OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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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: Credit for Increasing Research

This Field Service Advice responds to your memorandum dated January 12, 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 =
Year 1 =
Year 2 =
Year 3 =

ISSUES:

1. Whether separation payments from an employer to its downsized employees constitute “wages” for purposes of Internal Revenue Code (Code) § 3401(a).

2. If the separation payments constitute “wages” for purposes of section 3401(a), whether, under the given facts, the separation payments qualify for the credit for increasing research activities under section 41.

CONCLUSION:

1. Separation payments from an employer to its downsized employees constitute "wages" for purposes of section 3401(a).

2. Under the given facts, the separation payments qualify for the credit for increasing research activities under section 41.

FACTS:

In Year 1 through Year 3, T instituted various voluntary programs designed to reduce its workforce. If an employee elected to participate in the program, he would be entitled to receive a separation payment and would be required to sign a document releasing T from all future claims and actions. The amount of the separation payment the employee was entitled to varied with the program, but generally was based in part on the length of service and pay of the employee. Some of the programs also included some or all of the following benefits: a special assistance payment, career assistance for retraining, career transition services, and a transitional medical program.

The document which the employee was required to sign generally provided that the employee released T from any and all claims, demands, actions, and liabilities, including but not limited to any claims, such as those under any federal or state law dealing with discrimination in employment on the basis of sex, race, national origin, religion, age or handicap, which the employee had against T by reason of any act, omission, matter, every cause, or thing whatsoever occurring or arising prior to or on the date of signing the agreement. The document also provided that the employee would never institute any charge of employment discrimination with any agency or any suit or action at law or in equity against T by reason of any claim he had relating to his employment with T. Several employees have taken the position that the amounts received under the voluntary program were damages paid by T on account of personal injuries or sickness.

T withheld Federal Insurance Contributions Act (FICA) taxes and federal withholding taxes from the separation payments. Many employees who elected to participate in the programs have filed lawsuits alleging that the separation payments are excludable from income under section 104(a)(2) and are not subject to FICA.

Based on your incoming request, we are assuming that, for each employee who elected to participate in the program, during the entire length of the employee's employment with T (including the final year of employment), the employee performed only qualified services.

LAW AND ANALYSIS

A taxpayer is allowed a credit against taxes for increasing research activities. Section 41. In general, the credit is an incremental credit equal to the sum of 20 percent of the excess (if any) of the taxpayer's "qualified research expenses" for the taxable year over the base amount and 20 percent of the taxpayer's basic research payments determined under section 41(e)(1)(A). Section 41(a).

The term “qualified research expenses” means the sum of in-house research expenses and contract research expenses paid or incurred by the taxpayer during the taxable year in carrying on any trade or business. Section 41(b)(1). “In-house research expenses” means, in part, “any wages paid or incurred to an employee for qualified services performed by such employee.” Section 41(b)(2)(A)(i). The term “wages” has the meaning given such term by section 3401(a).
Section 41(b)(2)(D)(i).

1. Characterization of Separation Payment for Purposes of Section 3401(a)

Except for specific exceptions not currently applicable, “wages” is all remuneration for services performed by an employee for his employer. Section 3401(a). To the extent the payment is for damages received by the employee on account of personal injuries or sickness, the payment is not for services performed by an employee for his employer and is not wages. Sections 104(a)(2); 3401(a). Several employees have taken the position that the amounts received under the voluntary program were damages paid by T on account of personal injuries or sickness and therefore excludable from gross income.

Gross income includes income from all sources derived. Section 61(a); Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955). The definition of gross income is broadly construed so as to give effect to Congress' intent to tax all income comprehensively. Commissioner v. Jacobson, 336 U.S. 28, 49 (1949). The Supreme Court has long held that any funds or other accessions to wealth received by a taxpayer are considered gross income, unless the taxpayer can demonstrate that the accession fits into one of the specific exclusions created by other sections of the Code. Congress intended through section 61(a) and its statutory precursors to exert the full measure of its taxing power and to bring within the definition of income any accession to wealth. United States v. Burke, 504 U.S. 229, 233 (1992). Gross income includes compensation for services including severance pay. Treas. Reg. § 1.61-2(a)(1).

