The “Funded” Research Tax Credit Exclusion

By Kreig D. Mitchell

Kreig D. Mitchell examines the funded research limitation and addresses several of the major issues taxpayers and their advisors must consider when applying this exclusion.

There has been quite a bit of good news for the research tax credit. The credit was made permanent, modified so that smaller taxpayers can use the credit against their alternative minimum tax or payroll taxes, and the IRS has reduced its audit coverage for research tax credits. But all news is not good news. There have been several recent court cases that address a nuanced exclusion that can severely limit the credit for many taxpayers. The exclusion is for funded research. The exclusion applies when one party pays another to perform research. It is generally believed that the purpose of the exclusion is to prevent more than one taxpayer from taking the credit for the same research activity.

This is one of the few aspects of the research tax credit that the IRS continues to regularly challenge on audit. The existing law in the area is sparse and difficult to reconcile. It is even more difficult to apply and can require a significant effort to even try to comply with the rules. This puts taxpayers in a difficult position of having to take research tax credits with the realization that the IRS will adjust the credits if audited. This article examines the funded research limitation and addresses several of the major issues taxpayers and their advisors must consider when applying this exclusion.

The Funded Research Exclusion

The funded research exclusion is found in the Internal Revenue Code ("the Code"). It simply says that “[a]ny research to the extent funded by any grant, contract, or otherwise by another person (or governmental entity)” is not qualified. The implementing regulations create two tests for determining whether research is funded. One test requires the taxpayer to bear the financial risk for nonpayment if, hypothetically in the future, the research was to fail. The other test requires the researcher to retain substantial rights in the research. These tests are commonly referred to as the risk test and the rights test, respectively. This article addresses the
risk test, as the risk test is typically the more difficult to apply than the rights test when trying to calculate and defend research tax credits.

The Risk Test, Generally

The risk test is set out in two separate regulations. The first regulation applies to the researcher, not the client that pays the researcher. It says 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 agreements) 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 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.

The second regulation applies to the client who pays the researcher, saying that an expense is for qualified research “only to the extent that it is paid or incurred pursuant to an agreement that ... requires the taxpayer to bear the expense even if the research is not successful.” The regulation also says that:

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 paid for the product or result rather than the performance of the research, and the payment is not a contract research expense. The previous sentence applies only to that portion of a payment which is contingent on the success of the research.

The rules in these two regulations are commonly referred to as mirror image rules because, even though they use different language, they accomplish the same goal.

Given these rules, the researcher satisfies the risk test if payment is contingent on success of the research and the client satisfies this test if payment is not contingent. There have been several court cases involving credits taken by the party performing the research that expand on these concepts.

Fairchild Industries, Inc.

Fairchild Industries, Inc. is considered the seminal authority for this test. In Fairchild, the taxpayer entered into a fixed-price incentive contract to design and develop aircraft for the U.S. Air Force. The U.S. Court of Federal Claims concluded that the research was funded for the taxpayer. The court reached this conclusion by analyzing the terms included in the parties contract and considering the expectations generally, noting that it was likely that the taxpayer would be paid for the research. It also concluded that the taxpayer did not incur the research expenses itself as the taxpayer received periodic progress payments from the government for the work as the research progressed.

On appeal, the U.S. Court of Appeals for the Federal Circuit reversed the trial court’s decision, saying that payment did not need to be unexpected or surprising to qualify. The appeals court interpreted the regulations as allocating the tax credit to the party that bears the “financial risk of failure for the research.” To the appeals court, the risk that the researcher would not be paid was the risk to be considered. The appeals court found that the researcher bore this risk because the contract included detailed specifications, provided for inspection and acceptance terms, and did not require the other party to pay the taxpayer unless the taxpayer produced the results provided for in the contract.

The appeals court also concluded that periodic progress payments advanced to the researcher did not show that the research was funded for the researcher. The appeals court viewed the progress payments in terms of loans and partial payments. According to the appeals court, progress payments are loans (rather than partial payments) if there are contract terms that specify that the researcher may only retain the payments if the work is later inspected and rejected by the client. The appeals court concluded that the progress payments in Fairchild were loans rather than partial payments given the other terms in the contract.

