This legal advice responds to your request for assistance. This advice may not be used or cited as precedent.

**LEGEND**

- Taxpayer =
- Foreign Shareholder =
- U.S. Shareholder =
- Country A =
- Industry B =
- Inventions =
- Invention C =
- Factor D =
- Amount E =
- Amount F =
- Amount G =
- Amount H =
- Foreign Region I =
- J Percent =
- Year 1 =
- Year 2 =
ISSUE

Whether Taxpayer incurred research and experimental ("R&E") expenditures in connection with a trade or business for purposes of allowing a deduction for those expenditures under section 174 of the Internal Revenue Code of 1986 for its taxable years, Year 14 and Year 15.

SUMMARY CONCLUSION

Weighing the totality of all the facts and circumstances, we conclude that Taxpayer incurred R&E expenditures in connection with a trade or business and is therefore entitled to deduct those expenditures under section 174.

FACTS

Taxpayer, a U.S. corporation, is a joint venture between Foreign Shareholder, a Country A corporation, and U.S. Shareholder, a U.S. corporation. Foreign Shareholder and U.S. Shareholder each own 50 percent of Taxpayer’s stock. Both Foreign Shareholder and U.S. Shareholder are in Industry B.

In Year 1, Foreign Shareholder and U.S. Shareholder formed Taxpayer as a joint venture to undertake R&E with respect to specific Inventions and to commercialize the results of all successful R&E. Around the time of Year 1, U.S. Shareholder was conducting R&E on an in-process Invention called Invention C. At the time, Foreign Shareholder wished to expand its business in Industry B and was interested in Invention C. Thus, Foreign Shareholder and U.S. Shareholder established Taxpayer with the purpose of jointly developing and commercializing certain Inventions, beginning with Invention C. Foreign Shareholder and U.S. Shareholder collectively contributed capital, certain in-process R&E and other intangible assets to Taxpayer for this purpose, and Taxpayer started conducting R&E in Year 1.

Since Taxpayer’s inception in Year 1, Foreign Shareholder and U.S. Shareholder have provided contract R&E and administrative services to Taxpayer under two respective Services Agreements entered into in Year 1. Taxpayer itself has no employees and no offices. Rather, employees of Foreign Shareholder and U.S. Shareholder perform all R&E and other services on behalf of Taxpayer under the terms of the Services Agreement. The services covered by the Services Agreement include, but are not limited to, financial, legal, planning, personnel and public relations services.
In accordance with the Services Agreements, Foreign Shareholder and U.S. Shareholder each charge Taxpayer a fee for all services provided ("Service Fee") based on the actual number of hours worked by employees of Foreign Shareholder and U.S. Shareholder. The Service Fee to Foreign Shareholder and U.S. Shareholder is determined by multiplying the actual number of hours worked by an hourly rate; the hourly rate is determined by marking up by Factor D the base salary of the individual performing the services, divided by 2000 hours per year.

In addition to the Service Fee, Taxpayer also reimbursed Foreign Shareholder and U.S. Shareholder for actual R&E expenditures incurred. During Year 14 and Year 15, Taxpayer reimbursed Foreign Shareholder for Amount E and Amount F in R&E expenditures, respectively. Taxpayer reimbursed U.S. Shareholder for Amount G and Amount H in R&E expenditures for Year 14 and Year 15, respectively. Taxpayer claimed these expenditures on its Year 14 and Year 15 federal income tax returns.

From Year 1 to the present, Taxpayer’s operations have been managed by a board of directors and corporate officers. The board is comprised of six members, three from Foreign Shareholder and three from U.S. Shareholder. Taxpayer’s corporate officers are appointed by both Foreign Shareholder and U.S. Shareholder. Over the years, various senior management personnel from both Foreign Shareholder and U.S. Shareholder have served as Taxpayer’s directors and officers. Taxpayer’s directors and officers are employees of Foreign Shareholder and U.S. Shareholder and not employees of Taxpayer. As with other services, Foreign Shareholder and U.S. Shareholder charge Taxpayer a Service Fee for time spent by their employees who serve as Taxpayer’s officers and directors.

During Year 14 and Year 15, Taxpayer’s board of directors met a total of four times, with the corporate officers in attendance at each meeting. Taxpayer represents that the board’s and officer’s duties during those years were to evaluate new research projects, oversee R&E performed on Taxpayer’s behalf by Foreign Shareholder and U.S. Shareholder, evaluate new opportunities for commercial exploitation of Taxpayer’s technology, perfect and protect Taxpayer’s intangible rights, and monitor the activities of competitors.

Taxpayer’s board and officers also arranged for the research scientists from both Foreign Shareholder and U.S. Shareholder who conduct R&E on Taxpayer’s Inventions to meet on a regular basis for the purpose of exchanging ideas, disseminating R&E developments and promoting more efficient R&E. These meetings, referred to as Science Meetings, took place twice each year during Year 14 and Year 15.

Taxpayer retains ownership of all production and marketing rights to the successful Inventions developed from its R&E activities. Taxpayer’s general practice over the years with respect to successful R&E is to grant exclusive licenses to Foreign

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1 We have not been asked to opine on whether the Service Fees that Taxpayer paid to Foreign Shareholder and U.S. Shareholder under the Services Agreement for R&E and administrative services are subject to the section 482 arm’s length requirements. Therefore, this memorandum does not discuss section 482 issues.
Shareholder and U.S. Shareholder to use the successful Inventions for the purpose of manufacturing and selling products in their respective territories. Both Foreign Shareholder and U.S. Shareholder pay royalties to Taxpayer under their license agreements with Taxpayer. In general, these licenses give Foreign Shareholder and U.S. Shareholder the exclusive rights to exploit the successful Inventions in certain parts of Foreign Region I and in the United States, respectively. These licenses to Foreign Shareholder and U.S. Shareholder are granted at the outset of any R&E endeavor before it is known whether or not the R&E will be successful.

With respect to territories that are not covered by the license agreements with Foreign Shareholder and U.S. Shareholder, Taxpayer licenses successful Inventions to third parties in exchange for royalties. In Year 14 and Year 15, Taxpayer’s royalties received from third parties accounted for approximately J Percent of Taxpayer’s total revenue. Taxpayer’s board of directors made the ultimate management decisions regarding whether to enter into license agreements with specific third parties. As an example, Taxpayer represents that, prior to licensing the Invention C technology in territories not covered by its licenses with Foreign Shareholder and U.S. Shareholder, Taxpayer considered several potential third party licensees before making a final decision. The negotiations with all the potential licensees were conducted by personnel from both Foreign Shareholder and U.S. Shareholder. As with other services, Taxpayer paid a Service Fee for these negotiation services pursuant to the Services Agreements.

