BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of [redacted] Petitioner.	)	DOCKET NO. 0-723-166-208
	)	DECISION

[redacted] (Petitioner) protested the Notice of Deficiency Determination (Notice) dated November 2, 2023, issued by the Income Tax Audit Bureau (Bureau). Petitioner disagreed with the Bureau's disallowance of the credit claimed for Idaho research activities (Idaho research credit). The Idaho State Tax Commission (Tax Commission) reviewed the matter and for the reasons stated below modifies the Notice. Since Petitioner is a flow-through entity, Petitioner's shareholders are liable for any additional tax, penalty, and interest.

BACKGROUND

Petitioner is an Idaho partnership, providing [redacted]. 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 its tax returns for tax years 2017 through 2019, and filed a return for 2020, claiming the credit. Tax year 2017 is the first tax year that Petitioner claimed the Idaho research credit. The Bureau selected the 2017, 2018, and 2019 amended returns and the 2020 original return for examination, specifically, to examine Petitioner's entitlement to the Idaho research credit.

The Bureau requested Petitioner respond to specific questions regarding their research activities and provide a copy of the Idaho research credit study conducted by the third party.

Petitioner's representative responded and provided a copy of the study for the Idaho research credit. The study states that Petitioner claimed the Idaho research credit on multiple projects, including developing and improving software products for internal and external use. Their activities include concept development, system architecture, storyboarding, data mapping, coding, testing, supervision, support, and customer feedback analysis.

The Bureau reviewed the study and determined that only one[1] of Petitioner's projects satisfied all the required tests under Internal Revenue Code (IRC) section 41. Therefore, the Bureau disallowed the Idaho research credit claimed for all the projects, except for one, and issued a Notice.

Petitioner's representative protested the Notice, disagreeing with the Bureau's determination regarding the Idaho research credit. The representative argued that the activities undertaken for all projects are qualified research activities, and the expenditures are qualified research expenses. The representative believes that the Bureau's disallowance of the credit is because of the Bureau's "lack of experience with software development and the difficulties surrounding functional development in a dynamic environment." The Bureau acknowledged the protest and referred the matter to the Tax Commission's Appeals Unit (Appeals) for administrative review.

Appeals sent Petitioner and their representative a letter explaining the options available for redetermining a Notice. The representative responded, requesting an informal hearing which was held on September 5, 2024. Having reviewed the file, the Tax Commission hereby issues its final decision.

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[1] 2017-2019 Browser Extension, described more below in this decision.

ISSUE

The issue on appeal is whether Petitioner's activities met the requirements for the Idaho research credit pursuant to Idaho Code section 63-3029G.

LAW AND ANALYSIS

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" are the same as defined in 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. *See Union Carbide Corp. & Subsidiaries v. Comm'r*, 97 T.C.M. (CCH) 1207 (T.C. 2009), 2009 WL 605161, at *77, *aff'd*, 697 F.3d 104 (2d Cir. 2012).

First, the research expenses must be eligible for treatment as expenses under IRC section 174 (the section 174 test)[2]. Second, the research must be undertaken for the purpose of discovering information that is technological in nature (the discovering technological information test)[3]. Third, the application of the research must be intended to be useful in the development of a new or improved business component (the business component test)[4]. A "business component" is any product, process, technique, formula, or invention which is to be used by the taxpayer in its trade or business, and each "business component" of the taxpayer must satisfy all 4 tests. Fourth, substantially all the activities constitute elements of a process of experimentation for a new or

[2] IRC § 41(d)(1)(A)
[3] IRC § 41(d)(1)(B)(i)
[4] IRC § 41(d)(1)(B)(ii)

improved function, performance, or reliability or quality (the process of experimentation test)[5]. If the research fails any of these tests, it is not qualified research for the purposes of the research credit.

Research activity is not "qualified research" if the purpose of the research relates to style, taste, cosmetic, or seasonal design factors[6]. Further, the activities specifically excluded from "qualified research" are the research conducted after the beginning of commercial production of the business component[7], and the research related to the adaptation of an existing business component to a particular customer's requirement or need[8].

In addition to the 4 tests listed above, specifically regarding software for internal use (internal use software), a taxpayer must meet the high threshold of innovation test[9], consisting of three (3) parts, under Treasury Regulation (Treas. Reg.) section 1.41.-4(c)(6)(vii): (1) The software is innovative; (2) The software development involves significant economic risk; and (3) The software is not commercially available for use by the taxpayer in that the software cannot be purchased, leased, or licensed and used for the intended purpose without modifications that would satisfy the requirements of paragraphs (c)(6)(vii)(A)(1) and (2) of Treas. Reg. section 1.41.-4.