It should be noted that the difficulties posed by the risk test relate to how to apply the appeals court’s decision in Fairchild and, given the principles set out in the decision, how to apply Fairchild to different fact patterns not specifically addressed in Fairchild.

Geosyntec Consultants, Inc.

The U.S. District Court for the Southern District of Florida considered the risk test in Geosyntec Consultants, Inc. In Geosyntec, the taxpayer was an engineering firm that included 370 of 4,500 projects it worked on during the tax years considered by the court. These projects were performed under fixed-price contracts, cost-plus contracts with payment subject to a maximum or capped amount (“cost-plus capped contracts”) and cost-reimbursement contracts.
The taxpayer conceded that the cost-reimbursement contracts were funded. Thus, the district court only reviewed the taxpayer’s fixed-price and cost-plus capped contracts. The parties agreed to limit the court’s review to six of these contracts. The district court reviewed three fixed-price contracts and three cost-plus capped contracts. The district court concluded that the three fixed-price contracts were not funded for the taxpayer, as the other party was only liable for payment when the work succeeded and the other party accepted the work. The district court also concluded that the cost-plus capped contracts were funded for the taxpayer. With these contracts, the district court noted that the other parties were required to reimburse the taxpayer based on hourly rates based on pre-defined budgets regardless of whether the research failed. It should be noted that the district court did not accept the taxpayer’s economic arguments. Instead, the district court performed a legal analysis of the contract terms and concluded that the taxpayer did not bear the financial risk of nonpayment for the research given the terms included in the contracts.

The taxpayer appealed the district court’s decision for two of the three cost-plus capped contracts to the U.S. Court of Appeals for the Eleventh Circuit. The appeals court agreed with the district court. It noted that the taxpayer was not subject to performance requirements for these contracts as the taxpayer was only obligated to perform using the standard of care applicable to professionals performing comparable services and there were no quality assurance procedures included in the contracts. The appeals court also upheld the trial court’s holding that the financial risk of nonpayment is a legal test based on a legal analysis of the contract terms, rather than an economic test.

### Dynetics, Inc. & Subsidiaries

The U.S. Court of Federal Claims, which had its opinion in *Fairchild* reversed on appeal, considered the risk test again in the context of a refund claim in *Dynetics, Inc.* In *Dynetics*, the taxpayer was a government contractor that took credit for work performed on more than 100 projects. The taxpayer performed the work under fixed-price, cost-plus and time-and-materials contracts. The contracts divided the work into different components, which were generally identified by contract-line-item numbers. The government conceded that the taxpayer bore the financial risk for the fixed-price contracts and contract-line-items where the taxpayer was to be paid a fixed-price. The government only contested the cost-reimbursement and time-and-materials contracts and the related contract-line-items.

The government and the taxpayer filed motions for partial summary judgment, asking the court to decide whether seven contracts were funded. The court provided a more thorough analysis of the specific contract terms than it had in its opinion in *Fairchild*. The analysis addressed several issues specific to the terms included in the taxpayer’s contracts. The court ruled in the government’s favor in part because the taxpayer did not meet the higher burden imposed on taxpayers for refund claims. Both the terms and the court’s analysis are addressed in greater detail below.

### Applying the Risk Test

The courts have made it clear the risk test is to be evaluated by analyzing the terms the parties included in their contract, the terms are to be viewed as of the time the contract is entered into and the test is applied on a separate contract item-by-item basis rather than on a contract-by-contract basis. This raises several questions, such as what financial risk of failure means, what contracts and contract terms can be considered and how ambiguous and conflicting terms are to be handled in determining whether research is funded given this test.