From Year 1 through Year 15, Taxpayer conducted R&E on six different types of Inventions, of which four have been successful. The following table provides information on all Inventions developed by Taxpayer from Year 1 through Year 15:

The following table sets forth Taxpayer’s R&E expenditures and royalty and milestone income from Year 2 through Year 15:
As the preceding table illustrates, Taxpayer’s royalty income has generally increased over time as more of its R&E efforts became successful. Although Taxpayer’s R&E expenditures in the early years significantly exceeded its income, the opposite has been true since Year 7. For each year beginning with Year 7 through Year 15, Taxpayer’s annual royalty income exceeded the annual R&E expenditures incurred.

Taxpayer represents that it has funded its own research since around the time of Year 4 through Year 7 and has not received capital contributions from either Foreign Shareholder or U.S. Shareholder since Year 4. Taxpayer generally does not pay any dividends to its shareholders.

The Internal Revenue Service (“IRS”) team (“Exam”) that examined Taxpayer’s Year 14 and Year 15 federal income tax returns determined that Taxpayer’s contract R&E expenditures incurred during these years were not in connection with a trade or business as required by section 174 and disallowed Taxpayer’s section 174 deductions. In contrast to its disallowance of the R&E expenses, Exam allowed Taxpayer to deduct expenses under section 162 as incurred in carrying on a trade or business.

Exam apparently disallowed the section 174 deductions based on the conclusion that Taxpayer’s licensing activities did not qualify as a trade or business because the activities constituted passive activities, similar to those of an investor (and unlike those of a manufacturer). Exam also appeared to conclude that Foreign Shareholder and U.S. Shareholder have control over the R&E expenses and that Taxpayer should not be allowed to deduct the expenses because Taxpayer had no employees of its own and no office space – all work was performed under contract; Taxpayer hires its shareholders to perform R&E and other services on Taxpayer’s behalf; Taxpayer licenses the results
of the R&E to its shareholders; and Taxpayer’s board of directors and officers are employees of its shareholders.

The IRS Appeals Office (“Appeals”) submitted a request for legal advice on the issue of whether the R&E expenses claimed by Taxpayer were “in connection with a trade or business” as required pursuant to section 174.2

**LAW AND ANALYSIS**

Section 174(a)(1) provides that a taxpayer may treat R&E expenditures paid or incurred during the taxable 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.3

Before proceeding to our analysis of whether Taxpayer incurred R&E expenses in connection with a trade or business for purposes of section 174, we will discuss Exam’s decision to allow Taxpayer its claimed section 162 deductions yet deny Taxpayer its claimed section 174 deductions. After addressing this issue, we will analyze whether Taxpayer conducted a trade or business for section 174 purposes.

**A. Distinction Between Sections 162 and 174**

Section 162(a) permits taxpayers to deduct all ordinary and necessary business expenses paid or incurred during a taxable year in “carrying on any trade or business.” In Commissioner v. Groetzinger, 480 U.S. 23 (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 U.S. at 35. This definition remains in force. By allowing the taxpayer to deduct expenses under section 162, Exam implicitly acknowledged that Taxpayer operates a trade or business with continuity, regularity, and with the primary purpose of making a profit.

Exam apparently denied Taxpayer’s section 174 deductions in large part because Taxpayer did not appear to be engaged in an “active” trade or business, such as manufacturing. Thus, there appears to be a belief that a taxpayer, in order to deduct expenditures under section 174, must satisfy some additional requirement when determining whether the taxpayer’s activities constitute a trade or business. However, once it has been determined that a taxpayer operates a trade or business for section 162 purposes, generally it carries that the taxpayer is operating a trade or business for section 174 purposes. See Christensen v. Commissioner, 56 T.C.M. (CCH) 425 (1988)(concluding that a taxpayer that has a trade or business under section 162 also satisfies the requirements of section 174). Accordingly, no difference exists between

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2 Appeals and Taxpayer agree that Taxpayer is entitled to deduct the contract R&E expenses if the expenses were incurred in connection with a trade or business as required by section 174.  
3 Contract R&E expenditures paid by the taxpayer to another person for R&E services performed on the taxpayer’s behalf are deductible under section 174, provided the taxpayer meets certain requirements. Treas. Reg. § 1.174-2(a)(8). The parties agree the expenses meet these requirements if it is found that Taxpayer incurred its contract R&E expenses in connection with a trade or business.
the analysis of whether the taxpayer operates a trade or business for section 162 purposes or for section 174 purposes.

The only difference between the two sections relates to the timing of when a taxpayer is allowed to deduct an expenditure vis-à-vis its business operations. The courts have held that the section 174 “in connection with” language\(^4\) allows a taxpayer to deduct R&E expenses prior to the actual commencement of a trade or business, while under section 162 a taxpayer must be “carrying on”, or already engaged in, a trade or business.

Prior to 1974, the IRS and the courts narrowly construed section 174 as granting a deduction only for those taxpayers already engaged in the business of selling goods or services utilizing the R&E results. Kantor v. Commissioner, 998 F.2d 1514, 1518 (9th Cir. 1993). In 1974, however, the Supreme Court reversed this position in the case of Snow v. Commissioner, 416 U.S. 500 (1974). In Snow, the Court held that the section 174 deduction is available to start-up ventures incurring R&E expenditures even if the taxpayer is not yet engaged in the business of selling goods or services utilizing the R&E results.\(^5\) In contrast, section 162 allows deductions only for those expenditures paid or incurred “in carrying on” a trade or business. Under section 162, a taxpayer cannot deduct pre-formation R&E expenses incurred prior to the actual start of a trade or business.

Even though the “in connection with” language under section 174 permits a taxpayer to deduct R&E expenditures before a trade or business actually begins and before the taxpayer receives revenue from its R&E efforts, the taxpayer must still meet certain requirements. Under section 174, a taxpayer must show that it has a “realistic prospect” of entering into its own a trade or business in the future with the fruits of the R&E results in order to deduct R&E expenditures incurred prior to the commencement of its business.\(^6\)

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\(^4\) Because the Internal Revenue Code and its regulations do not define the phrase “in connection with,” we look to case law for the definition.

\(^5\) Note that Snow implies that a trade or business means “holding one’s self out to others as engaged in the selling of goods or services”, a definition articulated by Justice Frankfurter in his concurring opinion in Deputy v. DuPont, 308 U.S. 488, 499 (1940), a case involving section 162’s predecessor. However, in Commissioner v. Groetzinger, 480 U.S. 23 (U.S. 1987), the Supreme Court formally rejected Justice Frankfurter’s goods-and-services trade or business test. In holding that the Justice Frankfurter “gloss” never achieved the status of a Court ruling, the Court went on to define a trade or business as an activity conducted with continuity and regularity and with a primary purpose of making income or a profit. Id. at 32, 35. This trade or business definition established by Groetzinger has since been adopted universally by both the IRS and the courts. Even though the trade or business definition has since evolved, the holding in Snow that a taxpayer can deduct R&E expenditures prior to the commencement of a trade or business is still applicable today.

