UNITED STATES TAX COURT
WASHINGTON, DC 20217

POPULOUS HOLDINGS, INC.,	)	
	)	
Petitioner(s),	)	
	)	
v.	)	Docket No. 405-17.
	)	
COMMISSIONER OF INTERNAL REVENUE,	)	
	)	
Respondent	)	

ORDER

On March 15, 2019, the parties filed cross-motions for summary judgment on the issue of whether petitioner is entitled to a credit for qualified research expenses under section 41 for 2011, specifically whether the research expenses were for "funded research" and thus excluded from the definition of qualified research under section 41(d)(4)(H).[1]

We will grant a motion for summary judgment where there is no genuine issue as to any material fact and a decision may be rendered as a matter of law. Rule 121(b); Sundstrand Corp. v. Commissioner, 98 T.C. 518, 520 (1992), aff'd, 17 F.3d 965 (9th Cir. 1994). The moving party bears the burden of proving that there is no genuine dispute of material fact, and the Court will draw any factual inferences in the light most favorable to the nonmoving party. Dahlstrom v. Commissioner, 85 T.C. 812, 821 (1985).

Petitioner provides architectural design services. It claimed research credits for 2010 and 2011 relating to over 100 contracts and subcontracts.[2] The parties

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[1]Unless otherwise stated all section references are to the Internal Revenue Code (Code) in effect at all relevant times, and all Rules references are to the Tax Court Rules of Practice and Procedure.

[2]For 2011 respondent determined that petitioner was not entitled to a research credit of $132,539 for 2011 or a general business credit carryforward from 2010 of $151,494.

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have identified 5 contracts (McEnery, Houston Dynamo, University of Arkansas (UA), University of South Florida (USF), and Pico Hall) for us to review and have agreed that our decision with respect to the 5 representative contracts will resolve the issue in accordance with the allocation set forth in their stipulation of settled issues.

Section 41 allows a credit for qualified research expenses. Qualified research expenses include both in-house expenses and contract research expenses. Sec. 41(b)(1). Contract research expenses are the amounts paid to a third party to perform research. To determine which party to a contract is entitled to the credit, the statute further provides that qualified research does not include "funded research", defined as "Any research to the extent funded by any grant, contract, or otherwise by another person (or governmental entity)". No credit is allowable to the contractor for funded research. Sec. 41(d)(4)(H).

I. Contingent on Success

Contract research is considered funded research unless two conditions are met: (1) payment is contingent on the success of the research and (2) the contractor retains substantial rights in the research. Sec. 1.41-4A(d), Income Tax Regs. Contractors are not entitled to the credit if they fail either condition. Respondent contends that payments under all 5 contracts were not contingent on the success of the research. He further argues that if we hold the contingency requirement is satisfied, petitioner did not retain substantial rights to the research in 3 of the 5 contracts.

Section 1.41-2(e)(2)(iii), Income Tax Regs., which defines contract research expenses, states that payment is contingent on the success of the research when the payment is for the product or result of the research. Regulatory sections 1.41-2(e)(2)(iii) and 1.41-4A(d) are referred to as "mirror image rules" to ensure that the contractor and client do not both claim a research credit. Fairchild Indus., Inc. v. United States, 71 F.3d 868, 870 (Fed. Cir. 1995).

Our inquiry turns on who bears the cost of the research if it is unsuccessful. Id. at 873. One such instance is when the research fails to produce the desired product or result. Id. However, we consider the financial risk of the research's failure and not the project's failure.

We must examine the specific terms of the contract to determine which party bears the financial risk of the research's failure. Geosyntec Consultants, Inc. v.

United States, 76 F.3d at 1339; Fairchild Indus., 71 F.3d at 870. Courts have considered payment procedures, quality and performance standards, termination clauses, and warranty and default provisions. Geosyntec Consultants, 776 F.3d 1330; Fairchild Indus., 71 F.3d 868. While the contract in Fairchild Indus. made the client's obligation to pay conditional on its acceptance of a final product, a conditional obligation to pay is not required for research to be considered unfunded under the fixed price contracts.