### What Is the Financial Risk of Failure?

On first glance, it would seem that payment terms alone would dictate which taxpayer bears the financial risk of failure for the research. This is supported by a general understanding of the financial risks inherent in the different types of contracts. The U.S. District Court for the Northern District of Alabama described the financial risks in fixed-price and cost-reimbursement contracts as follows:

In a fixed price contract, a buyer and seller agree on an end item or result that the seller will deliver for a set amount of money. The parties agree that compensation for the seller is determined by the agreed-upon price, and not by the cost of performance. In a fixed-price contract, delivery of anything less than the agreed upon item fails to satisfy the terms of the contract.

Cost-reimbursement contracts, on the other, compensate contractors based on the cost of performance. Under this class of contract, the buyer does not purchase an end result; rather, the [client] … and the [researcher] … agree that the [researcher] … will exert its best efforts to reach the end result.

Thus, with fixed-price contracts, the researcher would not be able to deliver the item or result if the research was
to fail and, as such, the researcher would not be entitled to payment. This would seem to place the financial risk on the researcher rather than the researcher’s client. With cost-reimbursement and time and materials contracts, the researcher would be paid regardless of whether the research failed. It would place the financial risk of failure on the client who pays for the research and not the researcher.

This view is also supported by a cursory review of the above-cited court cases. The fixed-price contracts in these cases were generally found to be qualified, and cost-reimbursement and time and materials contracts were not. But the cases were not decided based on the payment terms. The courts focused on other terms that are commonly found in in fixed-price, cost-reimbursement and time and materials contracts.

The funded research exclusion is difficult to apply and creates a significant compliance burden for taxpayers.

The appeals court in *Fairchild* focused on the inspection and payment terms in the contract. The inspection term in *Fairchild* allowed the client to reject any work it considered defective or otherwise not in conformity with the contract. The term also allowed the client to correct rejected work at the researchers’ expense or accept the work and reduce the amount to be paid to the researcher. The payment term provided that the client was only obligated to pay for the work delivered and accepted. Thus, according to *Fairchild*, the financial risk for the research is actually the financial risk of nonpayment if the research was to fail.

Although the appeals court in *Fairchild* discusses several factors, the court does not set out a bright line test. Some of the factors the court considered were whether the client (1) has to pay the researcher until after the work is accepted and not rejected, (2) can reduce the amount to be paid to the researcher after the work is performed and (3) can require the researcher to re-perform nonconforming work for no additional pay. The court did not provide any guidance for or indication as to how to go about weighing or evaluating these factors.

The recent court cases that apply *Fairchild* do clarify that financial risk does not include every risk that causes the researcher to receive less than the full amount it hoped to receive. For example, the trial and appeals courts in *Geosyntec* and the court in *Dynetics* concluded that lost profit is not the same as the financial risk for nonpayment described in *Fairchild*. This came up in *Geosyntec* with contract terms that capped the amount the taxpayer could be paid for its services. The taxpayer argued that it could incur cost in excess of the capped amounts. The trial and appeals courts in *Geosyntec* concluded that a risk that limits the profit the taxpayer might make is not the risk to be considered. The court in *Dynetics* reached a similar conclusion regarding a cost-plus-fixed-fee contract that provided that the researcher was at risk of losing its fixed-fee or profit portion of its pay for performing the research but would still be reimbursed for its costs to perform the research.

The appeals court in *Geosyntec* and the court in *Dynetics* also distinguished the financial risk of nonpayment in *Fairchild* from the risk of nonpayment arising after the researcher fails to perform. In *Geosyntec*, the appeals court noted that:

… [T]hese cost-of-performance arguments focus on the amount *Geosyntec* would be paid ..., which is of no matter here. Cost-of-performance is not the financial risk with which we are concerned because “the only issue is whether payment was contingent on the success of the research”—that is, the financial risk of failure.\(^{13}\)

The U.S. Tax Court reached a similar conclusion on the failure to perform in *Dynetics*. In *Dynetics*, the failure to perform was addressed in the context of a cost-reimbursement contract that included the Federal Acquisition Regulation (FAR) 52.246-8 inspection term. This inspection term requires the researcher re-perform or correct nonconforming work. If the researcher did not re-perform or correct the work timely, this term allowed the client to reduce the amount paid to the researcher. The court refused to apply this reduction in payment language as it was only triggered if the researcher first fails to replace or correct its nonconforming work. The court concluded that this prerequisite risk of nonperformance was not the same as the financial risk for the research failing as contemplated by the regulations, saying that “reperforming nonconforming services is not the type of risk contemplated under the Treasury regulation.”\(^{14}\) Thus, the financial risk for nonpayment for research can be determined by asking whether, based on the terms in the party’s contract, the researcher would be paid or the client would not have to pay the expense if the research failed due to a technical aspect of the research.