\(^6\) Court decisions after Snow have required taxpayers that are not yet earning revenue in connection with their R&E efforts to demonstrate a “realistic prospect” of subsequently entering into their own trade or business in connection with the fruits of the research (assuming the research is successful). See Scoggins v. Commissioner, 46 F.3d 950, 952-53 (9th Cir. 1995); see also, Kantor, supra at 1520 (“Courts have repeatedly held that while the probability of a firm’s going into its own business will satisfy section 174, the mere possibility of its doing so will not.”). A taxpayer can demonstrate such a prospect by having both the objective intent to enter into the business and the capability of doing so. Scoggins at 953. A
With respect to a taxpayer that already conducts a trade or business, however, we found no precedent in the law to interpret the section 174 “in connection with” language as creating any additional legal requirement beyond that required under section 162. We also found no precedent for imposing a requirement that a taxpayer who incurs contract R&E expenses must manufacture products in order to qualify for the section 174 deduction.

Because Exam allowed the deduction of section 162 expenses, it can be concluded that Exam found that Taxpayer conducted its activities in a continuous and regular manner, and with a profit motive. Based on this finding, Taxpayer must also be found to operate a trade or business for purposes of section 174.

However, without regard to Exam’s conclusion that Taxpayer carried on a trade or business for section 162 purposes, we will analyze whether Taxpayer’s activities constitute a trade or business under section 174 case law.

B. Trade or Business Determination for Licensing Activities

Taxpayer engaged in licensing activities. In the section 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. For example, in Louw v. Commissioner, 30 T.C.M. (CCH) 1421 (1971), the issue was whether certain R&E expenses incurred by an individual taxpayer were in connection with a trade or business of being an inventor and therefore deductible under section 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 free-lance inventive work for several years. The court 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. Under these circumstances, the court found that the taxpayer “is not merely preparing to enter a business; he is already engaged in it.” Id. Under the Tax Court’s holding, a taxpayer is not required to manufacture products in order to satisfy section 174’s trade or business test; it is sufficient for the taxpayer to have a purpose of selling, leasing or licensing the patent or design to others, as long as he has the requisite profit motive and conducts his activities with regularity and continuity.

In Kilroy v. Commissioner, 41 T.C.M. (CCH) 292 (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 (citation omitted). In noting that the taxpayer that demonstrates a “realistic prospect” of utilizing the R&E results to enter into its own trade or business in the future is entitled to deduct its R&E expenditures prior to commencing such business. But see LDL Research & Dev. II, Ltd. v. Commissioner, 124 F.3d 1338, 1342 (10th Cir. 1997) (stating that the Tenth Circuit interprets the “in connection with” language as requiring a taxpayer to show it is actively involved in the research project as a trade or business rather than showing it has a realistic prospect of entering a trade or business).
concept of a “trade or business” under section 174 is similar to that in section 162, the 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.

While acknowledging that licensing can constitute a trade or business, 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, a taxpayer with a profit motive may be receiving a royalty as a return on its 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. See e.g., Green v. Commissioner, 83 T.C. 667, 689 (1984)(taxpayer’s royalty interest in the development and commercialization of certain intangibles was analogous to that of an investor in securities, in part because the taxpayer had no ownership interest in the inventions and no control over their actual development, production, or marketing); see also I-Tech Ltd. Research P’ship v. Commissioner, 81 T.C.M. (CCH) 1012 (2001) (management of investments held not to rise to the level of a trade or business). Additionally, a taxpayer that 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 Harris v. Commissioner, 16 F.3d 75, 81-82 (5th Cir. 1994) (the action of disposing of all inventions in one transaction, instead of regularly licensing inventions for profit, did not possess the indicia of continuity and regularity necessary to endow an activity with trade or business status).

Here, Taxpayer engaged in licensing the intangible property it developed. As determined in the cases discussed above, licensing intangible property can constitute a trade or business for purposes of section 174, so long as the facts of the case establish that the taxpayer is in fact conducting a trade or business. Thus, the key to determining whether Taxpayer’s licensing activities constitute a trade or business is to examine the facts and circumstances of its activities. Taxpayer must show that it had a profit motive and that it engaged in its activities in a continuous and regular manner.

We think it is clear based on these facts that Taxpayer’s formation and ongoing operations were for the purpose of making a profit by conducting a business. Taxpayer had the requisite profit motive. Foreign Shareholder and U.S. Shareholder formed Taxpayer for the purpose of going into business with each other through the joint development and commercialization of certain Inventions. For the years at issue, Taxpayer carried on such business by contracting with Foreign Shareholder and U.S. Shareholder to provide R&E and other services on Taxpayer’s behalf, and by licensing the results to others and receiving an income stream in return. Taxpayer commercially exploited the intangible property; it held the ownership interest in the results of the R&E, and it had control over the actual development and marketing.

Taxpayer also conducts its activities in a substantial, continuous and regular manner and has done so since Year 1. Taxpayer’s R&E and licensing activities are not limited to isolated instances. During the years at issue, Taxpayer oversaw the joint R&E
process by holding regular board and Science Meetings, engaged outside contractors to perform R&E and administrative services, and received royalty income pursuant to multiple license agreements with Foreign Shareholder and U.S. Shareholder as well as with third parties. Taxpayer’s revenue stream from multiple sources indicates that its activities are substantial and conducted with continuity and regularity.

Under our analysis of section 174, we conclude that Taxpayer conducted a trade or business for the years at issue. Thus, Taxpayer qualifies for the section 174 deduction.

C. Lack of Employees and Lack of Office Space

Exam focused in part on the lack of employees and absence of office space as evidence that Taxpayer does not conduct business activities. Although the existence of employees and office space are relevant factors to consider in determining whether a taxpayer has a profit motive and conducts its activities with continuity and regularity, we are not aware of any authority that would deny a taxpayer trade or business status just because the taxpayer chooses to conduct its day-to-day activities through contractors, particularly if there are other factors tending to establish the taxpayer’s profit motive.

In Kilroy, supra, the court held that the taxpayer was carrying on a trade or business, despite that fact that the taxpayer and his limited partnership hired outside consultants, such as attorneys, economists, and engineers, to perform activities on the taxpayer’s and the partnership’s behalf. The Tax Court found these facts to be favorable for the taxpayer because it supported his claim that he engaged in his activities with a profit motive. Kilroy, 41 T.C.M. (CCH) 292 at 293, 295 (1980).

