Rights for the R&D credit and Sec. 174

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Taxpayers claiming research and development (R&D) tax credits for work performed under contract must contend with the exclusion for "funded research."

Whether R&D is funded involves a two-pronged analysis to determine whether the taxpayer possesses economic risk related to the success of the research and retains substantial rights to the research results. Given the popularity of the Sec. 41 R&D tax credit, the funded research exclusion has been discussed extensively in judicial opinions, regulations, notices, treatises, and more. However, whether a similar framework exists for specified research and experimentation (SRE) expenditures under Sec. 174 has, until recently, largely been left to speculation. While Regs. Sec. 1.174-2(b)(3) requires that any expense claimed under Sec. 174, when paid to a third party to create depreciable property, must be at the taxpayer's own risk, whether Sec. 174 also requires any intellectual property right to the research has been less certain.

To address this murkiness, the IRS released Notice 2023-63, which was quickly followed by Notice 2024-12. Though proposed regulations on the topic have yet to be released (as of the date of this item's writing), the notices formally introduce the concept that taxpayers performing research under contract, and recognizing those expenditures under Sec. 174, must have the right to exploit the results of the research performed. Notice 2023-63 explicitly states that it is "not intended to change the rules for determining eligibility for or computation of the research credit under §41 and the regulations thereunder." But how should taxpayers understand the similarities and differences between "substantial rights" required for the R&D tax credit and the right to exploit associated with Sec. 174?

History of Sec. 174

The law known as the Tax Cuts and Jobs Act (TCJA), P.L. 115-97, represented a substantial change in U.S. tax policy. Among its numerous provisions, the TCJA imposed the mandatory capitalization of SRE expenditures for tax years beginning after Dec. 31, 2021.

Originally enacted in 1954, Sec. 174 has historically allowed taxpayers to deduct SRE expenditures in the year incurred. Its original aim was to level the playing field for small businesses, those without dedicated research teams, that may be unable to deduct product development expenses under Sec. 162 because the costs were not ordinary and necessary expenses paid or incurred in carrying on a trade or business. The intent was to allow immediate deductions for such development costs and encourage innovation. Taxpayers enjoyed this treatment for nearly 70 years until the TCJA required the amortization of SRE expenditures over a period of either five or 15 years for domestic or foreign expenditures, respectively.

The change from deduction to amortization was included among several other changes in the TCJA as a means to offset the tax revenue loss from corporate tax cuts, in order to pass the act via budget reconciliation and avoid a filibuster. Most people aware of the change, including those at the IRS, thought it would be pushed out or reversed by legislation before the effective date. Since such legislation has not yet materialized, the IRS has made a concerted effort over the last year to provide guidance on what expenditures should or should not be recognized under Sec. 174. Because taxpayers have historically been afforded flexibility on how they treat Sec. 174 expenses and because other provisions such as Sec. 162 allow the deduction of ordinary and necessary business expenses, whether costs were properly claimed as experimental was rarely challenged and little guidance existed.

The guidance that did exist consisted largely of Regs. Sec. 1.174-2 and a modest body of case law discussing the requirement that expenses must be incurred for development “in connection with” a taxpayer’s trade or business. For example, the Fourth Circuit in *Lewin*, 335 F.3d 345 (4th Cir. 2003), discussed the applicability of Sec. 174 to amounts paid by an investment group to fund the R&D activities of startups. In return for funding, the investment group secured certain rights to any intellectual property generated by the startups that it would then license back out for commercialization. At the time the expenses were incurred, the investment group lacked the infrastructure or specialized knowledge to commercialize the intellectual property in its own business. The court ultimately held that the amounts paid by the investment group could not be deducted under Sec. 174 because the investor group lacked any "realistic prospect of exploiting any discoveries in its own trade or business."

While the court in *Lewin* and other courts dealing with Sec. 174 — see, e.g., *Harris,* 16 F.3d 75 (5th Cir. 1994) — required that taxpayers claiming a deduction under Sec. 174 possess the intent and ability to exploit the results of research performed, the analysis focused on the purchasing party. The facts presented did not force those courts to consider what rights must be reserved by the research provider to satisfy the exploitation requirement should it have the means and desire to do so.

Notice 2023-63 attempted to address that ambiguity by including in the definition of SRE product "any pilot model, process, formula, invention, technique, patent, computer software, or similar property … *that is subject to protection under applicable domestic or foreign law"* [emphasis added], and that "mere knowhow gained by a research provider … that is not subject to protection under applicable domestic or foreign law does not give rise to an SRE product in the hands of the research provider." The notice went on to say: "[I]f the research provider has a right to use any resulting SRE product in the trade or business of the research provider or otherwise exploit any resulting SRE product through sale, lease, or license, then costs paid or incurred … are SRE expenditures of the research provider."