What Agreements Can Be Considered?

The regulations say that “all agreements, not just the research agreement, are to be considered” in determining whether research is funded.\(^{15}\) It seems like this broad
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language could encompass several documents that one might not normally consider to be part of the contract outside of the context of this specific test. Bid and proposal estimates that are not incorporated by reference in the contract are an example.

The court considered this in evaluating one of the contracts in *Dynetics*. The contract included a DD Form 254. The DD Form 254 is the Department of Defense Contract Security Classification Specification. It is a two-page form. The contract in question had four additional, individually-typed “continuation sheets” that included 29 enumerated paragraphs providing further information about security guidance and security requirements. The court concluded that the form was “clearly part of the ... contract.” The court distinguished these facts from those in *Lockheed Martin Corp.*, 16 in which the appeals court said that similar national security terms found in the applicable regulations could not be considered as they were not included in the contract.17 Thus, it appears that the agreement can include any attachments that are executed or exchanged at the time the agreement is entered into for purposes of applying the risk test.

It should be noted that the “all agreements” language is not all encompassing, however. For example, it does not appear that this language includes extrinsic evidence. Extrinsic evidence is evidence that relates to a contract that is not contained in the written contract itself. Verbal statements the parties made in negotiating the contract are an example. Courts apply the parol evidence rule to determine whether extrinsic evidence is admissible. The parol evidence rule generally says that extrinsic evidence cannot be considered where the parties reduce their agreement to a written contract, the contract is valid and the contract terms are not ambiguous. This rule prevents the parties to a contract from introducing extrinsic evidence to vary the terms of the written contract. The rule is also used in evaluating contracts to determine the parties’ rights and obligations under the contracts.

It would seem like the “all agreements” language in the regulations for the research tax credit would trump the parol evidence rule for the funded research limitation analysis. Extrinsic evidence and the parol evidence rule are not tax rules; they are general contract law interpretation rules. Moreover, they are not specific to the research tax credit.

The court addressed this in *Dynetics*. The taxpayer in *Dynetics* cited the “all agreements” language in the regulations to argue that its course of dealing, *i.e.*, extrinsic evidence, showed that the parties’ agreements included terms that differed from those included in its written contracts. The court did not accept the taxpayer’s argument that the “all agreements” language in the regulations required it to consider extrinsic evidence (or that there was even an ambiguity allowing consideration of extrinsic evidence). The court did not explain why it reached this conclusion. Instead, the court applied the parol evidence rule and refused to consider the taxpayer’s extrinsic evidence. If the court was correct, this would further support the position that only the research agreement and any accompanying written forms or attachments are part of the contract that can be considered for purposes of the risk test.

What Terms Can Be Considered?

The courts in *Fairchild*, *Lockheed* and *Dynetics* clarified that the contract terms the parties incorporate by reference into their contracts can be considered. For example, references to FAR clause numbers included in the parties’ contracts bring the specific language of the FAR clause into the contract.18 Presumably, this would also apply to other laws or standard terms that are specifically incorporated by reference into contracts.

**Incorporating Ancillary or Dependent Terms**

Standard terms that are part of a comprehensive set of rules generally have interdependent definitions and are intertwined with other terms in the same set of terms or body or laws or regulations. State laws that are compiled together in codes or other collections will usually also include interdependent definitions and terms.

The defined terms and the definitions included in the FARs provide an example. These defined terms and definitions are found in and referenced throughout other terms in the regulations. This raises the question as to whether these ancillary or dependent terms can be considered, even though they are not specifically cited in the contract.

