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DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR DISTRICT COUNSEL

FROM: Assistant Chief Counsel (Field Service)
CC:DOM:FS

SUBJECT: Research Credit

This Field Service Advice responds to your memorandum dated October 27, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

System	=
S	=
T	=
<u>a</u>	=
<u>b</u>	=
<u>c</u>	=
<u>m</u>	= \$
<u>n</u>	= \$
<u>o</u>	= \$
<u>p</u>	= \$
<u>q</u>	= \$
<u>r</u>	= \$
<u>s</u>	= \$
<u>t</u>	= \$
<u>u</u>	= \$
Year 1	=
Year 2	=
Year 3	=
Year 4	=

Year 5 =
 Year 6 =
 Year 9 =

ISSUE:

Whether research performed by T during Year 4, Year 5, and Year 6 was funded research under section 41(d)(4)(H).

CONCLUSION:

To the extent of the down payment, the payment to T is considered funded and is not eligible for the research tax credit. With respect to the milestone payments, the payments to T are considered funded, and not eligible for the research tax credit, to the extent T did not retain substantial rights to the research. There are insufficient facts to determine if T retained substantial rights to the research.

FACTS:

In Year 1, T began research to develop the System. In Year 2, T formed a wholly owned subsidiary, S, to own and operate the System. Immediately thereafter, T began soliciting investors in the project to shift the financial risk of the project and provide working capital. In Year 4, outside investors purchased shares of S stock such that T's ownership interest was reduced to a percent.

In Year 3, T entered into contracts to provide for the construction of of the System, including a contract with S (Contract).

. A separate agreement between T and S would provide for the operation and maintenance of the system upon completion of the Contract. Separate agreements were also entered into with other parties for the production of the other components of the System.

Payment

Under the Contract, T agreed to design, develop, produce, and deliver in accordance with the terms of the Contract the integrated system. In exchange, S was to pay T a down payment of \$m by Year 4, and separately fixed-price milestone payments upon T's completion of the milestone. S was obligated to

make the milestone payment to T only on completion of each milestone as set forth in the Contract. If T failed to complete a milestone by the scheduled completion date, then S was relieved of its obligation to pay until the milestone was completed. The cumulative total of the payments provided for under the Contract was \$n.

Termination of Contract

S could terminate the Contract if T did not complete the Contract within b months of the scheduled completion date, failed to complete a specified milestone, or failed to perform any of the Contract's material provisions. If S terminated the contract for any of these reasons, T was required to deliver hardware, some appropriate intellectual property licenses, and technical data for completed milestones. T would be paid for completed milestones and would be required to pay the excess costs of having the Contract completed by another contractor.

S could also terminate the Contract without cause. If the contract was terminated without cause, S was required to pay T for completed and partially completed milestones, the costs of stopping work, and a reasonable profit. In no event was T liable to S for an amount in excess of \$o.

T could terminate the Contract if S failed to make timely payments or failed to perform any obligation required under the Contract. If the contract was terminated for that reason, T was entitled to an immediate payment of \$o as partial compensation for lost profits. S was required to assign to T all licenses of S to use _____ in any country, return to T all documentation and technical data previously delivered to S, and pay T for all completed and partially completed milestones and the costs of stopping the work.

Intellectual Property Rights

Ownership and title to copyrights, and to computer programs and related documents, remained with T or its licensor. T granted S a paid up non-exclusive, non-transferable license to use solely for T's System the copies of computer programs and related documentation required for the operation of items deliverable under the Contract.

Unless the Contract was terminated without cause or by default of S, except for computer programs and related documentation discussed above, S had unlimited right to use, duplicate, and disclose the information contained in the functional specification that defines the interface and logical and physical protocols necessary for interoperability with the _____ system and the documentation which detailed the operation of the _____ system and actions required to retain its performance

characteristics at specific levels and which described the entire operations of the System. To the extent any of the written materials were copyrighted, S had an unlimited right to make copies of the copyrighted material and to use the copies for any of its purposes without payment of additional compensation to T to the extent T had the authority to grant such right. If T did not have such rights, it was obligated to attempt to obtain such rights. If the obtaining of such rights involved the payment of a fee, S was required to reimburse T for the fee.

Except for the items discussed above, S did not acquire any rights, title or interest in the intellectual property associated with the design of the System, except as negotiated in a license agreement.

Title

Title to each individual _____, the _____ facility, and the _____ was to pass to S. Except for the _____ facility, title to the components of the _____ remained with T. While title to the functional specification that defines the interface, logical and physical protocols necessary for interoperability with the _____ system remained with T, either T or S could release the document to third parties.