Section 174 Test

IRC section 174 provides that a taxpayer may treat research or experimental expenditures, paid or incurred, during the taxable year in connection with its trade or business, as expenses not chargeable to a capital account[10]. Treas. Reg. section 1.174-2(a)(1) defines the term "research or

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[5] IRC §§ 41(d)(1)(C) and 41(d)(3)
[6] IRC § 41(d)(3)(B)
[7] IRC § 41(d)(4)(A)
[8] IRC § 41(d)(4)(B)
[9] T.D. 9786, Final Regulations, effective 10/4/2016.
[10] IRC § 174(a)(1)

experimental expenditures" as used in section 174, generally includes all such costs incident to the development or improvement of a product[11] and would "… represent research and development costs in the experimental or laboratory sense". The qualified expenditure must be for activities intended to eliminate uncertainty in the development or improvement of a product. Treas. Reg. section 1.174-2(a)(1) states in part: "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.", which means that the taxpayer must be uncertain about whether they can achieve the objective through their research activities. *Max v. Commissioner of Internal Revenue*, T.C. Memo. 2021-37 (2021). Treas. Reg. section 1.174-2(a)(1) also states; "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." (emphasis added)

The Internal Revenue Service (IRS) Final Regulations (T.D. 9104)[12] further identifies uncertainty in software development, concerning a functional aspect of a software business component. There is a distinction between a software development uncertainty that is resolved through a process of experimentation, and other types of uncertainties, namely business and project uncertainties. The software development uncertainty exists when a taxpayer must configure a software application and is uncertain about which configuration choices to make. This "configuration" uncertainty, in and of itself, doesn't indicate that the taxpayer subsequently engaged in a process of experimentation to eliminate the uncertainty. The activities undertaken to eliminate

[11] Treas. Reg. 1.174-2(a)(1)
[12] Treasury Decision 9104, 69 FR 22-29, January 2, 2004, also called "IRS Final Regulations (T.D. 9104) on Credit for Increasing Research Activities".

the configuration uncertainty are determinative. Business uncertainties could, for example, be whether potential users will react favorably to the new product, and/or whether the product will be competitive. Project uncertainties could be whether the existing staff are adequately trained to use technology, and/or whether the project can be completed within a given schedule and budget. Such uncertainties, business/project uncertainties, do not meet the requirements of IRC section 41(d).

In the present case, the representative argued that the Bureau ignored the fact that Petitioner's expenditures were for the "new" and/or "improved" software. The representative claimed that Petitioner was seeking the appropriate design to develop and improve their software products for commercial sale or used by Petitioner's clients (i.e., user interface) as well as for internal use.

The study describes Petitioner's "technical" uncertainties and indicates that Petitioner identified these uncertainties at the outset of each project because of design, composition, and application. Petitioner's project details, provided in the study, describe various business/project uncertainties as well as configuration uncertainties. The Tax Commission finds that the business/project uncertainties do not meet the uncertainty requirement of IRC section 174. However, to determine whether the configuration uncertainties meet the IRC section 174 uncertainty requirement, the Tax Commission further reviews the configuration uncertainties in relation to the rest of the requirements[13] for the Idaho research credit.

Discovering 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

[13] The discovering technological information test, the business component test, the process of experimentation test, and the high threshold of innovation test for internal use software.

physical or biological sciences, engineering, or computer science[14]. 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 Internal Revenue Service (IRS) Final Regulations[15] state that the issuance of certain patents by the U.S. Patent and Trademark Office can be conclusive evidence that a taxpayer has discovered information that is technological in nature that is intended to eliminate uncertainty concerning the development or improvement of a business component, known as the "patent safe harbor".

During the tax years under the current review, Petitioner filed several patent applications[16], and the U.S. Patent and Trademark Office has approved one of their patent applications[17]. However, the issuance of a patent is not a precondition for credit availability[18].

Business Component Test

To meet the requirements of the business component test, a taxpayer must intend to apply the information being discovered to develop a new or improved business component. 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 a taxpayer.

In the present case, Petitioner claimed an Idaho research credit for the following projects:

[14] Computer science is the study of computers and algorithmic processes, including their principles, their hardware and software designs, their applications, and their impact on society.
[15] T.D. 9104, previously referred to under the "Section 174 Test" in this decision.
[16] Some of the applications are continuous to the previously filed application.
[17] 2017-2019 Browser Extension
[18] Treas. Reg. section 1.41-4(a)(3)(iii)

true process of experimentation, the project must use the scientific method. This means "the project must involve a methodical plan involving a series of trials to test a hypothesis, analyze the data, refine the hypothesis, and retest the hypothesis so that it constitutes experimentation in the scientific sense." *Union Carbide Corp. & Subs. v. Commissioner*, T.C. Memo. 2009-50 (2009).

Generally, there are many different categories in software development, such as, but not limited to, initial development of software products, new product applications, feature extensions and enhancements to existing products, combining existing products to create a new product or product suite, and creating new versions of existing products by removing features (i.e., to provide a more entry-level product). The facts and circumstances of each case must be considered in deciding whether a taxpayer's activities constitute elements of a process of experimentation under the IRC and the Treas. Regs.

The study explains that, when experimenting with alternatives for most of the projects, Petitioner used a project management approach called "Agile Scrum". This approach involves breaking the project into phases[23] and emphasizes continuous collaboration and improvement by repeating a cycle of the phases to meet objectives set in each project. Petitioner also used an approach called "Agile Kanban", which breaks out workflow into separate tasks, visualizes them, and creates a timeline by prioritizing the tasks and sharing findings with team members. With either approach, "Agile Scrum" or "Agile Kanban", the purpose is to move a project forward and accomplish the goal within the planned timeframe. The study explains that Petitioner's development process includes "conception, coding and developing, testing and modifications as needed". During the hearing, Petitioner clarified that they used a software developed by a third-

[23] The phases generally involve, but are not limited to, planning, designing, developing, testing, deploying, and reviewing.

party[24] as their project management tool, tracking bugs and issues on a project, which allows them to virtually document their process of experimentations and alternatives that they analyzed and evaluated during development of each project.

