INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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CASE-MIS No.: TAM-100407-17

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No:
Year(s) Involved:
Date of Conference:

LEGEND

Taxpayer:

Representative:

Year 1:

Year 2:

Year 3:

Year 4:

Year 5:

Date 1:

Date 2:

Date 3:

Date 4:

Drug 1:

Drug 2:

Drug 3:

Disease 1:

Disease 2:

N:

ISSUE

Pursuant to § 45C(c)(2) of the Internal Revenue Code, must Taxpayer include its prior taxable year qualified clinical testing expenses as prior taxable year qualified research expenses when calculating the alternative simplified credit under § 41(c)(5)?

CONCLUSION

Pursuant to § 45C(c)(2), Taxpayer must include its prior taxable year qualified clinical testing expenses as prior taxable year qualified research expenses when calculating the alternative simplified credit under § 41(c)(5).

FACTS

Taxpayer is a company primarily focused on developing and products . During the Year 4 and Year 5 taxable years, Taxpayer focused on developing and treatments for Disease 1 and Disease 2. Taxpayer engaged Representative to conduct research credit and orphan drug credit studies for the Year 4 and Year 5 taxable years. All of the § 45C(b)(1)(A) qualified clinical testing expenses (QCTEs) that Representative identified relate to one of Taxpayer's three drugs: Drug 1, Drug 2, and Drug 3.

On Date 1, the Food and Drug Administration (FDA) designated Drug 1 as an orphan drug to treat Disease 1. The Drug 1 QCTEs during the Year 4 and Year 5 taxable years pertain to . On Date 2, the FDA designated Drug 2 as an orphan drug to treat Disease 1. The Drug 2 QCTEs during the Year 4 and Year 5 taxable years pertain to an formulation that was undergoing

. On Date 3, the FDA designated Drug 3 as an orphan drug to treat Disease 2. Taxpayer included all human clinical testing expenses in the Year 4 and Year 5 taxable years for Drug 3 as QCTEs.

For its Year 4 and Year 5 taxable years, Taxpayer computed both the alternative simplified credit (ASC) under § 41(c)(5) and the orphan drug credit under § 45C. Except for the QCTEs that are foreign-based expenses, Taxpayer's QCTEs in taxable years Year 4 and Year 5, as well as in the three preceding relevant taxable years (Year 1 through Year 3, and Year 2 through Year 4, respectively), qualify as qualified research expenses (QREs) under § 41(b) and (d). Taxpayer did not include in its QREs for these taxable years amounts determined to be QCTEs under § 45C.

The Service adjusted Taxpayer's ASC to include Taxpayer's prior taxable year QCTEs for taxable years Year 4 and Year 5.

The following chart from the Form 886-A, Explanation of Items, issued on Date 4, shows the total disputed adjustments due to this issue:

Year 4		Year 5	Total

LAW AND LEGISLATIVE HISTORY

Applicable Statutory and Regulatory Provisions

Section 45C provides a credit for clinical testing expenses for certain drugs for rare diseases or conditions. Section 45C(a) provides that for purposes of § 38, the orphan drug credit for the taxable year is an amount equal to 50 percent of the QCTEs for the taxable year.

In general, § 45C(b)(1)(A) defines QCTEs as the amounts which are paid or incurred by the taxpayer during the taxable year which would be described in § 41(b) (defining QREs) if § 41(b) were applied with the modifications set forth in § 45C(b)(1)(B). Section 45C(b)(1)(B) applies § 41(b) by (i) substituting “clinical testing” for “qualified research” each place it appears in § 41(b)(2) (relating to in-house research expenses) and § 41(b)(3) (relating to contract research expenses) and (ii) substituting “100 percent” for “65 percent” in § 41(b)(3)(A).

Section 45C(c) provides rules for coordinating the research credit under § 41 with the orphan drug credit. Section 45C(c)(1) provides that, except as provided in § 45C(c)(2), any QCTEs for a taxable year to which an election under § 45C applies shall not be taken into account for purposes of determining the research credit for such taxable year. Under § 45C(c)(2), any QCTEs for any taxable year which are QREs (within the meaning of § 41(b)) shall be taken into account in determining base period research expenses for purposes of applying § 41 to subsequent taxable years.

Section 45C(d)(4) provides that § 45C shall apply to any taxpayer for any taxable year only if such taxpayer elects to have § 45C apply for such taxable year.

Under § 41(a), for purposes of § 38, the research credit equals the sum of 20 percent of the excess (if any) of the QREs for the taxable year over the base amount (regular credit), 20 percent of the taxpayer's basic research payments determined under § 41(e)(1)(A) (basic research credit), and 20 percent of the amounts paid or incurred by the taxpayer in carrying on any trade or business of the taxpayer during the taxable year (including as contributions) to an energy research consortium for energy research.

