



Foreign branch gross receipts must be included in research credit calculation, Tax Court rules

October 27, 2009

The Tax Court October 22 held, in *Deere & Company v. Commissioner*, that the gross receipts of a U.S. corporation's foreign branches must be included in the corporation's section 41 research credit calculation.

While the case presented the Tax Court with an "issue of first impression" -- an issue the court had not considered previously -- and is noteworthy for that reason, the most important aspect of the case is that it involves foreign branches and not controlled foreign corporations (CFCs). The decision, therefore, does not resolve the issue whether gross receipts from CFCs (that is, from transactions between controlled group members) should be disregarded when a corporation computes its annual research credit.

Tax Court Decision

Factual background

Deere, a manufacturer of agricultural equipment, had foreign branches in Germany, Italy, and Switzerland, as well as other countries. Deere's tax return for its tax year ending October 31, 2001, included the amounts from the operations during that tax year that Deere conducted through its German, Italian, and Swiss branches.

Deere calculated its research credit using the alternative incremental research credit method prescribed by section 41(c)(4). In determining its total annual gross receipts for each of the four tax years preceding the tax year ending on October 31, 2001, Deere started with the total amount that it reported on its consolidated return for each of those years, then reduced that amount by the total annual gross receipts from its foreign branch operations.

Taxpayer's arguments

Deere presented several arguments why its foreign branch income should be excluded from the research credit calculation:

- The structure of the statute demonstrates that Congress did not intend taxpayers to include the total annual gross receipts of their foreign branches;
- The legislative history of section 41 demonstrates that Congress did not intend to include in the calculation under section 41(c)(1)(B) the total annual gross receipts of foreign branches;
- Interpreting “gross receipts” under section 41(c) to exclude gross receipts from foreign branches such as those operated by Deere is consistent with the historical focus of the research credit on domestic activities; and
- Even if the term “gross receipts” under section 41(c)(4) could be read literally to include gross receipts from Deere’s foreign branch operations, the Tax Court should reject that reading to avoid a result plainly at variance with the Congressional intent behind the research credit.

The court's decision

Tax Court Judge Carolyn Chiechi rejected the taxpayer's arguments. Ruling for the government, she held that the gross receipts from Deere's foreign branch operations must be included in Deere's research credit calculations.

Observations

The *Deere* decision, because it involves foreign branches, appears to have no effect on the unresolved issue of whether the gross receipts component of the research credit computation for a controlled group under section 41(f) includes gross receipts from transactions between group members.

The IRS concluded in CCA 200233011 that such receipts should be excluded, while it concluded in CCA 200620023 that they should not be excluded. Thus, the 2002 CCA and the 2006 CCA take opposite positions, even though it seems that intercompany receipts should be either excluded or included from the gross receipts calculation as a pure question of law.

A comparison of the statutory and regulatory arguments of taxpayers and the IRS on the issue of whether transactions between group members should be included in gross receipts indicates that the IRS's reliance on the 2006 CCA is misplaced -- the 2002 CCA is far more persuasive. The IRS does not try to explain why the reasoning of the 2006 CCA is superior to that of the 2002 CCA; in fact, the 2006 CCA does not mention the 2002 CCA. (For prior discussion of this issue, see WNTS Insight, "[Excluding intercompany gross receipts from research credit calculations: IRS improves settlement offer](#)," October 24, 2008.)

We understand the IRS is in the process of issuing Appeals Settlement Guidelines under which taxpayers would concede 50 percent of the issue -- the IRS essentially would split the difference between the conflicting CCAs.

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