

## Tax Court Alert - Contractor *Did Not Retain Substantial Rights in Research*

On January 11, 2021 the United States tax court granted summary judgment in favor of the IRS in the case of *Tangel v. Commissioner* (T.C. Memo. 2021-1). The Tax Court sustained the IRS's disallowance of certain Section 41 research credits claimed by the Taxpayer while developing technology as a contractor for a power company. The Court confirmed the Taxpayer did not retain substantial rights in the developed technology and as a result the work performed was fully funded and subsequently ineligible for claim towards research tax credits.

### Background

The Taxpayer, Enercon Engineering Inc. (Enercon) was contracted by Vericor Power Systems LLC (Vericor) to develop a new enclosure for turbine power generation. Enercon is an S-Corporation that designs and produces integrated controls and switchgear for custom applications in the power generation industry. During the 2008 through 2010 tax years, Enercon claimed \$929,688 of RTC on the basis that "qualified research expenses" were incurred in connection with 142 different projects.



...the research conducted was funded research and therefore could not be included as part of the research tax credit.

"Qualified Research" is defined to exclude "...any research to the extent funded by any grant, contract or otherwise by another person (or governmental entity)." Section 41(d)(4)(H). Additionally, Section 41 includes regulations that expand on this concept of funding by defining two conditions of research performed under contract that is also considered "unfunded":

- 1) The amounts payable under the agreement are contingent on the success of the research and thus considered to be paid for the product or result; and
- 2) The taxpayer performing the research for another person retains substantial rights in the research results.

### Findings

The Court highlighted language found in the terms and conditions entered between Enercon and Vericor prior to beginning development work on the new enclosure. Specifically, the terms state that Enercon may not use or assist others in using, for the purpose of developing or selling articles or similar items, "any technical information" that Enercon has designed at Vericor's expense or meet Vericor's technical requirements. The restriction of Enercon's rights to the technical information obtained during development was limited to not only "technical information" but also included "tooling" that Enercon developed in execution of the contract.

It is possible that some of the research conducted by Enercon might be used in developing products other than the Articles or similar items as outlined. However, the second half of this agreement includes verbiage that further restricts Enercon whereby Enercon “shall not use...such information except in the performance of Orders for Buyers and upon Buyer’s request, such information and all copies thereof shall be returned to Buyer.” This prevents Enercon - without explicit written approval by Vericor - from using any of the results of the research for any purpose outside of the project outlined in the contract.

The Court ultimately determined that the presence of this language dictates that Enercon may not use “any technical information” or “tooling” developed for Vericor for anything other than the project they worked on and that any technical drawings or other copyrightable materials developed by Enercon belong to Vericor.

The Court agreed with the IRS’ disallowance because it was hard to see what rights - much less what ‘substantial rights’ - Enercon could be viewed as retaining in the research it performed. As a result of not maintaining any rights to the research performed, the Court stated that the research conducted by Enercon was funded research and therefore could not be included as part of the research tax credit.

## Conclusion

This case is a great reminder of the importance that your provider is performing a full evaluation of all contractual agreements that directly relate to the research the Taxpayer’s company is claiming towards the research and development tax credit. It is important to identify situations where the work being claimed towards the tax credit may be at risk of falling within the funded exclusion as emphasized by the Court in this most recent ruling. A thorough review of your contractual agreements can involve an extensive legal analysis, so having an expert who is well-versed with these exclusions is critical to make certain Taxpayers claim allowable expenses.

## DST Advantage

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DST can help with this analysis. Our legal experts will review all relevant contractual agreements to ensure that the Taxpayer can claim the expenses related to the development work they are performing. Coupled with our engineering experts, our team can confirm the retention of substantial rights through an evaluation of the necessary facts of the activities and work performed.

## QUICK LINKS

[www.dstadvisorygroup.com](http://www.dstadvisorygroup.com)

<http://casetext.com/case/tangel-v-commr>

For more information, please call **877-214-8920**

[www.dstadvisorygroup.com](http://www.dstadvisorygroup.com)