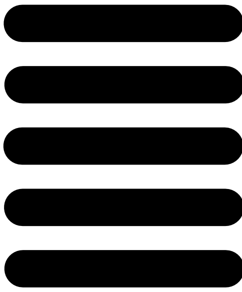


VOLUME 14, NUMBER 7
FEBRUARY 2006

THE M&A Tax Report

THE MONTHLY REVIEW OF
TAXES, TRENDS & TECHNIQUES

**EDITOR-IN-CHIEF**
Robert W. Wood
Wood & Porter
San Francisco

**ASSOCIATE EDITOR**
Joanna Schaller
Tax Institute
San Francisco

**ADVISORY BOARD**

Dominic L. Daher
University of San Francisco
San Francisco

Paul L. Davies III
The Cambria Group
Menlo Park

Jonathan R. Flora
Lindquist & Vennum
Minneapolis

David R. Gerson
Wilson Sonsini
Goodrich & Rosati
San Francisco

Lawrence B. Gibbs
Miller & Chevalier
Washington

Steven K. Matthias
Deloitte & Touche
San Francisco

Mark A. Muntean
Wood & Porter
San Francisco

Matthew A. Rosen
Skadden, Arps, Slate,
Meagher & Flom
New York

Mark J. Silverman
Steptoe & Johnson
Washington

Robert Willens
Lehman Brothers
New York

# Can Your Joint Venture Deduct Research and Experimental Expenditures?

**By David B. Porter • Wood & Porter • San Francisco**

Research and experimentation is costly. Section ("Code Sec.") 174 of the Internal Revenue Code can mitigate that cost by allowing an immediate deduction for these expenditures. But, as with so many other areas of the tax law, there are often questions of who can use this provision and how it works. In December 2005, the IRS issued guidance in the form of legal advice concerning the deductibility of research and experimental ("R&E") expenditures in connection with a trade or business under Code Sec.174. [Office of Chief Counsel IRS Memorandum No. 20055203F, 2005 TNT 250-15.] The focus is joint ventures.

## Whose Deduction?

Often, two companies will form a joint venture and place intellectual property in a foreign sales corporation to avoid U.S. tax on foreign sales by the joint venture. However, in the situation considered in the Chief Counsel Memorandum, the joint venture was a U.S. corporation. The Revenue Agent concluded the initial audit by determining that the joint venture was a mere investment by two shareholder corporations, as opposed to a trade or business.

As a result, the corporation was not allowed to deduct R&E expenditures in connection with a trade or business under Code Sec. 174. In effect, the Revenue Agent found no trade or business. Subsequently, the Appeals Division requested legal advice and determined, after weighing the totality of the facts and circumstances, that the licensing corporation was allowed to deduct R&E expenditures under Code Sec. 174.

*(continued on page 2)*

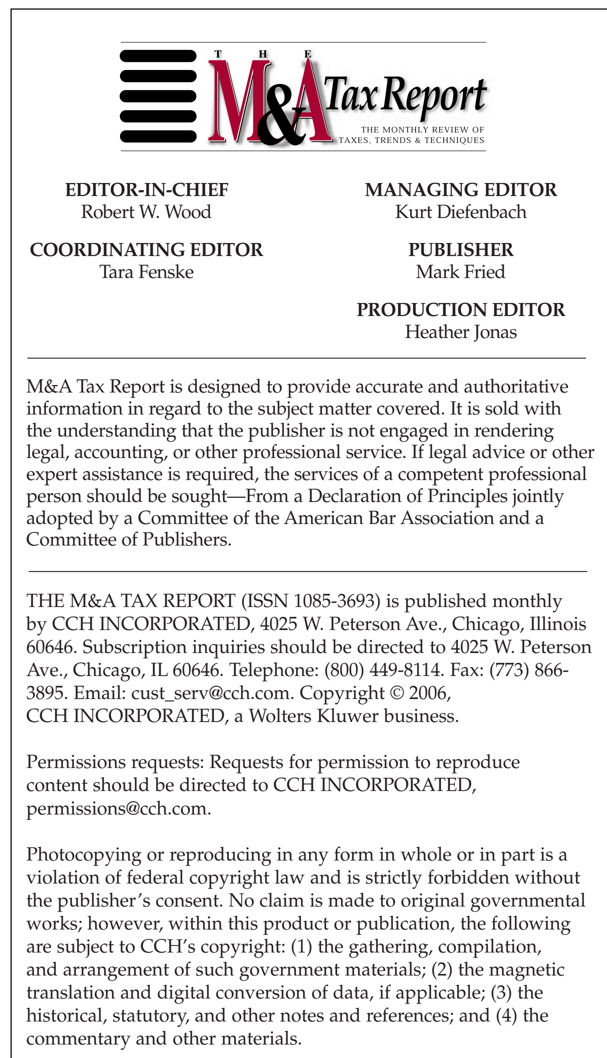
**ALSO IN THIS ISSUE**

California's Nonconforming Conformity Legislation .......... 4
Book Review: MERGERS, ACQUISITIONS AND BUYOUTS: A TRANSACTIONAL ANALYSIS OF THE GOVERNING TAX, LEGAL AND ACCOUNTING CONSIDERATIONS, by Martin Ginsburg and Jack Levin ...... 6
Reporting Acquisitions of Control .......... 7