To determine whether the project met the required tests under IRC section 41, projects are placed into four categories: "Browser Extension", "Interfaces", "For Sale", and "For Internal Use" based on functionality and types[25] of software Petitioner developed.

Browser Extension[26]

A browser extension, also called a plug-in, is a software application that adds capacity or functionality to a web browser. Vendors of web browsers[27] typically provide well-defined interfaces and/or application programing interfaces (APIs)[28] to permit new code[29] to interact with the vendor's code. Herein, the vendor's product is not modified, and the new code must conform to the vendor's defined interface or an API.

The study explains the purpose of the browser extension project, conducted from 2017 through 2019 (2017-2019 browser extension), is to build an extension by injecting a button into a web page, that when pressed by a client, will extract information relevant to a background check from the web page. To extract the correct information from multiple web pages via flexible and accurate mapping, Petitioner, first, evaluated many mapping technologies, and then ultimately

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[24] Atlassian Jira, a software for bug tracking, issue tracking, and agile project management.
[25] There are several types of software, including, but not limited to, application software, system software, operating system, etc.
[26] The study lists two projects, identified as "browser extension": one from 2017 through 2019, and the other as "improved" for 2020.
[27] Examples of browser vendors; Microsoft (Internet Explorer and Edge), Google (Chrome), Apple (Safari), Opera Software (Opera) and Mozilla (Firefox).
[28] Application Programing Interface (API) is a set of rules/protocols that enables software applications to communicate with each other.
[29] "Code", also known as computer programming, is the set of instructions that programmers write to create software. Code is written in a specific programming language, such as Python, HTML, C++, or Java, and is the fundamental building block of a computer.

selected "regular expression (regex)". Regex is a sequence of characters that specifies a match pattern in text. Such patterns are used by a string-searching algorithm[30] for "find" or "find and replace" operations, or for input validation[31]. Petitioner used regex to "build a template for each website, allowing the extension to search for, locate, and extract the relevant information across many different web pages with different formats", and "the templates allow the extension to accurately determine exactly where to extract data from for each web page." Petitioner's activities include, but are not limited to, writing code, testing the code on a cloud platform, analyzing and evaluating the testing results, and revising the code to develop the extension compatible to the vendor's web browser. The Tax Commission finds that Petitioner's software development activities conducted for the 2017-2019 browser extension project constitute elements of a process of experimentation under the IRC and the Treas. Regs. Since the Bureau accepted the 2017-2019 browser extension as a qualified project for the Idaho research credit[32], the Tax Commission suggests no further modifications to the Notice regarding the 2017-2019 browser extension project.

After Petitioner deployed the 2017-2019 browser extension, they developed another extension (2020 browser extension) from scratch, instead of reconfiguring the previously developed extension. The purpose of the 2020 browser extension project was to fit the 2017-2019 browser extension's functionalities into a small form factor[33], enhance secured access by clients, and improve browser compatibility allowing their clients to conduct background screening without

[30] In computer science, string-searching algorithms, sometimes called string-matching algorithms, are for finding a pattern.
[31] In computer science, input validation is the process of ensuring data is correct and useful.
[32] The Notice explains, "This project appears to meet the requirements necessary to claim the Idaho research credit."
[33] Small form factor is a term used for desktop computers and for some of their components, chasses and motherboard, to indicate that they are designed in accordance with one of several standardized form factors intended to minimize the volume and footprint of a desktop computer compared to the standard motherboard and power supply configuration specifications from factor.

logging in to the traditional web portal. The study explains the "technical" uncertainties for the 2020 browser extension project are regarding the appropriate design and the study describes the uncertainties as follows:

- How can we design improvements to our browser extension, allowing users to access the [redacted] product without logging in to the portal?
- How can we design the extension to have similar functionality to the web application, overcoming the difficulty imposed by the small space?
- How can we design the browser extension to work with several common web browsers, accommodating their specifications?

The study explains the development process for the 2020 browser extension involved designing, writing code, systematically testing code and evaluating alternatives[34], on a cloud platform, as a business component separate from the 2017-2019 browser extension. The Tax Commission, after a thorough review of the facts, finds that Petitioner's activities for the 2020 browser extension project have met the required tests under IRC section 41.

Interfaces

There are many ways in which a software business component can interface with other software components and/or users (bidirectional interaction). One type of interface development, for example, includes designing and implementing electronic interfaces between software applications, wherein one software application can "talk" to another software application and exchange data or execute a business transaction. A software business component may involve interfacing with one or more other software applications, whether internal or external. A software business component may also interface with a user via an Internet browser. The activities for the

[34] Treas. Reg. section 1.41-4(a)(8) Example 8.

Interface software development involve, first, defining the data and transaction requirements to support users on each end of the interface, and then writing the software.