The trial court in *Lockheed* concluded that ancillary or dependent terms are included when their counterpart terms are specifically incorporated into the contract. This came up in the context of the International Traffic in Arms Regulations in *Lockheed*. The terms in these regulations were not incorporated by reference into the taxpayer’s contract, but the contract included terms that would require application of the regulations. The trial court read these restrictions from the regulations into the taxpayer’s contracts. The appeals court reversed the trial court, saying that the trial court erred in reading these terms into the taxpayer’s contracts as the contracts themselves did not include the restrictions. Thus, *Lockheed* stands for the proposition that other terms not included in or incorporated by reference in the contracts cannot be used to add terms to the contracts.
This issue also came up in *Dynetics*. The government argued that the court should apply the Christian doctrine to read terms into the taxpayer’s contracts where the terms were required to be included by the FARs. The court did not address the government’s argument, as it ruled in the government’s favor on a different argument before reaching the issue. However, the court incorporated other terms that may not have been in the taxpayer’s contracts, such as the term “agreement” and “level-of-effort” as defined in the FARs. The trial court did not explain whether it was relying on the Christian doctrine to incorporate these definitions into the taxpayer’s contracts or how incorporating them is consistent with *Lockheed*. So it is not clear whether the courts would apply the Christian doctrine to add terms to contracts.

Because the IRS continues to audit this issue and it can result in significant reductions to tax credits, taxpayers and their advisors should develop a policy for and a process to comply with the funded research exclusion.

Even if the courts did, it is also not clear whether the Christian doctrine applies to contracts governed by other regulations or laws that are similar to the FARs. For example, implied warranties of fitness and merchantability required by operation of state law could shift which party bears the financial risk for nonpayment for the research. State law generally reads these terms into all contracts even if the contract disclaims these warranties. If these state laws did apply, it would seem that the client who pays for the research would bear the financial risk of nonpayment for the research in most cases.

**Relying on Nonresearch Tax Credit Laws**

The regulations for the research tax credit include several terms similar to those in other laws. This raises the question of whether laws that appear to be analogous but not provided in or incorporated by reference in the contract can be used to interpret the research tax credit rules.

The court addressed this question in *Lockheed*. *Lockheed* involved the other funded research rule, which asks whether the researcher retained substantial rights in the research. The trial court in *Lockheed* considered the phrase “substantial rights” found patent law and Code Sec. 1235 for the sale or exchange of patents in determining whether the researcher retained substantial rights in the research. The appeals court concluded that it was improper to use this law to interpret the research tax credit regulations, noting that:

The trial court relied in part on an analogy to patent cases. However, that analysis is unsound. The patent cases deal with the concept of “all substantial rights,” and whether any agreement transferring such rights amounts to an assignment, as opposed to a license. See, *e.g.*, *Vaupel Textilmaschinen KG v. Meccanica Euro Italia S.P.A.*, 944 F.2d 870 (Fed. Cir. 1991). We are not dealing here with a patent license, but with a tax statute, with different language and different concepts. The language of the statute and regulations do not require the retention of all substantial rights. The issue is only what “substantial rights” means for purposes of the “credit for increasing research activities” provision.

The appeals court reversed the trial court, in part, because the trial court used this non-research-tax-credit law, saying that law that is not included or incorporated in the parties contracts cannot be used to determine whether research is funded.

The court followed *Lockheed* in *Dynetics* in evaluating whether a warranty term in one of the taxpayer’s contracts satisfied the payment-contingent-on-success rule. The taxpayer in *Dynetics* argued that state warranty statute and the related case law supplemented a warranty term in its contract. The IRS National Office had issued guidance for a different taxpayer that supported this position. The court in *Dynetics* cited *Lockheed* for the rule that the funded research determination is to be made based on the contract between the parties without consideration of any external laws not incorporated in the contracts. Thus, based on *Dynetics* and *Lockheed*, it appears other sources of law cannot be used to interpret the research tax credit rules.

