

BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of)	
)	DOCKET NO. 39129
[Redacted] .,)	
)	
Petitioner.)	DECISION
<hr style="width: 40%; margin-left: 0;"/>)	

BACKGROUND

On May 27, 2014, the Audit Division (Audit) of the Idaho State Tax Commission (Commission) issued a Notice of Deficiency Determination (NODD) to [Redacted] . (Petitioner) proposing changes to the income tax credits for the taxable years 2010, 2011 and 2012. The Petitioner is an S corporation¹ (S corp.) Adjustments made to the taxable income or credits of an S corp. flow through to the shareholders.

On July 29, 2014, the Petitioner’s attorney-in-fact (POA), under authority of an Idaho Power of Attorney, filed a timely protest.

On December 10, 2014, the file was transferred to the Legal/Tax Policy Division for resolution. A letter was sent on August 27, 2015, explaining the options for resolving an appeal. The POA called and requested we set up a telephonic informal hearing. A hearing was scheduled and held on December 10, 2015.

One of the court cases mentioned in the hearing, United Stationers,² was sent to the POA for his review and response. A follow-up message was left on February 2, 2016, by the policy specialist, but there was no response. The Commission makes this decision with the information available.

¹ A subchapter S corporation is a corporation that elects to be treated as a “qualified small business corporation” under Internal Revenue Code section 1362. As an S corporation, all the income, expenses and credits are passed through to the owners.

² 82 AFTR 2 d 98-7488, 163 F3 d 440, 99-1 USTC ¶ 50,136.

ISSUE

Whether the software developed by the Petitioner meets the high threshold of innovation test described in Proposed Treasury Regulation 1.41-4(c)(6)(vi), therefore a qualified research expense.

DISCUSSION

During the hearing the Commission explained their concerns with whether this software implementation met the high standard for innovation required by the regulation. The basic rule is that internal use software is not eligible for the research credit. There is a limited exception to that exclusion. Research expenses are governed by Internal Revenue Code (IRC) sections 174 and 41. Section 174 defines research expenditures and section 41 is the law that allows a credit for doing research.

Treasury Regulation 1.174-2 (1) Research or experimental expenditures defined. The term research or experimental expenditures, as used in section 174, means expenditures incurred in connection with the taxpayer's trade or business which represent research and development costs in the experimental or laboratory sense. The term generally includes all such costs incident to the development or improvement of a product. The term includes the costs of obtaining a patent, such as attorneys' fees expended in making and perfecting a patent application. Expenditures represent research and development costs in the experimental or laboratory sense if they are for activities intended to discover information that would eliminate uncertainty concerning the development or improvement of a product. Uncertainty exists if the information available to the taxpayer does not establish the capability or method for developing or improving the product or the appropriate design of the product. Whether expenditures qualify as research or experimental expenditures depends on the nature of the activity to which the expenditures relate, not the nature of the product or improvement being developed or the level of technological advancement the product or improvement represents. The ultimate success, failure, sale, or use of the product is not relevant to a determination of eligibility under section 174. Costs may be eligible under section 174 if paid or incurred after production begins but before uncertainty concerning the development or improvement of the product is eliminated.

IRC section 41(d)(3):

(A) In general. Research shall be treated as conducted for a purpose described in this paragraph if it relates to—

- (i) a new or improved function,
- (ii) performance, or
- (iii) reliability or quality.

(B) Certain purposes not qualified. Research shall in no event be treated as conducted for a purpose described in this paragraph if it relates to style, taste, cosmetic, or seasonal design factors.

(4) Activities for which credit not allowed.

The term “qualified research” shall not include any of the following:

(A) Research after commercial production. Any research conducted after the beginning of commercial production of the business component.

(B) Adaptation of existing business components. Any research related to the adaptation of an existing business component to a particular customer’s requirement or need.

(C) Duplication of existing business component. Any research related to the reproduction of an existing business component (in whole or in part) from a physical examination of the business component itself or from plans, blueprints, detailed specifications, or publicly available information with respect to such business component.

(D) Surveys, studies, etc. Any—

- (i) efficiency survey,
- (ii) activity relating to management function or technique,
- (iii) market research, testing, or development (including advertising or promotions),
- (iv) routine data collection, or
- (v) routine or ordinary testing or inspection for quality control.

(E) **Computer software.** Except to the extent provided in regulations, any research with respect to computer software which is developed by (or for the benefit of) the taxpayer primarily for internal use by the taxpayer, other than for use in—

- (i) an activity which constitutes qualified research, or
- (ii) a production process with respect to which the requirements of paragraph (1) are met.

(F) Foreign research. Any research conducted outside the United States, the Commonwealth of Puerto Rico, or any possession of the United States.

(G) Social sciences, etc. Any research in the social sciences, arts, or humanities.

(H) Funded research. Any research to the extent funded by any grant, contract, or otherwise by another person (or governmental entity). Emphasis added.

