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INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR ASSOCIATE AREA COUNSEL --

FROM: ASSOCIATE CHIEF COUNSEL (PASSTHROUGHS AND SPECIAL INDUSTRIES) CC:PSI

SUBJECT: RESEARCH CREDIT

This Chief Counsel Advice responds to your memorandum dated January 5, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

Taxpayer:

Directive:
Supplement:
Year 1:
Year 2:
Year 3:
Year 4:
Year 5:
Date 1:
Date 2:
Date 3:
Date 4:
Date 5:

Date 6: _____
Date 7: _____
a:
b:
c:
d:
e:
p: $
q: $
r: $
s: $
t: $
u: $
v: $
w: $
x: $
y: $
z: $

ISSUE

Whether research that Taxpayer performed on various research projects is "funded" under I.R.C. § 41(d)(4)(H) where Taxpayer is reimbursed by its customers for expenditures attributable to such research regardless of the outcome of the research.

CONCLUSION

Research that Taxpayer performed on various research projects is "funded" under section 41(d)(4)(H) because amounts payable to Taxpayer under the agreements governing cost recovery are not contingent upon the success of the research, and Taxpayer performed such research with the expectation that it would be reimbursed for all expenses paid or incurred regardless of the outcome of the research.

FACTS

Taxpayer was created in Year 1 to serve its a shareholders (Shareholders) by providing a common research and development center. For the years at issue in this Field Service Advice, Taxpayer was engaged principally in the rendition of technical services to support the activities of its Shareholders.

In Year 2, Taxpayer's board of directors recognized a business need to ensure that funding was available for the timely initiation of studies and developmental efforts (Research Projects). The Research Projects generally were restricted to developmental efforts that would benefit at least b Shareholders, and that would most likely lead to multi-client projects (Product Projects) in c years. Taxpayer's total cost for Research Projects was not to exceed p annually.

Taxpayer's Directive, effective as of Date 1 and reissued on Date 3, outlines how Research Projects are approved, how their cost is monitored, and how their billing is deferred until they generate Product Projects. Specifically, Directive provides that if a Research Project is approved by Taxpayer's president, its billing is deferred for c years. During that time, the Research Project is expected to generate one or more Product Projects. The Research Project's cost, together with a financing charge calculated at an annual rate of d, is recovered over a maximum period of b years, from the time the project is initiated, by a chargeback to the Product Projects. Although billing is deferred, the cost of Research Projects is reported as it is incurred, similar to any other external billable project. Research Projects are tracked internally on a monthly basis to ensure that their total annual cost does not exceed p, the approved level of expenditure for Research Projects in a fiscal year. Deferred billing is recorded on Taxpayer's balance sheet as a debit to long-term or short-term deferred charges, and on the income statement as a revenue adjustment.

With respect to cost recovery, Directive provides that when a Research Project generates a Product Project, the Research Project expires, and its total cost, including financing charges, is recovered through a chargeback to the generated Product Project. Accordingly, the Research Project is paid for by the Shareholders benefitting from the generated Product Project, the cost of which is also assumed by the Shareholders. Put differently, the cost of the generated Product Project includes its current year expenses plus a chargeback for all or a portion of the Research Project's cost and financing charge.

Typically, Taxpayer's work on a Research Project would lead to one or more fully-developed Product Projects that Taxpayer would offer to its Shareholders. Taxpayer also had the option, however, of offering a Research Project to a Shareholder before a Product Project was generated. In this case, Directive provides that the price paid by the Shareholder includes the Research Project's costs and any financing charges.

Occasionally, a Shareholder that did not fund the Research Project would elect at a later date to participate in the generated Product Project. In this case, the Shareholder would pay a fee that would result in credits to participating

Shareholders that had funded the Research Project. Finally, Directive provides that where a Research Project failed to recover its cost from chargebacks to generated Product Projects, that cost was billed equally to all a Shareholders.

At the end of Year 3, Taxpayer embarked on a new program of work efforts, recognizing a need for more advanced Research Projects that would encompass work of a much larger scale over a longer period of time. On Date 5, Taxpayer issued Supplement, which retroactively modified Directive with respect to all Research Project expenses incurred on or after Date 2. In relevant part, Supplement provides that Taxpayer's total annual cost for Research Projects would be increased from p but was not to exceed q in Year 3, r in Year 4, and s in Year 5. The financing charge, previously calculated at an annual rate of d, would be calculated using e, and allocated monthly to the unbilled cost.