**How Are Ambiguities Dealt With?**

General contract interpretation principles say that the courts are only to look to the language of the contract when the terms are not ambiguous but allow the courts to apply various contract interpretation doctrines and rules to interpret ambiguous terms. This raises the question as to whether these contract interpretation doctrines and rules can be used in evaluating terms included in the contract for purposes of the risk test.
The court addressed this topic in *Dynetics*. The taxpayer in *Dynetics* argued that several of its contracts were ambiguous. The taxpayer noted that various required terms were missing from the contracts and one contract even included multiple conflicting inspection terms. The court concluded that these were not ambiguities that justified departing from the plain text of the contract terms, but even if they were, they were patent ambiguities. The patent ambiguity doctrine applies to government contracts. It allows the courts to read ambiguities that are obvious on the face of the contract in the government’s favor based on the idea that government contractors have a duty to inquire about obvious ambiguities in government contracts. When applied to a contract that includes multiple inspection terms, for example, one would think that the court would apply this doctrine to conclude that the inspection term that granted the government the most rights would be the one that the court enforced. This would seem to mean that the research was not funded for the researcher as the government would enforce the inspection term that gave the strongest inspection rights to the government. The court did not apply the patent ambiguity doctrine in this manner. Instead, the court applied the doctrine to the funded research determination, saying that the taxpayer could not benefit from ambiguities in determining whether its research was funded. It is not clear if the court was correct in applying the patent ambiguity doctrine in this manner.

The court also addressed other ambiguities in the *Dynetics* contracts. The court found two ambiguities in one of the taxpayer’s contracts. Both of these two ambiguities were in the rejection and warranty terms in the same contract.

One ambiguity related to whether the client could reject the taxpayer’s work and charge the taxpayer for the cost of securing replacement services. The rejection term allowed the client to do just that. The warranty term used similar language, but it only allowed the client to charge the taxpayer for the cost of securing replacement services after the taxpayer first refused to correct or re-perform the work. In comparing these two terms, the court determined that the conflict between the two created an ambiguity. Having found that there was an ambiguity, the court resolved the ambiguity by applying the *contra proferentem* doctrine. This doctrine says that ambiguities in a contract are construed against the drafter. The court then applied the doctrine to construe the contract terms against the client, finding that the client could only charge the taxpayer for the cost of securing replacement services after the taxpayer first refused to correct or re-perform the work. As explained above, the court had already concluded that this nonperformance risk is not the same as the risk for failure of the research required by the research tax credit regulations. As such, the court concluded that the research was funded for the taxpayer.

The second ambiguity related to the phrase “seller’s expense” found in the rejection and warranty terms. The rejection and warranty terms used similar language; however, the rejection term added language to limit the phrase “seller’s expense,” saying that the taxpayer would be paid its hourly rate but not the fee or profit it would otherwise earn. For this second ambiguity, instead of applying the *contra proferentem* doctrine, the court applied the consistency rule to resolve the ambiguity. This rule enables the courts to interpret contract terms so they have the same meaning. The court applied the consistency rule to read the extra language from the rejection term into the warranty term, concluding that the research was funded for the taxpayer.24

If the court is correct in finding that there were ambiguities and in applying these contract interpretation rules, this would mean that taxpayers would have to go much further to scrutinize their contract terms to determine whether research is funded. This would require more than a thorough reading and application of the contract terms. This would require a detailed in-depth analysis akin to a careful study of all the terms included in the contract, plus terms incorporated into contracts (as discussed above), to find and to resolve ambiguities. This would raise several questions as to what ambiguities are sufficient given the governing law (particularly for nongovernment contracts), what law is even the governing law (which can be a difficult determination by itself), and how the subjective contract interpretation rules are applied.

**How to Handle Conflicting Risk Terms?**

The courts have not squarely addressed contracts with terms that are not ambiguous where one term places the risk on the researcher and the other places the risk on the researcher’s client.

For example, this often comes up in cost-reimbursement contracts that include warranty terms. The warranty term may put the financial risk on the researcher and a cost reimbursement payment term may put the financial risk on the client. The two terms are not ambiguous as there is no conflict between the two terms. The terms simply address different features of parties’ agreement. But the financial risk inherent in these terms does conflict.