Congress enacted section 174 to put all businesses (and potential businesses) conducting R&E on an equal footing. See Hearings on H.R. 8300 Before the Senate Committee on Finance, 83d Cong., 2d Sess., pt.19, p.105 (1954) (statement of Marion B. Folsom, Under Secretary of the Treasury). The courts interpret section 174 as allowing a deduction prior to the commencement of a trade or business to give effect to Congress’ intent to stimulate the search for new products and new inventions, particularly by small and new enterprises, and to place them on an equal footing with established businesses. See e.g., Snow, 416 U.S. at 503-04.

To treat the hiring of employees and the leasing of office space as determinative factors would violate Congressional intent, since taxpayers engaged in legitimate joint business ventures that choose for business reasons not to hire separate employees or to lease separate office space would be treated differently from other businesses. 7 The form in

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7 We note that no person would benefit from a deduction for Taxpayer’s R&E expenditures if Taxpayer is not allowed to deduct them. Although Foreign Shareholder and U.S. Shareholder are allowed to deduct their R&E expenditures under section 174 (assuming Foreign Shareholder is subject to U.S. tax and its R&E expenditures are properly deductible against its income subject to U.S. tax), Foreign Shareholder and U.S. Shareholder should have reduced these expenditures by the amount of reimbursement they received from Taxpayer for performing R&E on Taxpayer’s behalf. Thus, Foreign Shareholder and U.S. Shareholder do not receive the economic benefit of a deduction for the R&E costs reimbursed by Taxpayer. This result, in which no person would benefit from a deduction for a true R&E expenditure
which a taxpayer chooses to operate its business, either through employees or outside contractors, should have no bearing on the availability of the section 174 deduction once a taxpayer has established it is in fact carrying on a trade or business. Thus, although Taxpayer’s lack of employees and absence of office space should be considered in light of all the facts and circumstances, these facts are not dispositive. Weighing the totality of all the facts, Taxpayer conducted a trade or business for the years at issue and qualifies for the section 174 deduction.

D. Case Law Under Section 174

In addition to its focus on the lack of employees and absence of office space, Exam identified several court cases disallowing the section 174 deduction that it believes are on point. The following discussion presents an in depth analysis of the section 174 case law, including those cases cited by Exam as well as other cases, and the application of the law to the facts of this case. This analysis further supports our conclusion that Taxpayer operates a trade or business for section 174 purposes.

1. Cases Disallowing the Section 174 Deduction

The cases in which the section 174 deduction was denied follow a general pattern. Individuals generally contributed cash to a partnership and the partnership used the cash to fund R&E undertaken by an unrelated business enterprise. Although the partnership purported to own all the rights to the fruits of the R&E, it was required through either a pre-existing legal agreement or otherwise to license all those rights back to the enterprise actually conducting the R&E. In one case, the enterprise conducting the R&E held an option to acquire these rights at a later date for a nominal sum. In virtually all the cases, the partnership and the partners had little or no technical knowledge of the specific R&E endeavors and no expertise in the particular industry, were not generally involved with the day-to-day R&E activities, had no rights to control the R&E process, and did not oversee the R&E activities.

The issue in these cases was whether the individual limited partners of the subject partnerships were entitled to deduct their distributive share of the losses created by the R&E expenditures deducted under section 174 at the partnership level. The partnerships argued that they were entitled to deduct these expenses as incurred in connection with a trade or business. The courts carefully reviewed the facts of each case and universally held that the partnership’s activities did not rise to the level of operating a business in connection with such R&E. Rather, the partnerships were merely investment vehicles by which the individuals invested in the R&E activities of someone else’s business.

For example, in Green v. Commissioner, 83 T.C. 667 (1984), the taxpayers invested cash in a partnership. The partnership’s stated purpose was to acquire four inventions for investment and income-producing purposes. The partnership used cash obtained incurred in connection with a business, would run counter to Congress’ intent of encouraging research by allowing an immediate deduction.
from several investors to fund four R&E projects undertaken by different inventors. Although a legal agreement conveyed to the partnership all the rights, title and interest to the inventions, a simultaneously executed agreement granted the inventors the exclusive, worldwide licensing rights to manufacture, use and sell any resulting inventions for the duration of the inventions’ patent term. The Tax Court held that the partnership’s activity constituted a management of investments, not a trade or business. The partnership’s activities were limited and purely ministerial. The partnership had no right to control the R&E results and relinquished all its interests in the four R&E projects at the outset of the endeavor.

In Kantor v. Commissioner, 998 F.2d 1514 (9th Cir. 1993), aff’g 60 T.C.M. (CCH) 225 (1990), the facts were slightly different in that the general partner of the partnership was involved to some extent with the R&E activities conducted on the partnership’s behalf by a research firm. At the outset of the endeavor, however, the partnership granted to the corporation conducting the R&E the option to acquire the exclusive marketing rights to the R&E results for a nominal sum of $5,000, even though the partnership advanced $3.15 million to fund the R&E expenditures. The Ninth Circuit held that the partnership effectively relinquished any possibility of conducting a business in connection with the research results by issuing the option at a nominal sum, making it more probable than not that the option holder would exercise the option. Thus, not only was the partnership merely an investment vehicle that is not engaged in a trade or business currently, it did not have a realistic prospect of ever conducting a business with the research results. The fact that the general partner was involved with the R&E activities did not change this result, because these activities constituted the promotion and protection of an investment, not a business.

In Harris v. Commissioner, 16 F.3d 75 (5th Cir. 1994), aff’g 58 T.C.M. (CCH) 1441 (1992), two individual inventors formed a partnership for purposes of obtaining capital to fund the R&E to be performed by a wholly owned corporation of the inventors. The partnership used cash from unrelated investors to fund the R&E conducted by the corporation and granted the corporation an option of obtaining a perpetual exclusive license for the resulting technology. The license called for very large royalty payments, which the taxpayer argued made it unlikely that the corporation would exercise the option, thereby leaving the partnership with no choice but to market the technology on its own. Thus, the taxpayer argued that it possessed a realistic prospect of entering its own trade or business with the technology. The Fifth Circuit affirmed the Tax Court’s finding that the parties intended at a later date to renegotiate the option to a lower level of royalty payments, thus allowing the corporation to license the technology at a reasonable price. Under these circumstances, the Court held that the partnership was not engaged in a trade or business and had no realistic prospect of doing so since the parties intended for the corporation, and not the partnership, to engage in the business. Thus, the partnership was truly an investor. In reaching its holding, the Court observed, “In our view, those cases in which a section 174 deduction was upheld may be distinguished by one dispositive factor: in each of the cases allowing the deduction, the entity that incurred the research expenses actually managed and actually controlled the use or marketing of the research results.” Id. at 80.
In Levin v. Commissioner, 832 F.2d 403 (7th Cir. 1987), aff’g 87 T.C. 698 (1986), several partnerships funded R&E projects to be conducted by a corporation for the development of food machinery equipment. On paper, each partnership appeared to have significant rights and interests such that it would be possible for the partnership to use the technology to manufacture and market the food machines. Nonetheless, the facts and circumstances of the case led the Seventh Circuit to affirm the Tax Court’s holding that the parties did not reasonably anticipate availing themselves of the privileges they possessed on paper and that each partnership’s role was restricted to that of a passive investor. The Court observed that “legal entitlements, divorced from economic incentives and business probabilities, are not enough” to create a realistic prospect that the taxpayer will enter a trade or business in connection with the R&E. Id. at 407.

