Hewlett-Packard Co. v. Comm'r, 139 T. C. 255 (2012)

In a ruling that impacts how companies calculate the research credit under I. R. C. sec. 41, the U. S. Tax Court held that Hewlett-Packard must include nonsales income such as dividends, interest, rent, and other income in its average annual gross receipts (AAGR) for tax years 1999-2001. This decision clarifies the broad scope of gross receipts for credit calculations, ensuring that all income streams are considered, aligning with the legislative intent to incentivize research expenditure growth relative to overall income.

Parties

Hewlett-Packard Company and Consolidated Subsidiaries (Petitioner) v. Commissioner of Internal Revenue (Respondent).

Facts

Hewlett-Packard Company (HP), a Delaware corporation with principal offices in California, operates globally in technology and services. For the tax years 1999 through 2001, HP claimed research credits under I. R. C. sec. 41, using the Alternative Incremental Research Credit (AIRC) method. HP included sales income in its AAGR but excluded nonsales income such as dividends, interest, rent, and other income. The Commissioner of Internal Revenue contested this exclusion, asserting that all income should be included in AAGR calculations for determining the research credit.

Procedural History

Following the issuance of statutory notices of deficiency by the Commissioner, HP petitioned the U. S. Tax Court. Both parties filed cross-motions for partial summary judgment to determine whether nonsales income should be included in HP's AAGR for the years in question. The court granted summary judgment in part to both parties, affirming the inclusion of nonsales income for 1999-2001 and excluding intercompany receipts from controlled foreign corporations for all years at issue.

Issue(s)

Whether, for the purposes of calculating the research credit under I. R. C. sec. 41 for the tax years 1999 through 2001, HP was required to include nonsales income, such as dividends, interest, rent, and other income, in its average annual gross receipts (AAGR)?

Rule(s) of Law

I. R. C. sec. 41(c)(6) defines "gross receipts" for the research credit as being reduced by returns and allowances made during the taxable year. The court interpreted this provision broadly, in line with its usage in other sections of the

Internal Revenue Code, to include all income streams, not just sales receipts. The court also considered the legislative history and purpose behind the research credit, which aimed to incentivize research expenditure growth relative to overall income.

Holding

The U. S. Tax Court held that HP was required to include nonsales income, such as dividends, interest, rent, and other income, in its AAGR for the calculation of its research credits under I. R. C. sec. 41 for the tax years 1999 through 2001.

Reasoning

The court's reasoning was grounded in statutory interpretation and legislative intent. It emphasized that the term "gross receipts" in I. R. C. sec. 41(c)(6) should be broadly construed to include all income streams, not limited to sales receipts, as evidenced by similar usage in other sections of the Internal Revenue Code. The court rejected HP's argument that the term should be narrowly defined, citing the legislative purpose of the research credit to encourage research expenditures relative to the company's overall income growth. The court also noted that a narrow definition could lead to disparate treatment among companies with different business models within the same industry. The court's interpretation was supported by the Department of the Treasury's rationale in its final regulations on the subject, despite those regulations not being applicable to the tax years in question.

Disposition

The court granted the Commissioner's motion for partial summary judgment, requiring HP to include nonsales income in its AAGR for calculating research credits for the tax years 1999 through 2001. The court also granted HP's motion in part, allowing it to exclude intercompany receipts from controlled foreign corporations from its AAGR for all years at issue.

Significance/Impact

This decision has significant implications for how companies calculate their research credits under I. R. C. sec. 41, emphasizing a comprehensive approach to gross receipts that includes all income streams. It aligns with the legislative intent to incentivize research expenditures relative to overall income growth, ensuring that companies cannot manipulate their credit calculations by excluding certain types of income. The ruling also provides clarity and consistency in the application of the research credit, affecting how companies structure their research budgets and report their income for tax purposes.

