Research conducted under fixed-price contracts held not "funded," eligible for research credit

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In brief

The US District Court for the Southern District of Florida has ruled that research expenses incurred by a taxpayer under fixed-price contracts do not fall within the 'funded research' exclusion to the definition of 'qualified research' and therefore are eligible for the section 41 research credit (*Geosyntec Consultants, Inc. v. US*, No. 9:12-cv-80334, April 17, 2013).

The court also ruled that research expenses of the taxpayer incurred under so-called 'capped contracts' – also known as 'cost-plus subject to a maximum' contracts -- are covered by the funded-research exclusion and therefore are not eligible for the research credit.

This decision should be of interest to taxpayers that perform research activities for others under fixed-price and capped contracts.

Note: The district court did not address the important issue of whether a taxpayer that performs research under a capped contract could be eligible for research credits for 'qualified research expenses' (QREs) incurred in excess of the amount it is paid under the contract.

In detail

Background

Under Section 41, taxpayers generally may claim a 20% research credit for QREs in a tax year over a base amount determined by reference to earlier years. Eight categories of research are expressly excluded from the definition of qualified research" including research "to the extent funded by any grant, contract, or otherwise by another person (or governmental entity)."

Whether research is funded is addressed in the regulations under Section 41, which provide in part that "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." (Emphasis added.)

Another part of the Section 41 regulations provides that "an expense is paid or incurred for the performance of 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….If the agreement provides that payment is contingent on the success of the research, 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 leading case on the funded research exclusion is *Fairchild*

Industries v. US, 71 F.3d 868 (Fed. Cir. 1995). The district court in *Geosyntec* summarized the teachings of *Fairchild* as follows:

- The applicable regulations "implement allocation of the tax credit to the person that bears the financial risk of failure of the research to produce the desired product or result."
- The contractual arrangement is the factor that determines who is entitled to the tax credit.
- The payor may claim the credit only if the agreement requires the payor to pay for the research even if it is unsuccessful.
- For the researcher (i.e., the payee) to claim the credit, the amounts payable under the agreement must be "contingent on success."
- "The inquiry turns on who bears the research cost upon failure, not on whether the researcher is likely to succeed in performing the project."

Facts in Geosyntec

Geosyntec is a consulting and engineering firm that performed thousands of projects for its clients during the tax period in question. Geosyntec and the IRS agreed to have the court review six contracts to determine if Geosyntec's research should be considered funded. Three of these contracts are fixed-price, and three are capped.

Under Geosyntec's fixed-price contracts, it agrees to perform specified work for a fixed total price set forth in each contract. Under its capped contracts, it is paid for labor and other expenses, plus a mark-up, subject to an agreed-upon maximum price.

District court analysis

The court analyzed these six contracts under the standards set forth in *Fairchild*. ***Note:*** At the request of the parties, the court did not consider the issue of the retention of substantial rights to research, which the court deemed a 'significant' issue that could change the analysis of some contracts. The regulations provide that a taxpayer is not eligible for the credit if it performs research on behalf of another person and retains 'no substantial rights" in the research.

The court distilled the *Fairchild* analysis by explaining that "the most salient characteristics of the unfunded research contract are payment conditioned on client satisfaction and a dispute mechanism to resolve payment issues."

Regarding the three **fixed-price contracts**, the district court agreed with Geosyntec that these contracts are not funded, so they fall outside the "funded research" exclusion and remain eligible for the research credit.

The court noted that the nature of fixed-price contracts makes them inherently risky to contractors such as Geosyntec. After reviewing the key provisions of each of the three fixed-price contracts – including warranties and price dispute mechanisms -- the court concluded that under each contract, Geosyntec bore the risk of failed research.

Regarding the three **capped contracts**, the district court agreed with the IRS that these contracts are funded – and therefore are not eligible for the research credit – because the client under each contract, and not Geosyntec, "assumes the salient risk."

The court concluded that capped contracts are not different enough from uncapped cost-plus contracts -- which Geosyntec had conceded do not qualify for the research credit – to enter "the realm of unfunded research." However, the court did not address whether QREs in excess of a capped contract amount could enter that "realm" and therefore be eligible for the credit.

The takeaway

Under the district court's analysis in *Geosyntec,* when a taxpayer performs research for another party, whether the taxpayer bears the risk of failed research is the key to whether the taxpayer is eligible to claim the section 41 research credit. According to the court, taxpayers that perform research under capped cost-plus contracts do not bear such risk and therefore are ineligible to claim the credit, while taxpayers that perform research under fixed-price contracts bear the risk and therefore are eligible to claim the credit. The IRS may continue to pursue its position in other cases.

Note: The court, in focusing on the terms of the contracts, rejected the government position that the "regulations contemplate only excess research costs, *i.e.* costs above the funding received, as being unfunded." As noted above, the court did not address the possible credit eligibility of such "excess research costs" when the research is performed under a capped contract.

Taxpayers that perform research for other parties therefore should consider the potential research credit benefits when determining whether to perform research under a fixed-price contract or a capped cost-plus contract.

Let's talk

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