Notice 2024-12 sought to further clarify the issue by defining "SRE product right" to mean "a right to use any resulting SRE product in a trade or business of the research provider or otherwise exploit any resulting SRE product through sale, lease, or license." Furthermore, that product right must exist without the need for separate consideration or authorization from an unrelated third party.

Substantial rights under Sec. 41

Similar to the requirements described in Notice 2024-12 that a research provider's right to exploit must be free of restrictions or additional payments, "substantial rights" in the context of the R&D tax credit requires a taxpayer to be able to use the results of its research without additional payment or approval. In the seminal case on this subject, *Lockheed Martin Corp.,* 210 F.3d 1366 (Fed. Cir. 2000), the Federal Circuit evaluated whether Lockheed Martin retained substantial rights to research it performed for the U.S. government. In reversing the Court of Federal Claims, the Federal Circuit reasoned that even though Lockheed Martin's right to use its research was not exclusive, it could use its results and technical data without paying the U.S. government for that right. Thus, it retained "substantial rights" for the purposes of the R&D tax credit.

In contrast to the court in *Lockheed,* the Tax Court in *Tangel,* T.C. Memo. 2021-1, was confronted with a situation in which the taxpayer conveyed all technical information to the buyer and was further restricted from using any technical information created at the buyer's expense. In that case, the taxpayer agreed in its contract with the buyer that all information created was a "work made for hire," and that all drawings, designs, equipment, and technical data would belong exclusively to the buyer. The court ultimately granted partial summary judgment in favor of the IRS, as the taxpayer failed to articulate any rights it retained, much less any substantial rights.

The most recent noteworthy discussion of "substantial rights" came from the Fifth Circuit in *Grigsby,* 86 F.4th 602 (5th Cir. 2023). Cajun Industries, a construction company out of Louisiana, entered into several construction contracts with various clients. Though less descriptive than some restrictions in *Tangel,* the only language in Cajun's contracts were affirmative conveyances of “all right, title, and interest” in any “work product,” which included “documents, data, analyses, reports, plans, procedures, manuals, drawings, specifications, calculations, or other technical tangible manifestations of [Cajun]’s efforts (whether written or electronic) created while performing the contract.” The court went on in its description, but, similar to the court in *Tangel,* ultimately ruled against Cajun on the basis that it failed to demonstrate any rights that it retained to the research.

Rights under Secs. 41 and 174

There is a great deal of overlap between the analyses surrounding Secs. 41 and 174. In fact, the first requirement for qualification under Sec. 41 is that an expense may be treated as an SRE under Sec. 174 (Sec. 41(d)(1)(A)). That said, the sections regulate fundamentally different concepts — while Sec. 174 was written to allow small businesses to expense costs that otherwise would have been capitalized, Sec. 41 grants a credit to incentivize research performed within the United States. Bearing that in mind, although the concepts of “substantial rights” and “right to exploit” are similar, they involve separate standards reflected by the distinct nature of each Code section.

The notices released by the IRS discussing the rights of research providers and the recognition of expenses under Sec. 174 focus on legally protectable rights and the ability to exploit the SRE product. As stated in Notice 2023-63, “if the research provider has a right to use any resulting *SRE product* in the trade or business of the research provider or otherwise exploit any resulting *SRE product* through sale, lease, or license, then costs paid or incurred by the research provider … are SRE expenditures of the research provider” (emphasis added). The purpose of Sec. 174 (as currently written) is to force the capitalization of costs incurred in the development of a research product, and the rights analysis justifiably focuses on the work product.

On the other hand, the Sec. 41 analysis of “substantial rights” extends beyond the work product to information and materials created throughout the research process. Though Lockheed Martin transferred the final product to the U.S. government, it nonetheless retained substantial rights for the purposes of the R&D tax credit because it retained access to the data and designs generated. Though the courts in *Tangel* and *Grigsby* ruled against the service providers in those cases, it is conceivable that if they had explicitly reserved some measure of rights to the underlying data or processes while still granting exclusive rights to the final product to the respective buyers, the courts may have ruled in their favor regarding substantial rights.

The focus of Sec. 174 is on the capitalizable asset, and the right to exploit is also tied to that asset. Meanwhile, Sec. 41 more broadly encompasses the discovery of information that is technological in nature. Though a taxpayer may lack a legally protectable right to exploit the ultimate product of its research activities, a right to use the associated technological information, without having to pay for that right, may nonetheless provide the taxpayer with substantial rights when applying for an R&D tax credit.

Editor notes

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