OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

CC:DOM:FS:P&SI Apr 27, 1999

UILC: 174.00-00

Number: **199930016**
Release Date: 7/30/1999

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR
DISTRICT COUNSEL

FROM: DEBORAH A. BUTLER
ASSISTANT CHIEF COUNSEL (FIELD SERVICE)
CC:DOM:FS

SUBJECT: Research and Experimental Expenditures

This Field Service Advice responds to your memorandum dated January 28, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

T	=
P	=
Year 1	=
Year 2	=
Year 3	=
Year 4	=
w	= $
x	= $
y	= $
z	= $

ISSUE:

Whether the taxpayer's expenditures were for the acquisition of another's production or process or incurred in connection with the construction or manufacture of depreciable property by another, not at the taxpayer's risk or pursuant to a performance guarantee.

CONCLUSION:

The taxpayer's expenditures were for the acquisition of another's production or process and not at the taxpayer's risk.

FACTS:

T is in the business of developing and marketing P.

In fiscal years ending April 30, Year 2 through Year 4, T claimed a deduction for research expenses pursuant to section 174 in the amounts of $w, $x, and $y, respectively. T filed an amended return for the fiscal year ending April 30, Year 1, claiming a deduction for research expenses pursuant to section 174 in the amount of $z. The claimed expenses arose from three standard contracts: a standard Product Agreement, a standard Product License Agreement and a standard Independent Contractor Agreement.

Standard Product Agreement

Under the standard Product Agreement, T hired the developer to develop specific property, i.e., P, on a work-for-hire basis (Work). The Work is defined as:

> (1) Finalization of that certain [P] known as . . . which shall operate on the . . . computer systems (the "Systems") having at least the following system requirements . . . .
>
> (2) The Work includes delivery to [T] of the object and source codes for the Work for use on the Systems plus the development tools (including compilers and editors) and all data and information at each milestone delivery date and deemed necessary by [T] to carry out and perform its rights under this Agreement (the "Deliverable"). Such Deliverables must include all the files and tools necessary to compile and create the final sellable version of the Work.

Under the terms of the agreement:

> [T] will be the owner of the copyright and all other proprietary rights in the Work and all products, materials, reports or other data developed under the terms of this Agreement. Developer agrees and acknowledges that the Work shall be considered a "work made for hire," that Developer has no claim to any right, title or interest in the Work supplied to [T] pursuant to the terms of this Agreement or otherwise, and that Developer will make no claims that any of such Works infringe upon the copyright or other right, title or interest of Developer and that the Work shall, upon creation, be owned exclusively by [T].

T had the right to request any and all modifications which it deemed necessary to adapt the Work to its specifications. The Work was not deemed accepted until all modifications requested by T had been made by the Developer.

T reserved the right to terminate the Agreement at any time for any reason. If terminated, the amounts paid by T under the Agreement to the developer were non-refundable, unless termination occurred as a result of a breach of the developer's representations and warranties. The developer represented and warranted the following:

> Developer hereby represents and warrants that it has full and exclusive right and power to the Work sold to [T] hereunder; that it has not heretofore granted any rights to the Work to any other person, party or company which remain in effect; that the rights granted herein will not infringe upon the rights of any other person or entity or breach or cause a default under Developer's organizational documents or any agreements entered into by Developer; that the Work will be merchantable and fit for use on the computer system for which the Work is intended to be used; that Developer will complete the Work in accordance with the provisions set forth on Schedule A and that the Work and any enhancements made thereto, does not and shall not violate or infringe any United States or foreign patent, trademark, trade secret, copyright, or similar law or right.

In regards to the development of the Work,

> (1) Developer shall immediately initiate the development of the Work and will notify [T] of Developer's expected delivery to [T] of the competed Work and the associated computer software in conformity with the milestones described herein. Developer shall consult with [T] during the development of the Work and [T] shall have the right to