In general, fixed priced contracts have been considered unfunded research, qualifying the contractor for the credit. See Geosyntec Consultants, Inc. v. United States, 76 F.3d 1330 (11th Cir. 2015); Fairchild Indus., 71 F.3d 868. Fixed price contracts are inherently risky for the contractor if the research is unsuccessful. Under fixed price contracts, the contractor must remedy failed research at its own expense. Fixed price contracts "generally place maximum economic risk on contractors who ultimately bear responsibility for all costs and resulting profit or loss." Geosyntec Consultants, Inc. v. United States, 2013 WL 5328479 (S.D. Ohio 2013).

The 5 representative contracts are fixed price, and 3 contracts (McEnery, Houston Dynamo, and UA) also provide for a capped reimbursement of certain expenses. Petitioner submitted monthly invoices for progress payments. None of the contracts expressly requires research; thus, none of the contracts expressly states that petitioner is being paid for research. Petitioner is paid for a work product at a fixed price. The work product included the need to perform research. If its research failed, petitioner would be required to incur additional expenses without additional compensation. Petitioner bore the financial risk of research failed. The capped expense reimbursement does not relate to research expenses and does not change our holding with respect to the McEnery, Houston Dynamo, and UA contracts.

We also note that all 5 contracts granted the clients the right to review and approve design documents and to dispute invoices, which further supports our holding that payment was contingent. Additionally, the Houston Dynamo and Pico Hall contracts expressly required petitioner to revise documents under certain circumstances at its own expense. The USF contract required payment "upon approval of each phase and/or deliverable of work for services performed". The McEnery contract contains a provision defining when petitioner was entitled to additional compensation that comports with our holding that petitioner bore the financial risk of failed research. Likewise, the UA contract provided for review and revisions but did not expressly state the revisions were at petitioner's expense.

It was a fixed price contract with reimbursements limited to travel expenses and in-house printing. It included a list of additional services available at an hourly rate. We have reviewed all relevant contract provisions, including the standards of care and termination provisions, and determined that petitioner bore the risk of the research's failure under each contract.

Accordingly, we hold that payments were contingent on the research's success in all 5 contracts and petitioner's research satisfied the contingency requirement.

II. Substantial Rights Retained

Respondent contends that petitioner did not retain substantial rights to the research in 3 contracts (McEnery, Pico Hill, and Houston Dynamo).

To qualify for the credit, petitioner must retain substantial rights in the research. Sec. 1.41-4A(d)(2), Income Tax Regs. The right to use the research without paying the client is a substantial retained right. Lockheed Martin Corp. v. United States, 210 F.3d 1366, 1374-1375 (Fed. Cir. 2000). The right to use the research does not need to be exclusive. Id. at 1375; see sec. 1.41-. 2(e)(3), Income Tax Regs. However, incidental benefits such as increased knowledge or experience do not constitute a substantial right in the research. Id. subsec. 4A(d)(2).

Respondent's argument focuses on the ownership of the documents produced by petitioner. However, ownership of documents does not dictate the right to use technology-related research results or mean that the clients had exclusive right to petitioner's research. Petitioner retained copies of the documents for its use. There is no provision in the contracts that prohibits petitioner from using the related researched technology in its business.

Under the McEnery contract, the documents owned by the client included all design documents, construction documents, and other documents prepared in connection such "studies, manuals, as-built drawings, technical and other reports and the like." Respondent also cites to the client's sole rights to architectural copyrights. Similarly, under the Pico Hall contract, the client owned the architectural copyrights and construction documents, models, renderings, and other work product. Respondent further notes that the contract also prohibited petitioner from using or recreating any distinctive original, material exterior features without the client's consent, i.e., using the copyright. Under the Houston Dynamo contract, the client owned the project-related documents. Respondent notes that petitioner retained the right only to design details that are "repetitive in nature, not project specific * * * and were preexisting and not developed for or identifiable with" the Houston Dynamo contract. 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.

We hold that petitioner retained substantial rights to use or exploit the results of its research under the McEnery, Pico Hall, and Houston Dynamo contracts. Thus, the research is unfunded, and petitioner is entitled to the section 41 credit. The amount of the deficiency determined in the notice of deficiency differs from the amounts set forth in the stipulation of settled issues, therefore the parties will be ordered to submit a Rule 155 computation.

Accordingly, it is

ORDERED that respondent's motion for summary judgment is denied. It is further

ORDERED that petitioner's motion for summary judgment is granted. It is further

ORDERED that the parties are directed on or before January 15, 2020, to submit to the Court a Rule 155 computation.

(Signed) Joseph Robert Goeke
Judge

Dated: Washington, D.C.
December 6, 2019