

BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of)	
)	DOCKET NO. 0-239-698-944
)	
)	
Petitioner.)	DECISION
_____)	

The Income Tax Audit (Bureau) at the Idaho State Tax Commission (Tax Commission) issued a Notice of Deficiency Determination (Notice) to _____ (Petitioner), a pass-through entity.¹ Petitioner filed a timely appeal and petition for redetermination of the Notice. The primary issue for decision is whether Petitioner qualifies for the Idaho research tax credit. The Tax Commission has reviewed the file and hereby issues its decision.

BACKGROUND

Petitioner is in the _____ business, headquartered in Boise, Idaho. It serves various industries including _____

During the referenced tax years, Petitioner participated in numerous projects. For example, Petitioner _____

¹ A pass-through entity is one in which the tax attributes (income, deductions, losses, credits) of the entity pass through the entity to the owner(s) of the entity for tax purposes. See related Docket No. 0-093-225-984
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Petitioner hired a third party to analyze whether it could claim the research and development (R&D) tax credit under Idaho Code section 63-3026G. The third party determined that Petitioner qualified for the R&D tax credits. Therefore, Petitioner amended its tax returns for tax years 2016, 2017, and 2018, and filed a tax return for tax year 2019, claiming the R&D tax credits.

The Bureau initiated an examination and requested Petitioner provide documentation supporting its R&D credits. Petitioner provided the R&D Tax Credit Study prepared by the third party. The Bureau reviewed the information, determined Petitioner did not qualify for the R&D credits, and issued a Notice. Petitioner appealed contending the Bureau erred in its determination.

LAW

Idaho Code section 63-3029G allows a nonrefundable credit for increasing research activities in Idaho. For purposes of the Idaho research credit, “qualified research expenses,” means the same as defined in Internal Revenue Code (IRC) section 41, except that the research must also be conducted in Idaho.

IRC section 41 allows taxpayers to take a credit for increasing research activities. Qualified research expenses are (i) in-house research expenses, including wages for employees working on qualified research and costs paid or incurred for supplies for qualified research, and (ii) contract research expenses.

To be qualified research under IRC section 41, activities or projects must satisfy four tests. These four tests are (i) the section 174 test, (ii) the technological information test, (iii) the business component test, and (iv) the process of experimentation test.

The Section 174 Test

The section 174 test requires research expenditures to be eligible for treatment as expenses under section 174.11. Section 174 generally allows taxpayers to deduct research and experimental expenditures during the taxable year in which they are paid or incurred.

The regulations define research and experimental expenditures as “expenditures incurred in connection with the taxpayer's trade or business which represent research and development costs in the experimental or laboratory sense.” Research and development costs in the experimental or laboratory sense are “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.” But resolution of uncertainty does not necessarily require experimentation.

Essentially, for there to be experimental expenditures, the taxpayer must show (1) that it does not already have information that can address a capability or method for improving the product or design of the product (uncertainty exists) and (2) its activities were meant to eliminate those uncertainties.

The Discovering Technological Information Test

Second, the research must be undertaken for the purpose of discovering technological information. In order to satisfy this requirement, the process of experimentation must fundamentally rely on principles of the physical or biological sciences, engineering, or computer science. Research is undertaken for the purpose of discovering information if it is intended to eliminate uncertainty concerning the development or improvement of a business component. Uncertainty exists if the information available to the taxpayer does not establish the

capability or method for developing or improving the business component, or the appropriate design of the business component.

Business Component Test

The taxpayer must intend to apply the information being discovered to develop a new or improved business component of the taxpayer. A business component is any product, process, computer software, technique, formula, or invention, which is to be held for sale, lease, license, or used in a trade or business of the taxpayer. Often times, taxpayers group all research in one broad category and do not identify the specific business component to which the research relates. A taxpayer must be able to tie the research it is claiming for the credit to the relevant business component. The ‘substantially all’ test is applied at the business component level.

The Process of Experimentation Test

Fourth, substantially all of the research activities must constitute elements of a process of experimentation for a purpose relating to a new or improved function, performance, reliability, or quality. The “Process of Experimentation Test” has three (3) elements: (1) Substantially all of the research activities must constitute (2) elements of a process of experimentation (3) for a qualified purpose. IRC section 41(d)(1)(C). “Substantially all” means that eighty percent (80%) or more of the taxpayer’s research activities for each business component, measured on a cost or other consistently applied reasonable basis, must constitute a process of experimentation for a qualified purpose. *Union Carbide Corp. & Subsidiaries v. Comm’r*, 97 T.C.M. (CCH) 1207 (T.C. 2009), *aff’d*, 697 F.3d 104 (2d Cir. 2012).

Specific Exclusions from “Qualified Research”

Research activity is not “qualified research” if the purpose of the research relates to style, taste, cosmetic, or seasonal design factors. IRC section 41(d)(3)(B). Further, some activities are

specifically excluded from “qualified research,” including: (1) research conducted after the beginning of commercial production of the business component and (2) research related to the adaptation of an existing business component to a particular customer’s requirement or need. IRC sections 41(d)(4)(A)–(B).

Exclusion for 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). In order to determine if the contractor’s research expenditures are “funded”, you must resolve the following issues: (1) Is payment for the contractor’s research activities “contingent upon the success of the research” under Treasury Regulation section 1.41-4A(d)(1)? (2) 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. 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 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.

Note that, if the 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.

