) and *Scholastic Book Clubs, Inc. v. State of Michigan, Dept. of Treasury*, 567 N.W.2d 692 (Ct. App. Mich. 1997).

[62] *Geoffrey, Inc. v South Carolina Tax Commission*, 437 S.E.2d 13, 17 (S.C. 1993), *cert. denied*, 114 S.Ct. 550 (1993).

Unlike sales taxes, income taxes on multistate operations are apportioned among the states. As noted in a recent case,[63] historically no apportionment of the tax base has been required for sales and use taxes because a "sale of goods is most readily viewed as a discrete event facilitated by the laws and amenities of the place of sale, and the transaction itself does not readily reveal the extent to which completed or anticipated interstate activity affects the value on which a buyer is taxed."

Observations on Sales Tax Nexus and the E-Commerce Taxation Debate

1. Due Process Issues Remain—While the *Quill* decision would seem to indicate that only Commerce Clause issues remain with respect to whether states may impose sales tax collection obligations on remote vendors, differences between e-commerce and mail order likely make this a false illusion. In the past few years, there have been several cases regarding whether it was "fair" to subject certain persons to the laws of particular jurisdictions where they had no physical presence. Several of these cases involved trademark infringement. These cases indicate that just having a web site is not enough to find jurisdiction within due process constraints. Instead, "something more" is required to show that a person purposefully directed its activities to the jurisdiction.[64] In situations where the person made no deliberate or repeated contact with the state, jurisdiction will likely not be found. Consider an example where a vendor's web site is selling regionalized merchandise (such as something related to a college or sports team in the area) yet anyone could order a product from the site. Has the vendor purposefully directed its activities to residents of every state? How many sales outside of the region would be necessary for a state not located in the region to make the vendor comply with state tax laws? Or, is setting up a web site that does not prohibit customers in any particular state constitute purposefully directing activities to Internet users in all states? These are some of the questions that remain in the e-commerce environment and for which Congress cannot address under the Due Process Clause.

2. Commerce Clause and Congressional Action—While the Court in *Quill* reminded everyone that Congress could address the Commerce Clause issue that prohibits states from making remote vendors collect sales taxes, it is unlikely that Congress will do so without significant changes first being made to simplify state sales tax systems. Subjecting multistate vendors to sales tax collection in potentially over 6,000 taxing jurisdictions would certainly impede interstate commerce.

3. Will Nexus Guidelines Help?—P.L. 86-272 has provided certainty to many multistate businesses with respect to whether they are subject to income states in states in which they have sales. A similar approach could be applied with respect to sales tax nexus which could address issues of how much physical presence establishes nexus and when a third party relationship constitutes nexus. While guidelines will be helpful to vendors by providing certainty, they will not address the concern of state and local governments in collecting use taxes given the difficulty of collecting it directly from consumers.

4. Global considerations—At the international level, the tax equivalent of nexus is permanent establishment (PE). That is, generally, a foreign country may not subject a vendor to taxation unless it has a physical presence in the country. The OECD is currently working on new rules to clarify what constitute a PE in the e-commerce realm.[65]

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63 *Oklahoma Tax Commission v. Jefferson Lines, Inc.*, 514 U.S. 175 (1995).

64 See *Cybersell, Inc. v. Cybersell, Inc.*, 130 F.3d 414 (9th Cir. 1997), and *Millennium Enterprises v. Millennium Music*, Civ. No. 98-1058-AA (DC Or 1999).

65 "OECD Working Party Releases Draft Proposal on Defining PEs in E-Commerce Context," 1999 WTD 189-16.

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Internet Taxation Considerations

Discussions of how to tax Internet transactions have raised a number of issues related to compliance. These include,

1. Identification of Customer's Location—If a vendor selling digitized products, including software that can be downloaded from the Internet, has a physical presence in states that tax such items, it will need to collect sales tax from the customers in those taxing states. However, it will be both difficult and an invasion of privacy to ask where the customer is located. Will states require vendors to perform some type of verification of the customer's location when customers indicate that they live in a state with no sales tax?

   While some commentators have suggested solving the customer identification issue by sourcing sales to the vendor's location (rather than the customer's location), such a solution is not without its problems. For example, where is the vendor's location if the sale occurs through servers located in more than one state? Also, will new vendors locate their operations in states with no sales taxes? In addition, will customers want to pay consumption taxes to a state in which they do not reside?

