Office of Chief Counsel
Internal Revenue Service
Memorandum

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to:

from: Jerry Jean-Felix, General Attorney
(Large Business & International)

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subject: Section 41 Research Credit Claims

Disclosure Statement

This advice responds to your request for assistance. It may not be cited as precedent. This advice contains confidential information subject to attorney-client privileges. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

This advice relies on facts provided by you to our office. If you find that any facts are incorrect, please advise us immediately so that we may modify and correct this advice.

Issue

Whether work performed by under certain contracts should be treated as funded activity pursuant to I.R.C. § 41(d)(4)(H) and Treas. Reg. § 1.41-4(c)(9) and not allowed for the credit for increasing research activities?[1]

Conclusions

Based on the facts and documents that you have provided, we have concluded the following:

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[1] The analysis herein does not address whether the work performed under the contracts constitutes qualified research under § 41(d)(1). Further, this advice does not address whether the contracts relate to a proper business component for § 41 purposes. If necessary, guidance on this issue can be provided.

- Contract 1: Because payment is not contingent on the success of the research, and Taxpayer does not retain substantial rights to use or exploit the results of its research, this contract is funded.

- Contract 2: Because payment is not contingent on the success of the research, and Taxpayer does not retain substantial rights to use or exploit the results of its research, this contract is funded.

- Contract 3: Because payment is not contingent on the success of the research, and Taxpayer does not retain substantial rights to use or exploit the results of its research, this contract is funded.

- Contract 4: Because payment is not contingent on the success of the research, and Taxpayer does not retain substantial rights to use or exploit the results of its research, this contract is funded.

- Contract 5: Because payment is not contingent on the success of the research, and Taxpayer does not retain substantial rights to use or exploit the results of its research, this contract is funded.

Facts

Taxpayer's research credit is under audit for proper application of the law under § 41.

In order to determine whether the expenditures incurred by Taxpayer are qualified research expenditures eligible for the credit for increasing research activities under § 41, the contractual arrangements between Taxpayer and third parties were reviewed. Documents evidencing the contractual relationship between the parties were provided by Taxpayer. The factual details of each contractual arrangement are discussed below.

The contracts at issue are as follows:

Contract	Client
1	
2	
3	
4	
5	

For each contract, the portions of the contracts relevant to the analysis are provided below:

Contract 1

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Termination:

Ownership of Deliverable:

Proposal Deck

Client:

Payment Terms:

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Termination:

Contract 2

Client:

Payment Terms:

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Termination:

Contract 3

Client:

Acceptance/Inspection:

Warranty:

Termination:

Ownership of Deliverable:

<u>Contract 4</u>

Client:

Acceptance/Inspection:

Warranty:

Termination:

Contract 5

Termination:

Payment Terms:

Ownership of Deliverable:

Law and Analysis

Section 41 allows a credit for qualified research expenses. I.R.C. § 41(a). Qualified research expenses can be either in-house research expenses or contract research expenses. I.R.C. § 41(b)(1). The expenses at issue are in-house research expenses. In- house research expenses are any wages paid or incurred to an employee for qualified services performed by such employee, any amount paid or incurred for supplies used in the conduct of qualified research, and any amount paid or incurred to another person for the right to use computers in the conduct of qualified research. I.R.C. § 41(b)(2)(A). Qualified services are services consisting of engaging in qualified research or the direct supervision or direct support of research activities which constitute qualified research. I.R.C. § 41(b)(2)(B). Qualified research does not include any research to the extent funded by any grant, contract, or otherwise by another person. I.R.C. § 41(d)(4)(H).

Treas. Reg. § 1.41-4(c)(9) applicable to qualified research expenditures paid or incurred in taxable years ending on or after December 31, 2003, defines the extent to which research is so funded. Research performed for a customer under a contract is considered funded unless two requirements are met by the taxpayer: (1) the amounts payable under the agreement are contingent on the success of the research and thus considered to be paid for the product or result of the research; and (2) the taxpayer retains substantial rights in the research. Treas. Reg. § 1.41-4A(d).[2]

i. Contingent on the Success of the Research

Amounts payable under any agreement that are contingent on the success of the research and thus considered to be paid for the product or result of the research are not treated as funded. Treas. Reg. § 1.41-4A(d)(1). If an expense is paid or incurred pursuant to an agreement under which payment is contingent on the success of the research, then the expense is considered to be paid for the product or result rather than the performance of the research. Treas. Reg. § 1.41-2(e)(2). This test is applied to each expenditure and not to the agreement as a whole. Treas. Reg. § 1.41-2(e)(5). Therefore, it is possible for a taxpayer to perform some research where the client pays for the end product and some research where the client is paying for the research itself within the same contractual agreement. All agreements and not only research contracts entered into between the taxpayer performing the research and other persons are considered in determining the extent to which the research is funded. Treas. Reg. § 1.41-4A(d)(1).