In Zink v. Commissioner, 929 F.2d 1015 (5th Cir. 1991), a partnership was not involved. Rather, two individuals, husband and wife, entered into a purported purchase agreement with two unrelated companies to purchase the R&E results (plans and specifications for airplane component parts) from these two companies. As part of the purchase agreement, the taxpayers agreed to grant a license to each company for the nonexclusive right to use, employ and exploit all the R&E results in exchange for fixed royalty payments per each airplane sold that contained the respective component parts. The two unrelated companies then contracted with other research firms to engage in the actual R&E. Under these circumstances, the Fifth Circuit found that the taxpayers were merely investors and that the activities they conducted, including receiving reports, keeping apprised of R&E developments, visiting a research plant on one occasion, and attending an exhibition in their hometown, were insufficient, as a matter of law, to rise to the level of a trade or business.

In other cases with similar fact patterns, the courts reached the same conclusion: taxpayers who are investors in the R&E activities of another enterprise’s business are not themselves engaged in a trade or business. See e.g., LDL Research & Dev. II, Ltd. v. Commissioner, 124 F.3d 1338 (10th Cir. 1997); Diamond v. Commissioner, 930 F.2d 372 (4th Cir. 1991); Spellman v. Commissioner, 845 F.2d 148 (7th Cir. 1988); I-Tech Ltd. Research P’ship v. Commissioner, 81 T.C.M. (CCH) 1012 (2001).

In each of these cases, the common factors weighing against the taxpayers included the lack of technical expertise on the part of the person claiming to have a trade or business; the lack of oversight or control over the R&E process; and the lack of management and control over the R&E results since the rights to those results were relinquished (or effectively relinquished) at the outset of the endeavor. These factors and the economic realities of the transactions demonstrated that the taxpayers were merely investors funding R&E, rather than incurring R&E expenditures in connection with a trade or business. The taxpayers were not substantively operating a trade or business, even if they purported to do so in form. See Harris, 167 F.3d at 80 (stating that the court cases “interpret the . . . ‘in connection with’ language using the economic realities, or substance over form, doctrine.”). Further, the facts and circumstances of each case demonstrated that the taxpayer did not have a realistic prospect of subsequently entering into its own trade or business with the R&E results, either
because the financial arrangements made it improbable that the taxpayer would do so or the taxpayer effectively relinquished all rights, title and interest to the R&E results.

Another case that has been cited as potentially supporting the denial of Taxpayer’s section 174 deductions is Saykally v. Commissioner, 85 T.C.M. (CCH) 1401 (2003). In that case, the court found that the taxpayer, Saykally, did not conduct his R&E activities with the intention of going into business himself, but to support the business of another entity (even though he was the sole shareholder of that entity). Thus, Saykally’s R&E expenditures, deducted on his individual income tax return, were denied since those expenditures were incurred in his capacity as an investor in his wholly owned corporation.

In Saykally, CPG, a corporation that marketed several lines of business software applications worldwide, hired Saykally as a contract consultant to help identify why CPG was losing money in its software marketing business and how such losses could be curtailed. Saykally was highly regarded in the computer software industry and had extensive familiarity with, and technical expertise, in this area.

As a result of Saykally’s findings, CPG and Saykally reached an agreement whereby CPG would move its software marketing business into CPSG, a new corporation that was wholly owned by Saykally. CPSG paid CPG a royalty for the right to market the software. The parties expected at the time they entered into this agreement that additional software development would occur and that this development would be funded by three Australian syndicates that were currently funding the R&E undertaken by CPG.

A legal dispute over ownership rights arose among the Australian syndicates, CPG and CPSG. As a result, the Australian syndicates terminated the R&E funding. Because CPSG would have gone out of business if additional R&E did not continue, Saykally decided to continue the R&E efforts in his own name and fund the future development. Saykally testified that he wished to fund the development in his own name rather than through CPSG because he believed doing so would enhance his bargaining position in the dispute with the Australian syndicates and CPG. Accordingly, he entered into an agreement with CPSG whereby he would provide R&E on behalf of CPSG. The agreement provided that Saykally, in his individual capacity, would fund the R&E at his discretion and sole expense in exchange for all the rights, title and interest to the developed technology. The agreement also simultaneously gave CPSG the right to license the technology in exchange for royalty payments.

Saykally intended to fund the R&E in his individual capacity by borrowing funds from CPSG. However, since CPSG did not have enough cash to pay for all the R&E costs, Saykally arranged for CPSG to borrow the funds from another entity, Uniplex Software. Saykally then borrowed these funds from CPSG (which CPSG borrowed from Uniplex Software) to pay for the additional R&E. CPSG paid the R&E costs on Saykally’s behalf and recorded Saykally’s indebtedness on its accounting system.
Saykally testified that the R&E expenditures were incurred to save CPSG’s business. He also testified that he funded the R&E efforts in his own name as a business strategy for CPSG’s benefit, because he believed that funding the R&E in his own name would give him and CPSG more negotiating leverage with the Australian syndicates and CPG, making it more likely that they would cooperate with CPSG.

The court found that it was always Saykally’s intention to market products through CPSG if the R&E proved successful and that the additional R&E that Saykally funded in his own name was undertaken to benefit CPSG’s existing business. Further, Saykally had no objective intent to enter into a business of his own with the developed technology, given that his actions were undertaken solely to further CPSG’s business. Thus, his activities “amounted to nothing more than those of a prudent investor.”  id. at 1411.

Whether in the partnership cases set forth above or in Saykally, when presented with the trade or business issue under section 174, courts have “scrutinized claimed research and development expenditures to sort out the legitimate expenditures from those designed to shelter the income of passive investors.”  Zink, 929 F.2d at 1021. Those R&E expenditures designed to shelter the income of passive investors were disallowed.

2. Cases Upholding the Section 174 Deduction

In contrast to the cases where the section 174 deduction was denied, the cases upholding the deduction presented very different fact patterns. For example, in Snow, supra, the individual taxpayer was a limited investor in a partnership. The partnership, through its general partner, actually conducted a significant amount of R&E and also contracted R&E out to others. Eventually, the R&E proved fruitful and the partnership incorporated. The taxpayer became a board member of the incorporated entity. The corporation manufactured products and sold the products to customers. The Supreme Court permitted the taxpayer a section 174 deduction even though the partnership was not yet selling goods in the year at issue.  Snow, 416 U.S. at 503-04.