Supplement describes an additional method for the recovery of Research Project cost. Shareholders were permitted to obtain components of Research Projects in the event the entire project did not meet their business needs. When this method was used, Shareholders were charged based on full cost including interest, estimates of the number of participants or buyers, and usage levels. This resulted in lower prices for Shareholders than for outside industry clients, and did not allow a Shareholder price to exceed full cost.

Supplement[1] also includes a discussion of " ," which is defined as unrecovered cost, or the total cost for all Research Project work efforts, including any unbilled cost carried over from previous years, less amounts billed to clients (revenue) in connection with Research Projects. Taxpayer's board of directors set limits for unrecovered cost of t at the end of Year 4 and u at the end of Year 5.

On Date 6, Taxpayer was sold to Purchaser. It is our understanding that Purchaser paid approximately v for Taxpayer, which is the w aggregate purchase price quoted by the sales and purchase agreement minus x in Research Project debt. Research Project debt is described as " " in the sale and purchase agreement. While neither Directive nor Supplement contains any explicit mention of this acquisition, Supplement does contain a provision stating that unrecovered Research Project cost shall be treated as corporate debt in the event Taxpayer changes ownership before Date 7. However, Supplement continues, if Taxpayer does not change ownership before Date 7, then unrecovered cost is trued-up and billed equally to the Shareholders. The only other mention of the treatment of such

[1] Directive contains no provision addressing " ." Directive does provide, however, that a Research Project's price will include the project's cost and any financing charges but will not include " ." The meaning of the term " " is not explained in either Directive or Supplement.

unrecovered Research Project cost is found in a synopsis of minutes from a meeting of Taxpayer's board of directors held on Date 4. The minutes state that in the event of a sale of Taxpayer, the board will determine the treatment of unrecovered balance and post-sale revenues associated with the Research Projects.

Taxpayer has filed a claim for refund on Form 1120X for the Year 3 taxable year. Taxpayer's total claim is for y, z of which is attributable to research credit.

LAW AND ANALYSIS

Section 41 allows taxpayers a credit against tax for increasing research activities. Generally, the credit is an incremental credit equal to the sum of 20 percent of the excess (if any) of the taxpayer's “qualified research expenses” for the taxable year over the base amount, and 20 percent of the taxpayer's basic research payments.

Section 41(b)(1) provides that the term “qualified research expenses” means the sum of the following amounts which are paid or incurred by the taxpayer during the taxable year in carrying on any trade or business of the taxpayer: (A) in-house research expenses, and (B) contract research expenses.

For purposes of the research credit in taxable years 1981 through December 31, 1985, the term "qualified research" had the same meaning as the term "research or experimental" had under section 174, except that the term did not include (1) qualified research conducted outside the United States, (2) qualified research in the social sciences or humanities, and (3) funded research. For taxable years beginning after December 31, 1985, section 41(d)(1) defines the term "qualified research" as research,

(1) with respect to which expenditures may be treated as expenses under section 174,

(2) which is undertaken for the purpose of discovering information which is technological in nature and the application of which is intended to be useful in developing a new or improved business component of the taxpayer, and

(3) substantially all of the activities of which constitute elements of a process of experimentation for a purpose described in section 41(d)(3).

Such term does not include any activity described in section 41(d)(4).

Section 41(d)(4) provides that the term "qualified research" shall not include several specifically listed activities, one of which is "funded research." The exclusion for "funded research" under section 41(d)(4)(H) provides that the credit shall not be available for qualified research to the extent funded by a contract, grant or otherwise by another person (or governmental entity).

Treas. Reg. § 1.41-5(d)(1) provides that research does not constitute qualified research to the extent it is funded by any grant, contract, or otherwise by another person (including any governmental entity). All agreements (not only research contracts) entered into between the taxpayer performing the research and other persons shall be considered in determining the extent to which the research is funded. 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 funding.

Treas. Reg. § 1.41-5(d)(2) provides, in relevant part, that if a taxpayer performing research for another person retains no substantial rights in research under the agreement providing for the research, the research is treated as fully funded for purposes of section 41(d)(4)(H), and no expenses paid or incurred by the taxpayer in performing the research are qualified research expenses. Treas. Reg. § 1.41-5(d)(2) further provides that if a taxpayer performing research for another person retains no substantial rights in the research and if the payments to the researcher are contingent upon the success of the research, neither the performer nor the person paying for the research is entitled to treat any portion of the expenditures as qualified research expenditures.