2. Physical Presence Nexus Standard—While the ITFA currently prevents a finding of nexus solely due to limited use of a server in a state, what will happen when the moratorium expires? Should a state find that a server creates sufficient nexus, vendors may just move these mobile servers to another state with a different nexus law.

3. Other Nexus Difficulties—As noted earlier, because there is no bright line test to determine if a vendor must collect sales tax within states where it has customers, vendors have potential exposure to significant tax liabilities should the taxing authority have a contrary interpretation of the law.

4. Global Considerations—Many countries impose consumption taxes, typically in the form of a value-added tax (VAT). Consideration should be given to changes being proposed at the international level since e-commerce will continue to grow as a global marketplace. States will want to consider how current systems and proposed systems scale to the international level so that they can better ensure that tax is collected when residents purchase taxable items from outside the U.S. The OECD has already begun discussions on many of these issues.[66]

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[66] A report, "Electronic Commerce: Taxation Framework Conditions," was released by the OECD's Committee on Fiscal Affairs (http://www.oecd.org/daf/fa/e_com/Ottawa.htm). The report noted:

- "Rules for the consumption taxation of cross-border trade should result in taxation in the jurisdiction where consumption takes place and an international consensus should be sought on the circumstances under which supplies are held to be consumed in a jurisdiction."
- "For the purpose of consumption taxes, the supply of digitized products should not be treated as a supply of goods."

Acquisition of Intangible Assets—IRC §197

- Overview**:** IRC §197 and §167(f) were added by the Revenue Reconciliation Act of 1993 to allow, for the first time, for acquired goodwill and going concern value to be amortizable. Also, to lessen disputes between taxpayers and the IRS over the allocation of purchase price (sales price) among assets acquired as part of the acquisition of a trade or business, most acquired intangible assets were given the same treatment—straight-line amortization over 15 years. Also, if a §197 intangible is disposed of when the taxpayer still owns other §197 intangibles that were acquired at the same time, no loss is allowed (but gain would be recognized); in effect, the intangible continues to be amortized. Proposed regulations were issued in January 1997 (REG-209709-94).
- An amortizable §197 intangible is an asset that ...

1) is held by the taxpayer in connection with the conduct of a trade or business or in an activity engaged in for the production of income (§212);

2) fits one of the following categories:
   - a) goodwill or going concern value,
   - b) workforce,
   - c) information base,
   - d) patent, copyright, formula, process, design, pattern, know-how, format, or similar items,
   - e) customer-based intangible,
   - f) supplier -based intangible,
   - g) license, permit or other right granted by the government,
   - h) covenant not to compete or similar arrangement, or
   - i) franchise, trademark or trade name;

3) was not created by the taxpayer, unless,
   - a) the asset is a license, permit or other right granted by the government,
   - b) the asset is a covenant not to compete or similar arrangement,
   - c) the asset is a franchise, trademark, or trade name, or
   - d) the asset was created in connection with a transaction (or series of related transactions) that involves the acquisition of a trade or business or a substantial portion thereof;

4) is not a "separately acquired":
   - a) interest in a film, sound recording, video tape, book, or similar property,
   - b) contract or government right to receive tangible property or services,
   - c) interest in a patent or copyright,
   - d) contract or government right of a fixed duration less than 15 years or of a fixed amount (see Prop. Reg. §1.197-2(c)(13) and §1.167(a)-14(c)(2)),
   - e) computer software program, or
   - f) mortgage servicing right

     (unless regulations provide that the intangible constitutes a business by itself);

5) is not one of the following:
   - a) an interest in a corporation, partnership, trust, or estate,
   - b) an interest under an existing futures contract, foreign currency contract, notional principal contract, or other similar financial contract,
   - c) any interest in land,
   - d) "off-the-shelf" computer software,
   - e) an interest under an existing lease or sublease of tangible property,
   - f) an interest under existing indebtedness,
   - g) a sports franchise, or
   - h) certain transaction costs related to corporate organizations and reorganizations; and

6) is acquired after August 10, 1993, but not in an anti-churning transaction, or was acquired after July 25, 1991 and the taxpayer properly elected to apply §197.

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