



BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of)	
)	DOCKET NO. 0-675-013-632
)	
)	DECISION
Petitioner.)	

The Intrastate Income Tax Audit Bureau (Bureau) sent  (Petitioner) a Notice of Deficiency Determination (Notice) for tax years 2019, 2020, 2021, and 2022. Petitioner protested, disagreeing with the Bureau’s disallowance of the Idaho Research Credit. The Tax Commission reviewed the matter and hereby cancels the Notice issued by the Bureau. Since Petitioner is a flow-through entity, any adjustments flow through to their shareholders.

BACKGROUND

Petitioner is an S-Corporation, reporting a less than 100% apportionment to Idaho. They primarily construct custom building products including doors, windows, cabinets, molding, and other architectural specialties. Petitioner hired a third party to analyze whether they could claim the Idaho research credit under Idaho Code section 63-3029G. The third party determined that Petitioner qualified for the Idaho research credit. Therefore, Petitioner amended their 2019 and 2020 tax returns, and filed their 2021 and 2022 returns, claiming the credit. The Bureau selected these returns to examine the Idaho research credit.

The Bureau requested that Petitioner address specific questions regarding its research activities and provide a copy of the study for the Idaho research credit conducted by the third party. Petitioner’s representative responded and provided a copy of the study for the Idaho research credit.

Petitioner claimed the Idaho research credit using a sample of projects completed during the years in question. Petitioner chose 25 projects through a variety of qualifications and selection criteria. Petitioner stated the 25 projects chosen were found to contain substantial activities that constituted qualified research. They claimed the projects bore economic risk, and Petitioner retained substantial rights to the research conducted. The Bureau reviewed the study and determined that Petitioner's projects did not satisfy all the requirements for the credit; therefore, the Bureau disallowed the Idaho research credit claimed for all the projects and issued a Notice.

Petitioner protested the Notice, disagreeing with the Bureau's determination, and argued that the activities undertaken for the projects are qualified research activities and the expenditures are qualified research expenses. The Bureau acknowledged the protest and referred the matter to the Tax Commission's Appeals Unit (Appeals) for administrative review. Appeals conducted an informal hearing on February 12, 2025, to discuss the case in detail. Following the hearing, Petitioner submitted additional documentation in support of its position. The Tax Commission has reviewed all relevant information and hereby issues its decision.

LAW AND ANALYSIS

Idaho Code section 63-3029G allows a nonrefundable tax 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 be conducted in Idaho.

To be eligible for the credit, a taxpayer must show that it performed "qualified research" during the years at issue in accordance with IRC section 41(d). Research activity is "qualified research" under IRC section 41(d) only if it satisfies all the four (4) tests.

First, the research expenses must be eligible for treatment as expenses under IRC section 174. Second, the research must be undertaken for the purpose of discovering information that is technological in nature. Third, the application of the research must be intended to be useful in the development of a new or improved business component. Fourth, substantially all the activities constitute elements of a process of experimentation for a new or improved function, performance, reliability or quality. If the research fails any of these tests, it is not qualified research for the purposes of the research credit.

Section 174 Test

The Bureau asserted that Petitioner did not meet the burden of providing specific uncertainty in the designing and building process. The Bureau argued the projects presented were built to the specifications of their customers, which does not qualify. Under Treasury Regulation section 1.174-2(a)(1), uncertainty exists if the information available to the taxpayer does not establish the capability or method for developing or improving the product and the activity is intended to eliminate uncertainty. Petitioner argues businesses that produce products for specific customer needs do not disqualify them from the credit. The customers contracting with Petitioner do not give them clear instructions or solutions, only desires. Many of the projects involved multiple site visits, measurements, mockup designs, and careful planning.