The study describes Petitioner's projects: "Invoicing Sage Financials", "Verifications in Salesforce", and "Invoicing System Salesforce" as building a system or tool that allows them and/or their clients to process invoices or verify data on existing applications, either owned by them or provided by their integrated partners (i.e., Salesforce). For these projects, Petitioner selected a suitable code for the project among alternatives (i.e., Visual Studio Code, C++, Java, and Python)[35], built coding for a bidirectional interactive system, and experimented with it in a testing environment licensed from an un-related third-party cloud service provider. As for the "[redacted] Web Application" project, Petitioner describes it as "to develop a faster and more user-friendly front end for [redacted] backend provider[36]" because the existing front end had been "slow and confusing for clients". Petitioner built an API[37] that allows an existing application to communicate with the back-end provider's system.

The study also explains that the preponderance of iterations was to overcome limitations[38] inherent to applications in an existing platform and/or optimize bidirectional interactions with the platform. Petitioner's software development activities involved defining the requirements of the interface, building algorithms, writing software (i.e., API) or adding custom improvements to

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[35] Petitioner also described their alternatives in the study report as "synchronous vs asynchronous code". "Synchronous" code means in this context that code is executed sequentially from top to bottom with each statement completed before the next begins. This means that a task can't run until the previous task is complete. "Asynchronous" is a programing technique that allows a program to start a potentially long-running task and still be able to be responsive to other events while that task runs, rather than having to wait until that task has finished. Programing languages, such as C++, Java, and Python, can run synchronously and asynchronously.

[36] A backend provider is a provider of a cloud-based service that allows developers to build a web-based application.

[37] Application Programing Interface (API) is a set of rules/protocols that enables software applications to communicate with each other.

[38] Petitioner's limitations include, but are not limited to, governor limits which are specific restrictions for operations that use shared resources, for example, a limitation in the number of transactions based on the number of user licenses.

commercially available software, choosing a merchant service provider[39] and a server[40]. The Tax Commission finds that "substantially all" of Petitioner's software development activities categorized as "interfaces" or "interfacing" have constituted elements of a process of experimentation under the IRC and the Treas. Regs.

For Commercial Sale

Software developed for commercial sales means the software is internally developed and intended to be sold, leased, licensed or marketed to third parties. The representative clarified that Petitioner developed "[redacted] Web Application" and "Volunteer Management System" for commercial sale[41], which was intended to operate autonomously via a web browser without dependence on any platform. For these projects, Petitioner selected a suitable code for the project among alternatives (i.e., Visual Studio Code, C++, Java, R, and Python), created the frontend (i.e., user interface) and backend (i.e., data architecture), and tested it in a cloud developer environment licensed from an un-related third-party provider.

The study explains that the preponderance of iterations was to build the frontend and backend, create algorithms for user identity confirmation without compromising user anonymity, and enforce access control (i.e., authentication and authorization) for "[redacted] Web Application". While evaluating alternatives, Petitioner searched for viable options; however, they found that "all commercially available solutions (e.g., Slack[42]) lacked desired functionalities

[39] A merchant service provider is a financial software partner that allows accepting and processing payments and acts as an intermediary between businesses and financial institutions.
[40] The study report lists alternatives as "On-premise services vs. Amazon Web Service, Azure, or Cloud servers". An on-premise service is a physical, on-site server that a company must manage and maintain individually. A cloud server, on the other hand, is a virtual (not physical) server running in a cloud computing environment that can be accessed on demand.
[41] The background of the projects, provided to Appeals.
[42] Slack is a cloud-based team communication platform developed by Slack Technologies, which has been owned by Salesforce since 2020.

facilitating anonymity, concern triage and data security[43].” In the process of developing their own business component, Petitioner designed and wrote code, systematically tested the code and evaluated alternatives by relying on the principles of computer science. The Tax Commission found that Petitioner’s activities for the development of this business component have met the requirements for process of experimentation.

As for “Volunteer Management System”, Petitioner explained the purpose of the project was to design and develop an application with the functionalities for clients to [redacted] and [redacted] Petitioner focused on security compliance with the industry requirements and interactivity with Salesforce applications. The Tax Commission finds that the initial development during tax year 2019 has constituted elements of process of experimentation. After the 2019 product became publicly available, Petitioner released version updates during tax year 2020. The project details explain that the version updates in 2020 are for functional improvements to [redacted] custom public site pages for volunteer opportunities, custom volunteer registration forms, and encrypted passwords for potential and existing volunteers. However, it is not clear whether the 2020 version updates are modifications or enhancements to the existing “Volunteer Management System” released in 2019, or a separate project after the release. The project details do not describe uncertainties, nor do they include a detailed description of the activities conducted specifically for the 2020 version updates. Due to a lack of substantiation, the Tax Commission is not able to determine whether Petitioner’s software development activities regarding the 2020 version updates

[43] Treas. Reg. section 1.41-4(c)(10), Example 8, illustrates the application of the duplication exclusion. The exclusion doesn’t apply merely because the taxpayer evaluates other’s business component in the course of developing its own business component.

for the "Volunteer Management System" project constituted elements of a process of experimentation under the IRC and the Treas. Regs.

For Internal Use

Generally, internal use software is developed primarily for general and administration functions, such as financial management functions, human resource management functions, and support service functions that support day-to-day operations like data processing or facilities services.