> review Developer's work. Developer shall make available to [T] all of Developer's work product in connection with such Work.
>
> (2) In the event any "bug" may appear in the Work at any time after acceptance of the Work, in addition to any other rights or remedies which [T] may have in such event, Developer agrees to immediately, following [T's] notification to Developer of such problem, correct such "bug" at Developer's own cost and expense. If Developer fails or refuses to correct such "bug" and [T] does so, then in such event Developer shall, upon [T's] demand, reimburse [T] for any and all reasonable costs incurred by [T] in connection with such "bug." [T] reserves the right to offset any amounts not reimbursed to [T] against amounts otherwise owed to Developer.
>
> (3) Developer shall complete the work on the Work in accordance with the milestones and no later than the dates set forth below, as such may be modified from time to time by written agreement of the parties. [T] shall pay Developer the sums set forth opposite each milestone below upon [T's] being satisfied that such milestone has been satisfactorily achieved. In the event that [T] does not believe that any milestone has been satisfactorily achieved, [T] shall so notify Developer after the milestone date, together with [T's] comments regarding such rejection, and Developer shall promptly submit or resubmit the materials to [T]. This procedure shall be repeated until [T] determines that the milestone has been met or that further submission will be to no avail. If [T] determines that further submission would be to no avail, or that the project should be terminated for any reason [T] may immediately terminate this Agreement whereby [T's] entire liability to Developer hereunder shall be the payments already made to Developer at the time such determination is made, minus amounts recoupable as a result of any breach of any representation or warranty by Developer.

The parties were required to set forth a schedule of milestones.

Standard Product License Agreement

The standard Product License Agreement was used to purchase exclusive world-wide computer software rights to existing P. The consideration paid was composed of advance payments and royalty payments. T provided to the licensor the right of first refusal to provide conversion or modification services in exchange for a royalty. T had the right to request any and all reasonable modifications which it deemed to

be necessary to adapt P to its specifications. P was not deemed acceptable until all requested modifications had been made by the licensor.

As specified in the agreement any trademark or service mark to P which came into existence during the term of the agreement was owned exclusively by T. The agreement provided:

> (a) Licensor shall immediately initiate the development and subsequent delivery of the [P] and will notify [T] of Licensor's expected delivery to [T] of the completed [P] and the associated computer software in conformity with the milestones described herein. Licensor shall consult with [T] during the development of the [P] and [T] shall have the right to review Licensor's work. Licensor shall make available to [T] all of Licensor's work product in connection with such [P].
>
> (b) In the event any "bug" may appear in the [P] at any time after acceptance of the [P], in addition to any other rights or remedies which [T] may have in such event, Licensor agrees to immediately correct such "bug" at Licensor's own cost and expense. If Licensor fails or refuses to correct such "bug" and [T] does so, then in such event Licensor shall, upon [T's] demand, reimburse [T] for any and all reasonable costs incurred by [T] in connection with correcting such "bug." [T] reserves the right to offset any amounts not reimbursed to [T] against amounts otherwise owed to Licensor.
>
> (c) (i) Licensor shall complete the work on the [P] in accordance with the milestones and no later than the dates set forth below, as such may be extended or modified from time to time by written agreement of the parties. It is expected that [T] will have creative input with respect to deliverables and Licensor will employ its best efforts to incorporate [T's] creative input into the [P]. [T] shall pay Licensor, as advances recoupable against all royalties payable to Licensor hereunder, the nonrefundable royalties sums set forth opposite each milestone below upon [T's] being satisfied that such milestone has been satisfactorily achieved. In the event that [T] does not believe in good faith that any milestone has been satisfactorily achieved, [T] shall so notify Licensor after the milestone date, together with [T's] comments regarding such rejection, and Licensor shall promptly submit or resubmit the materials to [T]. This procedure shall be repeated until [T] determines that the milestone has been met or that further submission will be to no avail. If Licensor determines that the changes requested by [T] will substantially increase the number of person-hours required to meet a particular milestone, the parties will negotiate in good faith any

changes thus required in payments to Licensor and/or changes to the milestones. If [T] determines in good faith that further submission would be to no avail, [T's] entire liability to Licensor hereunder shall be the payments already made to Licensor at the time such determination is made, minus amounts recoupable as a result of any breach of any representation or warranty by Licensor. All such milestones must be accompanied by the latest version of the source code.

(ii) Within two (2) weeks following Licensor's delivery to [T] of completed computer software for the [P] (in such form as required to meet the milestones described herein, as determined by [T]), [T] shall make an initial evaluation of such software to determine whether such computer software is, in [T's] sole opinion, in an acceptable form for testing by [T]. Should [T] determine that such computer software is not acceptable for testing, [T] shall give Licensor written notice of said determination or terminate this agreement, at [T's] sole discretion. Upon [T's] determination that such computer software is ready for testing, [T] shall have sixty (60) days within which to test it and review the completed software and computer software for such [P] (hereinafter the "Test Period"). The [P] is subject to [T's] acceptance as being commercially and technically satisfactory.

