

**Office of Chief Counsel
Internal Revenue Service
Memorandum**

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UILC: 41.00-00 (41.51-09 – Credit for Increasing Research Activities for Which Credit is Not Allowed)

date: March 07, 2012

to:

(Large Business & International)

from:

Paul V. Colleran

Attorney (Boston, Group 2)

(Large Business & International)

subject: Request for Advice – Research Credit – Excluded Activities Funded Research Taxpayer:

EIN:

Years:

DISCLOSURE STATEMENT

This advice constitutes return information subject to I.R.C. Section 6103.¹ This advice contains confidential information subject to attorney-client and deliberative process privileges and if prepared in contemplation of litigation, subject to the attorney work product privilege. Accordingly, the Examination or Appeals recipient of this document may provide it only to those persons whose official tax administration duties with respect to this case require such disclosure. In no event may this document be provided to Examination, Appeals, or other persons beyond those specifically indicated in this statement. This advice may not be disclosed to taxpayers or their representatives.

¹ All section citations herein are to the Internal Revenue Code of 1986, unless otherwise stated.

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.

LEGEND

- = Taxpayer
- = Project 1
- = Project 2
- = Project 3
- = Project 4
- = Project 5
- = Project 6
- = Project 7
- = Client 1
- = Client 2
- = Client 3
- = Client 4
- = Client 5
- = Client 6
- = Client 7

This amended² memorandum responds to your request for advice on whether the activities performed by Taxpayer are excluded from the definition of qualified research pursuant to section 41(d)(4)(H).

ISSUES

Is the work performed by Taxpayer under certain contracts funded by third parties under 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 (“research credit”) ?³

CONCLUSIONS

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

³ 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. We note that architectural designs may not be a proper business component under § 41.

- Project No. 1: Because payment is not contingent on the success of the research, this contract is funded.
- Project No. 2: Because payment is not contingent on the success of the research, this contract is funded.
- Project No. 3: Because payment is not contingent on the success of the research, this contract is funded.
- Project No. 4: Because payment is not contingent on the success of the research, this contract is funded.
- Project No. 5: Because Taxpayer does not retain substantial rights to the research, this contract is funded.
- Project No. 6: Because payment is not contingent on the success of the research, this contract is funded.
- Project No. 7: Because payment is not contingent on the success of the research, this contract is funded.

As discussed herein, in the contracts where payment is not contingent on the success of the research, some research and experimental expenditures may be included in the computation of the research credit, notwithstanding whether the activities are allowable under the other provisions of I.R.C. § 41.

FACTS

Taxpayer is a consulting, engineering, construction, and operations firm. Taxpayer claimed the research tax credit for expenses it incurred in connection with work performed under certain contracts with third parties. 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 parties⁴ were provided by Taxpayer. The factual details of each contractual arrangement are discussed below.

The contracts at issue are as follows:

Project No.	Client
1	Client 1

⁴ It is presumed for the purpose of this memorandum that Taxpayer provided all of the relevant, written documentation related to this selected contractual arrangements. If further documentation or information is provided regarding the four contractual arrangements discussed herein, the legal opinion provided may change.

2	Client 2
3	Client 3
4	Client 4
5	Client 5
6	Client 6
7	Client 7

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

Project 1

Client:

Client 1

Deliverable:

- Develop a 5 model of
- :
- tasks include:
 - : Prepare Reports
 - Modeling
 - Data Acquisition
 - Project Management

Payment terms:

⁵ In Rev. Rul. 80-245 (1980), a taxpayer's expenditures for environmental impact studies prepared in connection with the expansion of its facilities were determined not to be research and experimental expenditures within the meaning of I.R.C. §174.

Acceptance:

Warranty:

Termination:

-

Rights:

Contract No. 2

Client:

Client 2

Deliverable:

Phase : gather data, review characteristics, investigate, survey, and inventory existing systems, and develop the mapping of the system on a computerized data base.

- Phase : evaluate existing capacity and future demand of the system, develop alternative solutions,

collaboration plan, and obtain permit and long-term approval.

- Phase : prepare documents and permits, provide final design and construction drawings, right-of-way maps, bid documents, construction permits, and public information materials.

- Work Order : Address situation, in order to prevent further

. prepare construction plans and specifications for the preferred alternative.”

Payment terms:

- Fixed-fee basis in the amount of
-

Acceptance/Inspection:

-

Warranty:

Termination:

-

-

Rights:

Contract No. 3

Client:

Client 3

Deliverable:

- Prepare an Study of the Expansion of the
Plant.
- Stage includes three phases.
- Phase : Expansion Study. AES, Ex. A, p. 1.

Phase : Design Phase – preliminary and final engineering design services and bidding services.