## U.S. and Foreign Joint Venture

The facts involved a U.S. corporation taxpayer that was a joint venture between a foreign shareholder corporation and a U.S. shareholder corporation. The foreign shareholder and U.S. shareholder each owned 50 percent of the taxpayer's stock.

The taxpayer joint venture was formed to undertake R&E with respect to specific inventions and to commercialize the results of all successful R&E. Both corporate shareholders provided contract R&E and administrative services to the taxpayer under two respective services agreements. The taxpayer itself had no employees and no offices. Rather, employees of the foreign shareholder and U.S. shareholder performed all R&E and other services on behalf of the taxpayer, including financial, legal, planning, personnel and public relations services.




EDITOR-IN-CHIEF
Robert W. Wood

MANAGING EDITOR
Kurt Diefenbach

COORDINATING EDITOR
Tara Fenske

PUBLISHER
Mark Fried

PRODUCTION EDITOR
Heather Jonas

M&A Tax Report is designed to provide accurate and authoritative information in regard to the subject matter covered. It is sold with the understanding that the publisher is not engaged in rendering legal, accounting, or other professional service. If legal advice or other expert assistance is required, the services of a competent professional person should be sought—From a Declaration of Principles jointly adopted by a Committee of the American Bar Association and a Committee of Publishers.

THE M&A TAX REPORT (ISSN 1085-3693) is published monthly by CCH INCORPORATED, 4025 W. Peterson Ave., Chicago, Illinois 60646. Subscription inquiries should be directed to 4025 W. Peterson Ave., Chicago, IL 60646. Telephone: (800) 449-8114. Fax: (773) 866-3895. Email: cust_serv@cch.com. Copyright © 2006, CCH INCORPORATED, a Wolters Kluwer business.

Permissions requests: Requests for permission to reproduce content should be directed to CCH INCORPORATED, permissions@cch.com.

Photocopying or reproducing in any form in whole or in part is a violation of federal copyright law and is strictly forbidden without the publisher's consent. No claim is made to original governmental works; however, within this product or publication, the following are subject to CCH's copyright: (1) the gathering, compilation, and arrangement of such government materials; (2) the magnetic translation and digital conversion of data, if applicable; (3) the historical, statutory, and other notes and references; and (4) the commentary and other materials.

In accordance with the services agreements, the corporate shareholders each charged the taxpayer a fee for all services based on the actual number of hours worked by employees of shareholders. In addition to the service fee, the taxpayer reimbursed the corporate shareholders for different R&E expenditures.

The taxpayer's general practice over the years with respect to successful R&E was to grant exclusive licenses to the foreign shareholder and U.S. shareholder to use the successful inventions for the purpose of manufacturing and selling products in their respective territories. Both shareholders paid royalties to the taxpayer under their license agreements.

The Code Sec. 174 deductions were initially disallowed by the Revenue Agent on the basis that the taxpayer's licensing activities did not qualify as a trade or business. The Revenue Agent considered these activities as mere passive activities, similar to those of an investor (and unlike those of a manufacturer). The Revenue Agent also concluded that the shareholders actually had control over the R&E expenses and that the taxpayer should not be allowed to deduct them because the taxpayer had no employees of its own and no office space. In fact, the taxpayer hired its own shareholders and licensed the results of the R&E to its shareholders.

## Code Sec. 174

Code Sec. 174(a)(1) provides that a taxpayer may treat R&E expenditures paid or incurred during the tax year "in connection with a trade or business" as expenses that are not chargeable to capital account. Accordingly, a taxpayer may claim a deduction for such expenditures.

There is a distinction between Code Sec. 162 and Code Sec. 174 expenditures. Code Sec.162(a) permits taxpayers to deduct all ordinary and necessary business expenses paid or incurred during a tax year in "carrying on any trade or business." In *R.P. Groetzinger*, SCt, 87-1 USTC ¶9191, 480 US 23, 107 SCt 980 (1987), the Supreme Court defined a trade or business as an activity conducted with continuity and regularity and with a primary purpose of making income or a profit. [*Groetzinger*, 480 US, at 35.]