Under these circumstances, the Court found that the partnership was precisely the type of small and pioneering venture that section 174 was designed to benefit. Although the opinion is silent on whether the Court’s holding was based on a finding that the partnership was not an investment vehicle, we believe the Court’s holding is premised on the same principles articulated by subsequent courts. The Snow facts indicate clearly that the partnership was formed for the purpose of making a profit by conducting a business and even though the Court found that the business had not yet commenced, the partnership had a realistic prospect of conducting a business with the R&E results in the future given the economic realities of the current arrangement.

A key distinction between Snow and the other cases where the section 174 deduction was denied is that Snow did not involve outside investors funding the R&E activities of another business. Rather, the partnership that undertook and funded the R&E
expenditures did so for the purpose of developing an asset that it intended to exploit in its own business.

Another case upholding the section 174 deduction is Cleveland v. Commissioner, 297 F.2d 169 (4th Cir. 1961), aff’d in part, rev’d in part 34 T.C. 517 (1960). In that case, the court held that the taxpayer, who provided funding for R&E conducted by an inventor, was an equal participant in a joint business venture with the inventor. Although the relationship between the parties started off as one of investor and inventor, the court found that the relationship evolved over time into a joint business venture.

A written agreement executed between the parties a few years after their relationship began clearly set forth the parties’ intent that the taxpayer’s advances were “no longer loans but were made strictly at the risk of the venture with the expectation of profiting therefrom.” Id. at 173. Furthermore, the taxpayer acted as a business and legal advisor for the venture and was responsible for developing business contacts for the purpose of finding a commercial use for the invention. The inventor’s R&E activities, conducted on behalf of the joint venture, were attributable to the joint venture and the taxpayer was allowed to deduct expenditures under section 174.

Although Cleveland was decided before Snow, the Cleveland court applied similar principles to determine the taxpayer’s intent and motive, as evidenced by the attendant circumstances. It found based on the evidence that while the taxpayer was initially an investor in the R&E activities, he subsequently incurred R&E expenses in his capacity as an equal participant in a joint business venture and not as an investor.

In another case upholding the section 174 deduction, Scoggins v. Commissioner, 46 F.3d 950 (9th Cir. 1995), rev’d 61 T.C.M. (CCH) 2859 (1991), two inventors with significant technical knowledge and expertise formed both a partnership and a corporation. These inventors were the sole partners of the partnership and collectively owned 75% of the corporation’s stock. The partnership’s purpose was to engage in R&E to develop a new type of epitaxial reactor, which is a type of semiconductor equipment used to apply layers of silicon on substrate silicon wafers for the purpose of manufacturing computer chips. The two inventors, through the partnership, advanced $500,000 for the corporation to conduct the R&E. The inventors themselves actually conducted R&E as employees of the corporation. The partnership granted to the corporation a 15-month nonexclusive license to exploit the resulting technology (which the corporation was not obligated to exercise) and thereafter an option to purchase the rights to the technology for $5 million, which the corporation would be entitled to exercise three months after the conclusion of the 15-month license period. Thus, even if the corporation exercised the option at its earliest opportunity, the partnership still had an 18-month period during which it could market and sell the reactor.

The Ninth Circuit, taking great care to distinguish this case from its earlier decision in Kantor, held that the partnership had a realistic prospect of entering into a trade or business of its own with the technology. The Court noted several distinctions between the partnership in Kantor and the Scoggins partnership. First, the partnership in Kantor was composed entirely, with only one exception, of investors with no technical expertise
of the product that was to be developed and the research firm conducting the R&E was completely independent from the partnership. Second, the Kantor partnership granted the independent research firm an option to acquire the exclusive technology rights for a nominal sum of $5,000 as compared with the $3.15 million it funded in R&E, making it “unrealistic to conclude that if the $3.15 million expended in research were successful in producing a marketable product, the research corporation would not expend the $5,000 to obtain exclusive marketing rights.” \textit{Id.} at 955.

In contrast to Kantor, the $5 million option at issue in Scoggins is a significant amount when compared to the $500,000 in R&E expenditures to be funded by the partnership. Accordingly, the corporation holding the option would be required to raise a significant amount of capital to exercise that option. The Court found it significant that the partnership and the corporation in Scoggins were controlled and financed by the same individuals and that it would be these individuals who would decide whether it would be more fruitful to raise $5 million on behalf of the corporation to exercise its option, or to manufacture and sell the product through the partnership without raising this capital.

Thus, the Court appears to suggest that regardless of how the two individuals would choose at a later date to conduct their business, it does not change the fact that they possessed the good faith intent to enter the business of marketing the reactor if the R&E efforts proved successful and that there exists a realistic prospect that such business may be conducted through the partnership. The partnership was certainly capable of entering into a business with the R&E results given the expertise and experience of its partners, and would have the financial capacity to do so since it possessed the right to market the product for 18 months and for the indefinite future if the corporation did not choose to exercise its option. \textit{Id.} at 953. Under these circumstances, these two individuals, through their partnership, “are among the class of taxpayers Congress intended to encourage and reward by enacting section 174.” \textit{Id.} at 956.

3. Application of Case Law to the Facts of this Case

To determine whether a section 174 deduction is available, the courts have applied the substance over form doctrine and examined the true economic realities. See Harris, 167 F.3d at 80. Despite the varied fact patterns and the different financial arrangements at issue, the court cases we have discussed in this memorandum all have a common theme. The distinguishing factor has been whether the true substance of the case revealed that the taxpayer was an investor in another person’s business, or revealed that the taxpayer exhibited a good faith intent to use the fruits of the R&E in a business venture of its own.

In the cases where the deduction was denied, that good faith intent did not exist and the attendant circumstances made it clear that the taxpayers were merely investors that did not possess the objective intent, or the capability, of entering into a business of their own with the fruits of the R&E. These cases disallowing the section 174 deduction do not control the outcome here since the facts of this case are distinguishable in several key respects.
First, Taxpayer is a combined business operation, not an investment vehicle. Unlike the partnerships in the court cases, which merely functioned as a vehicle for injecting risk capital into another person’s existing business, Taxpayer was formed by its shareholders to undertake a new and separate business of engaging in the joint development and commercialization of certain Inventions, beginning with Invention C and continuing with other Inventions to the present date. In our view, the fact that Taxpayer operates a different business than the business carried on separately by either Foreign Shareholder or U.S. Shareholder is clear evidence that Taxpayer is not an investment vehicle attempting to disguise itself as a business – it is a true business. Taxpayer funds its own R&E efforts at its own risk with the intention of making a profit. Further, unlike the partnerships that lacked business and technical expertise, Taxpayer possesses significant business experience and expertise in Industry B by virtue of its officers and directors.

