

CLIENT ALERT

Contractor vs. Client: Research Tax Credit Update

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The Tax Court recently held that an S corporation, Enercon, could not claim research tax credits that it passed through to its owners because the research qualifying for the credits was completed under a contract with another company and Enercon did not retain substantial rights to the research. *Tangel v. Comm’r of Internal Revenue*, T.C.M. (RIA) 2021-001.

Enercon was hired to develop and design a new enclosure for turbine power generation, retrofit three existing turbine generator units, and design one new turbine generator unit. Enercon claimed the research credit related to its work and passed it through to its shareholders. The IRS denied the credits and asserted that the research Enercon performed in executing the project was 100 percent funded by Enercon’s client under Section 41(d)(4)(H). The Tax Court opinion focused on whether the research was in fact “funded research” under Section 41, which ultimately depended on the interpretation of the agreement between Enercon and the client.

General Rule of Section 41

In general, when a contractor performs research to fulfill a contract with its client, both the contractor and the client may seek to claim the research credit. To prevent both parties from claiming the credit, Section 41 provides that qualified research does not include “funded research.” “Funded research” is “[a]ny research to the extent funded by any grant, contract, or otherwise by another person (or governmental entity).” Section 41(d)(4)(H).

The related Treasury Regulations provide several factors to determine if research is funded research. Specifically the Regulations provide that funded research does not include research for which payment is contingent on the success of the research. Therefore, if payment is contingent, the contractor, not the client, is eligible for the credit. In addition, the court noted, a party is only entitled to the credit if it retains substantial rights in the research. This was the crux of the issue for Enercon. The Regulations specify that 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 in the future. Notably, incidental benefits arising from the research (such as increased experience) are not considered substantial rights in the research.

Terms of the Contract

The Tax Court then focused on the terms of the agreement between Enercon and the client, citing *Lockheed Martin Corp. v. United States*, 210 F.3d 1366 (Fed. Cir. 2000) in which the court held that the parties’ agreement controlled in determining whether the taxpayer performing the research retained “substantial rights.” The contract in question here severely limited Enercon’s ability to use any “information” except in the performance of work for the client. “Information” under the contract included anything Enercon designed at the client’s expense and anything Enercon designed to meet the client’s technical requirements. The Tax Court also looked to the terms of the copyright provisions in the contract, in which the client was deemed to be author of any related works.

Enercon argued that the language of the contract was boilerplate, part of a standard non-disclosure agreement. The Tax Court rejected this argument due to the specificity of the contract text. Enercon also argued that Enercon gained institutional knowledge from the research. The Court rejected this argument as well, equating institutional knowledge to an incidental benefit. In fact, Enercon was required to seek the client’s authorization prior to utilizing the “information” for another client.

Takeaways

Taxpayers claiming the research credit should mindfully draft service or development contracts with an eye on which party will be claiming the research credit. Taxpayers should pay attention not only to how the research product is defined (*i.e.*, “information”) and the rights specifically conferred, but the copyright provisions as well. Following this IRS favorable ruling, we expect additional audit attention to be paid to research credits claimed by contractors.

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