Consistent with this comprehensive definition of gross income, exclusions of income provided for in the Code have been narrowly construed. Jacobson, supra; Kovacs v. Commissioner, 100 T.C. 124, 127-28 (1993), aff'd, 25 F.3d 1048 (6th Cir.

1994). Taxpayers claiming an exclusion from income bear the burden of proving that their claims fall within an exclusionary provision of the Code. Taggi v. United States, 35 F.3d 93, 95 (2d Cir. 1994).

The Code provides an exclusion from gross income for damages received on account of personal injuries or sickness. Section 104(a)(2). During Year 1 through Year 3, section 104(a)(2),[1] provided that gross income does not include–

> the amount of any damages received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal injuries or sickness.

The term "damages received (whether by suit or agreement)" means an amount received through prosecution of a legal suit or action based upon tort or tort-type rights, or through a settlement agreement entered into in lieu of such prosecution. Treas. Reg. § 1.104-1(c). To be excludable under section 104(a)(2), two requirements must be satisfied. First, the taxpayer must establish that the underlying cause of action giving rise to the recovery is based upon tort or tort-type rights. Second, the taxpayer must show that the damages were received on account of personal injuries or sickness. Commissioner v. Schleier, 515 U.S. 323, 327-34 (1995).

To be excludable section 104(a)(2), the taxpayer must first be able to establish that the nature of the underlying cause of action giving rise to the recovery is based upon tort or tort-type rights. Schleier, supra; Stocks v. Commissioner, 98 T.C. 1, 11 (1992); Metzger v. Commissioner, 88 T.C. 834, 847 (1987), aff'd without published opinion, 845 F.2d 1013 (3d Cir. 1988). The claim must be a bona fide claim, but does not necessarily have to be sustainable or valid. Sodoma v. Commissioner, T.C. Memo. 1996-275; Foster v. Commissioner, T.C. Memo. 1996-276. Based on the facts provided, none of the employees of T have established that there was an underlying cause of action based upon tort or tort-type rights which gave rise to the separation payment.

To be excludable under section 104(a)(2), the taxpayer must also be able to establish that the damages were received on account of personal injuries or sickness. Schleier, supra. The most important factor in determining whether a payment was made on account of personal injury or sickness is the intent of the payor in making the payment. Kurowski v. Commissioner, 917 F.2d 1033, 1036 (7th

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[1]Section 104(a)(2) was amended by section 1605 of the Small Business Job Protection Act of 1996. Section 1605 generally applies to amounts received after August 20, 1996. Accordingly, any reference to section 104(a)(2) is to the statute in effect prior to August 20, 1996.

Cir. 1990), aff'g T. C. Memo. 1989-149; Knuckles v. Commissioner, 349 F.2d 610, 613 (10th Cir. 1965), aff'g T.C. Memo. 1964-33; Stocks, 98 T.C. at 11; Metzger, 88 T.C. at 847-48; Glynn v. Commissioner, 76 T.C. 116, 120 (1981), aff'd without published opinion, 676 F.2d 682 (1st Cir. 1982). In determining the intent of the payor, the language of the agreement is considered. Whitehead v. Commissioner, T.C. Memo. 1980-508. Based on the terms of the agreement in the facts provided, there is no indication T intended to make the separation payment to the employee on account of personal injury or sickness.

The separation payment was not based upon tort or tort-type rights or for damages received on account of personal injuries or sickness. Accordingly, the payment is not a payment of damages, excluded from the definition of wages.

Remuneration for services, unless such remuneration is specifically excepted by statute, constitutes wages even though at the time paid the relationship of employer and employee no longer exists between the person in whose employ the services are performed and the individual who performed them. Treas. Reg. § 31.3401(a)-1(a)(5).