(Iii) Prior to the expiration of such Test Period [T] shall notify Licensor in writing of [T's] acceptance or rejection of such software. If [T] rejects such software [T] shall specify the basis of [T's] rejection and Licensor shall have thirty (30) days thereafter to correct such software as specified by [T] and return the software to [T] together with such documentation thereto for retesting by [T]. Within sixty (60) days after Licensor's redelivery of the computer software, [T] shall provide Licensor with either a written acceptance or rejection with a specification of the reasons for rejection. This procedure shall be repeated until the computer software and the documentation are accepted by [T], or until [T] determines in its sole discretion that Licensor is unable to complete the [P], at which time [T] may terminate this Agreement. If [T] terminates this Agreement, [T's] entire liability to Licensor hereunder shall be the payments already made to Licensor at the time such determination is made, minus amounts recoupable as a result of any breach of any representation or warranty by Licensor.

Standard Independent Contractor Agreement

The standard Independent Contractor Agreement was used primarily to hire independent contractors to develop non-technical aspects of P, such as

background or theme music, on a work-for-hire basis. Under the terms of the agreement the contractor was required to deliver the work completed on each milestone delivery date, including all source codes. In addition:

> Contractor agrees to perform all services hereunder to [T's] reasonable satisfaction and in compliance with the requirements of [T] under this Agreement. Services shall be performed by Contractor at its place of business. Services shall be performed to the satisfaction of [T]. Contractor agrees to use its best efforts in performing such services, at a level consistent with persons having a similar level of education, experience and expertise in the software industry, in the performance of the services called for hereunder.
>
> ...
>
> If Contractor fails to deliver any deliverable item in conformance with the specification by its specified delivery date, [T] will have the option to either (a) terminate this Agreement and/or (b) supply, correct or complete the services and the deliverable item and deduct an amount equal to reasonable compensation for [T's] efforts (including all compensation payments paid to others) from any payments due Contractor under this Agreement. Contractor shall also be liable for any damages incurred by [T] resulting in the failure to timely deliver a deliverable item by its due date.
>
> . . .
>
> [T] will be the owner of the copyright and all other proprietary rights in the Work and all products, materials, reports or other data developed under the terms of this Independent Contractor Agreement. Contractor agrees and acknowledges that the Work shall be considered "works made for hire," that Contractor has no claim to any right, title or interest in the Work supplied to [T] pursuant to the terms of this Agreement or otherwise, and that Contractor will make no claims that any of such products infringe upon the copyright or other right, title or interest of the Contractor and that the Work shall, upon creation, be owned exclusively by [T].

LAW AND ANALYSIS

A taxpayer may treat research or experimental expenditures which are paid or incurred by it during the taxable year in connection with its trade or business as

expenses which are not chargeable to the capital account. I.R.C. § 174(a)(1). A taxpayer is generally allowed the election of either currently deducting its research and experimental expenditures or amortizing those expenditures over a period of not less than 60 months. I.R.C. §§ 174(a)(1), (b)(1); Treas. Reg. § 1.174-1. Research expenses which are neither treated as expenses nor deferred and amortized must be charged to the capital account. Treas. Reg. § 1.174-1.

In general, research and experimental expenditures are those "which represent research and development costs in the experimental or laboratory sense." Treas. Reg. § 1.174-2(a)(1). The term generally includes all such costs incident to the development or improvement of a product. Treas. Reg. § 1.174-2(a)(1). "Product" includes any pilot model, process, formula, invention, technique, patent, or similar property and includes products to be used by the taxpayer in its trade or business as well as products to be held for sale, lease or license. Treas. Reg. § 1.174-2(a)(2). It does not include the acquisition of another's production or process. Treas. Reg. § 1.174-2(a)(3).

Section 174 applies to costs paid or incurred by a taxpayer for research and experimentation undertaken directly by the taxpayer and to costs paid or incurred for research or experimentation carried on in the taxpayer's behalf by a third party. Section 174 does not apply to costs paid or incurred that represent expenditures for the acquisition or improvement of depreciable property, used in connection with the research or experimentation, to which the taxpayer acquires rights of ownership. Treas. Reg. § 1.174-2(a)(8).

If expenditures for research or experimentation are incurred in connection with the construction or manufacture of depreciable property by another, they are deductible under section 174(a) only if made upon the taxpayer's order and at its risk. No deduction is allowed if the taxpayer purchases another's product under a performance guarantee (whether express, implied, or imposed by local law) unless the guarantee is limited, to engineering specifications or otherwise, in such a way that economic utility is not taken into account. Treas. Reg. § 1.174-2(b)(3).