Contracts that include a limitation on costs terms can provide another common example. The limitation of cost term in FAR 52.232-20 in *Dynetics* is an example. This term says that the researcher is not required to perform or incur costs in excess of the amount of funds the client
set aside for the work if the client does not first increase the amount of funds for the work. The court noted that this would not require the taxpayer to produce unfunded work, which would seem to say that the researcher does not bear the financial risk of nonpayment. The facts in *Dynetics* did not provide for this, but this same contract could have included an inspection and acceptance term that required the researcher to refund monies it received for the work if the research failed. This type of inspection and acceptance term would seem to indicate that the researcher bore the financial risk of nonpayment. It is not clear how the courts would address this type of conflict. The court could not apply the contract interpretation rules discussed above, as the terms are not ambiguous. The financial risk is the only thing that is ambiguous.

Ultimately, this begs the question as to how much financial risk is sufficient to qualify for the credit? Can both parties have a sufficient quantum of financial risk so that they both qualify? Is an allocation of the financial risk needed, such as the researcher gets 50 percent of the credit and the client gets 50 percent of the credit? Is the fact that the other party bears some risk enough to disqualify the claimant from any credit?

This brings us back to the *Fairchild* case. The appeals court in *Fairchild* did not explain what amount of financial risk is necessary to qualify for the credit. The appeals court merely concluded that “Whatever risk Fairchild was bearing, the Air Force bore none of it … ” This could be interpreted to mean that the financial risk of nonpayment is an all or nothing test. It is equally plausible that the opposite is true—that some part of the financial risk of nonpayment can be borne by each party. This is not clear in *Fairchild* and it is not clear in the court cases that apply *Fairchild*.25

The court in *Dynetics* considered conflicting risk terms that may shed light on how the courts might address this issue. This came up in a contract that included the FAR 52.246-7 inspection term for fixed-price contracts. This term allows the client to reject the work or accept the work and reduce the fixed payment to be paid to the researcher. This term is like the FAR 52.246-8 inspection term for cost reimbursement contracts that was included in a different contract that the court considered.26 Given the court’s analysis of the FAR 52.246-8 term in the other contract, it would seem like the court would conclude that the taxpayer bore the financial risk for nonpayment for this contract given the similarity between FAR 52.246-8 and FAR 52.246-7. The court did not reach this conclusion. It focused on the level-of-effort term in the contract to conclude that the taxpayer did not bear the risk of nonpayment. The court did not explain how or why it concluded that the level-of-effort term trumped the FAR 52.246-7 inspection term. It is likely that the court construed the conflicting risk terms against the researcher the case involved a refund claim for which the taxpayer had a higher burden to show that it was entitled to the refund.

It is the author’s belief that the funded research rule is not an allocation rule. It is an exclusion. Therefore, it is not necessarily a bar to both parties taking credit for the same research. If the researcher and the payor have some quantum of financial risk given the terms of their agreement, they can both satisfy the exclusion rule and their credits are not limited due to financial risk. However, the second test, *i.e.*, the rights test, which is not addressed in this article, may then serve to limit the credit for the researcher.

**Conclusion**

- The funded research exclusion is difficult to apply and creates a significant compliance burden for taxpayers.
- Because the IRS continues to audit this issue and it can result in significant reductions to tax credits, taxpayers and their advisors should develop a policy for and a process to comply with the funded research exclusion.
- The regulations include two tests for determining whether research is funded. One test asks whether the taxpayer bears the financial risk for the research.
- The policy and process for complying with this test should address or be based on the following:
  - The risk test is a legal test, not an economic test.
  - The test is to be evaluated on a contract item-by-item basis.
  - The analysis is viewed as of the time the contract is entered into.
  - The contract that is evaluated should include forms and attachments.
  - The contract includes terms incorporated by reference, but not terms found in other laws that are not specifically incorporated by reference.
  - Non-R & D tax laws are generally not to be consulted in construing the R & D tax credit regulations.
  - Payment terms alone are not sufficient to determine which party bears the risk.
  - The risk to be considered is the risk of nonpayment if the research was to fail for a technical reason. The financial risk of nonperformance does not satisfy the test.
  - It is not clear whether risk is an all or nothing proposition.
  - Ambiguous contract terms must be identified and dealt with. When terms are ambiguous, contract
interpretation rules can be used to determine which party bears the risk. Ambiguous terms may be construed against the researcher when the government is paying for the research.