A payment made by an employer to an employee on account of involuntary separation from service constitutes wages, regardless of whether the employer is legally bound by contract, statute, or otherwise to make such payments. McCorkill v. United States, 32 F. Supp. 2d 46 (D. Conn. 1999) (court held that severance payments for involuntary separation which were based on a percentage of the employee's pre-layoff salary and his length of time of employment were wages for FICA tax purposes); Driscoll v. Exxon Corporation, 366 F.Supp. 992 (S.D. N.Y. 1973), aff'd, 493 F.2d 1397 (2d Cir. 1974) (court held that severance payments made upon involuntary layoff are wages under section 3401(a)); Treas. Reg. § 31.3401(a)-1(b)(4); Rev. Rul. 90-72, 1990-2 C.B. 211 (lump sum payments for involuntary separation made under employer plan do not qualify as supplemental unemployment benefits and were "wages" for purposes of FICA, Federal Unemployment Tax Act (FUTA) and federal withholding income tax); Rev. Rul. 74-252, 1974-1 C.B. 287 (involuntary separation from service payments were in the nature of dismissal payments and were "wages" for purposes of FICA, FUTA and income tax withholding); Rev. Rul. 73-166, 1973-1 C.B. 411 (lost pay to striking employee not re-employed after settlement of strike were dismissal payments subject to FICA, FUTA and income tax withholding); Rev. Rul. 72-572, 1972-2 C.B. 535 (payment made in settlement of a discrimination claim brought by employee whose services were involuntarily terminated constituted "wages" for purposes of FICA, FUTA and income tax withholding); Rev. Rul. 71-408, 1971-2 C.B. 340 (dismissal payments made to employees whose services were terminated were "wages" for purposes of FICA, FUTA and federal income tax withholding). See also H.R. Rept. No. 1300, 81st Cong., 1st Sess., 124 (1950-2 C.B. 277); S. Rep. No.

1669, 81st Cong., 2d Sess. 130 (1950-2 C.B. 336) (dismissal payment, which is any payment made by an employer on account of involuntary separation of the employee from the service of the employer, will constitute wages regardless of whether the employer is legally required to make such payment).

In general, a payment made by an employer to an employee on account of involuntary separation from service is "wages" because it is a benefit derived from the employment relationship; it is designed to cushion the impact of an employee's loss of employment. Similarly, a payment made by an employer to an employee on account of voluntary separation is generally "wages" because it is a benefit derived from the employment relationship. In Associated Elec. Coop. Inc. v. United States, 83 AFTR2d 749 (Ct. Fed. Cl. 1999), under a voluntary early-out program, employees received a one-time severance payment equal to one month's earnings for each full year of employment with the employer plus a supplemental cash payment equal to twelve months' earnings. Extended health and related insurance coverage were also provided. In determining if the payments were wages subject to FICA, the court considered whether the payment arose out of the employment relationship. In making this determination, it examined the program's eligibility requirements and the method of computing the severance payment. Because the factors indicated that the payment arose out of the employment relationship, the severance payments were wages and therefore subject to FICA.

It is our position that, to the extent a separation payment arises out of the employment relationship, it is wages for purposes of section 3401(a). Under the facts presented, the amount of separation payment the employee was entitled to varied with the program, but generally was based in part on the length of service and pay of the employee. Thus, it is our opinion that the payment arose out of the employment relationship and that the severance payment is wages for purposes of section 3401(a).[2]

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[2] Under the programs, certain of the benefits provided may be excludable from wages under section 3401(a) to the extent that they are "working condition fringes" under section 132(d). See Section 3401(a)(19). Under section 132(d), the term "working condition fringe" means property or services provided to an employee of the employer to the extent that, if the employee paid for such property or services, such payment would be allowable as a deduction under section 162 or 167. Rev. Rul. 92-69, 1992-2 C.B. 51, holds that, under certain circumstances described in the ruling, employer-provided outplacement services may be excluded from gross income as a working condition fringe and therefore excluded from wages for income tax withholding purposes. In addition, certain of the benefits provided (i.e., the medical coverage) may be excludable from wages as employer-provided coverage under an accident or health plan (section 106).

This position is consistent with the treatment of retirement payments. The Service has consistently held retirement payments to be wages subject to income tax withholding, unless the payments are made from a qualified plan or are taxable as an annuity. See Treas. Regs. § 31.3401(a)-1(b); Rev. Rul. 82-176, 1982-2 C.B. 223; Rev. Rul. 77-25, 1977-1 C.B. 301; Rev. Rul. 65-276, 1965-2 C.B. 386.[3]

This position is also consistent with the treatment of separation payments for purposes of FICA and FUTA. FICA and FUTA taxes apply to "wages," which are defined in the FICA and FUTA as "all remuneration for employment" unless specifically excepted. See Sections 3121(a) and 3306(b). "Employment" for FICA purposes is any service, of whatever nature, performed by an employee for the person employing him. Section 3121(b). A similar definition of "employment" for FUTA purposes is contained in section 3306(c). Thus, similar to section 3401(a), for FICA and FUTA purposes, "wages" is all remuneration for services performed by an employee for his employer.