Under the given facts, the amounts paid pursuant to the standard Product Agreement, standard Product License Agreement, and standard Independent Contractor Agreement are deductible if made upon T's order and at its risk.

Standard Product Agreements

In the standard Product Agreement, T would establish specific property which contained specific requirements to be developed on a work-for-hire basis. T had the right to request any and all modifications which it deemed necessary to adapt

the product to its specifications, and the Work was not deemed acceptable until all modifications requested by T had been made by the developer.

T paid the developer on a milestone basis when T believed the milestone had been met. If T did not believe a milestone had been achieved, T would notify the developer with comments regarding the rejection and the developer was to submit or resubmit the materials to T. This process would be repeated until T determined that the milestone had been met or that further submission would be to no avail. If further submission would be to no avail, T could immediately terminate the agreement. If terminated, the amounts paid by T under the Agreement to the developer were non-refundable, unless termination occurred as a result of a breach of the developer's representations and warranties. In addition, the developer had to make any necessary corrections for program errors discovered after acceptance of the final software programs at its own expense.

The agreement provides that the computer software programs produced by the developers would be the exclusive property of T and all materials produced by the developers in fulfilling their obligations under the agreements are works made for hire. The developer had no claim to any right, title or interest in the Work.

T had the right to request any and all modifications which it deemed necessary to adapt the Work to its specifications. The Work was not deemed accepted until all modifications request by T had been made by the Developer. At any time after acceptance of the Work a "bug" appeared, Developer was required to correct the "bug" at the Developer's own cost and expense.

Based on the terms of the standard Product Agreements, the developers were responsible for the operability of the P software according to T's specifications. Accordingly, the standard Product Agreements were contracts for the purchase of computer software.

Standard Product License Agreement

The standard Product License Agreement was used to purchase exclusive world-wide computer software rights to existing P. Research and experimental expenditures do not include the acquisition of another's production or process. Treas. Reg. § 1.174-2(a)(3). Accordingly, the amounts paid pursuant to the licensing agreement for the purchase of exclusive world-wide computer software rights to existing P are excluded from the definition of "research and experimental expenditures" and are not deductible under section 174(a).

Under the standard Product License Agreement, consideration was also paid for the conversion or modification services provided by the licensor. T would establish

specific modifications and the product was not deemed acceptable until all requested modifications had been made by the licensor.

T had the right to request any and all reasonable modifications which it deemed necessary to adapt the product to its specifications. The product was not deemed accepted until all modifications request by T had been made by the licensor. At any time after acceptance of the product a "bug" appeared, licensor was required to correct the "bug" at the licensor's own cost and expense.

T paid the licensor on a milestone basis when T believed the milestone had been met. If T did not believe a milestone had been achieved, T would notify the licensor with comments regarding the rejection and the licensor was to submit or resubmit the materials to T. This process would be repeated until T determined that the milestone had been met or that further submission would be to no avail. If further submission would be to no avail, T could immediately terminate the agreement. If terminated, the amounts paid by T under the Agreement to the licensor were non-refundable, unless termination occurred as a result of a breach of the developer's representations and warranties.

Within two weeks following the delivery of the product, T could determine if the software was acceptable. If T determined that the software was not acceptable, T could terminate the agreement or the licensor had 30 days to correct the software. After redelivery of the product, T had 60 days to determine whether the product should be accepted or rejected. The process could be repeated until T either accepted the product or terminated the agreement. If terminated, T's entire liability to the licensor was for payments already made, minus amounts recoupable as a result of any breach of any representation or warranty by Licensor.

Any trademark or service mark which came into existence during the term of the agreement was owned exclusively by T.

Based on the terms of the standard Product License Agreements, the licensors were responsible for the conversion or modification of the P software. Accordingly, the standard Product Licensing Agreements were contracts for the purchase of computer software.

