Are Wages for Research Credit Purposes Limited to "Reasonableness?"

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Smith v. Commissioner,[1] a pending research credit case in the United States Tax Court, presents an issue of first impression: Is a partner's self-employment income in a partnership allowable as a qualified research expense only to the extent that the amount is reasonable within the meaning of former IRC Section 174(e)? The case should interest partners in partnerships and self-employed individuals who perform technological research. [2]

Facts in *Smith*

The petitioners in *Smith* are partners in a partnership that provides architectural design services for extremely large and uniquely designed buildings, including the tallest building ever built. For the taxable years in issue, each partner calculated his federal income tax credits for research expenses from the tax attributes that the partnership passed through to him.

Statutory Framework

In 1981, Congress enacted a federal income tax credit for research expenses under the predecessor of IRC Section 41 ("Section 41").[3] The credit was in addition to the deduction for research expenditures already allowed by IRC Section 174 ("Section 174"). Congress thereafter came to believe that the credit as enacted in 1981 was interpreted by taxpayers too broadly, and that some taxpayers claimed the credit for virtually any expense related to product development.[4] The Tax Reform Act of 1986[5] consequently created a four-part test to limit research activities for research credit purposes.[6]

Section 174 Test:

The first credit-eligibility test, at issue in *Smith*, provided, that "qualified research [for credit purposes] means research … with respect to which expenditures may be treated as expenses under Section 174." [7] The Tax Court has consistently interpreted this provision "as requiring only that qualified research activities [under Section 41] constitute research and development within the meaning of Section 174."[8] This means that the Section 174 test refers not to the *amount* the taxpayer can currently *deduct* under Section 174 but instead to whether the taxpayer's *activity* is of a character that would permit its deduction under section 174.

Activities that satisfy Section 174 must then satisfy the three remaining tests that define credit-eligible qualified research (research activities (1) that are technological in nature, (2) that are intended to develop or improve a product or process, and (3) substantially all the activities of which constitute a process of experimentation). If they do, then the wages, contract expense, and supply expense paid or incurred to perform the qualified research are "qualified research expenses" from which the tax credit is calculated.

Partners in Service Partnerships

Partners in service partnerships, as well as self-employed individuals, are not "employees" – they do not employ themselves – and cannot pay themselves "wages" used to calculate the tax credit. Recognizing that these individuals would be disadvantaged if they performed qualified research activities but were not paid wages, Congress enacted a special definition of wages for them. For a partner in a partnership performing qualified research, "wages" means the partner's net income from self-employment.[9]

Partners "Wages" for Research Credit Purposes

In *Smith*, a partner's qualified research wages were calculated by the following steps. First, the IRS and each partner stipulated to the percentage of time during the taxable year that the partner engaged in qualified research activities. Second, which is the basis of the dispute with the IRS, each partner then multiplied his stipulated percentage by his share of partnership income that is treated as self-employment income from the partnership.

The Issue: Are Partner Wages "Reasonable"

The issue is whether the resulting amount of "wages" – the partner's self-employment income multiplied by the stipulated percentage – is unreasonable in violation of Section §174(e). Section 174(e), enacted in 1989, provided that the deduction under Section 174 "shall apply to a research or experimental expenditure only to the extent that the amount thereof is reasonable under the circumstances." Section 174(e) applies to the taxable years in issue in *Smith*. Congress repealed Section 174(e), effective January 1, 2022.

The IRS Argument

The IRS acknowledges that a partner uses self-employment income as a substitute for wage expense but argues that the amount taken into account is limited to the self-employment income that reasonably relates to the partner's performance of qualified research. Wages are qualified research expenses only if the wages paid or incurred to an employee are for qualified services,[10] which means that the wages are for engaging in qualified research.[11] From the IRS perspective, the self-employment income that the *Smith* partners took into account "were a function of the net income (profit) of [the partnership] and were not paid for the qualified services performed by the Partners." The IRS relies on Section 174(e) to limit the amount of self-employment income to an amount that is reasonable and plans to use an expert witness to express an opinion of the cost that is reasonable for the architectural services performed.

The IRS thus agrees to the percentage of time that each partner devoted to qualified research activities but argues that the percentage is being applied to an amount that is too large because it includes profits from the business.

The Partners' Argument

The partners argue that "[c]ertain forms of income, such as net earning[s] from self-employment and section 401(c)(2) earned income were never contemplated to have a reasonableness requirement as they are included as claimable under section 41 but not referenced under section 174." In other words, the partners are arguing that the reasonableness requirement in Section 174(e) logically applies only to research expenses that are deductible pursuant to Section 174

but cannot possibly apply to earned *income* from self-employment because an *income* item is not an *expense* item.

Comment

Section 174(e) Reliance

The IRS's reliance on Section 174(e) to limit the taxpayer's self-employment income to a reasonable expense amount for credit purposes is questionable. The statutory language does not appear to fit: Expenses are not income. Moreover, the only function that Section 174 serves for research credit purposes is to define "research activities" and not their cost. In relying on Section 174(e), the IRS may well be in the wrong pew.

IRC Section 1402(a) Reliance v. IRC Section 702(a)(8) Reliance

The fundamental question for a *Smith* partner is whether his self-employment income from the partnership, multiplied by the percentage of time that he devoted to qualified research, was for engaging in qualified research.