Common sense would seem to dictate that if the IRS allows a taxpayer to deduct expenses under Code Sec. 162, it acknowledges that the

taxpayer operates a trade or business with continuity, regularity, and with the primary purpose of making a profit, and therefore the IRS should also allow Code Sec. 174 expenditures.

However, in the case involved in Office of Chief Counsel IRS Memorandum No. 20055203F, the Revenue Agent had denied the taxpayer's Code Sec. 174 deductions in large part because the taxpayer did not appear to be engaged in an "active" trade or business, such as manufacturing.

## Business or Investment?

Whether an expense relates to a trade or business activity on the one hand, or only to something that is merely investment activity, would seem to be one of the most fundamental distinctions contained in the Internal Revenue Code. However, sometimes the question is one of identity. What may be a trade or business expense to one taxpayer may merely constitute an investment expense to another. That was the problem here.

Office of Chief Counsel IRS Memorandum No. 20055203F concluded that the term "in connection with a trade or business" used in Code Sec. 174 means that a taxpayer's contract R&E expenditures must be paid or incurred in connection with the taxpayer's own trade or business, rather than in connection with the taxpayer's investment in the trade or business of another person. This analysis is very important, and any counsel representing joint ventures should take heed of this distinction.

The IRS emphasized that its conclusion does not create a bright-line test for every joint venture. Although joint ventures are often created with the intent of carrying on a business, many taxpayers create joint ventures with the intent to invest in the businesses of another person.

The IRS made it clear that the economic realities of each particular case will be evaluated to determine whether the activity is undertaken with the requisite profit motive and carried on in a manner to endow it with trade or business status, or whether the activity is merely an investment purporting to be a business and the taxpayer has no realistic prospect of entering into a business of its own in the future with the R&E results.

## Trade or Business Requirement for Licensing Activities

In the Code Sec. 174 context, the Tax Court has held that licensing activities can constitute a trade or business, provided that the taxpayer has established a profit motive and conducts its activities in a regular and continuous manner. In *J.A. Louw*, 30 TCM 1421, Dec. 31,131(M), TC Memo. 1971-326 (1971), the issue was whether certain R&E expenses incurred by an individual taxpayer were in connection with the trade or business of being an inventor, and therefore were deductible under Code Sec. 174. Although the taxpayer had not yet received any income from his inventions, the court noted that he devoted his time regularly and continuously to freelance inventive work for several years.

The court in *Louw* concluded that the taxpayer was engaged in a trade or business, even though he did not expect to use the fruits of his R&E to manufacture products and his purpose was to "sell, lease, or license the patent or design to others." [*Id*., at 1423.] Then, in *O.B. Kilroy*, 41 TCM 292, Dec. 37,374(M), TC Memo. 1980-489 (1980), the Tax Court reiterated its position that the "exploitation of inventions through royalties, sales of patents, or otherwise may constitute a business." [*Id.*, at 295.] In noting that the concept of a "trade or business" under Code Sec. 174 is similar to that in Code Sec. 162, the Tax Court opined that "whether a [taxpayer] is engaged in a trade or business ... is a matter of intent to be determined from the facts." [*Id*.]

Significantly, the courts have acknowledged that licensing can constitute a trade or business. Yet, the courts have found that not all taxpayers that receive royalty income and have a profit motive are necessarily engaged in a trade or business. For example, many taxpayers with a profit motive may be receiving a royalty as a return on their investment in another person's business.

Under these circumstances, the taxpayer, although possessing a profit motive, is truly an investor in the R&E activities rather than engaged in the trade or business of conducting R&E and commercially exploiting the resulting intangible property. [*H.J. Green*, 83 TC 667, 689, Dec. 41,596 (1984); *I-Tech Ltd. Research P'ship*, 81 TCM 1012, Dec. 54,214(M), TC Memo. 2001-10 (2001).] Additionally, a taxpayer who concludes only *one* licensing transaction, rather than *regularly* engaging in licensing activities

for profit, may not be engaged in a trade or business because the licensing activity is not conducted with regularity and therefore fails to rise to the level of a trade or business. [*See J.R. Harris*, CA-5, 94-1 USTC ¶50,118, 16 F3d 75, 81–82 (1994).]

## Conclusion

Joint ventures raise a variety of tax issues, and the deductibility of R&E expenses is certainly one of them. Licensing intangible property obviously can constitute a trade or business for purposes of Code Sec. 174, as long as the facts of the case establish that the taxpayer is in fact conducting a trade or business. The specific facts and circumstances of the activities are the key to determining whether a taxpayer's licensing activities constitute a trade or business.

However, a taxpayer must show that it had a profit motive and that it engaged in its activities in a continuous and regular manner, not that it merely receives payments as a return on an investment in another taxpayer's business.