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The Tax Court Recently Decides Two Research Credit Cases

One Favorable on Funding (Smith) and One Unfavorable on the Four-Part Test (Phoenix Design Group)

January 9, 2025

Taxpayers had mixed success in two recent research credit cases in the United States Tax Court.

In *Smith v. Commissioner*,[1] the taxpayer was an architectural firm. The Tax Court denied the Commissioner's motion for summary judgment, allowing the case to proceed to trial on the issue of whether the taxpayer's clients funded its research activities.

In *Phoenix Design Group, Inc. v. Commissioner*,[2] disputed questions of fact proceeded to trial. Based on its findings, the court concluded that the taxpayer, a firm employing professional engineers, had not engaged in qualified research, and was not entitled to research credits.

Smith: The Architectural Case: In *Smith,* the IRS continued to apply the "funding exception" to disallow federal income tax credits for a taxpayer's qualified research activities. The "funding exception excludes from credit-eligible qualified research "any research to the extent funded by … contract…by another person…."[3]

Research is funded if the client's payment to the taxpayer is not contingent on the success of the taxpayer's research activities.[4] Research is also funded if the taxpayer does not retain substantial rights in the research.[5]

The taxpayer was a member in a limited liability partnership that sold its "innovative architectural design services" worldwide to its clients.[6] The taxpayer asserted that it conducted credit-eligible research to formulate architectural designs as required by contract with its clients. The IRS denied the credits on the theory that the clients funded the taxpayer's research activities.

Relying on selective provisions in contracts between the taxpayer and its clients, the IRS moved for summary judgment on the theory that the taxpayer was contractually required to perform its architectural services in accordance with professional standards, which alone did not put the taxpayer at risk if its research to effectuate the designs failed. The court ruled, however, that the contracts tended to provide that the clients were obligated to pay the taxpayer only if the taxpayer satisfied design milestones, which raised an issue about whether payment to the taxpayer was contingent on success of the research.

The court also ruled that local law provisions appeared to vest copyright protection for the designs in the taxpayer, which tended to rebut the IRS argument that the taxpayer did not retain substantial rights in the research, and thus preserved for trial the issue of retention of substantial rights in its research.[7]

Phoenix Design: The Engineering Case: In *Phoenix Design*, the IRS successfully argued that the taxpayer, a firm employing professional engineers, failed to prove that it engaged in qualified research to design mechanical (air handling), electrical, plumbing, and fire protection systems ("MEPF Systems") for laboratory and hospital building projects.

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Research is qualified if it passes a "four-part test."[8] At issue in *Phoenix Design* are only Test One – the Section 174 Test – and Test Four – the Process of Experimentation Test. The Section 174 Test requires a taxpayer to (i) identify uncertainty in the development or improvement of a product, process, technique, or formula and (ii) show that this uncertainty exists because the information objectively available does not establish the capability or method to develop or improve the product, process, technique, or formula or its appropriate design. The Process of Experimentation Test requires a taxpayer to use a process that is capable of evaluating one or more alternatives, for example, modeling, simulation, or a systematic trial and error methodology.

In *Phoenix Design*, the taxpayer argued that its professional engineers met the Section 174 Test by eliminating uncertainty in the design of the MEPF Systems. The taxpayer explained that, at the outset of the projects, it was uncertain about the specifications and designs that would achieve the air handling and other attributes of the systems, and that it intended to eliminate the uncertainty by performing sophisticated and iterative engineering calculations.

The court rejected the argument. The Section 174 Test requires investigatory activity, that is, the attempted acquisition of information. The court cited e-mails and meetings as examples of processes of acquiring information, but only if there is uncertainty about developing or improving the product. However, "basic calculations on available data is [sic] not an investigative activity because the taxpayer already has all the information necessary to address that unknown." Moreover, the taxpayer "failed to identify the specific information that was not available to PDG [the taxpayer's] engineers at the start of the project."

For the Process of Experimentation Test, the taxpayer argued that it performed iterative calculations to determine the appropriate designs of the MEPF Systems, but the court rejected the argument because "performing calculations and communicating the results to the architect is not an evaluative process that mirrors the scientific method."[9]

Comment: An architectural or engineering service is not intrinsically precluded from qualifying for research credits. The service may constitute a "business component," which includes a process, technique, or formula. [10] The business component need not be a tangible product to quality for tax credits.

Care should be taken to ensure that the agreement between a service provider and its client does not inadvertently use terminology that, from the IRS perspective, mistakenly appears to disqualify the research – as could have occurred in *Smith*. Also, activities intended to eliminate technological uncertainty through a rigorous engineering process should be carefully documented when they occur or soon thereafter to avoid the documentation deficiency that occurred in *Phoenix Design*. And note that a showing of the brilliance of a scientist or engineer will not qualify the research for tax credits. The taxpayer must still work through the statutory provisions and clearly show the IRS and court how the activities satisfy these provisions.

Please contact the authors of this alert or your Miller Canfield attorney if you would like to discuss the issues described here.

[1] No. 13382-17 (U.S. Tax Ct. Dec. 18, 2024).

[2] T.C. Memo. 2024-113 (Dec. 23, 2024).

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[3] I.R.C. §41(d)(4)(H).

[4] The rationale is that the taxpayer is not the researcher because the taxpayer is not at economic risk for the success of the research.

[5] The rationale is dubious. See "Tax Court Denies Research Credits for Research Activities," https://www.millercanfield.com/resources-Tax-Court-Tangel-Commissioner.html (Feb. 9, 2021).

[6] The architectural services at issue were for six projects located in Dubai, UAE, and Saudi Arabia.

[7] Retention of "other intellectual property rights" was an additional basis to deny the IRS's motion for the Kingdom Tower, one of the architectural projects.

[8] (i) The expenditures may be deductible under I.R.C. §174. The deduction is available if the taxpayer's activities are of an investigative nature that are intended to discover information that would eliminate uncertainty in development or improvement of a product, process, technique, or formula. The Tax Cuts and Jobs Act, Pub. L. 115-97, now requires that the expenditures be specified research and experimental expenditures, which are amortizable rather than currently deductible.

(ii) The expenditure is intended to discover information that is technological.

(iii) The information to be discovered is intended to develop or improve a product, process, technique, or formula.

(iv) Substantially all the research activities constitute elements of a process of experimentation for the purpose of developing or improving new or improved function, performance, reliability, or quality of the product, process, technique, or formula.

[9] The taxpayer's failing was primarily one of documentation of its engineers' activities. The fault may lie, however, not with the taxpayer's trial preparation but with a flaw in the Congressional design of the credit. Congress intended the credit be available to businesses that "apply" scientific principles to develop or improve products. Congress did not require taxpayers to discover basic scientific principles to claim the credit. However, Congress left the door open to the IRS to require a taxpayer to document its applied research as it the research were "basic research." Businesses that apply research often do not think of documenting their applied research as if it were basic research.

[10] I.R.C. §41(d)(2)(B).