UNITED STATES TAX COURT
WASHINGTON, DC 20217

MEYER, BORGMAN & JOHNSON, INC.,	)	
	)	
Petitioner(s),	)	
	)	
v.	)	Docket No. 7805-16.
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COMMISSIONER OF INTERNAL REVENUE,	)	
	)	
Respondent	)	
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O R D E R

This case arose from a dispute about the entitlement of a Minnesota consulting-engineering firm named Meyer, Borgman, & Johnson, Inc. (MBJ) to research credits under section 41[1] for its 2010, 2011, and 2013 tax years. Both parties selected a sample of 14 contracts to frame their dispute. The key question is whether these contracts are "funded" under section 41(d)(4)(H).

Background

MBJ is a Minnesota corporation that offers structural engineering services, typically as a consultant to architects retained by building owners for complex projects that require a high level of customized engineering and design. MBJ claims it incurred expenses while it did the research that it needed to do to perform under these contracts. It asserts that these expenses entitle it to tax credits under section 41. MBJ claimed these credits and carry-forwards for research activities for its 2010, 2011, and 2013 tax years:

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[1] All section references are to the Internal Revenue Code in effect for the years at issue, and all Rule references are to the Tax Court Rules of Practice and Procedure, unless we say otherwise.

Tax year	Research credit	Carry forward from prior year(s)	Total business credit	Allowable credit
2010	$17,010	$89,340	$106,350	$14,615
2011	106,561	91,735	91,735	157,760
2013	40,537	-0-	40,537	29,477

The Commissioner began an audit, and ultimately issued MBJ a notice of deficiency for the 2010, 2011, and 2013 tax years in which he determined to disallow all the credits. MBJ filed a timely petition with the Court.

The case moved into discovery, and the parties eventually agreed to exchange information regarding 14 specific projects taken on by MBJ. The Commissioner requested complete contract files for these projects. After MBJ and its clients produced a number of documents, MBJ represented that there are no additional contracts to provide. With all of the relevant facts in front of the Court, the parties filed cross-motions for partial summary judgment. Both expect that a ruling on these 14 contracts will enable them to resolve the rest of the case. The usual rules on summary judgments apply; we assume the parties know the detailed background of the case.

The Commissioner's motion frames the issue as whether MBJ's services on these projects are "funded" -- an important term under section 41(d)(4)(H) that is defined in the accompanying regulations. Research that is "funded" by a taxpayer's client is ineligible for the research credit. MBJ asserts that its work is not "funded".

Discussion

The Code provides taxpayers with a general business credit, which is the sum of the current year business credit and any carrybacks or carryforwards. Sec. 38(a). This general credit is itself the sum of about three dozen more specific credits, including the research credit under section 41(a). Sec. 38(b)(4). The

research credit entered the Code in the Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 221, 95 Stat. 172, 241. Research became a favored child in the Code's family of credits, as Congress regarded research as "the lifeblood of our economic progress and [] effective tax incentives for research and development must be a fundamental element of America's competitiveness strategy." H.R. Rep. No. 100-1104, pt. 2, at 88 (1988).

"Research" is not an unambiguous term. Eligibility for the credit depends on meeting the requirements of a series of Code sections and regulations. The credit is in general limited to "qualified research expenses." Sec. 41(a)(1). Qualified research is research expenditures for which may be treated as business expenses under section 174;

> that is undertaken for the purpose of discovering technological information that is useful in the development of new or improved business components; and
>
> that includes activities that constitute elements of an experimentation process.

Sec. 41(d)(1).

The Code also expressly excludes some activities from its definition of "qualified research." One of them is the item we focus on here -- there is no credit for funded research, which is "[a]ny research to the extent funded by any grant, contract, or otherwise by another person (or governmental entity)." Sec. 41(d)(4)(H); 26 C.F.R. § 1.41-4(c)(9).

The Code doesn't define "funded", but the regulations do. The key section in the regulations is section 1.41-4A(d). Here it is:

> *(d) Research funded by any grant, contract or otherwise* -
> *(1) In general.* 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 contracts) 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 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 . . . .*"

Sec. 1.41-4A(d), Income Tax Regs. (emphasis added).