For purposes of the rule that the research credit is available for internal use software that satisfies a high threshold of innovation, that test is met if the taxpayer can show all of the following:

- (1) The software must be innovative in that it is intended to be unique or novel and to differ in a significant and inventive way from earlier software implementations or methods.
- (2) The software development must involve significant risk in that substantial resources are committed to the software development and there is substantial uncertainty, because of technical risk, that those resources would be recovered in a reasonable period of time.
- (3) The software must not be commercially available for use by the taxpayer,

1) The first test; the software must be innovative. The [Redacted] first used the acronym [Redacted] , in the 1990s, where it was seen to extend the capabilities of [Redacted] , and the later [Redacted] , as well as computer-integrated manufacturing.

It is difficult to be certain exactly what software was available at the beginning of 2010, nearly 20 years after that type of software was first introduced in the marketplace. There were commercial software packages that claimed to provide all of the functions that the Petitioner desired. They bought one and tried it. It was not to their liking, but there is no evidence that it was different enough to meet the unique or novel standard described above. The description provided to the Commission was that the new software was actually creating a bridge between existing distinct software packages.

During the hearing, the Petitioner claimed that a patent search was conducted. The result of that search was that the software would be patentable, but the costs would be prohibitive. We asked if they could provide any written documentation to that affect and they stated that none was provided. In the response to the NODD, the Petitioner included a letter from [Redacted] confirming their involvement, but all communication between the Petitioner and [Redacted] regarding the results of that work was verbal. There is no written evidence that the software developed by the Petitioner was patentable.

This is a quote from the [Redacted] letter, dated June 26, 2014:

“[Redacted] ., provided this firm with an invention disclosure born of research and development on or about August, 2011. This firm, with the help of a search agent, conducted a patentability search relating to the invention disclosure and discussed the results of that search with the principals of [Redacted]

The Petitioner said in the hearing that he was not going to pay [Redacted] more money to create a report at this point. The letter only confirms that they conducted a search and not the results of that search.

2) The second test; the software development must involve significant risk. The Petitioner claimed that significant risk was undertaken to develop the software. The only evidence of risk is that the Petitioner made a \$13k investment in software and hired an employee to install it.

The following paragraph is a quote from an article published by BNA, Tax and Accounting, analyzing the research credit.³

“The substantial economic risk test also requires that there was substantial technical (not business) risk that the resources that the taxpayer expended would be recovered within a reasonable period. It is important to note that this risk must be a technical one since all new software development projects involve business risk. Technical risk arises when there is some question as to whether the software can be developed whereas business risk arises when there is some question as to whether the software will produce the desired efficiency⁴. If a reasonably competent software developer cannot confidently predict a completion date for a project, sufficient technical risk exists. Whether the project can be completed within business-related constraints, such as on time and within budget, is a business risk, not a technical risk. Technical risk arises when the solution, or means of arriving at the problem using known software development techniques and parameters. The lack of skilled and experienced programmers is not a technical risk⁵. Instead, the crucial issue is whether skilled and experienced computer programmers can complete the task. For example, in *Norwest*, the court denied the credit with respect to a project that it characterized as involving

³ Taxandaccounting.bna.com, April 25, 2008.

⁴ See *United Stationers, Inc. v. U.S.*, 163 F.3d 440, 446, 448. See also *Wilcor Inc. v. Comr.*, 116 F. Supp.2d 1028

⁵ *Id.* *United Stationers*, 97-1 USTC (“The only risk or uncertainty was whether the programs would produce the desired efficiency, not whether they could, in fact, be developed.”)

“cookbook” approaches to software development and the basic “skilled practice” of computer programmers.”

3) The third test; the software must not be commercially available. The Petitioner purchased a software package prior to the development of this software. While that did not perform to the standards that the Petitioner desired, there is no evidence to show that the purchased software did not have the functions or whether the Petitioner had different preferences.

The expenses claimed as qualified research expenses were primarily the salary of one person. During the first year, 2010, there were supplies purchased of \$13,812 and none after that. It appears that Petitioner simply hired the prior IT consultant to work as a full time employee to install the software. The software that was purchased was acquired during 2010. The Petitioner has made no distinction between testing and the normal operation of the IT department.

A Notice of Deficiency Determination issued by the Idaho State Tax Commission is presumed to be accurate. Parsons v. Idaho State Tax Commission, 110 Idaho 572 (Ct. App. 1986). The burden is on the taxpayer to show the deficiency is erroneous. Albertson’s, Inc. v. State, Dept. of Revenue, 106 Idaho 810 (1984).

Claiming research credit for purchasing and installing software is in most cases prohibited. There is an exception for “highly innovative” software. The Petitioner in this case has not provided us with the evidence that they meet that extraordinary standard to overcome the prohibition.

THEREFORE, the NODD dated May 27, 2014, and directed to [Redacted] is hereby AFFIRMED.

An explanation of the Petitioner’s right to appeal this decision is enclosed.

DATED this _____ day of _____ 2016.

IDAHO STATE TAX COMMISSION

COMMISSIONER

CERTIFICATE OF SERVICE

I hereby certify that on this _____ day of _____ 2016, a copy of the within and foregoing DECISION was served by sending the same by United States mail, postage prepaid, in an envelope addressed to:

[Redacted]

Receipt No.

[Redacted]