The Court in Fairchild Industries, Inc. v. United States, 71 F.3d 868 (Fed. Cir. 1995), rev'g 30 Fed. Cl. 839 (1994), held that research is not funded by a contract if the taxpayer bears the research costs upon failure to successfully complete the project for which it is doing the research. In Fairchild Industries, the taxpayer entered into fixed price incentive contracts with the United States Air force.[3] The Air Force was obligated to pay for the research only if the taxpayer produced results that met the contract specifications and certain provisions of the Defense Acquisition Regulations. Id. at 871. The contracts provided that the Air Force could terminate the Contract either for default or for the convenience of the government. Id. The Air Force would pay bi-monthly refundable advance payments, calculated as a percentage of the expenditures the taxpayer actually incurred. Id. The United States argued, and the Court of Federal claims agreed that the availability of the credit depends on the relative likelihood that the contracting entity would pay. Id. at 872.

The Court of Appeals disagreed and held that whether research is funded by a contract depends on "who bears the research costs upon failure, not on whether the researcher is likely to succeed in performing the project." Id. at 873. Since the Air Force was only liable for payment of the contract when the project succeeded and was accepted, the Court determined that the taxpayer bore the financial risk of failure and could claim the credit. Id. at 873. The fact that the taxpayer received advanced

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[2] Though Treas. Reg. § 1.41-4A applies to qualified research for taxable years beginning before January 1, 1986, Treas. Reg. § 1.41-4(c)(9) specifically incorporates Treas. Reg. § 1.41-4A(d) by reference for purposes of determining qualified research for expenditures paid or incurred in taxable years ending on or after December 31, 2003.

[3] A fixed price incentive contract is a "contract that provides for adjusting profit and establishing the final contract price by application of a formula based on the relationship of total final negotiated cost to total target costs. The final price is subject to a price ceiling, negotiated at the outset." 48 C.F.R. § 16.403(a)(1994); Fairchild Industries, 71 F.3d at 870 f.n. 3.

payments from the Air Force that were calculated as a percentage of the taxpayer's costs did not change the result because the advanced payments were refundable if the project was not successful. Id. at 873. The Court's test applies to all contracts and not just to unusually risky or uncertain contracts. The result is the same even if the contractor expects to perform as the contract contemplates. Id. at 874.

In Geosyntec Consultants, Inc. v. United States, 776 F.3d 1330 (2015), the taxpayer, a specialty consulting and engineering firm, filed suit seeking a federal income tax refund under § 41. The taxpayer claimed that it was entitled to the research tax credit under § 41 for qualified research expenses that it incurred on client projects in taxable years, 2002-2005. Relying on the standard articulated in Fairchild Industries, the district court's decision came down to who bears the research costs upon failure of the research. Id. at 1334. According to the taxpayer, both the contracts placed the costs of the research failure "squarely" on the taxpayer. Id. at 1339. The district court disagreed and found that research conducted by the taxpayer under the two contracts was funded by the taxpayer's clients, making the taxpayer ineligible for the research tax credit for those contracts. Id. at 1343. The district court reasoned that the taxpayer was entitled to payment under both contracts regardless of success. Id. at 1344. Further, the taxpayer did not bear the financial risk of its own failure. Id. at 1350. The Court of Appeals agreed, concluding that the district court was correct in its interpretation of § 41. Id. at 1352. Accordingly, the Court of Appeals affirmed the grant of summary judgment against the taxpayer. Id. at 1356.

Likewise, in an Order issued on November 19, 2020, in Meyers, Borgman, & Johnson, Inc. v. Commissioner of Internal Revenue, Docket No. 7805-16, the United States Tax Court determined that research was funded because the taxpayer, a structural engineering service company, received payments that were not contingent on the success of research. 14 contracts were reviewed, and the Commissioner's position was that none of the 14 contracts contained the language making the payments contingent on the success of research, thus determining the contracts funded. The taxpayer held the position that the 14 fixed-price or lump-sum contracts were inherently risky, and that the taxpayer bore the financial risk. The Court, referring to Fairchild Industries and Geosyntec Consultants, had little concern with the cost-of-performance as a financial risk. Instead, the concern of the Court focused on whether "payment was contingent on the success of the research – that is, the financial risk of failure." The taxpayer also argued that the contracts required adherence to requirements, specifications and codes. However, the Court found that no reference to these codes were present in the contracts and the Court stated, "we will not read into the contract language that is not actually present." The Court found that payments to the taxpayer were not contingent on the success of research, and whatever financial risk they imposed was not the financial risk that the research would fail. Thus, the contracts were funded by the taxpayer's clients, and as a result produced no § 41 credits.

