Employee separation payments do not qualify for research credit, IRS concludes

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In brief

The IRS has concluded, in Field Attorney Advice (FAA) 20131102F, that payments to certain salaried employees pursuant to a 'voluntary separation program' (VSP) do not constitute 'wages' eligible for the Section 41 research credit.

In the FAA, the IRS first took the position that the VSP payments were not Section 174 research and experimental (R&E) expenditures — one requirement for credit eligibility — but instead were ordinary and necessary business expenses under Section 162. The IRS also asserted that even if the VSP payments qualified as Section 174 expenses, the payments were ineligible for inclusion in the Section 41 research credit computation because the taxpayer failed to establish a nexus between the expenses incurred and the years in which the terminated employees performed qualified services.

In detail

Background

As part of a global restructuring process, the taxpayer had entered into agreements with select salaried employees to separate from the company in exchange for a separation remuneration package that was calculated on the basis of each participating employee's tenure with the company. The severance payments would be included in each employee's W-2 earnings and paid in addition to each participating employee's compensation for the tax year. The taxpayer included the severance payments in its Section 41 computations based on the level of qualified services each employee had performed in the tax year in which the severance payments were made.

IRS arguments

The IRS made two primary arguments in determining that the taxpayer could not include the severance payments as qualified research expenditures (QREs) for the tax year in which the payments were made.

VSP payments not deductible under Section 174. The IRS reasoned that the VSP payments were not Section 174 expenses because the payments were not made to encourage activities in the 'experimental or laboratory sense,' but instead were paid to employees to reduce the taxpayer's workforce. The IRS contended that the severance payments are properly deducted under Section 162 as ordinary and necessary expenses of a trade or business.

The IRS also maintained that the taxpayer's VSP payments were not 'reasonable' R&E expenditures as required by Section 174(e) and Reg. sec. 1.174-2(a)(6). The regulation provides that R&E expenditure is reasonable "if the amount would ordinarily be paid for like activities by like enterprises under like circumstances." The IRS reasoned that paying certain employees not to do research was analogous to dismissal payments described in Reg. sec. 1.162-10(a) and therefore appropriately deducted under Section 162.

The IRS asserted that its conclusion regarding the taxpayer's severance cost is in keeping with Congressional intent in enacting Section 174, pointing to legislative history indicating that Section 174 was enacted to encourage R&E activities and to eliminate uncertainty in the tax treatment of R&E expenditures.

Lack of nexus between payments and 'qualified services.' The IRS also argued that even if the taxpayer's severance payments qualified for deduction under Section 174, the severance payments still must be excluded from the taxpayer's wages-QRE computation because the taxpayer failed to establish a nexus between the payments and each employee's qualified services performed over his or her entire employment tenure. The term 'qualified services' means services consisting of engaging in qualified research or in directly supervising or supporting qualified research.

The taxpayer evaluated each employee's qualified services only in the tax year the severance payment was made. The IRS therefore maintained that nexus was not established, because a portion of each employee's severance payment was attributable to services performed in previous tax years not evaluated in the taxpayer's qualified services analysis.

The IRS reasoned that because each employee's severance payment was computed based on the employee's services to the company over the employee's total service years, the appropriate evaluation of that employee's qualified services, as defined under Reg. sec. 1.41-2(d)(1), would be to evaluate each employee's total services provided over their entire employment period. That regulation provides in part that:

the amount of in-house research expense shall be determined by multiplying the total amount of wages paid to or incurred for the employee during the taxable year by the ratio of total time actually spent by the employee in the performance of qualified services for the taxpayer to the total time spent by the employee in the performance of all services for the taxpayer *during the taxable year [emphasis added].*

The IRS distinguished its analysis in the FAA from a contrary conclusion it had reached in FSA 199931012, on the ground that the previous analysis of severance payments did not address the nexus issue. Instead, the FSA determination was based on the assumption that the employees performed only qualified research during their employment tenure.

Observations

The IRS position in the FAA seems inconsistent with the Tax Court's rulings on whether income from the exercise of stock options constituted qualified wages in *Apple Computer, Inc. v. Commissioner*, 98 T.C. 232 (1992), *and Sun Microsystems, Inc. v. Commissioner*, T.C. Memo. 1995-69. In Apple, the court held that in-house research expenses included "any wages paid…to an employee for qualified services by such employee" in the year the wages were paid or incurred. The court rejected the IRS's argument that each employee's qualified services had to be evaluated for earlier years in which exercised options at issue were granted.

The IRS's conclusion in FSA 199931012 followed the Tax Court's decisions in *Apple and Sun Microsystems*. In the FSA, the IRS concluded that severance payments to employees constituted wages for purposes of the research credit (i.e., constituted wages as defined in Section 3401(a)) and that the related wages would constitute in-house research expenses under Section 41(b)(2) to the extent of qualified services performed.

Also, contrary to the IRS's assertion, allowing these payments to qualify under Section 174 seems consistent with Congressional intent. The research credit was designed to provide an incentive to hire technical resources throughout the life cycle of qualified research. There is nothing in the legislative history to indicate that wage payments incurred to separate employees at the termination of research services would be ineligible -- they should be considered part of 'all costs incident to' qualified research.

The takeaway

Companies that make severance payments to employees whose regular wages qualify for the research credit should consider the IRS's latest analysis of severance payments when developing their documentation strategy and also consider IRS examination risk for purposes of financial statement evaluation.

Let's talk

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