Disclosure and Use of Information

All information considered as proprietary information was required to be identified in writing. For c years after receiving proprietary information, S could use the information only to monitor the progress of the performance of the Contract and T could use the information only in the performance of the work specified in the Contract. Both T and S were required to take reasonable efforts to preserve in confidence proprietary information and prevent disclosure to third parties.

The contract was successfully completed by T during Year 9 and the system is operational. T incurred research expenses and claimed credits for research activities for the following years at issue in the following amounts:

	<u>Year 4</u>	<u>Year 5</u>	<u>Year 6</u>
Research expenses	<u>\$p</u>	<u>\$q</u>	<u>\$r</u>
Research credit	<u>\$s</u>	<u>\$t</u>	<u>\$u</u>

LAW AND ANALYSIS

A taxpayer is allowed a credit against tax for qualified research expenses paid or incurred in a trade or business. I.R.C. § 41(a). The amount of the credit is equal to

20 percent of the excess 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. I.R.C. § 41(a). Qualified research expenses include amounts which are paid or incurred by the taxpayer during the taxable year in carrying on any trade or business of the taxpayer for in-house research and contract research expenses. I.R.C. § 41(b)(1).

Qualified research is research:

- with respect to which expenditures may be treated as expenses under section 174;
- 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 the development of a new or improved business component of the taxpayer, and
- substantially all of the activities of which constitute elements of a process of experimentation for research that relates to a new or improved function, performance, or reliability or quality and does not relate to style, taste, cosmetic, or seasonal design factors.

I.R.C. §§ 41(d)(1), (d)(3).

Several activities are specifically excluded from the definition of qualified research, including research to the extent funded by grant, contract, or otherwise by another person. I.R.C. § 41(d)(4)(H); Treas. Reg. § 1.41-5(d)(I).¹

Contingent on Success

Amounts payable under any agreement that are contingent on the success of the research, and thus are considered to be paid for the product or result of the research, are not treated as funding. Treas. Reg. § 1.41-5(d)(1). The inquiry turns on who bears the research costs upon failure; whether the researcher is likely to succeed in performing the project is not relevant. Fairchild Indus., Incorp. v. United

¹ We recognize that Treas. Reg. § 1.41-5 states that it only applies to pre-1986 tax years. However, because section 41 has been reenacted without any change to the funded exclusion to qualified research, we believe that the funded exclusion should have the same interpretation for post-1985 tax years. See Lockheed Martin Corp. v. United States, 42 Fed. Cl. 485, 495-96 (1998).

States, 71 F.3d 868, 872-73 (Fed. Cir. 1995), rev'g 30 Fed. Cl. 839 (1994). Because the contractual relationship controls who bears the financial risk of failed research, the contract also determines who is entitled to the credit. Treas. Reg. § 1.41-5(d)(1); see also Treas. Reg. § 1.41-2(e)(2). The customer may claim the credit only if the agreement requires the customer to pay for the research even if the research is unsuccessful. If, however, the customer need not pay unless the research is successful, the customer has paid for the product or result rather than the performance of the research and cannot claim the tax credit because the customer has assumed no risk. Fairchild Indus., Incorp., 71 F.3d at 870; Treas. Reg. § 1.41-5(d)(1).

Under the Contract, T agreed to design, develop, produce, and deliver in accordance with the terms of the Contract the integrated _____ system. S was obligated to pay T a down payment of \$m by Year 4. The down payment was not contingent on the success of the research. Accordingly, to the extent of the down payment, the payment is considered funded and is not eligible for the research tax credit.

S was also obligated to pay separately fixed-price milestone payments upon T's completion of the milestone as set forth in the Contract. If T failed to complete a milestone by the scheduled completion date, then S was relieved of its obligation to pay until the milestone was completed. The contract specifically allowed S to decline payment to T if the research was not successful. Thus, whatever the risk T was bearing, S bore none of it because S was liable for payment only when the work, line item by item, succeeded and was accepted. Accordingly, to the extent of the milestone payments, the payments are contingent on success under Treas. Reg. § 1.41-5(d)(1).

To determine if the milestone payments are considered funded and not eligible for the research tax credit, a determination must be made as to whether T has substantial rights in the research. Treas. Reg. §§ 1.41-5(d)(2), (3).

Substantial Rights

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 and no expenses paid or incurred by the taxpayer in performing the research are qualified research expenses. Treas. Reg. § 1.41-5(d)(2). 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. Treas. Reg. § 1.41-5(d)(3)(i). The substantial rights requirement is

not mentioned in section 41, but appears in the regulations. Nevertheless, the incorporation of a substantial rights inquiry in Treas. Reg. § 1.41-5(d) is a reasonable construction of the funded exclusion set forth in section 41(d)(4)(H). Lockheed Martin Corp. v. United States, 42 Fed. Cl. 485, 495 (1998).