Notice two things -- one that is not subtle, and one that is. The not-subtle part of this regulation is that it defines as unfunded research "amounts payable . . . that are contingent on the success of the research . . . ." *Id.* Think about, as a current example, a contract that pays $1 billion for a drug company upon delivery of 300 millions doses of a successful antivirus vaccine. "No vaccine, no money" is a paradigm of contingent payment.

The subtle thing in the regulation is the phrase "and thus considered to be paid for the product or result of the research . . . ." *Id.* This is a key phrase -- the first sentence of the regulation, which speaks of "research to the extent it is funded by any grant, contract, or otherwise by another person" is potentially a wildly expansive definition. *Id.* Imagine a drug company that sells t-shirts in a gift shop to visitors who've taken a plant tour. Revenue from those sales benefit the company's bottom line and the company might plow the money back into R&D. But it would be absurd to undermine the research credit's availabilty by reading the regulation this way. Our signal not to do so is the distinction made in that last phrase of the regulation's last sentence -- "and thus considered to be paid for the product or result of the research." *Id.*

This tells us MBJ might have a point. Its contracts don't have clauses that plainly make them contingent on the success of any research. But this last phrase makes it possible to argue that a contract for a "product or result of research" isn't a *funded* contract. Contracts for the sale of t-shirts with a corporate logo may fund research, but they are neither contingent on the success of that research nor payable for a product or result of the research that would otherwise produce creditable research expenses.

How does one recognize a contract for the sale of a "product or result or research?" MBJ first argues that one should look to see what its clients are buying. If there's no way *they* could claim the credit, then the credit should go to MBJ. This would have us read the regulation as one whose purpose is to allocate the credit between two taxpayers. There's something to this: There is part of the regulation that governs a client's eligibility to claim the credit. *See* 26 C.F.R. § 1.41-2(e)(2). A court will sometimes refer to that regulation and the one we're construing here as "mirror image rules." *Fairchild Indus. v. United States*, 71 F.3d 868, 870 (Fed. Cir. 1995). MBJ notes that none of its clients have ever tried to claim a research credit for these projects.

But we don't think that is true in all cases -- athough the regulations often work together to allocate the research credit, they do not actually mirror each other exactly. There are some scenarios, for example, where some qualified research is not creditable by either the client or the researcher. *See, e.g.*, § 1.41-4A(d)(2), Income Tax Regs. ("If a taxpayer performing research for another person retains no substantial rights in the research and if the payments to the researcher are contingent upon the success of the research, neither the performer nor the person paying for the research is entitled to treat any portion of the expenditures as qualified research expenditure").

We think that the "mirror image" metaphor distorts the meaning of the regulation. The proper focus, as the skimpy case law reminds us, to on "who will bear the risk of financial loss" of unsuccessful research. *Id.* at 874. And to figure that out, we look to the specific terms of the contracts before us. *See Geosyntec Consultants, Inc. v. United States*, 776 F.3d 1330, 1336 (11th Cir. 2015); *Fairchild*, 71 F.3d at 870; 26 C.F.R. § 1.41-4A(d)(1).

The Commissioner looks at the contracts and sees no provisions in any of them that make payment contingent on the success of research.[2] He says this means that MBJ's performance on all 14 of the projects at issue should be considered funded and therefore not eligible for the research credit.

MBJ recognizes this, but argues that for all 14 projects it was being paid for its results -- results that depended on research. If that research weren't successful, MBJ argues, then it wouldn't have been able to complete its work successfully. MBJ relies heavily on the argument that it entered into fixed-price or lump-sum agreements with its clients, which are inherently risky for the party conducting the

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[2] The Commissioner also sees no contracts at all for 3 of the projects. He argues in the alternative that for these projects, MBJ should lose because it's failed to produce written agreements between itself and its clients. MBJ argues that under state law an unsigned proposal combined with actual performance can form a contract. We don't need think this dispute affects our analysis. The unsigned documents that we have set out terms that are similar to the signed agreements for the other 11 projects. If MBJ's performance on these 3 projects into binding contracts we can just analyze the terms in the proposals as we do the terms in the contracts for the other 11 projects.

research. This shows, according to MBJ, that it bore the financial risk and was being paid for a specific result, not just its time.

