



Funded Research

The exclusion for "funded research" under section 41(d)(4)(H) provides that **the credit shall not be available** for qualified research to the extent funded by a contract, grant, or otherwise by another person (or governmental entity).

All agreements (not only research contracts) entered into between the taxpayer performing the research and other persons are to be considered in determining the extent to which the research is funded.

Therefore, the auditor should request a complete copy of all contracts (including modifications), agreements, letters of understanding or similar documents where funding is an issue.

These contracts and similar documents will need to be reviewed to determine whether, and to what, extent the research is to be considered funded.

A "lump sum" contract, where the customer agrees to pay a set price for a deliverable, a "time and materials" contract, or a "cost-plus" contract where the customer agrees to pay the actual costs incurred by the contractor in acquiring/constructing the deliverable plus an additional amount for profit, are examples of the different contracts you may encounter.

The taxpayer's representative can be helpful in securing and interpreting these agreements.

In order to determine if the contractor's research expenditures are "funded," you must resolve the following issues:

- Is payment for the contractor's research activities "contingent upon the success of the research" under Treasury Regulation section 1.41-4A(d)(1)?
- Does the contractor retain "substantial rights" in the results of the research activities within the meaning of Treasury Regulation section 1.41-4A(d)(2)?

If the answer to either question is **no**, then the research is treated as funded (not eligible to claim the credit).

Amounts payable under any agreements that are contingent on the success of the research (thus considered to be paid for the product or result of the research) are not treated as funded research.

If a contractor retains substantial rights in the results of the research, and if payment to him is contingent on the success of the research, then the contract is not funded and the contractor is eligible to claim the credit.

If a contractor, performing research for another person, does not retain substantial rights in the research, and if the research payments are contingent on the contractor's success, neither the contractor nor the person paying for the research is eligible to claim the credit.

If a taxpayer performing qualified research for another person retains substantial rights in the research under the agreement providing for the research, the research is funded to the extent of the payments (and fair market value

of any property) to which the taxpayer becomes entitled by performing the research. A taxpayer does not retain substantial rights in the research if the taxpayer must pay for the right to use the results of the research.

Frequently, taxpayers make some sort of funding allocation between “qualified research” and “non-qualified research” expenditures incurred in certain types of contracts, e.g., cost-share or cost overrun situations. In so doing, taxpayers often overlook the “pro rata allocation” requirements of Treasury Regulation section 1.41-4A(d)(3)(ii).

The general rule is that funding is to be allocated 100 percent to otherwise qualified research expenses (as provided by Treasury Regulation section 1.41-4A(d)(3)(i)) unless the taxpayer can meet the pro rata allocation requirements of Treasury Regulation section 1.41-4A(d)(3)(ii).

Pursuant to Treasury Regulation section 1.41-4A(d)(3)(ii), the taxpayer may allocate funding pro rata to nonqualified, and otherwise qualified research expenses, rather than allocating it 100 percent to otherwise qualified research expenses, if the taxpayer can establish to the satisfaction of the Service:

1. the total amount of research expenses,
2. that the total amount of research expenses exceed the funding, and
3. that the otherwise qualified research expenses (that is, the expenses that would be qualified research expenses if there were no funding) exceed 65 percent of the funding.

In no event, however, shall less than 65 percent of the funding be applied against the otherwise qualified research expenses. Material adjustments may be warranted if the specific requirements of Treasury Regulation section 1.41-4A(d)(3)(ii) have not been met.

Funding is determinable only in the subsequent taxable year. Treasury Regulation section 1.41-4A(d)(5) states that if, at the time the taxpayer files its return for a taxable year, it is impossible to determine to what extent particular research performed by the taxpayer during the year may be funded, then the taxpayer shall treat the research as completely funded for purposes of completing that return. When the amount of funding is finally determined, the taxpayer should amend the return and any interim returns to reflect the proper amount of funding.