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RE: Certain Prototype Costs That May Be Eligible for the Hawaii Tax Credit For Research Activities Under Section 235-110.91, Hawaii Revised Statutes.

The purpose of this Tax Information Release (TIR) is to advise taxpayers and practitioners of the Department of Taxation's (Department) position on construing application of the Hawaii Tax Credit for Research Activities ("TCRA") under Section 235-110.91, Hawaii Revised Statutes ("HRS") and when certain prototype expenses qualify for the TCRA.

I. OVERVIEW

"It is well established that exemptions from taxation are strictly construed against the taxpayer." In re Tax Appeal of Aloha Motors, Inc., 56 Haw. 321, 326, 536 P.2d 91, 94 (1975). This flows from the general principle that "provisions granting special tax exemptions are to be strictly construed." Helvering v. Northwest Steel Rolling Mills, Inc., 311 U.S. 46, 49 (1940). "The right to the credit claimed is a privilege granted by the Government, and hence the statute is to be strictly construed in favor of the Government." Burroughs Adding Machine Co. v. Terwilliger, 135 F.2d 608, 610 (6th Cir. 1943). See also Helvering v. Northwest Steel Mills, 311 U.S. 46, 49 (1940) (provisions of tax statutes granting exemptions are to be strictly construed); United States v. Hemme, 476 U.S. 558, 566 (1986) (court will not impute to Congress an unstated intention); Commissioner v. Drovers Journal Pub. Co., 135 F.2d 276, 278 (7th Cir. 1943) (deductions from gross income must be construed narrowly and strictly).

In order to qualify for the TCRA, the taxpayer must do "qualified research". IRC § 41(d)(1) defines "qualified research" as research with respect to which expenditures may be treated as expenses under section 174, which is undertaken for the purposes of discovering information which is technological in nature and the application of which is intended to be useful in the development of a new or improved business component of the taxpayer, and substantially all of the activities of which constitute elements of a process of experimentation. IRC § 174 generally provides that research and experimental expenditures paid or incurred during the taxable year in connection with a taxpayer's trade or business may, at the taxpayer's election, be deducted currently rather than capitalized. IRC § 174(c) provides in pertinent part that research and experimental expenditures do not include any expenditure for the acquisition or improvement of land, or for the acquisition or improvement of property to be used in connection with the research or experimentation and of a

character which is subject to the allowance under section 167 (relating to allowance for depreciation, etc). Likewise, IRC § 41(b)(2)(C) provides that supplies are "qualified research expenses" except for land, improvements to land, or property of a character subject to the allowance for depreciation. In addition, IRC § 41(b)(2)(A) requires that the supplies be used in the conduct of qualified research.

Whether expenditures qualify as research and experimental expenditures depends on the nature of the activity to which the expenditures relate, not the nature of the product or improvement being developed or the level of technological advancement the product or improvement represents. Treas. Reg. § 1.174-2(a)(2) defines product as including 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(b)(1) provides that expenditures by the taxpayer for the acquisition or improvement of property which is subject to an allowance for depreciation under section 167 are not section 174 expenses even if the property or improvements may be used by the taxpayer in connection with research or experimentation. Treas. Reg. § 1.174-2(b)(2) provides in relevant part that if, because of the expenditures for research and experimentation, depreciable property is produced which is used in the taxpayer's trade or business, the expenditures (subject to the limitations contained in Treas. Reg. § 1.174-2(b)(4)) is allowable as a IRC § 174 expenditure. Treas. Reg. § 1.174-2(b)(4), however, limits the deduction referred to in Treas. Reg. § 1.174-2(b)(2) to solely the amounts expended for research or experimentation and do not include the costs attributable to the construction of the property. Thus, the component costs of materials, costs of labor, and other costs attributable to the construction, improvements, or acquisition of depreciable property by the taxpayer are not eligible costs for purposes of the TCRA.

The term “property of a character subject to the allowance for depreciation” refers to the character of the property, not to whether it is depreciable in the hands of a particular taxpayer. See IRC § 167(a). In Ekman v Commissioner, 184 F. 3d 522, 526 (6th Cir 1999), the taxpayer argued that the property in question had to be used in producing final goods that were to be sold in order to be disallowed as a § 174 expense. The court rejected this argument, noting that "[t]he clear import of these sections is that the character of the property, not the use of the property, is critical to the determination of whether an expense is deductible or only depreciable." Noting that the trial court had found the engine in question to be subject to wear and tear, the court affirmed the trial court's determination that the engine was of a character subject to the allowance for depreciation and thus an ineligible expense. The Internal Revenue Service (IRS) has consistently applied this view. See e.g. Technical Advice Memorandum 199927001; Field Service Advice 200125019; Field Service Advice 200013017.

