

Use the Right Words and Claim Research Credits

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Issue: In *Meyer, Borgman, and Johnson, Inc. v. Commissioner*,^[1] the issue was whether the taxpayer's ("MBJ" or "MBJ's") customers funded MBJ's research activities. The court found that its customers did so, with the consequence that MBJ could not claim federal income tax credits for expenses it incurred to conduct research activities. MBJ lost its case because its contracts with its customers did not expressly state that the customers would not pay MBJ if MBJ's research activities were unsuccessful.

Qualified Research Activities: A taxpayer is entitled to federal income tax credits for expenses incurred to perform qualified research activities. Qualified research activities generally require performance of an experimental process intended to eliminate technological uncertainty to develop or improve a product or process.^[2]

Funded Research: A taxpayer whose activities satisfy the definition of qualified research is not entitled to tax credits for its research expenses if the taxpayer's customer "funds" the research.^[3] But if the contract price is payable under an agreement that is contingent on the success of the research, it is considered to be paid for the product or result of the research, and the taxpayer's research is not treated as funded by its customer.^[4]

Facts: MBJ is a structural engineering firm. It 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.^[5] Structural engineers design buildings so the buildings are strong enough to support the loads on them and stable against elements like wind.^[6] MBJ created construction documents showing the structural design that it developed for its customers' building projects. MBJ then delivered the documents to its customers for their use in the construction of the buildings.^[7]

MBJ's contracts were fixed price or lump sum contracts, meaning that if MBJ needed to conduct additional research because its designs failed modeling, simulation, or other testing it conducted, MBJ bore the cost of additional design research. MBJ's contracts did not, however, specifically state that their customers' payments were contingent on the success of MBJ's research. MBJ argued that it sold the product of the research or result of the research to its customers so that the customers were not funding MBJ's research.

Discussion

Tax Court Decision: Rejecting MBJ's argument that it sold a product or the result of the research, the Tax Court said, "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." The court thus relied on the absence of a contract provision expressly imposing the financial risk on MBJ for the cost of any research activities that were unsuccessful, with the consequence that the customers contracts funded MBJ's research. The court disallowed the research credits.[8]

MBJ argued that the contingent on success requirement is found in the contract provision making MBJ "responsible for the method and means used in performing under the contracts, and ... to perform these services with ordinary professional skill and care." The court rejected the argument "because general standard of care provisions "do not mandate success."

MBJ's contracts presumably spelled out specifications that the structuring components of a building were required to satisfy, and MBJ's modeling, simulation, and other experimental methods presumably determined that its design met those specifications. Nevertheless, according to the Tax Court, the customers paid MBJ because MBJ showed them that it performed the research consistent with general standards of ordinary care and not because its research was successful.

The court's analysis assumed a meaningful difference between a contract provision making payment contingent on success of research activities and a contract provision making payment contingent on performance satisfying professional standards. For structural design contracts, there should be no difference. MBJ's customers undoubtedly wanted structures that were strong enough to support the loads on them and stable against elements like wind. One could reasonably doubt that its customers would have agreed to pay MBJ for structural designs even if MBJ's modeling, simulation, and other experimental tests proved that the designs were not strong enough. No customer would risk building a structure based on MBJ's unsuccessful research.

The Eighth Circuit: The Federal Court of Appeals for the Eighth Circuit reviewed MBJ's contracts de novo and found, as did the Tax Court, that the contract payments due MBJ were not contingent on the success of MBJ's research. Like the Tax Court, the Eighth Circuit stated that "none of the contracts expressly or by clear implication make payment contingent on the success of MBJ's research." The reasoning was that requirements to comply with pertinent codes and regulations or to perform pursuant to a general standard of care did not mandate that MBJ's research be successful. But again, no customer reasonably would have paid for MBJ's designs if the research that MBJ conducted to formulate the designs failed to satisfy design specifications.

Prior Tax Court Decision: The Tax Court decision adverse to MBJ was surprising because it appears inconsistent with the court's earlier decision in *Populous Holdings, Inc. v. Commissioner*.^[9] In that case, the taxpayer provided architectural services. Like MBJ, the IRS denied research credits on the theory that the taxpayer's customers funded the research. The court decided in favor of the taxpayer:

"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 *Populous Holding* decision certainly is sensible and appears irreconcilable with *MBJ*.

Practice Pointer: Unless adding a contract provision making payment contingent on the success of the research actually increases risk to the party conducting the research, the researcher should consider including a provision stating that (i) payment of the contract price is expressly contingent on the success of the research, and (ii) the contract is for a product or result of an any research that is conducted. The provision might avoid a dispute with the IRS about whether the taxpayer's customers funded the taxpayer's research.

Footnotes

[1] No.23-1523 (8th Cir. May 6, 2024), 2024 WL 1980299, *aff'g* No. 7805-16 (U.S. Tax Ct. Nov.19, 2020).

[2] IRC §41(a), -(d).

[3] IRC §41(d)(1)(H)

[4] Treas. Reg. §1.41-4A(d)(1).

[5] Meyer, Borgman, and Johnson, Inc., Docket No. 47 (U.S. Tax Ct. Nov. 19, 2020).

[6] The Institution of Structural Engineers <https://www.istructe.org/become-a-structural-engineer>.

[7] Meyer, Borgman, and Johnson, Inc., 2024 WL 1980299, at *1.

[8] The court relied on *Fairchild Industries, Inc. v. United States*, 71 F.3d, 868 (Fed. Cir. 1996), which held that the Air Force did not fund the taxpayer's research because the contract explicitly stated that the Air Force would pay the taxpayer only if its research was successful. The contract in *Fairchild* was a defense contract between an aircraft manufacturer – Fairchild – and the United States Air Force, which was “obligated to pay for the research only if Fairchild produced results that met the contract specifications, in accordance with certain provisions of the Defense Acquisition Regulations.” The MBJ court assumed that the obverse was true: If the contract does not explicitly state that payment of the contract price is contingent on the success of the taxpayer's research activities, then the contract is funded.

[9] No. 405-17 (U.S. Tax Ct. Dec. 6, 2019).

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