- Amendment includes:

Deliverables will be an
engineering memorandum, plan and specification submittals, estimate of
probable construction costs.

- Phase : Construction Phase – construction and start-up assistance.
- Amendment No. :
-

Payment terms:

Acceptance/Inspection:

- None.

Warranty:

- None.

Termination:

-

Rights:

Contract No. 4

Client:

Client 4

Deliverable:

- Prepare an Plan

Deliverables are comprised of twelve (12) parts.

- Task 1 – Establish Priority of Study Criteria
- Task 2 – Development of Decision Making Model for Evaluation of Alternatives (memorandum)
- Task 3 – Evaluate and assessment of Additional Items (memorandum)
- Task 4 – Evaluate All Resources
- Task 5 – Develop and evaluate scenarios (analysis)
- Task 6 – Formulation of a resource implementation plan (strategy)
- Task 7 – Development of Contingency Plan
(memorandum)

- Task 8 – Interagency Coordination
- Task 9 – Public/Community Outreach
- Task 10 – Required Meetings and Communications
- Task 11 – Deliverables
- Task 12 – Supplemental Tasks (memoranda)

Payment terms:

Acceptance/Inspection:

- None.

Warranty:

Termination:

Rights:

Contract No. 5

Client:

Client 5

Deliverable:

- Compliance Study for Admin. Code Resolution.⁶
- Assist Client 5 in evaluating the ability of the facility to comply with the new system requirements, provide a list of possible modifications to meet the new system requirements, provide conceptual planning level capital cost estimates for the alternatives, and provide a letter report detailing the findings of the evaluation
 - Identification of Modification Alternatives
 - Modification Alternatives Adjustment Based on Recently Revised Manual

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⁶ See Rev. Rul. 80-245 (1980), holding expenses attributable to site specific investigations of projected environmental impacts resulting from the construction and operation of the proposed electric generating plants and transmission line, conducted by or on behalf of the taxpayer for the purpose of obtaining licensing approval from the state regulatory agencies, are not research and experimental expenditures within the meaning of I.R.C. § 174.

Payment terms:

Acceptance/Inspection:

Warranty:

Termination:

Rights:

Contract No. 6

Client:

Client 6

Deliverable:

- Technical and Consulting Services.
 - Work divided into 12 parts:
 - Perform site assessments, site visits and building inspections; prepare remediation work plans and specification for removal of
 - Prepare remedial actions plans and specifications
 - Assist staff with various regulatory agencies
 - Assist staff in implementing and monitoring Program
 - Assist staff in maintaining and upgrading its Management System ()
 - Perform quality investigations at or near the , etc.
 - Perform investigations at or near the to characterize the presence of resources
 - Perform environmental audits
 - Perform specialized environmental analysis, assessment, monitoring, modeling, risk analysis, and compliance tasks
 - Assist in tenant compliance on environmental issues
 - Provide technical assistance and construction oversight for Client 6 projects that have environmental ramifications.
 - Resolution No. :
 - Preparation for, and participation in, Client meetings
 - Provide overall strategic support services
 - Assist in the development of the program, processes, and tools for the complete and systematic evaluation of individual projects
 - Support Client 6 through the environmental review process
 - Conduct specific studies and provide technical support for specific projects
 - Assist in implementation
 - Provide general and technical environmental support
 - Public Outreach
- Contract funding levels for
- Total Contact is (Time and Materials with Cap).

Payment Terms:

- Annual budget for the Taxpayer is \$.
-

Acceptance/Inspection:

Warranty:

- None.

Termination:

-

Rights:

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Contract No. 7

Client: Client 7

Deliverable:

- Providing a Master Plan Update (Project).

- Forecasting of average, maximum month maximum day and maximum for the entire system for a year planning horizon, including customers.
- Analyze of
- Review of all pertinent legislative and regulatory requirements.
- -year plan
- Task :
 - Address requirements
 - Conduct investigation of
 - Explore
 - Profile historical usage by
 - Continue provision of services

Payment Terms:

- Payment may be in the form of:
 - Fee as a multiple of direct salary cost and fixed hourly rate
 - Lump sum fee
 - Reimbursable expenses
- Task is lump sum \$; total amount available increased to \$
 - Amendment
 - Amendments to Tasks : lump sum payment of \$

Acceptance/Inspection:

Warranty:

Termination:

Rights:

LAW AND ANALYSIS

Legal Standard

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).

Treasury Regulation Section 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. Since the period at issue is the tax year ending on December 31, 2004, Treasury Regulation Section 1.41-4A(d) is applicable. 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).

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. See 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 force⁷. 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 advanced payments, calculated as a percentage of the expenditures the taxpayer actually incurred. Id. The United States argued and the Court of Federal

⁷ 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.

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 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 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. 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 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.

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."