Treas. Reg. § 1.41-5(d)(3) provides, in relevant part, that if a taxpayer performing research for another person retains substantial rights in the research under the agreement providing for the research, the research is funded to the extent of the payments (and fair market value of any property) to which the taxpayer becomes entitled by performing the research. 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.

The issue in this request for Field Service Advice is whether expenses paid or incurred in the Year 3 taxable year for research performed by Taxpayer on the Research Projects are expenses for “funded research" under section 41(d)(4)(H). This issue was first considered by the Court of Federal Claims in Fairchild Industries, Inc. v. United States, 30 Fed. Cl. 839 (1994), and thereafter by the Court of Appeals for the Federal Circuit, which held adversely to the government. See 71 F.3d 868 (Fed. Cir. 1995). Finding that the trial court incorrectly construed the contract between Fairchild and the government, the appeals court determined that "[t]he inquiry turns on who bears the research costs upon failure, not on whether

the researcher is likely to succeed in performing the project." Fairchild Industries, 71 F.3d at 873. Applying that test, the court found that Fairchild's right to payment was "contingent on success" because "[t]he contract explicitly placed solely on Fairchild the risk of failure of every line item of the [contract]." Id. The court acknowledged that, as each line item was successfully completed and accepted, and the progress payments for that line item liquidated, Fairchild's total risk was reduced. The court concluded, however, that Fairchild's total risk was never eliminated to the extent it remained at risk until the research was successfully completed and the product of the research accepted.

The Fairchild reversal was significant in that the Federal Circuit made a compelling argument that the determination of who is at "economic risk" for unsuccessful research should be based upon the contractual events by which the parties choose to measure success or failure. As a result, the contract may encompass a "risk-sharing" arrangement whereby risk is allocated between the contractor and the customer (in this case, Taxpayer and the Shareholders, respectively). This allocation may shift during the course of the contract depending upon the level of progress and completion achieved. However, the allocation of risk is established by the terms of the contract and is present for the contract's duration regardless of whether the outcome is success or failure. See Fairchild, 71 F.3d at 872-73 (noting that it was incorrect for the trial court to change, upon successful completion of the contract, the allocation of risk that was established in the contract and was present throughout its performance).

The legislative history,[2] the statute, and the regulations all indicate that the meaning of the terms "funded" and "contingent upon success" is premised upon which party, the customer or the contractor, bears the economic risk of failure. In other words, the credit should go to the party who will be out-of-pocket in the event the research is unsuccessful. This is clearly consistent with Congress' intention to provide an incentive to researchers who would otherwise be dissuaded from undertaking costly research because of the possibility the research might result in failure.

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[2] The legislative history of the research credit provides little guidance on the meaning of the term "funded." In considering government contracting, the original Senate bill would have allowed a credit to the taxpayer who reimbursed a research contractor for wages it incurred in performing research services, although it would have disqualified research or experimentation expenses to the extent funded by any grant, contract or subcontract with any governmental entity. See S. Rep. No. 97-144, at 75 (1981); H.R. Rep. No. 97-201, at 116 n.8 (1981). Thus, Congress concluded, when research is performed for others, the research is funded, and the researcher is not entitled to the credit as long as the customer pays for the research.

The relevant regulations for the issue of whether research is funded are found at Treas. Reg. §§ 1.41-5 and 1.41-2 which provide mirror rules allocating the research credit to either the contractor when payment is contingent on success, or the customer when payment is made regardless of the success of the research. Thus, from the perspective of the contractor (in this case, Taxpayer), Treas. Reg. § 1.41-5(d)(1) provides that

> [a]ll agreements (not only research contracts) entered into between the taxpayer performing the research and other persons shall be considered in determining the extent to which the research is funded. 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 (see § 1.41-2(e)(2)) are not treated as funding.

(Emphasis added).