To resolve this dispute, we look first at the Federal Circuit's opinion in *Fairchild Indus. v. United States*, 71 F.3d 858 (Fed. Cir. 1995), one of two key appellate cases on this topic. There, the Federal Circuit stated that the "inquiry turns on who bears the research costs upon failure, not on whether the researcher is likely to succeed in performing the project." *Id.* at 873. We look to see who bears the financial risk of the research's failure. "When payment is contingent on performance, such as the successful research and development of a new product or process, the researcher bears the risk of failure." *Id.*

When reviewing contracts with this in mind, courts have considered things like payment clauses and procedures, the methods for evaluating and accepting the work, quality and performance standards, warranty clauses, default provisions, and termination provisions. *See Fairchild*, 71 F.3d at 872-74; *Geosyntec Consultants*, 776 F.3d at 1339-43; *Dynetics, Inc. v. United States*, 121 Fed. Cl. 492, 504-16 (2015). The contracts and its terms are looked at holistically. *See Fairchild*, 71 F.3d at 870 ("[T]he contractual arrangement is the factor that determines who is entitled to the tax benefit . . . .").

Here we come to a key distinction. The cases do direct us to look for who bears the financial risk under a contract. But there are many kinds of financial risk, and at least two are in play here. The first is the kind of risk Fairchild took on -- it would lose money if various milestones for the development of a prototype training plane weren't met, or if the government tested prototype parts and found them wanting. But there's another kind of financial risk -- the kind where the seller of services doesn't price those services correctly, perhaps by underestimating the amount of time a project will take or the mix of highly paid and less highly paid professionals needed to do it.

MBJ's argument on this motion relies heavily on the undisputed fact that the agreements between it and its clients are fixed-fee or capped-price contracts. MBJ is correct that each of these contracts laid out a set amount that MBJ would be due under the contract, or an amount that it could not bill beyond. MBJ argues that this made the contracts "inherently risky." The risk was present because, according to MBJ, if they could not perform efficiently under the contract they would be forced to take a loss. They use this as reasoning to show that MBJ bore the financial risk that the research could fail.

But *Geosyntec Consultants, Inc. v. United States*, 776 F.3d 1330 (11th Cir. 2015) the second key case in this area, warns us to distinguish risk from the failure of a research project from the risk of not correctly setting prices for one's services. The risk associated with a fixed-fee or capped-price contract is this more "general economic risk." *Id.* at 1339. "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." *Id.* (citing *Fairchild Industries*, 71 F.3d at 872).

MBJ thus also argues that its contracts show that its clients were paying fees for the result of its research or a final product. According to MBJ, its clients only cared "about receiving properly designed structures that met their requirements" and "that costs of these results did not exceed a certain amount (regardless as to the cost, or amount of work, required of MBJ to achieve said results)." This would mean that the amounts payable under the agreement would be contingent on the success of the research, and therefore not treated as funded under section 1.41-4A(d)(1), Income Tax Regs.

The problem for MBJ here is that none of the contracts we examined expressly or by clear implication make payment contingent on the success of MBJ's research. MBJ contends that under all of its contracts with the clients it "must meet all requirements, specifications and codes and will not get paid unless it does so," and that its clients "only care about receiving properly designed structures that meet their requirements and applicable codes and regulations." MBJ claims that "the contractual terms of the contracts" express as much. But MBJ fails to specifically point out or cite to any examples of these contractual terms. The court in *Fairchild* found that the taxpayer's research expenses were not funded because "[t]he contract explicitly placed solely on Fairchild the risk of failure of every line item . . . ." *Fairchild*, 71 F.3d at 873. The Court in *Geosyntec* found the research provided for under the contracts at issue to be funded because "neither [of the clients' contracts] expressly made payment to [the taxpayers] contingent on the success of [the taxpayer's] research." *Geosyntec Consultants*, 776 F.3d at 1340. The Court of Federal Claims in *Dynetics, Inc. v. United States*, 121 Fed. Cl. 492 (2015), also found research to be funded when none of the explicit language present in the *Fairchild* contracts was present in the taxpayer's agreements. *See id.* at 505. MBJ's contracts here lack any of these express terms that courts have identified in this caselaw as important.