Second, in the cases where the section 174 deduction was disallowed, the research firms conducting R&E were generally independent from the partnerships (or individuals) that provided funding for the R&E. Thus, the person purporting to incur R&E expenditures in connection with a trade or business generally had no power to direct or control the R&E process. Even where such persons were involved to some extent in the R&E process, the court found that these activities did not rise to the level of a trade or business because they were undertaken to protect and promote the partnership’s investment. This is not the case with Taxpayer, which exercises significant control over the R&E process in connection with its business. Through its officers and directors, Taxpayer decides which R&E projects it will undertake and oversees the R&E process undertaken by the employees of Foreign Shareholder and U.S. Shareholder. Taxpayer’s management has the power to direct the R&E process and actually exercised that power by sponsoring regular Science Meetings, where the research scientists at both Foreign Shareholder and U.S. Shareholder met to address both technical and operational matters. Thus, Taxpayer exercises management and control over the R&E process.

Third, unlike the partnerships in the court cases that relinquished management and control over the right to market the R&E results, Taxpayer retains significant legal rights to market its R&E results and actually did market such results (and continues to do so) through its licensing activities. Although Taxpayer relinquished its rights to exploit the R&E results in territories covered by Foreign Shareholder and U.S. Shareholder, it retained rights for all other markets. A significant percentage of Taxpayer’s income for the years at issue, J Percent, is derived from third party licenses. This fact is significant because it establishes not only that Taxpayer had management and control over a significant portion of the research results, but that Taxpayer actually exercised that control by choosing to license to third parties. As observed by the Harris court, management and control over the R&E results is a dispositive factor in determining whether a taxpayer has a trade or business. See Harris, supra, 16 F.3d at 80.

Finally, this case is distinguishable from the Saykally case because Taxpayer utilizes the R&E results in its own trade or business by licensing such results to other parties
and earning revenue therefrom. In contrast, Saykally never intended to conduct a business of his own. Although Saykally was not an unrelated investor as was the case in the other court cases, he incurred R&E expenses in his individual capacity not with the intention to conduct his own business, but for the purpose of furthering the business interests of his wholly owned corporation. Under these circumstances, his actions amounted to nothing more than those of a prudent investor in his wholly owned corporation.

Although Saykally’s wholly owned corporation initially deducted the R&E expenditures on its return, the corporation later amended its return to eliminate the deduction so that Saykally was free to deduct such expenditures on his individual income tax return instead, which offset the tax on a substantial capital gain. Saykally, 85 T.C.M. (CCH) 1401, 1405. Thus, there was evidence in Saykally that the taxpayer used the R&E expenditures to offset his personal income tax when it was clear that he never had the objective intent to enter into a business in his individual capacity.

The facts here do not present the same type of situation as Saykally or any of the other cases disallowing the section 174 deduction. Taxpayer’s business structure and financial arrangements are more similar to the cases where the section 174 deduction was upheld than the cases where the deduction was denied. Taxpayer conducted R&E in connection with its business of developing intangible property utilizing joint assets, resources and personnel, with the intention of making a profit from these activities by licensing the results to its shareholders and to others. Taxpayer funded its own R&E expenditures and owned the resulting intangible property. Accordingly, there can be no question that Taxpayer possessed a good faith intent, which it carried out during the years at issue, to conduct a business.

E. Other Considerations

1. Investment Vehicle for Foreign Shareholder and U.S. Shareholder

It has been suggested that Taxpayer may be viewed as an investment vehicle if Foreign Shareholder and U.S. Shareholder had created Taxpayer only for the purpose of conducting joint R&E and decided to exploit the R&E results independently without licensing the results to third parties. In determining whether a party purporting to conduct a trade or business is truly making an investment in the business of another, courts have examined the economic realities of the financial arrangements at issue. See e.g., Harris, 167 F.3d at 80.

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8 We note that there is no evidence of any type of tax avoidance in this case as there was in Saykally. Taxpayer’s R&E expenditures offset its royalty income. In some years, Taxpayer had net operating losses, which were carried over to offset the income in other years. However, these net operating losses are not permitted to offset U.S. Shareholder’s income because Taxpayer is not a member of U.S. Shareholder’s consolidated group. Moreover, U.S. Shareholder is not permitted to deduct its R&E expenditures that are reimbursed by Taxpayer. Under these circumstances, there is no attempt to avoid tax by shifting the R&E expenditures among related parties to a person that can benefit from the deduction but does not intend to use the R&E results in its own business, as was the case in Saykally.
The economic realities of the arrangement between Foreign Shareholder and U.S. Shareholder point to the indisputable fact that Taxpayer was not formed, and does not conduct its activities, so that Foreign Shareholder and U.S. Shareholder could each invest in the separate business of the other. Rather, Foreign Shareholder and U.S. Shareholder formed Taxpayer for the purpose of entering, and carrying on, a new business to co-develop intangible property and commercialize the results. This would be the case even if Taxpayer chose not to license its R&E results to third parties, or chose to license all its worldwide rights to its shareholders. Even though Taxpayer would be licensing its intangible property to the two entities that performed the R&E activities in exchange for royalties, this case would nevertheless be distinguishable from the case law because Taxpayer would not be receiving the royalty income in an investment capacity. Even under these circumstances, Taxpayer would still be conducting (in a regular and continuous manner) a business of developing R&E utilizing joint assets, resources and personnel, with the intention of making a profit from these activities by licensing the results to its shareholders.

There is a fundamental difference between a person that invests in the R&E conducted by an unrelated enterprise and two existing businesses which form a joint venture in the same field as their existing businesses and conduct R&E on behalf of that joint venture, with the intention of making a profit from the assets to be developed by the joint venture. In the latter situation, these businesses are conducting a new business through the joint venture, not making an investment through it. We believe these types of pioneering joint ventures are among the class of taxpayers Congress intended to benefit when it enacted section 174. See Hearings on H.R. 8300 Before the Senate Committee on Finance, 83d Cong., 2d Sess., pt.19, p.105 (1954) (statement of Marion B. Folsom, Under Secretary of the Treasury); see also S. Rep. No. 83-1622, at 33 (1954).

2. Effect of Same Corporate Officers and Directors

As stated earlier, a taxpayer must incur R&E expenses in connection with its own trade or business, and not someone else’s trade or business, to qualify for the section 174 deduction. It has been suggested that a taxpayer may be viewed as engaged in the trade or business of another person if it maintains the same corporate offices, and has the same officers and directors, as its participants. See, e.g., FSA 2001145011. In support of its position, Exam relies on the perceived fact that Taxpayer’s board members and officers (who are also board members and officers of Foreign Shareholder and U.S. Shareholder) cannot possibly be independent from either Foreign Shareholder or U.S. Shareholder and concludes that Taxpayer cannot be carrying on its own trade or business, in part, for this reason.