Concomitantly, from the perspective of the customer (in this case, the Shareholders), Treas. Reg. § 1.41-2(e)(2) provides that the customer may claim the research credit based on payments made to a contractor only if its payments are made "pursuant to an agreement that . . . requires the [customer] to bear the expense even if the research is not successful." However, if the customer pays the contractor "pursuant to an agreement under which payment is contingent on the success of the research . . . the expense is considered paid for the product or result rather than for the performance of the research." Treas. Reg. § 1.41-2(e)(2) (emphasis added).

The regulations quoted above clearly suggest that research performed in connection with a contract is not funded unless the customer agrees to reimburse the researcher for its expenses regardless of whether the research is successful. However, if payments are contingent on the success of the research, they do not constitute "funding." Thus, both sets of implementing regulations treat payments that are "contingent on success" as attributable to the commercial product or result of the research, rather than to the contractor's performance of research.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

In the present case, Taxpayer supported the activities of its Shareholders by providing technical services. Specifically, Taxpayer engaged in formative studies and developmental efforts (that is, Research Projects) for the benefit of its Shareholders. Directive and Supplement, both issued by Taxpayer's comptroller and applicable for expenses paid or incurred by Taxpayer for expenses relative to the Research Projects during the Year 3 taxable year, contain guidelines and

procedures ensuring that funding would be available for the timely initiation of Research Projects that would generate Product Projects. Both Directive and Supplement generally provide that Research Project costs, together with Product Project costs, are assumed by the Shareholders. The cost of the generated Product Project includes its current year expenses plus a chargeback for all or a portion of the Research Project's cost and financing charge, all of which are assumed by the Shareholders. Even where a Research Project fails to recover its cost from chargebacks to generated Product Projects, that cost was billed equally to all a Shareholders.

Notwithstanding the explicit provisions governing cost recovery in Directive and Supplement, Taxpayer has claimed that reimbursement by the Shareholders for Taxpayer's work on the Research Projects was not an enforceable right. Specifically, in a recent memorandum in response to IDR #50, Taxpayer states that Supplement showed that Directive, in which the Shareholders "agreed among themselves to share the formative costs, was subject to significant contingencies and was not in any way enforceable by [Taxpayer] against the [Shareholders]." We do not agree that Directive was, in any respect, an agreement only between the Shareholders. In fact, Directive and Supplement were directives issued by Taxpayer's board of directors delineating the terms under which funding for the Research Projects would be assured. Those directives explicitly state that Taxpayer would be reimbursed for Research Project costs.

[redacted]

[redacted]

As noted above, Fairchild stands for the proposition that the term “contingent on success” should be interpreted in terms of the explicit provisions of the contract wherein the parties prospectively allocate, at the time the contract is entered into, the economic or financial risk that the contracted-for research will not be successful. Applied to the facts of this case, we are required, therefore, to examine the explicit terms of Directive and Supplement in determining which party, Taxpayer or the Shareholders, will be out-of-pocket in the event the research is unsuccessful. Under these facts provided, it is clear that Taxpayer does not bear the economic risk of failure, thus the research is funded.[3]

In applying the “funded research" exclusion, a determination must also be made, in addition to the contingency determination, as to whether or not a taxpayer retains "substantial rights" in the research. Thus, if a taxpayer performing research for another person retains no substantial rights in research under the research agreement, the research is treated as fully funded, and no expenses paid or incurred by the taxpayer in performing the research are qualified research expenses. Conversely, if a taxpayer performing research for another person retains substantial rights in the research under the agreement providing for the research, the research is funded to the extent of the payments to which the taxpayer becomes entitled by performing the research.

[redacted]

[3] The crux of the government’s argument before the trial court in Fairchild was that Fairchild’s research costs were funded, and hence not eligible for the research credit, where payment is "expected and likely to be made in the normal course of events." Fairchild, 30 Fed. Cl. at 847. The trial court explicitly rejected the government’s “expected and likely” standard finding that there was no statutory or legislative support for such a test. It is interesting that this is essentially the argument being made by Taxpayer in this case to the extent we are being asked to look beyond the four corners of the contract and consider the likelihood of success based upon the course of dealing between the parties.

[redacted]

For purposes of responding to your request for Field Service Advice, you have asked us to focus upon the issue of whether Taxpayer's research is funded and to disregard the issue of whether the research activities of Taxpayer constitute qualified research. [redacted] Please contact the National Office if you require further guidance concerning these potential issues.

[redacted]

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

Please call if you have any further questions.

By: _____
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