***TG Missouri Corporation F.K.A. TG (U.S.A.) Corporation v. Commissioner of Internal Revenue*, 133 T.C. 278 (2009)**

Costs of production molds sold to customers are considered ‘supplies’ for research tax credit purposes if the taxpayer does not retain an economic interest allowing depreciation of those molds.

Summary

TG Missouri Corporation (TG) claimed research tax credits for costs associated with production molds sold to its automotive customers. The IRS Commissioner argued that these costs should not be included as ‘supplies’ in qualified research expenses because the molds were depreciable property. The Tax Court held that production molds sold to customers are not ‘property of a character subject to the allowance for depreciation’ for TG because TG did not retain an economic interest in the sold molds, even though TG retained possession for manufacturing. Therefore, TG properly included the costs of these molds as ‘supplies’ when calculating its research tax credit.

Facts

TG manufactures injection-molded automotive parts. Customers provide product specifications, and TG develops production molds, either in-house or through third-party toolmakers. TG purchases molds from toolmakers and further modifies them. Depending on customer agreements, TG either sells the completed molds to customers or retains ownership. If TG retains ownership, it depreciates the molds. For molds sold to customers, title transfers upon completion and payment, but TG keeps possession for production and the customer bears the risk of loss. TG claimed research tax credits, including costs of molds sold to customers as ‘supplies’.

Procedural History

The Commissioner issued a notice of deficiency for 1998 and 1999, disallowing a portion of TG’s claimed research tax credits, arguing that costs of production molds sold to customers were improperly included as qualified research expenses. TG petitioned the Tax Court, challenging the Commissioner’s adjustments. The case was submitted fully stipulated to the Tax Court.

Issue(s)

1. Whether production molds sold by TG to its customers are ‘property of a character subject to the allowance for depreciation’ under sections 41(b)(2)(C) and 174(c) of the Internal Revenue Code.
2. Whether TG properly included the costs of these production molds as ‘supplies’ in calculating its research tax credit under section 41.

Holding

1. No, because TG did not retain an economic interest in the production molds sold to its customers that would allow TG to depreciate them.
2. Yes, because the production molds sold to customers are not ‘property of a character subject to the allowance for depreciation’ in TG’s hands and thus qualify as ‘supplies’ for the research tax credit.

Court’s Reasoning

The Tax Court interpreted the phrase ‘property of a character subject to the allowance for depreciation’ in sections 41(b)(2)(C) and 174(c) to mean property that is depreciable in the hands of the taxpayer, not inherently depreciable property in general. The court emphasized that sections 174(b) and (c) and 41(b)(2)(C) consistently refer to the taxpayer’s treatment of the property. Referencing section 1239 and 453, the court noted that other Code sections clarify that ‘depreciable property’ status is determined ‘in the hands of the transferee,’ suggesting a taxpayer-specific approach is intended throughout the Code. The court reasoned that depreciation is allowed to the party suffering economic loss from asset deterioration. Although TG retained possession of the molds, the customers bore the risk of loss and effectively paid for the molds. Since TG lacked an economic interest in the sold molds, it could not depreciate them. Therefore, the molds were not ‘property of a character subject to depreciation’ for TG and qualified as ‘supplies’ for the research credit.

Practical Implications

This case clarifies that when determining whether property is ‘of a character subject to the allowance for depreciation’ for purposes of the research tax credit and research expense deductions, the focus is on whether the taxpayer claiming the credit or deduction can depreciate the property. It is not sufficient that the property is inherently depreciable in some abstract sense. Legal professionals should analyze the economic substance of transactions to determine if a taxpayer retains a depreciable interest in property, even if they retain physical possession. This ruling provides a taxpayer-favorable interpretation, allowing costs of assets sold to customers to be treated as ‘supplies’ for the research credit if the seller does not retain a depreciable economic interest, even if the seller uses the assets in their business operations.