Customer specifications range from simple size differentials to grand blueprints that require immense preparation. A customer request for a cabinet with specific dimensions where all measurements were submitted to the business would indeed not qualify for the credit, as no investigation was carried out to complete the task. To “investigate” is “to observe or study through close examination and systematic inquiry” (*Max v. Commissioner* T.C. Memo 2021-037). For Petitioner’s activities to be “investigative in nature,” Petitioner must closely examine the

uncertainty at issue and systematically inquire after potential solutions to resolve it. During both the audit and appeals process, Petitioner provided examples where they were uncertain, investigated a solution, and implemented alternatives to ultimately complete the project. The Bureau argued that Petitioner already knew the process to design the components and therefore uncertainty did not exist. However, while it might be true that Petitioner understood the process to investigate a solution, they were uncertain of the appropriate design which required investigation. The Tax Commission reviewed the mock-ups, investigative process, and timecards provided during the appeals process and found that Petitioner incurred sufficient uncertainty to pass the Section 174 test.

Technological Information Test

To satisfy the technological in nature requirement for qualified research, the process of experimentation used to discover information must fundamentally rely on principles of the physical or biological sciences, engineering, or computer science. A taxpayer may employ existing technologies and may rely on existing principles of the physical or biological sciences, engineering, or computer science to satisfy this requirement. The Bureau did not believe Petitioner met this requirement in part because:

Using computer-aided modeling and simulations is not qualified research to eliminate technical uncertainty. Uncertainty does not exist because the same methods are used to design and build desks, counter tops, etc. in prior years compared to the audited years. No new discoveries were made. Using AutoCAD and CabinetVision software does not satisfy the requirement of relying on the principles of computer science.

Petitioner disputes the assertion that they used computer science to qualify for the research credit. Petitioner states they relied on engineering to determine load capacity, load distribution, and to ensure the structural integrity of the business components. Petitioner explained in the [REDACTED] [REDACTED] project, they relied on a blend of engineering including structural and sound engineering

for its completion. Petitioner constructed and installed an acoustic cloud where they needed to test if the cloud was working as intended for sound absorption. They also ensured it was safely secured so it did not fall onto audience members, and it would be safely secured for decades.

The Bureau made the comment “no new discoveries were made” in their analysis of Petitioner’s research projects. In December of 2003, new regulations were promulgated specifically to Treasury Regulation section 1.41-4. According to the 2003 Regulations:

Discovering information does not require the taxpayer be seeking to obtain information that exceeds, expands or refines the common knowledge of skilled professionals in the particular field of science or engineering in which the taxpayer is performing the research. 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.

Petitioner does not need to be a trailblazer in their industry to qualify for the research credit. The Tax Commission has reviewed Petitioner’s arguments and documentation and found they relied on physical science and engineering to qualify under this test.

Business Component Test

A 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. Treasury Regulation section 1.174-2(a)(5) explains that, even if a business component as a whole fails any of the four tests, a taxpayer may still satisfy the tests “at the level of the component or subcomponent of the product.”

The Bureau argued that Petitioner did not qualify under this test because their customers would dictate design and style. New business components are not qualified if they are due to style, taste, cosmetic, or seasonal design factors according to IRC section 41(d)(3)(B). Additionally, the Bureau argued Petitioner did not have qualifying business components because they are simply

adaptations of existing components, not qualified under IRC section 41(d)(4)(B). Petitioner disagreed with this assessment, stating while Petitioner did perform custom work, it was not to taste, style, or seasonal design. Petitioner argues the custom work was to primarily enhance the quality, reliability, and performance of the business components.