Treas. Reg. section 1.41-4(c)(6)(vi)(A) provides the following presumption for software developed for both internal use and to enable interaction with third parties (dual function software):

> …software developed by (or for the benefit of) the taxpayer both for use in general and administrative functions that facilitate or support the conduct of the taxpayer's trade or business and to enable a taxpayer to interact with third parties or to allow third parties to initiate functions or review data on the taxpayer's system (dual function software) is presumed to be developed primarily for a taxpayer's internal use.

The representative clarified the rest of the projects were to develop software for internal use. The study shows that Petitioner designed and developed most of the internal use software[44] to interact with Salesforce platform and/or be compatible with the existing Salesforce database, and the development process is very similar to the activities previously described under "Interfaces" in this decision.

Specifically for internal use software, in addition to the 4 tests under the IRC and Treas. Regs, Petitioner must meet the high threshold of innovation test, provided under Treas. Reg. section 1.41-4(c)(6)(vii)(3):

> (B) *Innovative*. Software is innovative if the software would result in a reduction in cost or improvement in speed or other measurable improvement, that is substantial

[44] All internal use software, except for Sanity Bot.

> and economically significant, if the development is or would have been successful. This is a measurable objective standard, not a determination of the unique or novel nature of the software or the software development process.
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> (C) *Significant economic risk*. The software development involves significant economic risk if the taxpayer commits substantial resources to the development and if there is substantial uncertainty, because of technical risk, that such resources would be recovered within a reasonable period. The term "substantial uncertainty" requires a higher level of uncertainty and technical risk than that required for business components that are not internal use software. This standard does not require technical uncertainty regarding whether the final result can ever be achieved, but rather whether the final result can be achieved within a timeframe that will allow the substantial resources committed to the development to be recovered within a reasonable period. Technical risk arises from uncertainty that is technological in nature, as defined in paragraph (a)(4) of this section, and substantial uncertainty must exist at the beginning of the taxpayer's activities.
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> (D) *Application of high threshold of innovation test*. The high threshold of innovation test of paragraph (c)(6)(vii) of this section takes into account only the results anticipated to be attributable to the development of new or improved software at the beginning of the software development independent of the effect of any modifications to related hardware or other software. The implementation of existing technology by itself is not evidence of innovation, but the use of existing technology in new ways could be evidence of a high threshold of innovation if it resolves substantial uncertainty as defined in paragraph (c)(6)(vii)(C) of this section.

The Tax Commission found that Petitioner's software development activities categorized as "for internal use", have met the higher threshold tests under Treas. Reg. section 1.41-4(c)(6)(vii).

Qualified Research Expenses (QREs)

In addition to reviewing Petitioner's qualified research activities, the Tax Commission must also review the expenses associated with the projects to determine whether they are qualified research expenses (QREs). QREs consist of four types of expenses: wages for qualified services

performed in Idaho, cost of supplies used in Idaho, rental or lease costs of computers used in Idaho, and contract research expenses at applicable percentage[45].

In their qualified research expense, Petitioner included wages paid to employees who resided in states other than Idaho. However, the only wages allowable as qualified research expenses are the amount paid to Idaho employees. Therefore, the wages paid to nonresident employees must be excluded from the QREs. Additionally, since the Tax Commission determined that Petitioner's activities for all the projects, except for the 2020 version updates on "Volunteer Management System", are qualified research activities, the wages associated with the 2020 version updates must be excluded from the QREs.

For the cost of supplies, if the supplies are used for qualified research activities conducted in Idaho, it may be a QRE. Petitioner claimed supply costs for the "Verifications in Salesforce" project for tax years 2018 and 2019. These costs were to purchase additional and upgraded equipment and accessories for their software developers in Idaho. The Tax Commission previously determined that Petitioner's activities for the "Verifications in Salesforce" project are qualified research activities; therefore, the cost of supplies for this project are QRE.

For the rental or lease costs of computers used in Idaho, Petitioner claimed the computer rental expenses for, including, but not limited to, an on-demand cloud computing platform for staging software, developer platform for developers to create, store, manage and share their code, deployment of a mobile app, subscription for professional support, software for security information and event management (SIEM), static and dynamic code scanning[46], etc. The "computers" in this context include server hardware, network infrastructure, storage and backup

[45] 65% of total contractor expenses, as required by IRC section 41(b)(3)(A).
[46] Two different approaches to identifying defects in code.

infrastructure, data center facilities, etc., and the licensing fees Petitioner paid to use the "computers" in Idaho. Petitioner provided a breakout of the computer rental expenses for each project. The Tax Commission found that the computer rental expenses Petitioner claimed for the qualified research activities are qualified research expenses.

For the contract research expenditures, the study shows that Petitioner included the amounts paid to vendors located outside Idaho (out-of-state venders) for design work, system administration, patent preparation, new portal/software work, user interface design, API integration with new portal/software, and penetration testing. To be qualified for the Idaho research credit, a qualified research activity must have taken place in Idaho. The Tax Commission finds that the expenditure(s) paid to the out-of-state venders do(does) not qualify for the credit.

Once QREs are determined, the next step for the credit calculation is to determine the base amount, and the Tax Commission reviews the base amount calculation as follows.

Base Amount

IRC section 41(c) defines the "base amount", a threshold, that is used in the process of calculating the amount of allowable credit, as the product of the fixed-based percentage[47], and the "average annual gross receipts of the taxpayer for the 4 taxable years preceding the taxable year for which the credit is being determined (hereinafter in this subsection referred to as the 'credit year')[48]". Since the gross receipt amounts affect the calculation of the fixed-base percentage, the Tax Commission reviews the gross receipt first, and then the fixed-base percentage.