Under FICA, a payment need not be in return for actual services performed in order to be wages. The definitions of "wages" and "employment" used in the FICA provisions originated in the Social Security Act of 1935, Pub. L. No. 74-271, § 210, 49 Stat. 620, 625, and have been retained since then essentially unchanged. "Wages" under the Social Security Act of 1935 has been interpreted to be broadly defined as "all remuneration for employment" unless specifically excepted. Social Sec. Bd. v. Nierotko, 327 U.S. 358 (1946) (back pay awarded under the National Labor Relations Act to an employee who had been wrongfully discharged constituted "wages" under the Social Security Act of 1935); Gerbec v. United States, 164 F.3d 1015 (6th Cir. 1999) ("remuneration for employment" included back pay and front pay compensation in the employer-employer relationship for which no actual services were performed); Sheet Metal Workers Local 141 Supplemental Unemployment Benefit Trust Fund v. United States, 64 F.3d 245 (6th Cir. 1995) (proceeds from liquidation of supplemental unemployment benefit trust fund that were distributed to participants in amounts based on length of service of each participant were wages for FICA tax purposes); Lane Processing Trust v. United States, 25 F.3d 662 (8th Cir. 1994) (proceeds from the sale of a company which were distributed to the company's employees in amounts based on years of service and salary were wages for FICA tax purposes); STA of Baltimore-ILA Container Royalty Fund v. United States, 621 F.Supp. 1567 (D.Md. 1985), aff'd, 804 F.2d 296 (4th Cir. 1986) (distributions to members of union who performed prior service to compensate them for loss of employment because of containerization were wages for FICA tax purposes).

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[3] The analysis of FICA and FUTA in these rulings reflects prior law which provided an exception from FICA and FUTA for certain retirement payments.

Under FICA, in determining whether a payment is wages, the criteria used to determine the amount of the payment is important. Mayberry v. United States, 151 F.3d 855, 860 (8th Cir. 1998) (class members' employment relationship for which compensation was paid was factored into both components of the settlement award); Hemelt v. United States, 122 F.3d 204, 210 (4th Cir. 1997) (method used to calculate the awards supported the view that the settlement payments were properly characterized as wages); Sheet Metal Workers, supra; Lane Processing Trust, supra; STA Container Royalty Fund supra. Under the facts presented, the criteria used by T to determine the amount of the separation payment is indicative of wages because the amount of the payment was calculated based on the employee's length of service with T and salary at the time of separation.

The revenue rulings concerning whether payments for relinquishment of a contractual right or entitlement are wages are inapplicable to T's payments made under the programs. In Rev. Rul. 58-301, 1958-1 C.B. 23, a lump sum payment was made to an employee as consideration for the cancellation of his employment contract. Because he was relinquishing a contractual right or entitlement, the payment was not subject to employment taxes. In contrast, in Rev. Rul. 75-44, 1975-1 C.B. 15, a lump sum payment was made to an employee for the employee's agreeing to refrain from asserting a previously acquired right. Because the right was derived from the employee's past performance of services, the payment was subject to employment taxes. See also Associated Elec. Coop. Inc. v. United States, 83 AFTR2d 749 (Ct. Fed. Cl. 1999). Under the facts presented, the employee was not relinquishing a contractual right or entitlement. Rather, the payment was based on the employment relationship and are wages under section 3401(a).

2. Payment for "Qualified Services"

The term "qualified research expenses" means the sum of in-house research expenses and contract research expenses paid or incurred by the taxpayer during the taxable year in carrying on any trade or business. Section 41(b)(1). "In-house research expenses" means, in part, "any wages paid or incurred to an employee for qualified services performed by such employee." Section 41(b)(2)(A)(i). The term "wages" has the meaning given such term by section 3401(a). Section 41(b)(2)(D)(i). As determined above, the separation payments constitute wages. Section 41(b)(2)(D)(i). Section 41(b)(2)(B) provides that "qualified services" means services consisting of:

> (i) engaging in qualified research, or
> (ii) engaging in the direct supervision or direct support of research activities which constitute qualified research.