If the contract includes two or more terms that are not ambiguous but one puts the risk on the researcher and the other puts the risk on the payor, one might conclude that both parties satisfy the exclusion rule and can take credit for the research.

ENDNOTES

1 Kreig Mitchell (kreig.mitchell@empoweredtax.com) is the author of RESEARCH TAX CREDITS (ALI-ABA 2011) and has published a number of articles about the research tax credit. Kreig helps CPAs and other tax firms and their clients comply with the funded research tax credit rules. He has read thousands and thousands of contracts in light of these rules and manages to maintain a good sense of humor.

2 The IRS decommissioned its tiered ranking system in 2012. This system prioritized tax issues by designating them as a tiered issue and assigning them to a tier. The research tax credit was a tiered issue. Since the tiered system was decommissioned, the number of IRS audits of research tax credits decreased dramatically. The IRS has also shifted its focus and allocated its audit resources to international tax issues recently. This has also reduced the number of audits of research tax credits.

3 The rule is set out in Code Sec. 41(d)(4)(H).

4 Reg. §1.41-5(d)(1), incorporating Reg. §1.41-4A(d).

5 Reg. §1.41-2(e)(2).

6 Id.


9 See Darrell B. Chodorow & Shaun D. Ledgerwood, An Economic Evaluation of ‘Funding’ for Research Tax Credits, 144 TNT 13 (Sept. 29, 2014) which advocates for an economic approach.

10 Dynetics, Inc., FedCl, 2015-1 ustc ¶50,322, 121 FedCl 492.


12 The courts concluded that the fixed-price contracts in Fairchild and Geosyntec were not funded and that they cost reimbursement contracts in Geosyntec and Dynetics and time and materials contracts in Dynetics were funded.


14 Dynetics, Inc., FedCl, 2015-1 ustc ¶50,322, 121 FedCl 492, 529.

15 Dynetics, Inc., FedCl, 121 FedCl 492, 508 (2015) (citing Reg. §1.41-4A(d)(1)) which says that “All agreements (not only research agreements) entered into between the taxpayer performing the research and other persons shall be considered in determining the extent to which the research is funded.”


17 The Lockheed case is another funded research case. It addresses the substantial rights test, rather than the risk test. The IRS conceded the risk test in Lockheed when the court issued its opinion in Fairchild.

18 The FARs are a standardized set of contract terms that some government agencies include in their contracts. There are several other standardized contract term sets, such as those in the Defense Federal Acquisition Regulation Supplement and the Department of Energy Acquisition Regulators.

19 The substantial rights test is set out in Reg. §1.41-2(a)(3). This article does not address the substantial rights test.


21 See IRS National Service Advice 20350, 72002 WL 32168014 (Aug. 21, 2002).


23 Many contracts say that the cost to correct or re-perform “shall be at no cost to the Government,” rather than saying that it shall be at the “Seller’s expense.” See, e.g., FAR 52.246-20.

24 The appeals court in Geosyntec said that “The regulations allocate the research tax credit to the entity or person that bears the financial risk of failure of the research to produce the desired product or result.” (Emphasis added). This also seems to imply that the risk test is an all or nothing test.

25 The court concluded that FAR 52.246-8 shows that the researcher did not bear the financial risk of non-performance because the term only allows the client to inspect and accept the work and require the researcher to replace or correct work that does not meet the contract requirements, it does not actually allow the client to reject the work or allow the client to not pay the researcher for its costs to re-perform. FAR 52.246-7 is similar to FAR 52.246-8, but it allows the client to reject the work.

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