[47] IRC section 41(c)(1)(A)
[48] IRC section 41(c)(1)(B)

Idaho Gross Receipts

Idaho Code section 63-3029G(2)(b)(i) states in pertinent part: "A taxpayer's gross receipts include only those gross receipts attributable to sources within this state as provided in subsections (q) and (r) of section 63-3027, Idaho Code[49]…" Idaho Code section 63-3027(q) provides for an apportionment of receipts from the sales of tangible personal property, which is not applicable to Petitioner as their gross receipts are from sales of services, not the sales of tangible property.

Idaho Code section 63-3027(r) provides the following definition of sales:

> Sales, other than sales of tangible property, are in this state, if:
>
> (1) The income-producing activity is performed in this state; or
>
> (2) The income-producing activity is performed both in and outside this state and a greater proportion of the income-producing activity is performed in this state than in any other state, based on costs of performance.[50]

Idaho Income Tax Administrative Rule 550.03[51] defines Costs of Performance as the direct costs that are "to perform the income producing activity that gives rise to the particular item of income" and the costs (i.e., wages, salaries, contractor costs, etc.) directly traceable to and associated with a specific income item.

In the present case, Petitioner generated their income from sales of the on-line services their employees provide to their clients. The wages and salaries paid to these employees are the direct costs. During the years under review, Petitioner had a significant presence in Idaho,[52] paying

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[49] Idaho Code sections are specific to relevant tax years. The tax years under the current review are from 2017 through 2019.
[50] Idaho Income Tax Administrative Rule 550.03. defines "Costs of Performance"
[51] Idaho Rule sections are specific to relevant tax years. The tax years under the current review are from 2017 to 2019.
[52] The 2017 apportionment factor: 98.7879% (100% property factor, and 96.3164% payroll factor).
The 2018 apportionment factor: 95.9859% (100% property factor, and 95.3931% payroll factor).
The 2019 apportionment factor: 90.2376% (98.1052% property factor, and 95.5084% payroll factor).
The 2020 apportionment factor: 89.6893% (98.5533% property factor, and 100% payroll factor).

more than 95% of their total wages and salaries to Idaho employees. Therefore, Petitioner must apportion the applicable amount of their sales of services to Idaho as the services were performed by their employees located in Idaho.

The representative argued in a letter submitted before the informal hearing that "the definition of gross receipts that should be allocated to Idaho is receipts for purchases where the customer received the goods or services in Idaho." Idaho Code section 63-3027(r) provides the definition of Idaho gross receipts, and the amount of Idaho gross receipts should be determined based on the Idaho income tax law for each applicable tax year. During the hearing, the representative confirmed that they used the receipts from sale of service based on customer location, instead of costs of performance, for their calculation of the Idaho research credit.

As of January 1, 2022, Idaho adopted a new sourcing method for the sale of service, which apportions sale of services to the state where the services are delivered (also known as market-based sourcing), and this sourcing method is effective for the tax year starting on and after January 1, 2022[53]. The years under the current review are from 2017 through 2020. Therefore, sourcing receipts from service sales based on customer location is not acceptable, and the gross receipts must be calculated based on costs of performance.

The Tax Commission reviewed the gross receipts calculated by the Bureau and found that they erroneously calculated the amount by multiplying the total gross receipts reported on Petitioner's federal Form 1065 with the Idaho apportionment factor (total apportionment factor divided by four). The gross receipts attributable to Idaho in accordance with subsection (r) of

[53] Idaho Code section 63-3027(13)(c), effective 1/1/2022, states, "Sales, other than sales of tangible property, are in this state if the taxpayer's market for the sales is in this state. The taxpayer's market for sales is in this state: (c) In the case of a service, if and to the extent the service is delivered to a location in this state…"

section 63-3027, Idaho Code, are the sales amounts reported in the "IDAHO" column on line 16[54], Idaho Form 42, Part I. Apportionment Formula[55]. Therefore, The Tax Commission modifies the gross receipts as follows:

Year	Gross receipts per federal Form 1065	Idaho apportionment per Idaho Form 42 *	Idaho gross receipts		Average Idaho gross receipts from previous 4 years
2013	243,613	100%	243,613	(1)	N/A
2014	1,118,338	100%	1,118,338	(1)	60,903
2015	2,940,705	100%	2,940,705	(1)	340,488
2016	5,345,254	100%	5,345,254	(1)	1,075,664
2017	8,886,664	98.7879%	8,834,912	(2)	2,411,978
2018	12,876,785	95.9859%	12,139,618	(2)	4,559,802
2019	16,308,970	90.2376%	13,645,450	(2)	7,315,122
2020	15,797,048	89.6893%	13,076,218	(2)	9,991,309

(1) Idaho gross receipts = Federal Form 1065 Gross receipts.
(2) Idaho gross receipts reported on Idaho Form 42 of the 2nd amended return.