Custom work does not automatically disqualify a taxpayer from qualifying for the research credit. Treasury Regulation section 1.41-4(c)(3) states:

Activities relating to adapting an existing business component to a particular customer's requirement or need are not qualified research. **This exclusion does not apply merely because a business component is intended for a specific customer. (Emphasis Added)**

While it is true that custom architectural work can be utilized for style, taste, and cosmetic preferences of the customer, the Tax Commission does not believe the work done in Petitioner's projects fits that description. In the acoustic cloud project cited earlier, Petitioner needed to design and install the product so it would be secure for decades and would not fall on students due to lack of structural integrity. The desire for structural integrity does not fall under style, taste, or cosmetic preference. Another example is designing and installing a custom orchestra pit, which needed a removable lid and wheelchair lift. Again, the customer's desire was not a matter of style, taste, or cosmetic preference, but for structural integrity, safety, and overall compatibility with their space. The Tax Commission reviewed Petitioner's presentation of their sample projects and found the activities were qualified under the business component test.

Process of Experimentation Test

Lastly, research is treated as qualified research if substantially all the activities constituted elements of a process of experimentation and were undertaken for a qualified purpose. Treasury Regulation section 1.41-4(a)(5)(i) states in part:

...a process of experimentation is a process designed to evaluate one or more alternatives to achieve a result where the capability or the method of achieving that result, or the appropriate design of that result, is uncertain as of the beginning of the taxpayer's research activities. A process of experimentation must fundamentally rely on the principles of the physical or biological sciences, engineering, or computer science and involves the identification of uncertainty concerning the development or improvement of a business component, the identification of one or more alternatives intended to eliminate that uncertainty, and the identification and the conduct of a process of evaluating the alternatives (through, for example, modeling, simulation, or a systematic trial and error methodology). A process of experimentation must be an evaluative process and generally should be capable of evaluating more than one alternative.

Experimentation is undertaken for a “qualified purpose” if:

...it relates to a new or improved function, performance, reliability or quality of the business component. Research will not be treated as conducted for a qualified purpose if it relates to style, taste, cosmetic, or seasonal design factors.

The Treasury Regulations also require that “substantially all” of the activities must constitute elements of a process of experimentation. The substantially all test would be satisfied if 80 percent or more of a taxpayer’s research activities constitute elements of a process of experimentation.

The Bureau argued Petitioner did not qualify under this test because they did not provide documentation establishing a hypothesis, systematic trial and error, or evaluated alternatives to their activities. The Bureau also stated that simply explaining their process does not establish that Petitioner engaged in experimentation. In response to the Notice, Petitioner provided examples of their planning process, sketch ideas, and mockups of the projects.

In Petitioner’s presentation during the informal hearing, they went over how they created a hypothesis, evaluated alternatives, and created the final design. First, Petitioner would evaluate the feasibility of the project. This included site visits to review and establish specifications of measurements and requirements by the customer. Petitioner would then develop initial schematics using CAD software. Second, Petitioner would refine the drawings and simulate models of product they are creating for the customer. Finally, Petitioner would test the designs and fabricate a final

design for production. After the hearing, Appeals requested Petitioner to provide additional mockups and documentation related to how they tracked research time for their employees. Petitioner satisfied that request by providing pictures of different mockup designs they had built in their shop. They also provided timecards of selected employees showing how many hours they spent on each project. The Tax Commission has reviewed the additional information provided by Petitioner and found that Petitioner satisfied the process of experimentation test for the projects listed in the study. Petitioner demonstrated how the experimentation was undertaken for a qualified purpose and that substantially all of the research done had elements of the process of experimentation.

CONCLUSION

The Tax Commission holds that Petitioner's development of architectural mill work and casework constituted qualified research under IRC section 41. Petitioner established the expenditures claimed qualified under IRC section 174, discovered information which was technological in nature, developed a new or improved business component, and constituted elements of a process of experimentation.

THEREFORE, the Notice of Deficiency Determination directed to [REDACTED] [REDACTED]

[REDACTED] [REDACTED] [REDACTED] dated June 27, 2024, is hereby CANCELLED.

DATED this _____ day of _____ 2025.

IDAHO STATE TAX COMMISSION

CERTIFICATE OF SERVICE

I hereby certify that on this _____ day of _____ 2025,
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.

[REDACTED]

[REDACTED]

[REDACTED]