Standard Independent Contractor Agreement

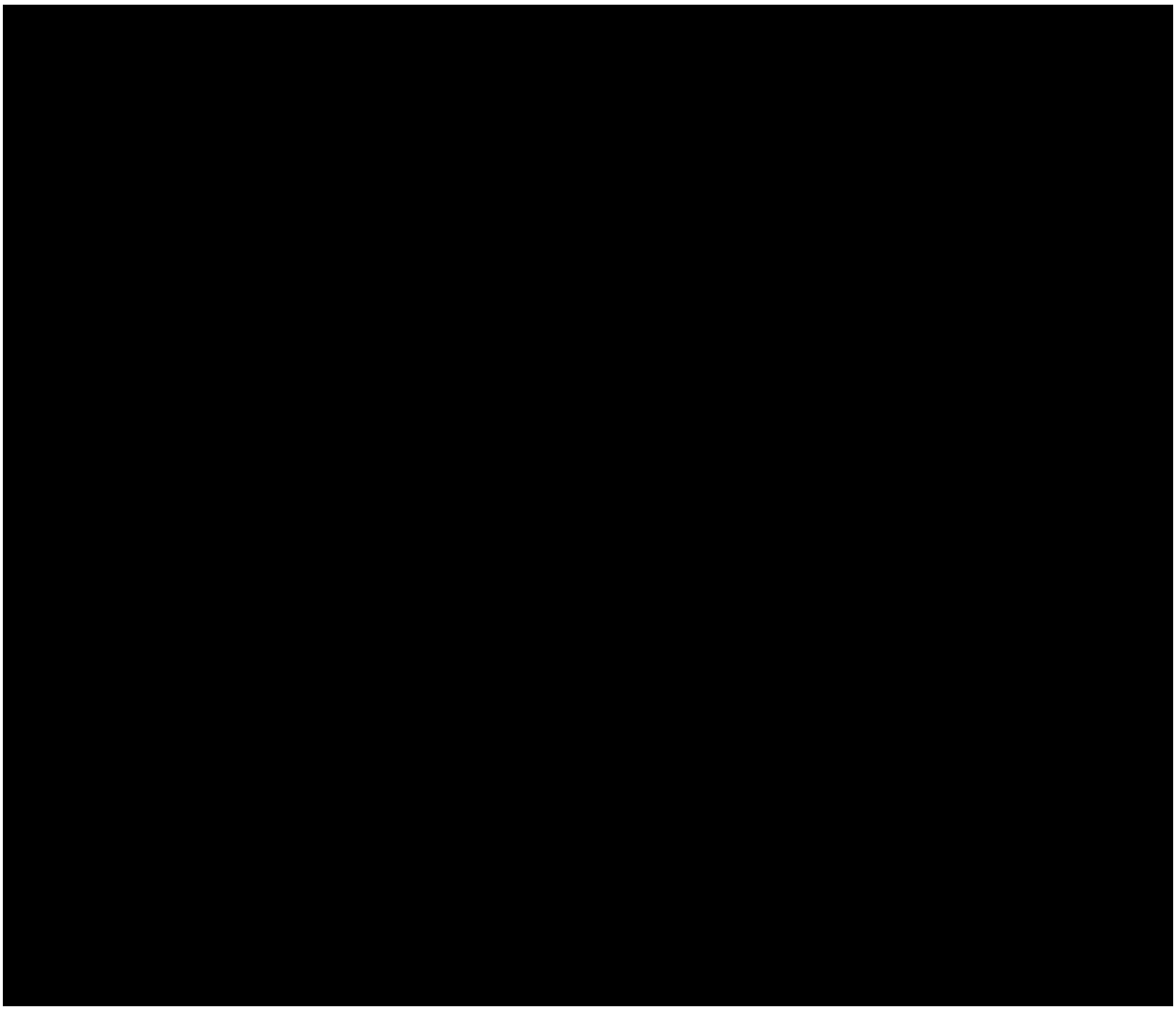
In the standard Independent Contractor Agreement, T would establish specific property which contained specific requirements to be developed on a work-for-hire basis. T paid the contractor on a milestone basis when T believed the milestone had been met. If T did not believe a milestone had been achieved, T could either terminate the agreement and/or supply, correct or complete the services and the

deliverable items and deduct an amount equal to reasonable compensation for T's efforts from any payments due under the agreement.

The agreement provides that T will be the owner of the copyright and all other proprietary rights in the work. The contractor had no claim to any right, title or interest in the work.

Based on the terms of the standard Independent Contractor Agreements, the contractors were responsible for the operability of the nontechnical aspects of P according to T's product specifications. Accordingly, the standard Contractor Agreements were contracts for the purchase of computer software.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:



[redacted]

Please call if you have any further questions.

By: _____
HARVE M. LEWIS
Chief, Passthroughs & Special
Industries Branch
Field Service Division