
Opinion of the Tax Commissioner

Date Issued: November 21, 2003

Opinion No: 03-0003

Tax: Sales

XXXX
XXXX
XXXX

Subject: Capitalized

Re: Request for Opinion of the Tax Commissioner

Dear XXXX:

This is in response to your company's request for an Opinion of the Tax Commissioner dated September 18, 2003 and submitted through your counsel, XXXX. You asked for an Opinion as to the application of the sales tax exemption for qualified research and development equipment found in former Ohio Revised Code ("R.C.") section 5739.01(E)(11), now R.C. 5739.02(B)(43)(i).

Question Presented

Will equipment identified as being used "primarily to perform research and development" for purposes of R.C. 5739.01(GG), 5739.01(HH), and 5739.02(B)(43)(i) be treated as "capitalized" for purposes of those statutes, provided that the equipment is capitalized for Ohio personal property tax purposes, and without regard to whether such equipment is capitalized for GAAP¹ purposes?

Facts Presented by the Taxpayer

XXXX has determined that some of its machinery and equipment must be expensed, not capitalized, under GAAP. In this regard, FASB² statement 2 provides the proper method for accounting for costs incurred for research and development. That document states at page 6:

However, the cost of materials, equipment, or facilities that are acquired or constructed for a particular research and development project and that have no alternative future uses (in other research and development projects or otherwise) and therefore no separate economic values are research and development costs at the time the costs are incurred.

XXXX has determined that some of the equipment in this instance has no "separate economic value" for FASB statement 2 purposes because it will have no alternative future use, and will be

¹ GAAP stands for Generally Accepted Accounting Principles

² FASB stands for Financial Accounting Standards Board

used for experimental and analytical purposes only. Thus, under FASB statement 2, that equipment must be expensed, not capitalized, for financial reporting purposes (GAAP).

Analysis

R.C. 5739.01(GG) defines “research and development” as follows;

"Research and development" means designing, creating, or formulating new or enhanced products, equipment, or manufacturing processes, and also means conducting scientific or technological inquiry and experimentation in the physical sciences with the goal of increasing scientific knowledge which may reveal the bases for new or enhanced products, equipment, or manufacturing processes.

As noted above, R.C. 5739.02(B)(43)(i), formerly 5739.01(E)(11), provides an exemption for “qualified research and development equipment.” That term is defined by R.C. 5739.01(HH), in pertinent part, as follows:

"Qualified research and development equipment" means **capitalized** tangible personal property, and leased personal property that would be capitalized if purchased, used by a person primarily to perform research and development. [Emphasis added.]

This Opinion request involves the meaning “capitalized” in R.C. 5739.01(HH). The sales tax law does not provide a definition of that term, and a review of various dictionaries for guidance is not of great assistance. However, it appears that the purpose of the General Assembly in enacting R.C. 5739.02(B)(43)(i) was to promote research and development activities in Ohio – excluding purchases that are expensed.

In a generic sense, a purchase of personal property is either “capitalized” or “expensed.” Normally, an item is capitalized, rather than treated as an expense, when the property has a substantial useful life. In Treasury Reg. 1.263(a)-2, an example of a capital expenditure is “[t]he cost of acquisition, construction, or erection of buildings, machinery and equipment, furniture and fixtures, and similar property having a useful life substantially beyond the taxable year.” When property has a useful life substantially beyond the period of acquisition, expensing the acquisition cost may result in a distorted matching of revenues and expenses. Accordingly, for most accounting and tax purposes, such cost is capitalized and amortized or depreciated on the records of the property owner over the period of the useful life.

FASB statement 2 provides an exception to this general rule and requires that all equipment and materials acquired for research and development activities that have no alternative future uses are considered to be research and development costs that are expensed when incurred rather than being capitalized and amortized or depreciated over the useful lives of the assets. Thus, acquisition costs that in other contexts might be capitalized are, for GAAP purposes, immediately expensed. This is true even if the property has a useful life substantially in excess of the annual accounting period in which it is acquired or constructed. The issue in this Opinion is whether strict application of this accounting rule determines eligibility for the sales and use tax exemption.

Section 167 of the Internal Revenue Code (“I.R.C.”) allows an income tax deduction for depreciation of property used in a trade or business or property held for the production of income. As a general rule, property that is subject to depreciation under I.R.C. section 167 would qualify as “capitalized” for purposes of the sales and use tax exemption found in R.C. 5739.02(B)(43)(i).

I.R.C. section 174 provides an alternative treatment for certain research and experimental expenditures, essentially allowing a taxpayer an election to treat such expenditures as currently deductible expenses or as “deferred expenses” which may be deducted from income over a five year period. Apparently some property that would normally be capitalized under I.R.C. section 167 must be expensed under I.R.C. section 174 because the taxpayer’s use of the property is not considered to be for its trade or business. Under that circumstance, property that must be expensed under I.R.C. section 174 that would otherwise have been subject to depreciation under I.R.C. section 167 had the property been used in the taxpayer’s trade or business also would qualify as “capitalized” for purposes of the sales and use tax exemption.

Addressing how the property is treated for personal property tax purposes, R.C. 5711.18 measures true value by book value less book depreciation if the assessor does not find another value more properly reflective. That section does not obviate the need to list property not capitalized on the taxpayer’s books and records. Personal property physically in existence and used in business in this state on the applicable tax list date must be listed for taxation even if it has not been “capitalized” on the taxpayer’s books and records and is clearly an expense item (e.g. most supplies).

Opinion of the Tax Commissioner

It is the opinion of the Tax Commissioner that equipment used in research and development, as defined in R.C. 5739.01(GG), that has been expensed under FASB statement 2 will be considered to be “capitalized” as that term is used in R.C. 5739.01(HH) if the property has a useful life substantially beyond the taxpayer’s annual accounting period in which the property was acquired or constructed. This is property of a character to be chargeable to a capital account and depreciated under I.R.C. section 167, or if I.R.C. section 174 applies, would be property of a character that is chargeable to a capital account and subject to depreciation under I.R.C. section 167 if the property were used in the taxpayer’s trade or business.

This Opinion is limited to the legal issue addressed in this opinion. This Opinion only applies to the taxpayer and it may not be transferred or assigned. In addition, the tax consequences stated in this Opinion may be subject to change for any of the reasons stated in R.C. 5703.53(C). It is the duty of the taxpayer to be aware of such changes. See R.C. 5703.53(E).

Sincerely,

J. Patrick McAndrew
Tax Commissioner