Section 41(c)(1) defines the base amount as the product of the fixed-base percentage and the average annual gross receipts of the taxpayer for the four taxable years preceding the taxable year for which the credit is being determined (credit year). Section 41(c)(2) provides, however, that in no event shall the base amount be less than 50 percent of the QREs for the credit year.

Section 41(c)(5) permits a taxpayer to elect the ASC in lieu of the regular credit. Section 41(c)(5)(A) provides that at the election of the taxpayer, the research credit determined under § 41(a)(1) shall be equal to 14 percent (12 percent in the case of taxable years ending before January 1, 2009) of so much of the QREs for the taxable year as exceeds 50 percent of the average QREs for the three taxable years preceding the taxable year for which the credit is being determined.

Section 41(c)(6)(A) provides that notwithstanding whether the period for filing a claim for credit or refund has expired for any taxable year taken into account in determining the fixed-base percentage, the QREs taken into account in computing such percentage

shall be determined on a basis consistent with the determination of QREs for the credit year.

Under § 1.41-9(c)(2) of the Income Tax Regulations, for purposes of the ASC, QREs for the three taxable years preceding the credit year must be determined on a basis consistent with the definition of QREs for the credit year, without regard to the law in effect for the three taxable years preceding the credit year. This consistency requirement applies even if the period for filing a claim for credit or refund has expired for any of the three taxable years preceding the credit year.

Legislative History

Prior to the enactment of the Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, 103 Stat. 2106 (the 1989 Act), § 41(a) provided for a research credit equal to (1) 20 percent of the excess (if any) of (A) the QREs for the taxable year, over (B) the base period research expenses, and (2) 20 percent of the basic research payments determined under § 41(e)(1)(A). Former § 41(c)(1) defined “base period research expenses” as the average of the QREs for each year in the base period. Former § 41(c)(2) generally defined “base period’ as the three taxable years immediately preceding the taxable year for which the determination was being made. In addition, prior to the 1989 Act, the basic research credit under § 41(e) included a separately defined “base period” in § 41(e)(7)(B), which was the three-taxable-year-period ending with the taxable year immediately preceding the first taxable year of the taxpayer beginning after December 31, 1983.

On January 4, 1983, the orphan drug credit was first enacted as § 44H, as part of the Orphan Drug Act, Pub. L. No. 97-414, 96 Stat. 2049. Section 44H was renumbered as § 28 on July 18, 1984, as a part of the Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 494. Then, § 28, including the coordination rule currently in § 45C(c)(2), was renumbered as § 45C on August 20, 1996, as a part of the Small Business Job Protection Act of 1996, Pub. L. No. 104-188, 110 Stat. 1755.

On December 19, 1989, Congress modified § 41 in the 1989 Act. Congress eliminated the terms "base period research expenses” and “base period” in § 41(a)(1) and (c), and added the term “base amount.” Congress did not amend § 41(e), other than to make conforming amendments relevant to § 41(c). In addition, Congress added the consistency rule under former § 41(c)(4) (the consistency rule is in the current Code in § 41(c)(6)).

In the legislative history to the 1989 Act, Congress explained that it was making these changes to § 41 to modify:

> the method of calculating a taxpayer's base amount in order to enhance the credit's incentive effect. The committee did wish, however, to retain

> an incremental credit structure in order to maximize the credit's efficiency by not allowing (to the extent possible) credits for research that would have been undertaken in any event.

H.R. Rep. No. 101-247, at 1199 (1989).

Because businesses often determine their research budgets as a fixed percentage of gross receipts, Congress thought that it was appropriate to index each taxpayer's base amount to average growth in its gross receipts. By adjusting each taxpayer's base amount, Congress believed that the credit would be better able to achieve its intended purpose of rewarding taxpayers for research expenses exceeding amounts which would have been expended in any case. Id. at 1200.

The legislative history is silent as to whether the change from “base period expenses” to “base amount” should impact the coordination between § 45C and § 41.

On December 20, 2006, Congress added the ASC to § 41(c)(5) in the Tax Relief and Health Care Act of 2006, Pub. L. No. 109-432, 120 Stat. 2922. The legislative history for this provision also does not address the coordination of § 45C and ASC under § 41(c)(5).