Fixed-base Percentage

The fixed-base percentage is another component of the base amount calculation. IRC section 41(c)(3)(B)(ii)(I) defines fixed-base percentage for start-up companies, stating; "**3 percent for each of the taxpayer's 1st 5 taxable years beginning after December 31, 1993**." (emphasis added) Additionally, Idaho Rule 35.01.01.721.01.c (effective 4/7/11) provides the example outlining how to determine the base period in the pertinent part that,

> … For example, if the taxpayer's fiscal year beginning in 2001 is the 8th such taxable year beginning after December 31, 1993 in which the taxpayer had Idaho qualified research expenses…

[54] The line number on Form 42 is specific to each tax year.
[55] Idaho Sales

IRC section 41(c)(3)(B)(ii)(II) through (VII)[56] defines the fixed-base % calculation for the 6th through 10th tax years and provides that the fixed-base % is based on a taxpayer's historic ratio of research expenditures to gross receipts for each applicable year.

Petitioner started their business activities in Idaho during 2013 and elected to be treated as a start-up company for the Idaho research credit. Although Petitioner did not report any Idaho qualified research expenses prior to 2017, the representative argued that the 2017 tax year is the 5th taxable year in which they reported Idaho research expenses. Petitioner filed two amended returns (1st amended return and 2nd amended return) for each tax year from 2017 through 2019, reporting changes in their Idaho research credit calculation. Petitioner computed 3% for the 2017 fixed-base percentage on both amended returns. For the 2018 and 2019 fixed-based percentage, Petitioner's 1st amended return reported 16%, and later they changed it to 0% on the 2nd amended return. For tax year 2020, Petitioner claimed the credit on its original return by using 0% for its fixed-base percentage, and the representative now argues that the fixed-base percentage should be 16%.

After the hearing, Appeals asked the representative and Petitioner to clarify whether they had Idaho research expenses prior to 2017. Petitioner responded that they had Idaho research expenses in the latter half of 2014; however, they provided no specific amount of Idaho research expenses prior to 2017. The representative also argued that the fixed base % for 2018 and forward

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[56] The 6th tax year's fixed base % is 1/6 of the percentage calculated by dividing the 4th and 5th years' aggregate qualified research expenses with the 4th and 5th years' aggregate gross receipts.
For the 7th tax year: 1/3 of the 5th and 6th tax years
For the 8th tax year: 1/2 of the 5th, 6th and 7th tax years.
For the 9th tax year: 2/3 of 5th through 8th tax years.
For the 10th tax year, 5/6 of 5th through 9th tax years, and
For the tax years thereafter, any tax years selected from among the 5th through 10th tax years.

should be 16%, and during the hearing, he provided an Idaho Form 67 Credit for Idaho Research Activities for each tax year under the current review.

As previously mentioned in this decision, the Tax Commission modified the Idaho QREs and the Idaho gross receipts; therefore, the Tax Commission also modifies the fixed base % as follows:

		Idaho QREs per Appeals a	Idaho Gross Receipts per Appeals b	a/b	c	Fixed-Base % per Appeals (a/b)*c	
1st year	2013	0	243,613				
2nd year	2014	0	1,118,338				
3rd year	2015	0	2,940,705				
4th year	2016	0	5,345,254				
5th year	2017	160,635	8,834,912			3.00%	(1)
6th year	2018	400,210	12,139,618	1.13%	16.67%	0.19%	(2)
7th year	2019	814,380	13,645,450	2.67%	33.33%	0.89%	(3)
8th year	2020	475,789	13,076,218	3.97%	50.00%	1.99%	(4)

(1) 2017 is the 5th year: Idaho Form 67, provided during the hearing.
(2) The 6th year is 1/6 of the the % calculated by dividing the 4th and 5th aggregate ID QREs with the 4th and 5th years' aggregate Idaho gross receipts.
0.19% = 1/6 x ((0 + 160,635) / (5,445,254 + 8,834,912))
(3) The 7th year is 1/3 of the 5th and 6th years.
0.89% = 1/3 x ((160,635 + 400,210) / (8,834,912 + 12,139,618))
(4) The 8th year is 1/2 of the 5th through 7th years.
1.99% = 1/2 x ((160,635 + 400,210 + 814,380) / (8,834,912 + 12,139,618,+,13,645,450))

The modifications to the gross receipts and the fixed base % as identified in this decision lead to changes in the rest of the Idaho research credit calculation, where the smaller of the QREs exceeding the predetermined base amount or 50% of the QREs is subject to 5%[57]. The "Per Appeals" column in the calculation table below shows that 50% of the QREs (line 13) is smaller than the QREs exceeding the base amount (line 12); therefore, 50% of the QREs is subject to 5%.

[57] 5% is the allowable credit % under Idaho Code section 63-3029G.

The Tax Commission calculates $4,016 as the Idaho research credit allowable for tax year 2017, and $11,005, $20,360, and $11,895 for 2018 through 2020, respectively.