This is also consistent with the legislative history to IRC § 41. The Committee Report provides:

> Property which is of a character subject to the depreciation allowance is not eligible for the credit whether or not amounts of depreciation are deductible during the year and whether or not the cost of such property can be "expensed".

[H.R. Rep. No.201, 97th Cong., 1st Sess at 118 (1981)].

In order to qualify as a supply for purposes of the TCRA, the taxpayer "must demonstrate that it acquired non-depreciable tangible property and used it to engage in experimental or laboratory research to discover technological information, substantially all of the activities of which constituted elements of a process of experimentation (to develop a new or improved function, performance, reliability or quality of a new or improved business component)." Lockheed Martin Corp. v. United States, 49 Fed. Cl. 241 (2001). The only exception to the general rule is for certain "extraordinary utilities" expenditures. See Treas. Reg. § 1.41-2(b)(2).

II. CREDIT DISALLOWED FOR COSTS INCURRED IN CONSTRUCTION OF A PROTOTYPE EXCEPT TO THE EXTENT THE "SHRINK BACK RULE" OF IRC § 41 APPLIES

The costs incurred in building property having a useful life greater than one year will generally not generate the TCRA. It is immaterial if the property being built is called a "prototype", "pilot model", or any other description. The name applied is not the controlling factor. Rather, it is the activity that determines whether the expenditure qualifies. In this regards, the "shrink back rule" of IRC § 41 applies. The shrink back rule provides that the requirements of section 41(d) are first tested at the level of the discrete business component, i.e., the product, process, computer software, technique, formula, or invention to be held for sale, lease, or license, or used by the taxpayer in its trade or business.

If the requirements for credit eligibility are met at that first level, then some, or all, of the taxpayer's research activities are eligible for the credit. However, if all aspects of such requirements are not met at that level, the test is then applied to the next most significant subset of elements of the product, process, computer software, technique, formula, or invention to be held for sale, lease, or license. This “shrinking back” continues until either a subset of elements of the business component that satisfies the requirements is reached, or the most basic element of the business component is reached and such element fails to satisfy the tests.

For example, consider a taxpayer that is developing a new and innovative jet aircraft engine that will burn less fuel and be quieter than existing technologies. The fact that the taxpayer may build, retrofit, purchase, modify, and/or repair an entire jet aircraft in order to fully test and validate the taxpayer's design does not mean that all of the costs involved in building the aircraft qualify for the TCRA. Rather, each test under IRC § 41 must be met in order for the TCRA to be earned.

Assuming that qualification for the credit is otherwise met, if the taxpayer in this scenario were to be building, retrofitting, purchasing, modifying, and/or repairing the jet using known designs and techniques, the project would fail the process of experimentation test, which requires that substantially all of the activities involve a process of experimentation[1]. Since the taxpayer cannot

[1] To satisfy the process of experimentation requirement, a process must fundamentally rely on the principles of the physical or biological sciences, engineering, or computer science and must identify (1) uncertainty concerning the capability or method of achieving a result or concerning the appropriate design of a result, (2) one or more alternatives intended to eliminate that uncertainty, and (3) a process of evaluating the alternatives (such as modeling, simulation, or systematic trial and error methodology). For “substantially all” of the research activity to constitute a process of experimentation, at least 80 percent of the research activities (measured on a cost or other reasonable basis) must constitute elements of a process of experimentation for a functional (rather than cosmetic) purpose.

meet the "substantially all" requirement for the process of experimentation test, the entire project fails the process of experimentation test, and the taxpayer must shrink back the project to the next smaller subset of the product, process, computer software, technique, formula, or invention to be held for sale, lease, or license. This "shrinking back" continues until a subset of elements of the of the business component satisfies all of the IRC § 41 requirements or until the smallest subset of elements is reached. If the smallest subset is reached and that subset fails to meet all of the IRC § 41 requirements, then no costs incurred will qualify for the TCRA. In the example noted above, the shrinking back would continue until the point the jet engine is reached, because at that time, the taxpayer will satisfy all of the IRC § 41 tests, including the process of experimentation test. Consequently, only the costs incurred in building the test engine would qualify for the TCRA.

III. APPLICATION OF THIS TIR BY THE DEPARTMENT

This analysis will be applied in all pending audits and to ruling requests provided by the Department effective immediately. For taxpayers requesting a ruling from the Department related to the TCRA, such ruling request must state that the costs of constructing property having a useful life of greater than one year will not be costs qualifying for TCRA except to the extent that the IRC § 41 requirements are met based upon the shrink back rule noted above.

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HRS Applied: HRS §§ 235-1; 235-110.91