On March 23, 2010, Congress added § 48D (the qualifying therapeutic discovery project credit) as a part of the Patient Protection and Affordable Care Act, Pub. L. No. 111-148, 124 Stat. 119, § 9023. Virtually identical to § 45C(c)(2), § 48D(e)(2)(C)(i), provides that, except as provided in § 48D(e)(2)(C)(ii), any expenses taken into account under § 48D for a taxable year shall not be taken into account for purposes of determining the research credit or the orphan drug credit allowable for such taxable year. Under § 48D(e)(2)(C)(ii), any expenses for any taxable year which are QREs (within the meaning of § 41(b)) shall be taken into account in determining base period research expenses for purposes of applying § 41 to subsequent taxable years.

ANALYSIS

Taxpayer believes that the plain language of §§ 41(c) and 45C(c) and §§ 1.41-3(d) and 1.41-9(c)(2) requires Taxpayer to exclude its QCTEs from its QREs for the three taxable years prior to taxable Year 4 (Year 1 - Year 3) and the three taxable years prior to taxable Year 5 (Year 2 - Year 4) when computing its ASC in the Year 4 and Year 5 taxable years. Taxpayer asserts that § 45C(c)(2) only applies to determine “base period research expenses” and does not apply to the ASC because the term "base period research expenses" does not appear in § 41(c)(5). Further, Taxpayer believes that, following the 1989 Act, § 45C(c)(2) only continues to apply for purposes of determining the basic research credit under § 41(e). Finally, Taxpayer states that the consistency rule, under § 41(c)(6) and §§ 1.41-3(d) and 1.41-9(c)(2), requires Taxpayer to exclude QCTEs from its QREs in the Year 1 through Year 4 base taxable years because Taxpayer is not including QCTEs in QREs in the Year 4 and Year 5 taxable years.

LB&I believes that the term "base period research expenses" in § 45C(c)(2) is ambiguous, and, therefore, it is appropriate to look to the legislative history to determine its proper meaning. LB&I asserts that Congress has consistently intended that a taxpayer must include its prior year QCTEs as prior year QREs when calculating its current taxable year research credit, which includes the ASC. Further, LB&I states that Taxpayer's interpretation of § 45C(c)(2) would render the provision inoperative or superfluous. Finally, LB&I disputes Taxpayer's positions that (1) § 45C(c)(2) continues to apply only for purposes of § 41(e) and (2) including QCTEs as prior year QREs violates the consistency rule.

The term "base period research expenses" is an ambiguous term because it is susceptible to more than one interpretation in the context of coordinating §§ 41 and 45C. Because, following the 1989 Act, the specific term "base period research expenses" in § 45C(c)(2) is not the precise term used for purposes of § 41(a)(1) and (c), including for the ASC in § 41(c)(5), Congress arguably intended to disconnect § 45C from § 41(a)(1) and (c) (including for the ASC). However, Congress possibly used the term "base period research expenses" in § 45C(c)(2) to generally refer to prior taxable year base QREs for purposes of § 41(a)(1) and (c). Thus, prior taxable year QCTEs that are also QREs arguably should be included as prior taxable year QREs for purposes of calculating the research credit, regardless of the method used under § 41(a)(1) and (c) to calculate the credit.

We believe that the term "base period research expenses" refers to prior taxable year base QREs for purposes of the regular credit and the ASC. Therefore, prior taxable year QCTEs that are also QREs are treated as prior taxable year QREs for purposes of calculating the regular credit and the ASC. This interpretation is supported by 1) the purpose of §§ 45C(c)(2) and 41, 2) the fact that a different reading renders § 45C(c)(2) inoperative, 3) the lack of Congressional intent to repeal § 45C(c)(2), and 4) the use of the same term in § 48D.

The orphan drug credit under § 45C and the research credit under § 41 are intertwined. QCTEs under § 45C are amounts which are paid or incurred by a taxpayer during the taxable year which would be described in § 41(b), as modified to particularly apply to the orphan drug credit. Section 45C(c)(2) further coordinates the orphan drug credit and the research credit. Because of the interdependence of the two credits, we believe that it is unlikely that Congress intended to disconnect them in the 1989 Act without mentioning the 1989 Act's impact on § 41 in § 45C(c)(2) or in the legislative history.

Taxpayer's interpretation of the 1989 Act undermines the incremental nature of the research credit under § 41. The legislative history to the 1989 Act supports the view that the 1989 Act was not intended to distort the incremental nature of the § 41 credit by excluding a class of QREs that also qualify as QCTEs from base QREs under § 41. See H.R. Rep. No. 101-247, at 1199. Excluding QCTEs that are also QREs from the

base credit calculation results in an inaccurate determination of the relative increase in QREs over the amount a taxpayer typically spends on research. Under Taxpayer's view, Taxpayer receives larger § 41 credits in Year 4 and Year 5 for expenses that are QREs, but not QCTEs, merely because Taxpayer elected the orphan drug credit for expenses that qualified as both QREs and QCTEs in the base years (Year 1 through Year 4) and the credit years (Year 4 and Year 5). Taxpayer's combined research credit under § 41 in Year 4 and Year 5 is more than N times larger if § 45C(c)(2) is read out of the Code. Without clear Congressional intent to provide for such a heightened credit, we decline to find that it exists. See, e.g., Helvering v. Northwest Steel Rolling Mills, Inc., 311 U.S. 46, 49 (1940).