Tax year 2017

Line	Description	Per Return	**Per Appeals**		Adjustment
1	Research payments	0	0		
2	Base period amount	0	0		
3	Subtract line 2 from line 1	0	0		
4	Wages	183,241	151,895	(1)	
5	Supplies	0	0		
6	Rental of computers	8,740	8,740		
7	Contract research expenses[3]	37,103	0		
8	Add lines 4 through 7	229,084	160,635		
9	Fixed base %	3.00%	3.00%	(2)	
10	Average Idaho gross receipts	70,779	2,411,978	(3)	
11	Multiply line 10 by line 9	2,123	72,359		
12	Subtract line 11 from line 8	226,961	88,276		
13	Multiply line 8 by 50%	114,542	80,318		
14	Smaller of line 12 or line 13	114,542	80,318		
15	Add line 3 and line 14	114,542	80,318		
16	Credit earned. Multiply line 15 by 5%	5,727	4,016		**1,711**

(1) Appeals excluded the wages paid to nonresidents.
(2) Idaho Form 67, submitted by the representative during the hearing.
(3) Total per return is based on customer location. Appeals caluclated based on the costs of performance.

Tax year 2018

Line	Description	Per Return	Per Appeals		Adjustment
1	Research payments	0	0		
2	Base period amount	0	0		
3	Subtract line 2 from line 1	0	0		
4	Wages	395,125	346,893	(1)	
5	Supplies	4,523	4,523		
6	Rental of computers	45,008	45,008		
7	Contract research expenses	61,035	3,786	(2)	
8	Add lines 4 through 7	505,691	400,210		
9	Fixed base %	16.00%	0.19%	(3)	
10	Average Idaho gross receipts	94,923	4,559,802	(4)	
11	Multiply line 10 by line 9	15,188	8,611		
12	Subtract line 11 from line 8	490,503	391,599		
13	Multiply line 8 by 50%	252,846	200,105		
14	Smaller of line 12 or line 13	252,846	200,105		
15	Add line 3 and line 14	252,846	200,105		
16	Credit earned. Multiply line 15 by 5%	12,642	10,005		**2,637**

(1) Appeals excluded the wages paid to nonresidents.
(2) Appeals excluded the expenses paid to out of state contractors.
(3) Appeals adjusted in this decision.
(4) Total per return is based on customer location. Appeals caluclated based on the costs of performance.

Tax year 2019

Line	Description	Per Return	Per Appeals		Adjustment
1	Research payments	0	0		
2	Base period amount	0	0		
3	Subtract line 2 from line 1	0	0		
4	Wages	714,099	695,369	(1)	
5	Supplies	2,494	2,494		
6	Rental of computers	115,294	115,294		
7	Contract research expenses	56,010	1,223	(2)	
8	Add lines 4 through 7	887,897	814,380		
9	Fixed base %	16.00%	0.89%	(3)	
10	Average Idaho gross receipts	129,053	7,315,122	(4)	
11	Multiply line 10 by line 9	20,648	65,194		
12	Subtract line 11 from line 8	867,249	749,186		
13	Multiply line 8 by 50%	443,949	407,190		
14	Smaller of line 12 or line 13	443,949	407,190		
15	Add line 3 and line 14	443,949	407,190		
16	Credit earned. Multiply line 15 by 5%	22,197	20,360		**1,838**

(1) Appeals excluded the wages paid to nonresidents.
(2) Appeals excluded the expenses paid to out of state contractors.
(3) Appeals adjusted in this decision.
(4) Total per return is based on customer location. Appeals caluclated based on the costs of performance.

Tax year 2020

Line	Description	Per Return	Per Appeals		Adjustment
1	Research payments	0	0		
2	Base period amount	0	0		
3	Subtract line 2 from line 1	0	0		
4	Wages	641,972	446,839	(1)	
5	Supplies	0	0		
6	Rental of computers	27,962	27,962		
7	Contract research expenses	7,416	988	(2)	
8	Add lines 4 through 7	677,350	475,789		
9	Fixed base %*	0.00%	1.99%	(3)	
10	Average Idaho gross receipts	181,307	9,991,309	(4)	
11	Multiply line 10 by line 9	0	198,445		
12	Subtract line 11 from line 8	677,350	277,344		
13	Multiply line 8 by 50%	338,675	237,895		
14	Smaller of line 12 or line 13	338,675	237,895		
15	Add line 3 and line 14	338,675	237,895		
16	Credit earned. Multiply line 15 by 5%	16,934	11,895		**5,039**

(1) Appeals excluded the wages related to the nonqualified project (Volunteer Management System for 2020).
(2) Appeals excluded the expenses paid to out of state contractors.
(3) Appeals adjusted in this decision.
(4) Total per return is based on customer location. Appeals caluclated based on the costs of performance.

CONCLUSION

Petitioner claimed the Idaho research credit for tax years 2017 through 2020. The Bureau disallowed the credit for all projects, except for the 2017-2019 extension project. Upon review, the Tax Commission finds that all projects, except for a portion of the Volunteer Management System project (2022 upgrade), satisfy the requirements for the Idaho research credit. The Tax Commission also finds that the gross receipts and the fixed base % were in need of adjustment, which led to the modification of the base amount in the Idaho research credit calculation. After incorporating all the adjustments described above, the Tax Commission modifies the amount of Petitioner's Idaho research credit for tax years 2017 through 2020.

THEREFORE, the Notice dated November 2, 2023, and directed to [redacted] is MODIFIED. Since Petitioner is a flow-through entity, the additional tax due flows through to its shareholders. Therefore, no demand or order for payment is necessary.

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

DATED this _____ day of _____ 2024.

IDAHO STATE TAX COMMISSION

CERTIFICATE OF SERVICE

I hereby certify that on this _____ day of _____ 2024, 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]