INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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Index (UIL) No.: 41.00-00
CASE-MIS No.: TAM-134572-07

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No
Year(s) Involved:
Date of Conference:

LEGEND:

Taxpayer:
Company 1:
Company 2:
Country:
Industry:
Inventions:
Year 1:
Year 2:
Year 3:
Year 4:
Year 5:
a:
b:
c:

ISSUE:

Do contract research expenses incurred by Taxpayer in carrying on its trade or business that involves the licensing of its research results constitute qualified research expenses (QREs) under § 41(b)(1) of the Internal Revenue Code (Code) and § 1.41-2(a)(1) of the Income Tax Regulations?

CONCLUSION:

Contract research expenses incurred by Taxpayer in carrying on its trade or business that involves the licensing of its research results constitute QREs under § 41(b)(1) and § 1.41-2(a)(1).

FACTS:

Taxpayer, a U.S. corporation formed in Year 1, is a joint venture between Company 1, a Country corporation, and Company 2, a U.S. corporation (collectively "Companies"). Companies each own 50 percent of Taxpayer's stock. Companies are in Industry.

Taxpayer was formed by Companies to allow them to jointly develop and commercialize Inventions. Companies contributed capital, in-process research and experimentation (R&E), and other intangible assets to Taxpayer, and Taxpayer began conducting R&E in Year 1.

Taxpayer retains ownership of all production and marketing rights to Inventions developed from its successful R&E activities. Taxpayer's general practice with respect to successful R&E is to grant exclusive licenses to Companies to use Inventions for the purpose of manufacturing and selling products in Companies' respective territories. Companies pay royalties to Taxpayer under license agreements. Generally, these licenses give Companies the exclusive rights to exploit the technology in their respective territories. The licenses to Companies are granted at the outset of an R&E project before it is known if the R&E will be successful.

Taxpayer also licenses successful Inventions to third parties in territories that are not covered by the licenses to Companies and receives royalties from those licenses. In Year 2 and Year 3, royalties from third parties accounted for approximately a percent of Taxpayer's total revenue. Taxpayer's board makes the ultimate management decisions regarding whether to enter into license agreements with third parties.

Although Taxpayer licenses Inventions, Taxpayer retains the rights to continue research on and further develop Inventions. In most instances, Taxpayer continues research and development of Inventions even after they have been licensed.

From Year 1 to Year 3, Taxpayer developed b Inventions. Of these Inventions c were unsuccessful. In Year 4, Taxpayer's royalty income exceeded its expenditures for R&E,

and this remained true through Year 3. In addition, Taxpayer has funded its own research since around the time of Year 5 through Year 4 and has not received capital contributions from Companies since Year 5. Taxpayer generally does not pay any dividends to its shareholders.

LAW AND ANALYSIS:

Section 41(a) provides that for purposes of § 38, the research credit determined under § 41 for the taxable year is an amount equal to the sum of 20 percent of the excess (if any) of the taxpayer's QREs for the taxable year over the base amount, and 20 percent of the basic research payments determined under § 41(e)(1)(A), and 20 percent of the amounts paid or incurred by the taxpayer in carrying on any trade or business of the taxpayer during the taxable year (including as contributions) to an energy research consortium.

Section 41(b)(1) provides that the term QREs means the sum of in-house research expenses and contract research expenses that are paid or incurred by the taxpayer during the taxable year in carrying on any trade or business of the taxpayer.

Section 1.41-2(a)(1) provides that, in general, an in-house research expense of the taxpayer or a contract research expense of the taxpayer is a QRE only if the expense is paid or incurred by the taxpayer in carrying on a trade or business of the taxpayer. The phrase "in carrying on a trade or business" has the same meaning for purposes of § 41(b)(1) as it has for purposes of § 162; thus, expenses paid or incurred in connection with a trade or business within the meaning of § 174(a) (relating to the deduction for research and experimental expenses) are not necessarily paid or incurred in carrying on a trade or business for purposes of § 41. A research expense must relate to a particular trade or business being carried on by the taxpayer at the time the expense is paid or incurred in order to be a QRE. For purposes of § 41, a contract research expense of the taxpayer is not a QRE if the product or result of the research is intended to be transferred to another in return for license or royalty payments and the taxpayer does not use the product of the research in the taxpayer's trade or business.

At issue is whether contract research expenses incurred by Taxpayer in its business of conducting R&E and licensing the results of its research constitute QREs under § 41(b)(1) and § 1.41-2(a)(1). For purposes of this technical advice, the Service and Taxpayer agree that Taxpayer is carrying on a trade or business within the meaning of § 162 and § 41(b)(1).

The research credit was enacted as § 44F of the Code in the Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 221 (1981). Section 44F provided that the term "qualified research expenses" means the sum of in-house research expenses and contract research expenses that are paid or incurred by the taxpayer during the taxable year in carrying on any trade or business of the taxpayer. The legislative history indicates that the phrase "in carrying on any trade or business" is intended to have the

same meaning for research credit purposes as it has under § 162, and that the research credit is not available for expenditures paid or incurred by a taxpayer as part of a hobby or a financing arrangement. H. Rep. No. 97-201 at 112 (1981).

The legislative history also states that under the trade or business test of § 41, the credit generally is not available with regard to a taxpayer's expenditures for "outside" or contract research intended to be transferred by the taxpayer to another in return for license or royalty payments. Furthermore, the receipt of royalties does not constitute a trade or business under the law, even though expenses attributable to those royalties are deductible from gross income in arriving at adjusted gross income. In such a case, the nexus, between the research and the transferee's activities generally would be insufficient to support a finding that the taxpayer had incurred the research expenditures in carrying on a trade or business. However, if the taxpayer used the product of the research in the taxpayer's trade or business, as well as licensing use of the product by others, the relationship between the expenditures and the taxpayer's trade or business generally would be sufficient for purposes of claiming the research credit. Id. at 113.

Under § 41(b)(1), QREs must be incurred by a taxpayer in carrying on a trade or business of the taxpayer. The plain language of § 41(b)(1) does not limit its application only to certain types of businesses. Rather, it broadly provides that a taxpayer may be engaged in "any trade or business." Consistent with the legislative history underlying § 41, § 1.41-2(a)(1) provides that a contract research expense is not a QRE if the product or result of the research is intended to be transferred to another in return for license or royalty payments and the taxpayer does not use the product of the research in the taxpayer's trade or business. This provision was intended to prevent the abusive use of QREs by individuals or tax shelter partnerships. However, this language was not directed toward situations in which there is no tax avoidance motive, and in which the research results are used by the taxpayer in carrying on the taxpayer's trade or business.

In this case, it is agreed that since Year 1, Taxpayer has been involved in a bona fide business operation that involves the licensing of the results of Taxpayer's research. In the course of its business operations, Taxpayer not only licenses the results of its research, but uses the result of that research in continued research and development of new Inventions. Neither the statute, nor the legislative history or regulations underlying § 41(b)(1) define the term "use" for purposes of § 41(b)(1) and § 1.41-2(a)(1). We, however, believe that a reasonable interpretation of this term involves the type of uses that Taxpayer undertakes by continuing to use and develop Inventions even after it has licensed them.

Based on the foregoing, we conclude that under § 41(b)(1) and § 1.41-2(a)(1), the contract research expenses incurred by Taxpayer in carrying on its trade or business that involves the licensing of its research results constitute QREs.

CAVEAT(S):

A copy of this technical advice memorandum is to be given to the taxpayer. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Except as expressly provided herein, we express or imply no opinion concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this request. Further, we express or imply no opinion concerning expenditures Taxpayer treated as QREs.