In other advice, the Service has stated that contracts are not considered contingent on the success where the standard of performance is that of a similar qualified design professional exercising due care. 2002 IRS NSAR 20350.[4] Where the contract requires substantial performance, warrants results, or the contract is governed by local law that applies a warranty of results standard, then the contract is contingent on results, and is therefore not funded. Id.

ii. Substantial Rights

If the taxpayer performs research on behalf of another entity and does not retain substantial rights in the research, then the expenses paid or incurred by taxpayer are not qualified research expenses and the research is treated as fully funded by a contract. Treas. Reg. § 1.41-2(a)(3)(i); Treas. Reg. § 1.41-4A(d)(2). Incidental benefits to the taxpayer from performance of the research, such as increased experience in a field of research, do not constitute substantial rights in the research. Treas. Reg. § 1.41-4A(d)(2).

If the taxpayer in carrying on a trade or business performs research on behalf of another person but retains substantial rights in the research under the agreement providing for the research, then the research is funded, but only to the extent the payments to which the taxpayer becomes entitled by performing the research. Treas. Reg. § 1.41-2(a)(3)(ii); Treas. Reg. § 1.41-4A(d)(3). The taxpayer must reduce the amount paid or incurred for research that would otherwise constitute qualified research expenses of the taxpayer, but for the restriction in Section 41(d)(4)(H) by the amount of the research funded by a contract. Treas. Reg. § 1.41-4A(d)(3). A taxpayer does not retain substantial rights in the research if the taxpayer must pay for the right to use the results of the research. Treas. Reg. § 1.41-4A(d)(3). Whether a taxpayer has retained substantial rights is applied on a project-by-project basis. Treas. Reg. § 1.41-4A(d)(3)(iii).

The issue in Lockheed Martin Corp. v. Unites States, 210 F.3d 1366 (Fed. Cir. 2000), rev. in part 42 Fed. Cl. 485 (1988), was whether the taxpayer retained substantial rights in the research so that it could claim the research tax credit. The taxpayer entered into many substantially similar fixed price contracts with the United States. The Court of Federal Claims found that the taxpayer did not retain substantial rights because under the contracts (1) the government had unlimited right to use the taxpayer's technical data and disclose it to third parties; (2) the taxpayer had to seek approval from the State Department prior to entering into licensing agreements or discussing with other customers technical information not in the public domain; (3) the government had veto power over the taxpayer's right to file patent applications and could require the taxpayer to transfer title to a subject invention if the taxpayer failed to file a patent application within a specific period of time; and (4) the recoupment provisions in the contracts required the taxpayer to pay the government for certain costs for each commercial sale made by the taxpayer of technology that utilized the research results attained under the government contracts. Id. at 1369-70. The Court of Federal

[4] 2002 IRS NSAR 20350 is not precedential but is indicative of the Service's thought at the time.

Claims characterized the profits the taxpayer received on private sales of related technology as incidental benefits. Id. at 1370.

The government argued that a taxpayer only retains substantial rights if the taxpayer retains the right to exclude others, including the government, from its research and in which other parties do not also have the right to use or disclose the taxpayer's research, including patented inventions. Id. at 1375. The Court of Appeals disagreed and held that the taxpayer retained substantial rights in the research. Id. at 1375. "The right to use the research results, even without the exclusive right, is a substantial right." Id. at 1375. The Court found that under the agreements, the taxpayer was able to use the results of its research in its business without paying for it and this was a substantial right that allowed the taxpayer to manufacture and sell up-to-date products meeting the needs of its customers. Id. at 1376. The Court found that the recoupment provision that required the taxpayer to reimburse the government for research costs each time it made use of the government research results in a commercial sale did not restrict the taxpayer's use of the technology. Id. at 1377. This recoupment provision did not amount to the taxpayer paying for the use of the research and so the taxpayer retained substantial rights under the contracts. Id. at 1377.