Much as with the contracts in *Geosyntec*, the contracts here do "not require installation and integration of specific elements; each task was not subject to

complex contract specifications; and [the taxpayer's] work was not subject to inspection and acceptance." *Geosyntec Consultants, Inc. v. United States*, 776 F.3d 1330, 1340 (11th Cir. 2015). The Court in *Geosyntec* said it was not enough when "the design was left almost entirely to Geosyntec's professional expertise, informed by Geosyntec's own research and subject to general (and at times passive) requirements." *Geosyntec Consultants*, 776 F.3d at 1340.

According to MBJ, its situation is distinguishable from Geosyntec's because MBJ did have structural engineering deliverables under the contracts that included compliance with "local and federal building codes and client added requirements that must be integrated with the final results . . . ." But we see no reference to these different codes present in the contracts. And we will not read into the contract language that is not actually present. *See Key v. Allstate Ins. Co.*, 90 F.3d 1546, 1549 (11th Cir. 1996) ("[W]here the language is plain a court should not create confusion by adding hidden meanings, terms, conditions, or unexpressed intentions." (citations omitted)).

The performance requirements that are listed in MBJ's contracts are ones setting out that MBJ was responsible for the method and means used in performing under the contracts, and MBJ was to perform these services with ordinary professional skill and care. These types of contract provisions are "unavailing" when potentially used to show that MBJ bore any of the risk of failure because general standard of care provisions "do not mandate success." *Geosyntec Consultants*, 776 F.3d at 1341.

MBJ also argues that the lack of specificity in each of the contracts regarding the process for which MBJ was to complete its work is actually "a clear indication that MBJ was being paid for the result of its research, not the research itself." But MBJ is misinterpreting the relevant regulations and case law in attempting to make this point. Amounts payable under agreements are considered to be paid for the product or result of the research -- and not treated as funded -- only when they are contingent on the success of the research. *See* secs. 1.41-2(e)(2) and 4A(d)(1), Income Tax Regs. (For example, a promise to pay $1 billion for delivery of 300 million doses of a generic polio vaccine isn't dependent on research but on conformance to manufacturing standards. A generic drug maker takes financial risk in accepting a fixed price, but isn't taking on the risk of research failure.) Contract provisions like quality assurance procedures, specific barometers for success, and mechanisms for inspection, evaluation, and acceptance show that payments made under the contracts were contingent on the success of the research required under the contract. *See Fairchild*, 71 F.3d at 871-73; *Geosyntec*

Consultants, 776 F.3d at 1339-43; *Dynetics*, 121 Fed. Cl. at 505, 515-16. MBJ's contracts don't have such provisions.

After reviewing all of the contracts and their relevant provisions, we hold that there is no genuine dispute that the payments to MBJ was not contingent on the success of research, and whatever financial risk they imposed on MBJ was not the financial risk that its research would fail. These contracts were funded by MBJ's clients, and produce no section 41 credits.[3]

It is therefore

ORDERED that petitioner's motion for partial summary judgment is denied. It is also

ORDERED that respondent's motion for partial summary judgment is granted. It is also

ORDERED that on or before January 22, 2021 the parties submit decision documents or file a status report on their progress to settlement or trial.

(Signed) Mark V. Holmes
Judge

Dated: Washington, D.C.
November 19, 2020

[3] Since we hold that MBJ's research was "funded" because payments that it received were not contingent on the success of research, we do not need to analyze whether MBJ retained substantial rights in its research.