> If substantially all of the services performed by an individual for the taxpayer during the taxable year consists of services meeting the requirements of clause (i) or (ii), the term "qualified services" means all of the services performed by such individual for the taxpayer during the taxable year.

Based on your incoming request, we are assuming that, for each employee who elected to participate in the program, during the entire length of the employee's employment with T (including the final year of employment), the employee performed only qualified services. Accordingly, the separation payments constitute "qualified research expenses" paid or incurred by T for "in-house research."

To the extent an employee did not perform qualified services, however, the separation payments will not constitute in-house research expenses. See Treas. Reg. § 1.41-2(d)(1) which provides:

> *In general.* Wages paid to or incurred for an employee constitute in-house research expenses only to the extent the wages were paid or incurred for qualified services performed by the employee. If an employee has performed both qualified services and nonqualified services, only the amount of wages allocated to the performance of qualified services constitutes an in-house research expense. In the absence of another method of allocation that the taxpayer can demonstrate to be more appropriate, 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 the 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.

Accordingly, the extent to which the services performed by T's employees are qualified services under section 41(b)(2)(B) should be verified.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

[redacted] Given the broad definition of "wages," the statutory language of section 41(b)(2)(A)(i) provides no basis for differentiating between a payment which satisfies the definition of wages and is paid to an employee who performed qualified services, thereby qualifying the payment as an in-house research expense, and a payment which satisfies the definition of wages and is paid to an employee who has only performed qualified services, but does not qualify as an in-house research expense.

As discussed above, the separation payments are considered wages because they are a benefit derived from the employment relationship, a nexus which is sufficiently strong so as to require the payments to be characterized as remuneration for services for withholding, FICA, and FUTA tax purposes. Thus, once a determination has been made that the payments are wages, i.e., that they are derived from the employment relationship, they must be remuneration for the services provided. Under the facts presented, the services provided were all qualified services.

In support of the position that the separation payment is not paid for qualified services, it is argued that the separation payment is "not compensatory in nature" because the payment was not made at the time the services were performed, an employee who is subsequently rehired may be required to pay back the separation pay, the employee could elect to forgo the separation pay in favor of the substantial equivalent of early retirement, and the separation payment was made for agreeing to terminate the employment relationship.

The statute does not require that the payment be "compensatory in nature." Rather, it only requires that the payment be wages paid for qualified services. An argument that the payment must be "compensatory in nature," to the extent it encompasses a different requirement than that the payment constitutes "wages," cannot be supported by the statutory language. Once a determination is made that there is a sufficiently strong nexus between the payment and the employment relationship so as to require the payments to be characterized as remuneration for services, any argument that the separation payments were *not* for services would be inconsistent. It is our opinion that, to the extent the separation payment constitutes wages as defined by section 3401(a), the sole remaining issue is whether the services provided were qualified services.

The holdings in Apple Computer, Inc. v. Commissioner, 98 T.C. 232 (1992), and Sun Microsystems, Inc. v. Commissioner, T.C. Memo. 1995-69, are consistent with the position taken in this Field Service Advice. One of the issues before the court in Apple Computer, Inc. , supra, was whether the excess of the fair market value of an option on the exercise date over the option price (spread) was wages under section 44F, the predecessor to section 41. The parties agreed that the services performed by the employees were qualified services and that the spreads constituted wages. Apple Computer, Inc., 98 T.C. at 236. The Commissioner argued that, based on the legislative history, Congress did not intend to include the spreads in the definition of wages. The court noted that, at the time Congress enacted the credit for increasing research, spreads constituted compensation for services. Because the spreads were wages under section 3401(a), the spreads were wages for purposes of the research credit. The court also noted that it would interpret section 41, but would not redraft it. Apple Computer, Inc., 98 T.C. at 237.

T has filed several protective claims for FICA taxes paid with respect to the separation payments. T's filing of protective claims does not alter the analysis set forth above. To the extent the separation payments are characterized as "wages" under section 41(b)(2)(D) and the wages were paid for "qualified services" under section 41(b)(2)(B), the separation payments are "in-house research expenses" under section 41(b)(2)(A)(i).

Please call if you have any further questions.

By: _____

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