TSR, Inc. v. Commissioner, 92 T. C. 1210 (1989)

The Section 44F research credit applies only to expenses for research that is technological in nature, involving natural, physical, or laboratory sciences, and excludes research in social sciences, humanities, or other non-technological fields.

Summary

TSR, Inc. , known for creating 'Dungeons & Dragons,' sought a tax credit under Section 44F for expenses related to developing games and game-related products. The Tax Court held that these expenses did not qualify as 'qualified research expenses' because the research was not technological in nature. The court emphasized that the credit was intended for scientific and technological research, not for activities like game design that involve literary, historical, or similar projects. This ruling clarified the scope of the Section 44F credit, limiting it to research in the natural and physical sciences.

Facts

TSR, Inc. , a Wisconsin corporation, developed and sold various games, including the popular 'Dungeons & Dragons. ' The company claimed tax credits under Section 44F for expenses incurred in developing new products, including games, game modules, and related items. These expenses were primarily for research on historical and technical details integrated into the games, developing game mechanics, and play testing. The Internal Revenue Service disallowed these credits, leading to the dispute over whether these expenses constituted 'qualified research expenses' under Section 44F.

Procedural History

The IRS issued a notice of deficiency to TSR, Inc. , disallowing the claimed research credits. TSR, Inc. , then petitioned the Tax Court for a redetermination of the deficiencies. The Tax Court, after reviewing the case, upheld the IRS's disallowance of the credits, finding that the expenses did not qualify under Section 44F.

Issue(s)

1. Whether the expenses incurred by TSR, Inc. , for creating, developing, and writing games, game-related products, and game-related books and magazines constitute 'qualified research expenses' for purposes of the credit for increasing research activities under Section 44F.

Holding

1. No, because the research conducted by TSR, Inc. , was not technological in nature and did not involve the natural, physical, or laboratory sciences, as required by Section 44F.

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Court’s Reasoning

The court analyzed the plain and ordinary meaning of the terms used in Section 44F and its regulations, concluding that ‘qualified research’ must be technological in nature, involving the natural or physical sciences. The legislative history of Section 44F and subsequent amendments reinforced this interpretation, indicating Congress’s intent to limit the credit to scientific and technological research. The court found that TSR’s research, which involved gathering historical and technical information for game development, did not meet this criterion. The court also noted that the 1986 amendment to the definition of ‘qualified research’ further clarified that the credit was intended for research that fundamentally relies on principles of the physical or biological sciences, engineering, or computer science. The court rejected TSR’s argument that expenses related to the development of game accessories like miniatures and dice qualified for the credit, as there was no evidence of scientific or technological research in their development.

Practical Implications

This decision significantly narrows the scope of what constitutes ‘qualified research expenses’ under Section 44F, limiting the credit to research in the natural and physical sciences. Legal practitioners and businesses must carefully assess whether their research activities meet the stringent criteria of being technological in nature. This ruling may affect how companies claim research credits, particularly those in non-technological fields like game development, literature, and the arts. It underscores the importance of understanding the legislative intent behind tax incentives and the need for precise documentation of research activities. Subsequent cases have followed this interpretation, reinforcing the limited applicability of the Section 44F credit to high-tech industries and scientific research.

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