Similarly, in Dynetics, Inc. & Subsidiaries v. United States, 121 Fed. Cl. 492 (2015), the Court of Federal Claims granted a partial summary judgment ruling that the taxpayer did not qualify for the research tax credits because it bears the burden of showing it had substantial rights in the results of the research and, in this case, it failed to do so. The Court held that the contract payments were not contingent on the success of the research, and substantial rights to the research were not retained by the taxpayer. Id. at 523.The decision was based on a sample of seven (7) contracts out of a total of 100 contracts. Id. at 499. The Court refused to accept the taxpayer's argument that the contract language was ambiguous. Id. at 524. Further, the Court rejected the taxpayer's reliance on Fairchild Industries and Lockheed Martin Corp to argue that the research was not funded. Id. The Court found that the "terms of taxpayer's contracts with the government were not ambiguous, the contracts were not contingent on taxpayer's success, and the taxpayer did not retain substantial rights in the results of research performed under its contracts. Id.

In an Order issued on December 9, 2019, Populous Holdings, Inc. v. Commissioner of Internal Revenue, Docket No. 405-17 (2019), the United Sates Tax Court determined that the taxpayer, a provider of architectural design services, (1) received payments that were contingent on the success of research, and (2) retained substantial rights to use or exploit the results of its research under certain representative contracts, and that the contracts met both conditions thus making the research not funded. Five contracts were reviewed as representative contracts and the Court found in all five representative contracts the payments were contingent on the success of the research, thus they satisfied the contingent requirement. For the second condition, three contracts were reviewed as representative contracts. In two of the contracts, the taxpayer owned the architectural copyrights; however, they are unable to use the copyrights without the client's consent. For the third contract, the taxpayer retained the right only to design details that were “repetitive in nature, not project specific and were preexisting and not developed for or identifiable with” the third contract. The Court concluded “[t]here were no provisions in these contracts that prohibited the taxpayer from using the research it performed or that required it to pay the client for use of the research.” For the foregoing reasons, the Court determined that the taxpayer retained substantial rights to use or exploit the results of its research under the three representative contracts and that the three contracts met both conditions. Therefore, the research was not funded.

In 2002 IRS NSAR 20350, the Service noted that “except where a contract has explicit provisions granting ownership of all intangible or intellectual property (not merely designs, specifications, blueprints and the like) to the client, [the contactor] retains substantial rights.”

i. Contract 1

We conclude that Contract 1 is funded, and Taxpayer is therefore not entitled to credit under § 41. Relying on the standard articulated in Fairchild Industries and Lockheed Martin Corp., the decision came down to (1) who bears the research costs upon failure of the research, and (2) whether Taxpayer retained substantial rights under the contract.

The contract is essentially for services and not the results of research.

Similar to Dynetics,

ii. Contract 2

We conclude that Contract 2 is a fixed fee contract, where payment is not contingent upon the success of the research. Similar to Geosyntec Consultants, relying on the standard articulated in Fairchild Industries, the decision came down to who bears the research costs upon failure of the research.

Thus Contract 2 is a fixed-fee contract not contingent on satisfactory research.

Unlike the conclusion reached in the court's order in Populous Holdings, Contract 2 does not bestow substantial rights to use or exploit the results of the research to Taxpayer. Thus, the client will retain a substantial right to the research.

As a result of Contract 2 being funded, Taxpayer is not entitled to credit under § 41.

iii. Contracts 3 & 4

We decided to provide one analysis for this section because Contract 3 is an Engagement Letter and Contract 4 is the related SOW. Accordingly, we conclude that Contracts 3 and 4 are funded and Taxpayer is therefore not entitled to credit under § 41.

Similar to the analysis for Contract 1, the language in Contracts 3 and - 4

The contract is essentially for services and not the results of research. In addition, the contract does not include acceptance or inspection requirements prior to the tender of payment for the research.

Payment to Taxpayer is not contingent on the success of the research

Further, although the client may perform evaluations of the services provided, such evaluations do not appear to impact the client's obligation to pay for such services. Therefore, it appears that Taxpayer's burden of risk is limited

iv. Contract 5

We conclude that Contract 5 is funded, and Taxpayer is therefore not entitled to credit under § 41. Similar to the analysis immediately above, payments to Taxpayer do not appear to be contingent on the success of research. Taxpayer offers only to perform to a standard of care and does not warrant its work.

Similar to Contracts 3 and 4, termination of Taxpayer's services does not appear to affect the client's responsibility for payment of fees for services rendered. Further---, As stated above, this memorandum only addresses the issue of funded research under § 41. The Compliance Team must still review Taxpayer's activities to determine whether they constitute qualified research under § 41(d)(1).

If you have any questions, please contact attorney Jerry Jean-Felix.

/S/

Jerry Jean-Felix
General Attorney
(Large Business & International)