PETITIONER'S POSITION

Petitioner submitted a twenty-five-page appeal. Petitioner's principal argument on appeal is the Bureau erred in determining it did not qualify for the Idaho research credit and that it satisfied all four tests.

DECISION

A Notice of Deficiency Determination issued by the Tax Commission is presumed to be accurate. *Parsons v. Idaho State Tax Commission*, 110 Idaho 572, 574-575 n.2, 716 P.2d 1344, 1346-1347 n.2 (Ct. App. 1986). The burden is on Petitioner to show the deficiency is erroneous. *Albertson's, Inc. v. State, Dept. of Revenue*, 106 Idaho 810, 814, 683 P.2d 846, 850 (1984). Deductions and credits are a matter of legislative grace. *New Colonial Ice Co. v. Helvering*, 292 US. 435, 54 S.Ct. 788 (1934). As with all claimed tax credits, the taxpayer bears the burden of showing that it is entitled to the credit. *United Stationers, Inc. v. United States*, 163 F.3d 440, 443 (7th Cir. 1998) (citing *Interstate Transit Lines v. Commissioner of Internal Revenue*, 319 U.S. 590, 593, 63 S.Ct. 1279, 87 L.Ed. 1607 (1943)). The taxpayer must maintain sufficient records to allow the Tax Commission to determine its correct tax liability. IRC section 6001; Treas. Reg. section 1.6001-1(a). If a taxpayer is unable to provide adequate proof of any material fact upon which a deduction or credit depends, the deduction or credit is not allowed. *Burnet v. Houston*, 283 US. 223, 51 S.Ct. 413 (1931).

The Tax Commission finds that Petitioner did not meet its burden of proving the deficiency erroneous. The goal of the research tax credit is to provide incentives for companies to invest in research that might not otherwise be undertaken due to its high risks. *Tax & Accounting Software Corp. v. United States*, 301 F.3d 1254, 1266 (10th Cir. 2002). The research tax credit is not intended for research projects that only expand a wealth of knowledge in a particular industry.

Wicor, Inc. v. United States, 116 F. Supp. 2d 1028, 1034 (E.D. Wis. 2000), *aff'd*, 263 F.3d 659 (7th Cir. 2001). The knowledge gained from the research must exceed that which is known in the field in which the taxpayer is performing the research and experimentation. *Id.* Here, the information used in the _____ appears to be well known in the _____ industry.

The Tax Commission finds that Petitioner’s research is excluded from “qualified research” because it is an adaptation of its existing business component—i.e.,

—to a particular customer’s need. See I.R.C. § 41(d)(4)(B). Petitioner was in the business of _____ prior to the tax years at issue, and it appears that the cost of wages and material claimed as research were not specifically expended for research purposes; rather, the claimed costs would have been incurred regardless in order to _____ to the customer’s specifications.

Petitioner has not met its burden of proving the specific uncertainty in the _____ that its research activity was intended to eliminate; therefore, the Tax Commission finds that the research activity does not pass the Section 174 Test. Uncertainty exists only 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. Treas. Reg. section 1.174-2(a)(1). It appears to the Tax Commission that _____ was within the information available to Petitioner and was technically feasible without engaging in specific research.

Nonetheless, “uncertainty concerning the development or improvement of the business component (e.g., its appropriate design) does not establish that all activities undertaken to achieve that new or improved business component constitute a process of experimentation.” Treas. Reg.

section 1.41-4(a)(5)(i). The _____ where the _____ was uncertain at the outset of the project, could have been determined by means other than a process of experimentation.

Ultimately, Petitioner has not established that its research activities were a part of a process of experimentation. See IRC section 41(d)(1)(C). The documents provided do not establish how Petitioner formulated or tested hypotheses, engaged in systematic trial and error or evaluated alternatives during the years in issue. *Union Carbide Corp. & Subs. v. Commissioner*, supra, 2009 WL 605161, at *81. Petitioner was required to show through its records that each research project had a methodical plan setting forth a series of trials to test a hypothesis, analyze the data, and retest the hypothesis so that the research conducted was part of a process of experimentation in the scientific sense. *Id.*

A taxpayer must “retain records in sufficiently usable form and detail to substantiate that the expenditures claimed are eligible for the credit.” Treas. Reg. section 1.41-4(d). The Tax Commission finds that Petitioner’s records are not sufficiently detailed to substantiate its entitlement to the Idaho research credit.

The Tax Commission requested Petitioner provide complete copies of all contracts (including modifications), agreements, letters of understanding or similar documents where funding is an issue. The Tax Commission wanted to review the contracts and similar documents to determine whether, and to what extent the research is to be considered funded. Petitioner didn’t provide the requested documentation.

THEREFORE, the Notice dated February 26, 2021, and directed to Petitioner is hereby AFFIRMED.

In general, an adjustment to a partnership, S corporation, estate or trust allowed or required by Idaho statute generally is claimed on the income tax returns of the partners, shareholders, or beneficiaries of the entity. Income Tax Administrative Rule 128. In this case, the adjustments to Petitioner's return pass-through to the shareholder. Therefore, Petitioner does not owe any additional tax, penalty, or interest as a result of this decision.

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

DATED this _____ day of _____ 2023.

IDAHO STATE TAX COMMISSION

CERTIFICATE OF SERVICE

I hereby certify that on this _____ day of _____ 2023,
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:

Receipt No.
