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KPMG report: Contractor's "substantial rights" for research tax credit (U.S. Tax Court)

The U.S. Tax Court granted an order for summary judgment to an architectural design services firm on the issue of "funded" research under section 41(d)(1)(H).

The Tax Court's order was based on the analyses of rights and risks under several selected contracts —notably, the issue of whether the taxpayer had retained "substantial rights" under the contracts— and concluded that the activities performed under the contracts did not comprise funded research and, thus, that the related expenses should qualify for the research credit.

The case is: *Populous Holdings, Inc. v. Commissioner,* Docket No. 405-17 (December 6, 2019). Read the Tax Court's **order** [PDF 349 KB]

Overview

The taxpayer claimed research credits for 2010 and 2011 relating to over 100 contracts and subcontracts for which it was the payee and that were related to its architectural design services. In March 2019, the taxpayer and the IRS filed cross-motions for summary judgment on the issue as to whether the taxpayer was entitled to qualified research expenses under section 41, and specifically whether the research expenses were for "funded research" and thus excluded from the definition of qualified research under section 41(d)(4)(H).

The taxpayer and the IRS identified five representative contracts for review, and agreed that the Tax Court's decision with respect to the five contracts would resolve the issue.

U.S. Tax Court Judge Robert Goeke analyzed the contracts, noting that all five were fixed price; that the taxpayer was being paid for work product that included the need to perform research; and if its research failed, the taxpayer would have to incur added expenses without additional compensation. Judge Goeke further noted that all five contracts granted the taxpayer's clients the right to review and approve design documents and to dispute invoices—all of which supported conclusions that payment was contingent on success and that the taxpayer bore the financial risk if the research failed.

In Judge Goeke's opinion, his review of all relevant contract provisions—including the standards of care and termination provisions—supported the finding that the taxpayer bore the risk of the research's failure under each contract. In reaching this conclusion, *Fairchild Indus., Inc. v. United States,* 71 F.3d 868, 870 (Fed. Cir. 1995), and *Geosyntec Consultants, Inc. v. United States,* 76 F.3d 1330 (11th Cir. 2015), were cited.

Regarding substantial rights, the IRS contended that the taxpayer did not retain such rights to the research in three of the contracts, with the argument focusing on the ownership of the documents produced through the work under the contracts. Under all three of these contracts, the taxpayer's client owned various types of work product, such as all design documents, studies, and technical reports. Further, in two of the contracts, the clients gained sole rights to any architectural copyrights. However, noting that the right to use the research does not need to be exclusive to constitute a substantial right, Judge Goeke concluded that ownership of documents does not dictate the right to use research results, or mean that the taxpayer's clients had exclusive right to the taxpayer's research. The taxpayer had retained copies of the documents for its use, and there "were no provisions in these contracts that prohibited petitioner from using the research it performed or that required it to pay the client for use of the research**."** Citing the decision in *Lockheed Martin Corp. v. United States*, 210 F.3d 1366 (Fed. Cir. 2000), Judge Goeke noted that the "right to use the research without paying the client is a substantial retained right."

KPMG observation

What constitutes substantial rights is often an issue in IRS audits of research tax credit claims and the *Populous Holdings* case is viewed as a significant victory for taxpayers. Although the parties had been directed to file Tax Court Rule 155 computations by January 15, 2020, a January 16, 2020 **stipulated decision** [PDF 51 KB] in the case indicates that "there is no deficiency in income tax due from, nor overpayment due to, petitioner for the taxable year 2011."

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