Analysis

i. Project No. 1

We conclude that project no. 1 is funded up to the extent the Taxpayer is not reimbursed for its expenses because payment is not contingent on the success of the research. The contract is a cost-plus fixed-fee contract, the Taxpayer will be reimbursed for costs up to the ceiling of \$. The Taxpayer contractual obligation is to perform satisfactorily, which is a promise to use a standard of care. This

does not imply a warranty or guarantee the success of a project. Even if the Taxpayer defaults on the contract, the Taxpayer will be reimbursed for the work performed.

Regarding rights, Client 1 does not retain exclusive rights to the research. Although Client 1 retains the rights to all reports, calculations, and materials, the agreement does not convey to Client 1 ownership of the underlying information or ideas. Accordingly, the Taxpayer has substantial rights to make use of the research in accordance with Lockheed.

ii. Project No. 2

Under Project No.2, payment to the Taxpayer is not contingent on the success of the research because Taxpayer will be reimbursed for work performed regardless of whether the research is successful. Project 2 is a fixed-fee contract, under which the Taxpayer will invoice Client 2 monthly. Upon completion of the contract, Client 2 will pay retained amounts if the work is acceptable. Thus, the Taxpayer could receive payment even though Client 2 ultimately deems the work unacceptable.

Because the Taxpayer must correct any deficiencies in its work without additional compensation pursuant to the warranty and the compensation is capped, the Taxpayer could be at risk for any amounts over the fixed fee or for expenditures incurred during the correction of deficiencies in its work.

The Taxpayer appears to retain sufficient rights to the research. Under the contract, the Client 2 retains the written documents and designs, but not exclusive rights to the research.

iii. Project No. 3

Here, payment to the Taxpayer is not contingent on the results of the research. Project No. 3 relates to a capped time-and-materials contract. The Taxpayer does not warrant its work and there is no acceptance or inspection requirements. If the Taxpayer incurs expense in excess of the cap, it will assume the risk for such amounts.

With respect rights, Client 3 does not retain exclusive rights, and therefore, the Taxpayer will retain a substantial right to the research for the purpose of § 41.

iv. Project No. 4

Under project no.4, payment to the Taxpayer is not contingent on the success of the research. This is a capped time-and-materials contract. The contract is essentially for services and not the results of the research; the Taxpayer offers only to perform to a standard of care and does not warrant its work. In addition, the contract does not include acceptance or inspection requirements. However, as the case with other capped time-and-materials contracts, the Taxpayer's expenditures in excess of the cap may be at risk.

With respect rights, Client 4 does not retain exclusive rights, and therefore, the Taxpayer will retain a substantial right to the research for the purpose of § 41.

v. Project No. 5

Here, all rights to “research” are retained by the Client 5. Accordingly, the contract is funded.

Regarding the burden of risk, it would appear that payment is contingent on the approval of services. If a work order is not completed and approved, Client 5 can withhold payment. If the Taxpayer defaults, the Taxpayer could be liable for additional costs incurred by the Client 5 for the completion of the contracted work. As noted, however, the contract is considered funded because the Taxpayer does not have a substantial right to the research.

vi. Project No. 6

Project No. 6, a capped time-and-materials contact, is funded because payment to the Taxpayer is not contingent on the results of the research. Although work must be deemed satisfactory prior to payment, the Taxpayer will be paid in the event of default under the termination/cancellation terms of the contract. Further, the Taxpayer does not offer a warranty for the work provided.

With respect to rights, the contract does not bestow all rights to the research to Client 6. Thus, the Taxpayer will retain a substantial right to the research.

If the Taxpayer incurs costs over the capped amount, such expenditures may be included in the credit calculation, provided the other provisions of § 41 are satisfied.

vii. Project No. 7

Project No. 7 is a fixed fee contract, where payment is not contingent upon the success of the research. Even if the Taxpayer defaults, the Taxpayer will receive payment from Client 7. In addition, the Taxpayer only warrants ordinary care and skill. Although Client 7 may perform evaluations of the services provided, such evaluations will only be used for future solicitations. As the case with other capped or fixed fees, the Taxpayer may be at risk for amounts incurred over the cap.

With respect to rights, the contract does not bestow all rights to the research to Client 7. Thus, the Taxpayer will retain a substantial right to the research.

As stated above, this memorandum only addresses the issue of funded research under section 41. The Compliance Team must still review the Taxpayer’s activities to determine whether they constitute qualified research under section 41(d)(1).

This writing may contain privileged information. 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 memorandum was reviewed by _____ (CC:PSI:B5).

Please call (617) 565-7861 if you have any further questions.

Associate Area Counsel (z)
(Large Business & International)

By: _____
Paul V. Colleran
Attorney (Boston, Group 2)
(Large Business & International)

cc: