DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224
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OFFICE OF
CHIEF COUNSEL

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR DISTRICT COUNSEL,

FROM: ASSOCIATE CHIEF COUNSEL (PASSTHROUGHS AND SPECIAL INDUSTRIES) CC:PSI

SUBJECT: RESEARCH CREDIT

This Field Service Advice responds to your memorandum dated July 7, 2000. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be used or cited as precedent.

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LEGEND

Taxpayer:

Date:
Year 1:
Year 2:
x: $
y: $
z: $

ISSUE

Whether a portion of fees paid by Taxpayer to the Department of Energy pursuant to a contract for the disposal of nuclear waste constitutes a contract research expense under I.R.C. § 41(b)(3).

CONCLUSION

The contract at issue is not within the scope of the contract research regulations in Treas. Reg. § 1.41-2(e) because the contract is for the performance of services and not for the performance of qualified research. Therefore, a portion of fees paid by Taxpayer to the Department of Energy pursuant to a contract for the disposal of nuclear waste does not constitute a contract research expense.

FACTS

Background:

In 1982, Congress enacted the Nuclear Waste Policy Act, 42 U.S.C. § 10101 (Act), to establish a comprehensive program for the disposal of high-level radioactive waste and spent nuclear fuel generated by civilian nuclear power reactors. To ensure that the costs of designing, constructing, and operating waste repositories was borne by those generating the waste, Congress provided for a Nuclear Waste Fund to be "composed of payments made by the generators and owners of such waste and spent fuel." 42 U.S.C. § 10131(b)(4).[1]

Section 302(d) of the Act, as amended, provides that the Department of Energy (DOE) may make expenditures from the Nuclear Waste Fund only for purposes of radioactive waste disposal activities, including:

1. the identification, development, licensing, construction, operation, decommissioning, and post-decommissioning

[1] As of 1996, utilities in forty-one states had paid $6.6 billion (plus $2.5 billion in interest) into the Nuclear Waste Trust Fund. See Comment, Utilities: De Facto Repositories for High-Level Radioactive Waste?, 5 Dick. J. Env. L. Pol. 375, 389 (1996).

> maintenance and monitoring of any repository, monitored retrievable storage facility, or test and evaluation facility constructed under this Act;
>
> 2. the conducting of nongeneric research, development, and demonstration activities under this Act;
>
> . . . .
>
> 4. any costs that may be incurred by the Secretary in connection with the transportation, treating, or packaging of spent nuclear fuel or high-level radioactive waste to be disposed of in a repository, to be stored in a monitored retrievable storage site, or to be used in a test and evaluation facility;
>
> 5. the costs associated with acquisition, design, modification, replacement, operation, and construction of facilities at a repository site, a monitored, retrievable storage site or a test and evaluation facility site and necessary or incident to such repository, monitored, retrievable storage facility or test and evaluation facility; . . .

42 U.S.C. § 10222(d).

Congress delegated primary responsibility for developing and administering the waste disposal program to DOE. The Act authorizes the Secretary of DOE (through the Office of Civilian Radioactive Waste Management) to enter into standard contracts with generators of nuclear waste to provide for its transportation and disposal, and specifies that such contracts will provide for the payment of fees sufficient to offset expenditures connected with the waste disposal program. Pursuant to this statutory authorization, DOE has entered into a standard contract with all civilian entities that generate or hold title to nuclear waste (Standard Contract for Disposal of Spent Nuclear Fuel and/or High-Level Radioactive Waste). See 10 C.F.R. § 961.11.

The Standard Contract:

The "Standard Contract for Disposal of Spent Nuclear Fuel and/or High-Level Radioactive Waste" (the Standard Contract) provides that the Purchaser utility will pay to DOE a fee to take title to spent nuclear fuel and high-level radioactive waste and dispose of such waste materials at a DOE-constructed disposal facility. The fee is based upon the amount of electricity generated at the utility's nuclear power

reactors and is payable quarterly. Disposal is to begin after a disposal site is selected and a facility constructed but, in any event, disposal must commence no later than January 31, 1998. In general, the government will retain unlimited rights in all recorded information produced or delivered under the contract while the utility has rights only in proprietary data.

Included in the Standard Contract are the following pertinent representations:

> WHEREAS, the DOE has the responsibility for the disposal of spent nuclear fuel and high-level radioactive waste of domestic origin from civilian nuclear power reactors in order to protect the public health and safety, and the environment; and
>
> . . . .
>
> WHEREAS, all costs associated with the preparation, transportation, and the disposal of spent nuclear fuel and high-level radioactive waste from civilian nuclear power reactors shall be borne by the owners and generators of such fuel and waste; and
>
> . . . .
>
> WHEREAS, the DOE is authorized to enter into contracts for the permanent disposal of spent nuclear fuel and/or high-level radioactive waste of domestic origin in DOE facilities; and
>
> WHEREAS, the Purchaser [utility] desires to obtain disposal services from DOE; and
>
> WHEREAS, DOE is obligated and willing to provide such disposal services, under the terms and conditions hereinafter set forth; . . .

10 C.F.R. § 961.11.

Article I, paragraph 8 of the Standard Contract defines the term "disposal" to mean "the emplacement in a repository of high-level radioactive waste, spent nuclear fuel, or other highly radioactive waste with no foreseeable intent of recovery, whether or not such emplacement permits recovery of such waste." 10 C.F.R. § 961.11.

Article II of the Standard Contract delineates the scope of the contract, as follows:

> This contract applies to the delivery by Purchaser to DOE of SNF [spent nuclear fuel] and/or HLW [high-level radioactive waste] of domestic origin from civilian nuclear power reactors, acceptance of title

> by DOE to such SNF and/or HLW, subsequent transportation, and disposal of such SNF and/or HLW and, with respect to such material, establishes the fees to be paid by the Purchaser for the services to be rendered hereunder by DOE. . . . The services to be provided by DOE under this contract shall begin, after commencement of facility operations, not later than January 31, 1998 and shall continue until such time as all SNF and/or HLW from the civilian nuclear power reactors . . . , has been disposed of.

Id.

Article XXII of the Standard Contract further delineates the scope of the contract, as follows:

> A. This contract, which consists of Articles I through XXII and Appendices A through G, . . . contains the entire agreement between the parties with respect to the subject matter hereof. Any representation, promise, or condition not incorporated in this contract shall not be binding on either party. No course of dealing or usage of trade or course of performance shall be relevant to explain or supplement any provision contained in this contract.

Id.

Shortly after the passage of the Act in 1982, DOE began searching for an appropriate nuclear waste repository. In 1987, after DOE had studied nine separate sites, the search was narrowed to Yucca Mountain, Nevada. Current schedules anticipate that DOE will decide by the year 2001 whether to recommend the site to the President as a preliminary step to ultimate site designation and construction authorization.

The Standard Contract between Taxpayer and DOE:

Taxpayer is an electric utility company that uses nuclear power to generate electricity. On Date, Taxpayer and DOE entered into a Standard Contract for the disposal of Taxpayer's nuclear waste. From Year 1 through Year 2, Taxpayer paid to DOE disposal fees of approximately x. Of the x, Taxpayer claims that y was expended by DOE for the performance of qualified research. Taxpayer is claiming a research credit of approximately z with respect to the Year 1 through Year 2 taxable years.

Taxpayer claims that the fees paid to DOE are contract research expenditures under section 41(b)(3) because: (1) Taxpayer and DOE entered into the contract for disposal of the nuclear waste prior to the performance of the qualified research;

(2) DOE performed the research on behalf of Taxpayer; and (3) Taxpayer bears the expense if the research is not successful. Taxpayer further claims that DOE's activities to study and select the appropriate disposal site (including, surface- and underground-based testing, off-site laboratory testing, and thermal studies), for the purpose of determining a method of disposal or long-term storage of nuclear waste, satisfy the requirements for qualified research. Specifically, Taxpayer states,

> [w]hile not explicitly stated in the Contract, it is clear that the DOE cannot dispose of SNF unless a disposal site is selected, constructed and subjected to rigorous alternative testing and evaluations (i.e. process of experimentation) constituting research and development. As such, the Contract constitutes a research contract between [Taxpayer] and the DOE for the establishment of a permanent site for the disposal of [Taxpayer's] SNF and HLW. Even if the Contract is found not to be a research contract, the relationship between [Taxpayer] and the DOE is still one of contract research.

LAW AND ANALYSIS

Section 41 allows taxpayers a credit against tax for increasing research activities. Generally, the credit is an incremental credit equal to the sum of 20 percent of the excess (if any) of the taxpayer's "qualified research expenses" for the taxable year over the base amount, and 20 percent of the taxpayer's basic research payments. Under section 41(c)(4), however, taxpayers may elect to use the alternative incremental research credit for taxable years beginning after June 30, 1996.

Section 41(b)(1) provides that the term "qualified research expenses" means the sum of the following amounts which are paid or incurred by the taxpayer during the taxable year in carrying on any trade or business of the taxpayer: (A) in-house research expenses, and (B) contract research expenses.

Section 41(b)(3) provides that the term "contract research expenses" means 65 percent (or, 75 percent for research consortia) of any amount paid or incurred by the taxpayer to any person (other than an employee of the taxpayer) for qualified research.

Treas. Reg. § 1.41-2 provides a three-part test for determining if the payment is for the performance of qualified research where a third party performs the research for the taxpayer. Treas. Reg. § 1.41-2(e)(2) provides that an expense is paid or incurred for the performance of qualified research only to the extent that it is paid or incurred pursuant to an agreement that--

> (i) is entered into prior to the performance of the qualified research;
>
> (ii) provides that research be performed on behalf of the taxpayer; and

> (iii) requires the taxpayer to bear the expense even if the research is not successful.

Further, if an expense is paid or incurred pursuant to an agreement under which payment is contingent on the success of the research, then the expense is considered paid for the product or result rather than the performance of the research, and the payment is not a contract research expense. Treas. Reg. § 1.41-2(e)(2).

Treas. Reg. § 1.41-2(e)(3) provides that qualified research is performed on behalf of the taxpayer if the taxpayer has a right to the research results. Qualified research can be performed on behalf of the taxpayer notwithstanding the fact that the taxpayer does not have exclusive rights to the results.

The issue in this request for Field Service Advice is whether a portion of the fees paid by Taxpayer to DOE under a contract for the disposal of nuclear waste is a contract research expense under section 41(b)(3). For purposes of this request, we have been asked to assume that, in connection with the Standard Contract, DOE engaged in activities that constitute qualified research under section 41(d)(1). For the reasons discussed below, we cannot adopt this approach.

The Standard Contract is not a Research Contract:

The contract at issue is not a contract for research but rather a standard service contract. The basic obligations assumed by the parties are for Taxpayer to provide for the delivery of the nuclear waste to DOE, and for DOE, in turn, to take title to and dispose of the nuclear waste. By its terms, the Standard Contract

> applies to the delivery by Purchaser to DOE of [nuclear waste] from civilian nuclear power reactors, acceptance of title by DOE to such [nuclear waste], . . . and, with respect to such material, establishes the fees to be paid by the Purchaser for the services to be rendered hereunder by DOE.

Standard Contract, Article II. The Standard Contract does not include any terms, representations, or requirements pursuant to which either of the parties must perform qualified research. DOE does not have any specific contractual obligation to perform research, and there is no specific language in the Standard Contract that provides that research is necessary to complete the delivery and disposal of the nuclear waste.

Taxpayer claims that the nature of the services provided by DOE for the performance of the Standard Contract, in effect, presupposes the construction of a waste disposal facility that would entail the performance of qualified research. Specifically, Taxpayer contends that DOE cannot dispose of Taxpayer's nuclear

waste unless it develops a disposal facility, and such facility cannot be developed without engaging in activities constituting qualified research. Taxpayer further asserts that "[e]ven if the Contract is found not to be a research contract, the relationship between [Taxpayer] and the DOE is still one of contract research." We disagree. The mere fact that there is a contractual obligation to provide for the disposal of nuclear waste does not establish a contract for the performance of qualified research as contemplated by the section 41 statute and regulations.

Moreover, we cannot ignore the terms of the Standard Contract itself. The Standard Contract provides that "[a]ny representation, promise, or condition not incorporated in this contract shall not be binding on either party. No course of dealing or usage of trade or course of performance shall be relevant to explain or supplement any provision contained in this contract." Article XXII. We are clearly bound to the four corners of the Standard Contract between Taxpayer and DOE and we cannot assume that the performance of qualified research is contemplated within those four corners based simply upon the relationship of the parties or a common course of dealing. See Fairchild Industries v. United States, 71 F.3d 868, 873 (Fed. Cir. 1995), rev'g 30 Fed. Cl. 839 (1994) (finding that the Court of Federal Claims incorrectly construed the contract between Fairchild and the Air Force when it concluded that the contractor assumed no risk under the contract because the contract explicitly placed the risk of failure on the contractor).

Taxpayer's argument that the Standard Contract constitutes a research contract between Taxpayer and DOE is premised upon its contention that DOE cannot dispose of Taxpayer's nuclear waste unless it develops a disposal facility, and such facility cannot be developed without engaging in qualified research activities. We do not necessarily dispute Taxpayer's contention that DOE may have to engage in some qualified research activities to fulfill its obligation under the Act to dispose of nuclear waste.[2] In fact, the Act explicitly provides that nongeneric research and development activities will be conducted. DOE's obligation to perform research is pursuant to the Act, however, and not pursuant the Standard Contract with Taxpayer.

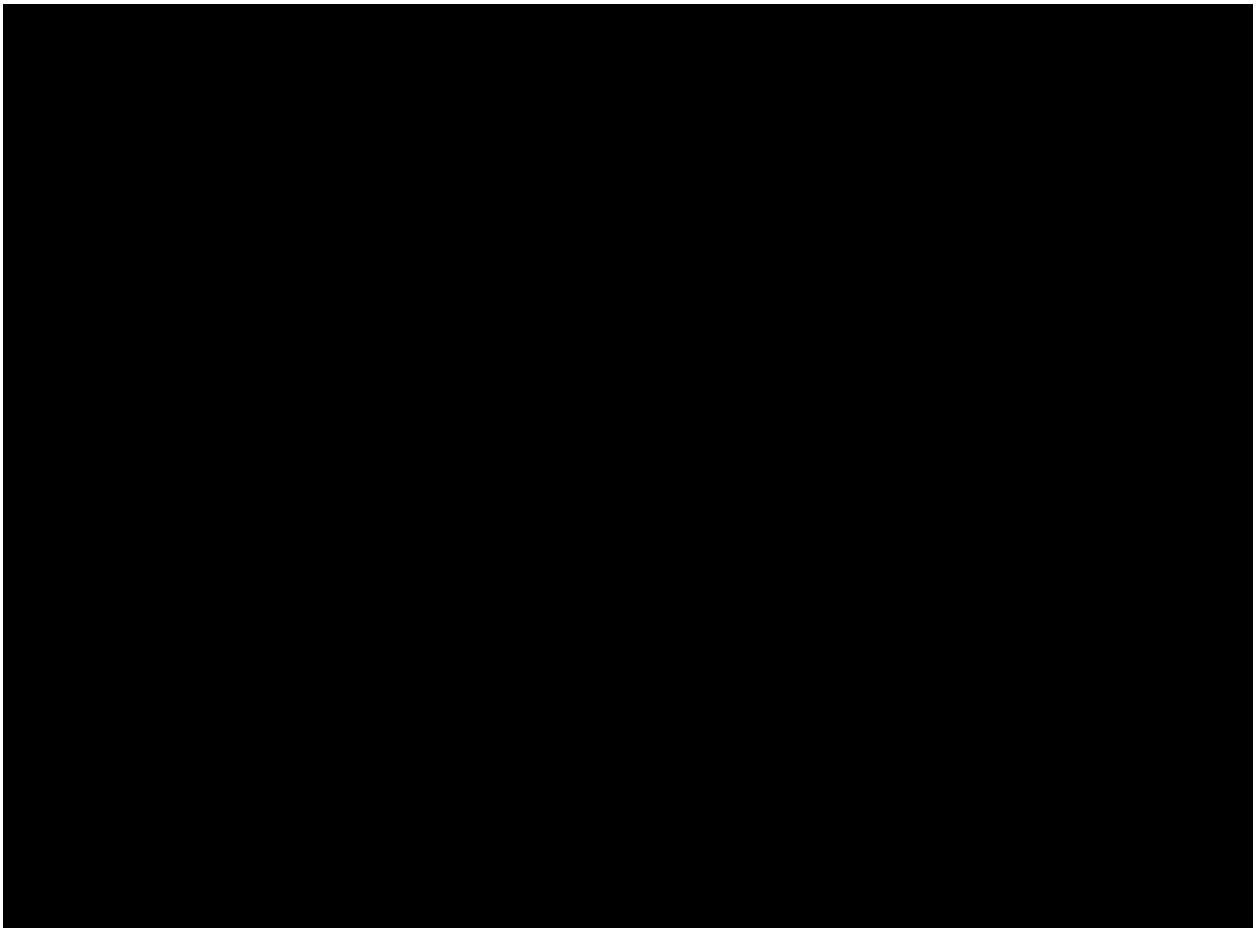
Taxpayer further contends that it satisfies the requirements for contract research because DOE performed the research on behalf of Taxpayer, and that Taxpayer bears the expense if the research is not successful. Both of these arguments are premised upon Taxpayer's belief that Taxpayer and DOE are parties to a contract for the performance of qualified research. Even if we were to find that the Standard Contract did contain language providing for the performance of qualified research, we have no specific information regarding any expenditures for any type of research or service activities. More importantly, however, the broadest reading of the Standard Contract does not allow us to conclude that DOE conducted any

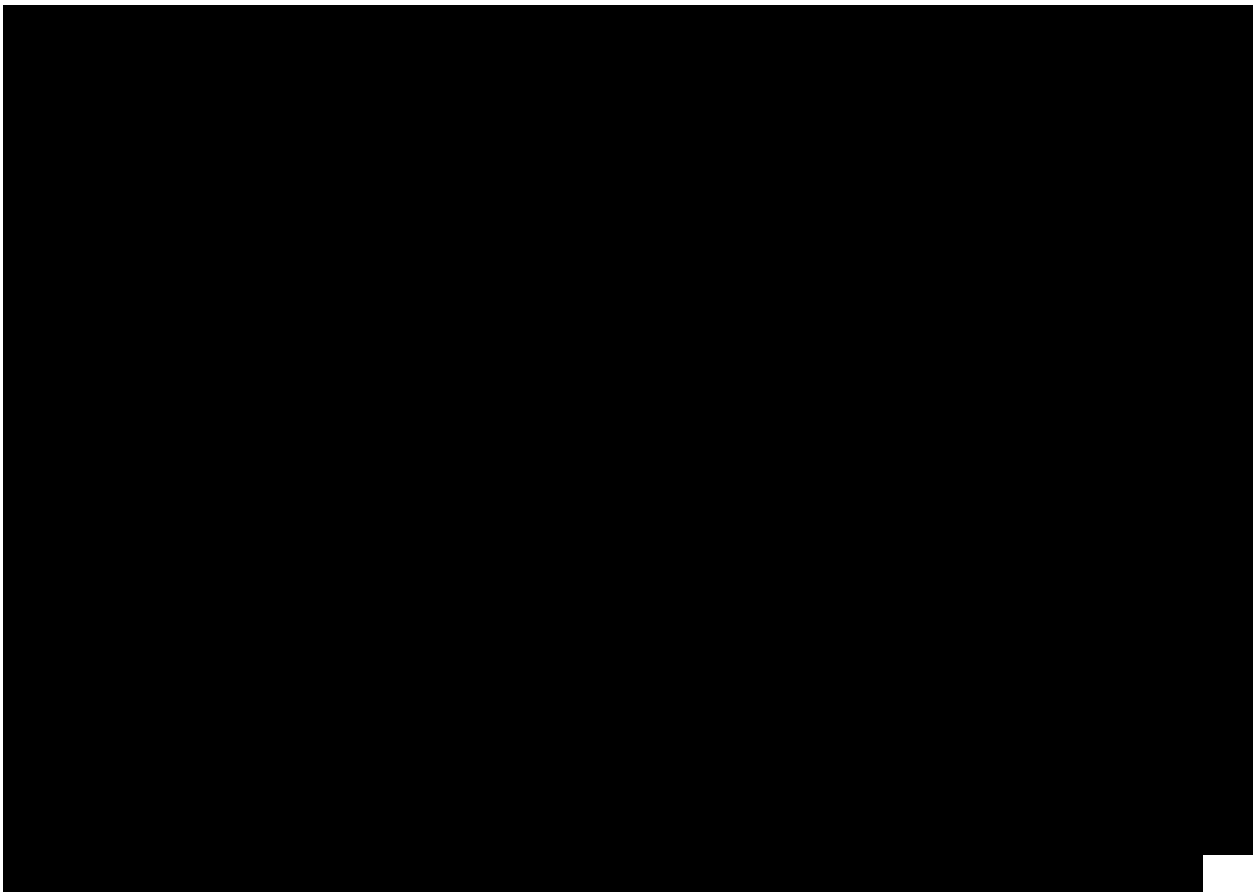
[2] Except as specifically provided in this memorandum, we provide no opinion as to whether the expenditures made by DOE satisfy the definition of qualified research under section 41(d)(1).

activities, either research or service activities, on behalf of either Taxpayer or any one identifiable purchaser utility. In fact, DOE is constructing the disposal facility on behalf of numerous utilities from different states whose fees are payable to a general fund created under the Act.

In addition, we are not persuaded that Taxpayer bears the expense if the research is not successful. It is clear from the terms of the Act that DOE bears the ultimate responsibility for the disposal of nuclear waste. Under these circumstances, therefore, ultimate liability clearly must lie with the government. The fact that Taxpayer, as well as other utilities, have filed suit against DOE seeking damages to compensate Taxpayer for costs of storing nuclear waste is not helpful to Taxpayer's case. Finally, it must be kept in mind that utilities, including Taxpayer, pass their costs onto their consumers. Thus, it is the consumers, and not the utilities, who are ultimately funding the Nuclear Waste Act disposal program. Numerous courts have upheld the assessment of a fee against current consumers for a future permanent disposal site of nuclear waste. See, e.g., Consolidated Edison Co. of New York v. U.S. Dept. of Energy, 870 F.2d 694 (D.C. Cir. 1989).

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS





Please call if you have any further questions.

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