Further, Taxpayer's interpretation of § 45C(c)(2) renders the provision inoperative. If the term "base period research expenses" under § 45C(c)(2) only refers to the literal term "base period research expenses" as it existed in former § 41(a)(1) and (c), then § 45C(c)(2) has no current relevance in the Code. We are not convinced by Taxpayer's argument that § 45C(c)(2) only continues to be relevant for purposes of § 41(e). Prior to the 1989 Act, § 41(c)(1) defined "base period research expenses," and § 41(c)(2) defined "base period" for purposes of § 41(a)(1) and (c). Section 41(e)(7)(B) distinctly defined "base period" solely for purposes of § 41(e). Section 41(e)(7)(C)(ii) referenced "base period research expenses," but only for purposes of computing the regular credit under § 41(a)(1) and (c).

In the 1989 Act, Congress revised § 41 by removing "base period research expenses" and "base period" as it pertained to the computation of the regular credit under §§ 41(a)(1) and (c), replacing it with "base amount," including in § 41(e)(7)(C)(ii). Congress did not remove the term "base period" from § 41(e) because the 1989 Act's revisions to § 41 did not have any impact on the term "base period" as defined under § 41(e). Section 41(e) has never relied on the former § 41(c) definition of "base period," as § 41(e) has a self-contained definition of "base period" with a distinct meaning in § 41(e)(7)(B). Therefore, we are not persuaded that the term "base period research expenses" in § 45C(c)(2) exclusively applies for purposes of § 41(e).

Taxpayer's position effectively repeals the coordination rule in § 45C(c)(2) because the 1989 Act changes the way the research credit is computed under § 41(a) and (c). However, repealing a statutory provision by implication is not favored and is only permitted when there is "manifest" Congressional intent to do so. See, e.g., Posadas v. National City Bank, 296 U.S. 497, 503 (1936). The changes to § 41 in the 1989 Act do not support the position that Congress intended to sever the nexus between §§ 41 and 45C. Congress amended § 41(c) in the 1989 Act to modify the method for calculating the research credit under § 41(c) to incorporate gross receipts. Absent from both the 1989 Act and its legislative history is any discussion regarding § 45C(c). No clear expression of Congressional intent to repeal the coordination rule in § 45C(c)(2) exists. Further, § 45C(c)(2) and § 41 can be read harmoniously if the term "base period research expenses" in § 45C(c)(2) is read to mean prior year QREs for purposes of

determining the research credit under § 41(a)(1) and (c), regardless of the method used.

In addition, when Congress enacted § 48D on March 23, 2010, it virtually copied the language from § 45(C)(c)(2) to § 48D(e)(2)(C) to coordinate §§ 48D and 41. If Congress had intended that the term “base period research expenses” to refer solely to the term as used in § 41 as it existed prior to the 1989 Act, then it would have needed to choose a different term. The term “base period research expenses” had not existed in § 41 for almost 21 years by the time that § 48D was enacted. Therefore, under Taxpayer's position, § 48D(e)(2)(C) would have been inoperative the moment it was enacted.

Finally, LB&I’s position does not violate the consistency rule under § 41(c)(6). The consistency rule "aims to ensure that the research tax credit due is not overstated or understated because the taxpayer inconsistently compares QREs in the base period years and the claim year." Trinity Industries. Inc. v. U.S., 757 F.3d 400, 411 (5th Cir. 2014). In this case, LB&I’s position does not violate the consistency rule because the definition of QREs is consistently applied to Taxpayer's current year and prior year expenses. The parties agree that Taxpayer's QCTEs meet the definition of QREs under § 41(b) and (d) for the base years and the credit years. Taxpayer received credits in the credit years for its QCTEs and elected to claim the credit under § 45C for these expenses, rather than the § 41 research credit. This does not change the fact that these expenses are QREs, or mean that the consistency rule is violated merely because Taxpayer elected the larger credit under § 45C in the Year 4 and Year 5 taxable years.

In conclusion, § 45C(c)(2) requires QCTEs to be included in base amount computations under § 41(c), including the three-year-average base computation under § 41(c)(5) applicable to the ASC.

CAVEATS

A copy of this technical advice memorandum is to be given to the taxpayer. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.