"Substantial" means more than minimal rights to the research. Lockheed Martin Corp., 42 Fed. Ct. at 496. To determine whether the taxpayer retained substantial rights in the research it performed, the nature and degree of the rights deemed substantial must be determined. Lockheed Martin Corp., 42 Fed. Cl. at 496; Treas. Reg. § 1.41-5(d). If the taxpayer performs research under an agreement that confers on another person the exclusive right to exploit the results of the research, the taxpayer is not performing qualified research because the research is treated as fully funded. Treas. Reg. § 1.41-5(d)(2). Similarly, if the taxpayer must pay for the right to use the results of the research, the taxpayer does not retain substantial rights. Treas. Reg. § 1.41-5(d)(3)(i). Incidental benefits to the taxpayer from performance of the research do not constitute substantial rights in the research. Treas. Reg. § 1.41-5(d)(2).

Looking to the body of law for determining whether a transfer of rights in a patent is a sale or exchange upon which capital gain or loss should be recognized, the court in Lockheed Martin Corp. found that the right to prevent unauthorized use or disclosure and the discretion to terminate the transfer of property were substantial rights. Lockheed Martin Corp., 42 Fed. Ct. at 497-98. However, whether a retained right is substantial depends on the circumstances and the commercial or practical value of the retained right. Lockheed Martin Corp., 42 Fed. Ct. at 498.

Thus, to determine if the milestone payments are considered funded and not eligible for the research tax credit, a determination must be made as to whether T has substantial rights in the research. Treas. Reg. §§ 1.41-5(d)(2), (3).

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

Contingent on Success

The incoming memorandum suggests that, to the extent T is in default and required to pay the excess costs of having the Contract completed by another contractor, the research would not be considered funded. We do not agree with this conclusion. To the extent T is required to pay such amounts, the issue of whether T is entitled to the research credit can no longer be framed in terms of whether the research is "funded" research. If such a breach were to occur, T would not longer be performing research. Rather it would be potentially financially responsible for the performance of research by another party. Whether T would be entitled to the

credit for such research would depend on the terms of the contract with such party and whether payment to such third party was contingent on its success. As no such contract came into existence, no determination needs to be made with respect to such a potential outcome. Furthermore, the fact that T might be required to pay for research performed by another contractor does not alter the relationship between T and S; T would be paid only for completed milestones. Accordingly, to the extent of the milestone payments (without reduction for the costs associated with a potential breach), the payments are contingent on success.

Substantial Rights

T retained ownership and title to copyrights and in computer programs and related documents. Except for the system control segment facility, title to the components of the space control segment remained with T. Except for the items discussed below and the system control segment, T retained rights, title and interest in intellectual property or other intellectual property associated with the design of the System. It is unclear from the information provided whether T was entitled to exploit the research embodied in such items or had other rights sufficient to establish it had a substantial right in the research. [REDACTED]

Except for computer programs and related documentation discussed above, S had an unlimited right to use, duplicate, and disclose the information contained in the functional specification that defines the interface and logical and physical protocols necessary for interoperability with the space system and the documentation which detailed the operation of the space system and actions required to retain its performance characteristics at specific levels and which described the entire operations of the System. To the extent any of the written materials were copyrighted, S had an unlimited right to use the copies for any of its purposes without payment of additional compensation to T to the extent T had the authority to grant such right. With respect to this information, from the facts provided, S retained rights to such research. It is unclear, however, whether such rights were substantial. [REDACTED]

S received title to each individual space vehicle, the system control segment facility, and the space operation plan.

With respect to the functional specification that defines the interface, logical and physical protocols necessary for interoperability with the space system which remained with T, either T or S could release the document to third parties.

With respect to information identified as proprietary information, for c years after receiving proprietary information, S could use the information only to monitor the progress of the performance of the Contract and T could use the information only in the performance of the work specified in the Contract. Both T and S were required to take reasonable efforts to preserve in confidence proprietary information and prevent disclosure to third parties. It is unclear from the information provided what the value of such proprietary information was to T and whether there were any limitations on T's benefitting from the information. Specifically, it is unclear whether, while not disclosing the information, T could use the information for its own benefit for a purpose other than the System. To the extent T could establish it had the right to exploit the information (i.e., the research results), T could establish it had a substantial right and such research would not be considered funded.

In determining whether T had substantial rights to the research results, the Contract contains little determinative information.

Please call if you have any further questions.

By:

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