- The IRS argument focuses on IRC Section 702(a)(8), the statutory provision determining a partner's distributive share of taxable income from the partnership, to conclude that the partners are erroneously taking into account their profit from the partnership, which was "not paid for the qualified services performed by the Partners."
- The partners' argument focuses on I.R.C. Section 1402(a), the statutory definition of net earnings from self-employment. When the stipulated percentage of time that each partner engaged in research is multiplied by that partner's "net earnings from self-employment," the result certainly looks like the portion of the partner's self-employment income allocated to the performance of qualified research, that is, his qualified "wages."
- The taxpayer's argument appears more faithful to the statutory language defining wages for a partner[12] than does the IRS's argument. The partner's "wages" are his "earned income (as defined in section 401(c)(2)," which means net earnings from self-employment (as defined in section 1402(a))." Once the partner's net earnings from self-employment is determined, that should end the statutory analysis. The IRS would go further, pursuing in IRC Section 702(a)(8) the partnership items that make up net earnings from self-employment. That pursuit is of a level of detail that is not expressed in the statutory language defining a partner's "wages" for research credit purposes.

Can Reasonable Qualified Research Wages Be Derived from Partnership Income?

The IRS approach, extended to its logical conclusion, might never allow research credits, because the timing of the self-employment income, *if any*, from qualified research might always be out-of-synch with the performance of qualified research. Unlike an employee who receives wages regardless of whether the research in which he engages produces any revenue for his employer, a partner who engages in qualified research that produces no revenue will not have any "wages" to take into account as qualified research expenses for the qualified research activities. Also, the likelihood of a partner having qualified research in one taxable year and revenue from commercialization of the research in a later taxable year is quite likely to result in no qualified research expenses for the partner's qualified research activities. In these circumstances the partner would get no research credit for his performance of qualified research, which seems an

inappropriate outcome.

The IRS in the *Smith* case would throw out the partners' self-employment income and substitute expert witness testimony to determine the hypothetical wages that architects would be paid for performing the qualified research that the partners performed. That approach ignores the statutory provision that makes self-employment income a substitute for wages.

Congress did not require a partner to show under Section 41 that his self-employment income for the taxable year reflects what would be the partner's wages if the partner were an employee. Instead, Congress said that self-employment income *is* wage expense. It is a policy choice that approximates wages. The IRS has no authority to challenge it. Sometimes the approximation works to the benefit of a taxpayer and sometimes to his detriment because an approximation is never going to be mathematically perfect, and an effort to find perfection is fruitless.

If you would like to discuss this matter and how it may affect your organization, please contact your Miller Canfield attorney or one of the authors of this alert.

[1] No. 13382-17 (U.S. Tax Ct. filed June 14, 2017).

[2] Also pending is an issue of funding, previously discussed in The Tax Court Recently Decides Two Research Credit Cases: Miller Canfield.

[3] Economic Recovery Tax Act of 1981, Pub. Law 97-34.

[4] General Explanation of the Tax Reform Act of 1986 at 130, Staff of the Joint Comm. on Taxation, 99th Cong. (Comm. Print May 4, 1987).

[5] Pub. Law 95-914 (Oct. 22, 1986).

[6] IRC §41(d)(1). The four-test test, as applied to the taxable years in issue in *Smith* defined qualified research as research (i) with respect to which the expenditures may be treated as expenses under Section 174, (ii) was technological in nature, (iii) the application of which was intended to be useful in the development or improvement of the taxpayer's product or process, and (iv) substantially all of the activities of which constituted an experimental process related to a new function, performance, reliability, or quality.

[7] IRC §41(d)(1)(A), prior to its amendment by the Tax Cuts and Jobs Act, Pub. Law 115-97, sec. 13206(d)(1). The Tax Cuts and Jobs Act amended Section 174, effective for amounts paid or incurred after December 31, 2021. Prior to the amendment, Section 174 allowed a current deduction for the cost of research activity. The current version of Section 174 disallows the current deduction and instead requires research expenditures incurred in a taxable year to be amortized over a five-year period (fifteen years for foreign research). The version of Section 174 prior to its amendment applies in the *Smith* case.

[8] *Siemer Milling Co. v. Comm'r*, T.C. Memo 2019-37 (2019).

[9] "In the case of an employee (within the meaning of section 401(c)(1)) for such taxable year, the term 'wages' includes the earned income (as defined in section 401(c)(2)) of such employee." IRC. IRC §41(b)(2)(D)(ii). An employee within the meaning of IRC §401(c)(1) is a self-employed individual who has earned income as described in IRC §401(c)(2). Earned

income described in IRC §401(c)(2) means “net earnings from self-employment” (as defined in IRC § 1402(a)), but only with respect to a trade or business in which personal services of the taxpayer are a material income-producing factor. “Net earnings from self-employment,” as defined in IRC §1402(a), means for a partner his distributive share (whether or not distributed) of income or loss described in IRC §702(a)(8) from any trade or business carried on by a partnership of which he is a member. Section 702(a)(8) provides that in determining his income tax, each partner shall take into account separately his distributive share of the partnership's taxable income or loss, exclusive of items requiring separate computation. In summary, a partner’s earned income from self-employment is a surrogate for the partner’s “wages” for research credit purposes.

[10] IRC §41(b)(2)(A)(i).

[11] IRC §41(b)(2)(B)(i).

[12] §41(b)(2)(D)(ii).