This view appears to be based on a perception that case law principles would treat Taxpayer as carrying on the trade or business of one of its shareholders rather than its own trade or business because its officers and directors are also officers and directors of its shareholders. The cases in this area, however, held that the partnerships purporting to do business were truly investors in another person’s business, not that the partnerships were engaged in another person’s business. Levin, 832 F.2d at 405-06;
Kantor, 998 F.2d at 1519-20. In our view, Taxpayer clearly carries on its own business. Taxpayer’s R&E activities necessarily involve an undertaking of combined resources, assets and personnel. Thus, by its very nature as a joint venture, Taxpayer’s business activities are distinguishable from the trade or business carried on separately by either Foreign Shareholder or U.S. Shareholder.

We do not find it out of the ordinary that Taxpayer’s management mirrors Foreign Shareholder’s and U.S. Shareholder’s management. It makes perfect business sense for a joint venture to be managed by the stakeholders in the joint venture. There is no requirement under the law that an entity must be independent from its interest holders in order to be treated as carrying on its own trade or business. The cases in this area do not impose a requirement that the entity funding R&E must be independent from the entity that performs R&E. To the contrary, the courts that disallowed the section 174 deduction took the opposite view, ruling against the taxpayers, in part, because the partnership that funded the R&E was independent from the entity performing the R&E and thus, the partnership had no ability to direct or control the R&E process. See, e.g., Green, 83 T.C. at 690; see also LDL Research, 124 F.3d at 1342. This fact supported the conclusion that the partnership was merely a passive investor. Thus, the fact that Taxpayer is under similar management as its shareholders is actually a positive factor weighing in Taxpayer’s favor because the common management permits Taxpayer to direct and control the R&E process performed by Foreign Shareholder and U.S. Shareholder, thus tending to establish that Taxpayer is not an investment vehicle.

The Scoggins court also viewed common management and control as a favorable factor. The Scoggins holding was based, in part, on the fact that the partnership funding the R&E and the corporation performing the R&E were under common control and that the two individuals controlling these entities were actively involved in the R&E process. Thus, the partnership funding the R&E was not effectively foreclosed from entering into a business of its own in the future with the R&E efforts because the two individuals that controlled the partnership, who clearly had the intent to conduct a

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9 In fact, it is not uncommon for entities within the same controlled group to share the same, or a similar, management structure. If we accepted the notion that entities having the same (or similar) management structure cannot be each carrying on its own trade or business, many wholly owned subsidiaries would simply fail to satisfy the trade or business test.

10 Even if there was such a requirement, we would not agree that Taxpayer would not act in its own interest but would act in the interest of Foreign Shareholder and U.S. Shareholder just because its management mirrors the management of Foreign Shareholder and U.S. Shareholder. Board members and corporate officers that provide services to more than one entity can act in a dual capacity. In Taxpayer’s case, when Taxpayer’s officers and directors act in their capacity as Taxpayer’s management, their decisions affect the parties’ joint business, not the separate businesses of the shareholders. When they act in their capacity as part of the management of either Foreign Shareholder or U.S. Shareholder, their activities do not impact the joint venture. While it is true that decisions that impact Taxpayer’s business necessarily impact’s Foreign Shareholder’s and U.S. Shareholder’s businesses, this is true only because Foreign Shareholder and U.S. Shareholder are interest holders in Taxpayer and exploit property developed by Taxpayer, and not because Taxpayer is carrying on the business of either Foreign Shareholder or U.S. Shareholder.

11 Note, however, that even if Taxpayer had separate management, the facts and circumstances of this case would still lead us to conclude that Taxpayer is engaged in a separate business of jointly developing intangible property with the intent to commercialize that property, and not acting as an investment vehicle.
business with the R&E results, could choose for business reasons to conduct that business through either the partnership or the corporation. Under these circumstances, the court found that the R&E activities undertaken by these two individuals, through their partnership, was precisely the type of activity section 174 was designed to benefit since these individuals intended, through either the corporation or the partnership, to conduct a business with the fruits of the R&E in the future. Likewise, the R&E undertaken by Foreign Shareholder and U.S. Shareholder, funded by their joint venture, is also precisely the type of activity section 174 was designed to benefit since the fruits of the R&E are used in connection with the joint venture’s business activity.

3. R&E Performed Outside the United States

A question has been raised as to whether allowing the section 174 deduction in this case would sanction a potential abuse, since R&E expenditures attributable to the R&E conducted by Foreign Shareholder in Country A would be deductible for U.S. tax purposes. We do not perceive an abuse. Section 174 does not limit the deduction to only those R&E expenditures incurred in the United States. If Taxpayer and Foreign Shareholder were not related in any capacity and Taxpayer hired Foreign Shareholder to perform R&E on its behalf, Taxpayer would be entitled to deduct these expenditures under section 174, provided all the applicable requirements are met. Moreover, the royalty income attributable to Taxpayer’s ownership of the rights licensed to Foreign Shareholder is includible in Taxpayer’s income. Thus, although Taxpayer enjoys a deduction for R&E conducted in Country A, it must also include in income those amounts attributable to the exploitation in Country A of the Inventions developed by its successful R&E. Under these circumstances, we do not see any potential for abuse.  

4. Manufacturing of Inventions

A question has also been raised as to whether it is relevant that Taxpayer could have earned more revenue if it had manufactured products rather than licensed the R&E results. We find this fact to be irrelevant. Even if it were true that Taxpayer could have earned more income if it had manufactured products, there is no requirement under the law that a taxpayer owning intangible property, in order to qualify as carrying on a trade or business, must manufacture products rather than license the intangible property to others. Imposing such a requirement is not within the purview of the tax laws. In fact, cases such as Kilroy, 41 T.C.M. (CCH) 292 (1980), and Louw, 30 T.C.M. (CCH) 1421 (1971), make it clear that a taxpayer is not required to utilize its R&E results to manufacture products in order to qualify for the section 174 deduction.

CONCLUSION

Based on the court cases in this area, we conclude that the term “in connection with a trade or business” means that a taxpayer’s contract R&E expenditures

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12 We assume that Taxpayer’s royalty income from Foreign Shareholder is not understated. If Exam believes such income is understated, the appropriate course of action is to examine whether an adjustment can be made under section 482.
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. The facts and circumstances of this case demonstrate that Taxpayer incurred R&E expenditures in connection with its own business, and did not incur such expenditures in connection with an investment in another person’s business.

We wish to emphasize that our 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, it is possible for taxpayers to create joint ventures with the intent to invest in the business (or businesses) of another person(s). Each case must be examined based on its own facts and circumstances to determine the true substance of the activity. That is, the economic realities of each particular case must 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.

Please call if you have any further questions.