



additional tax was due. Instead, the adjustment for additional tax was passed through to Petitioner's sole shareholder at the time via a Notice issued in a related case.

On February 5, 2024, Audit received a Form ID-POA, *Power of Attorney*, naming [REDACTED] (AIF NS) as a representative to the Tax Commission for Petitioner. On March 7, 2024, AIF NS provided Audit with a letter formally protesting the Notice, along with documentation to support the Idaho research credit and ITC. Documents included invoices for equipment, depreciation schedules, and a vehicle mileage log. Additional responses indicate that a third party – [REDACTED] [REDACTED] [REDACTED] ( [REDACTED] ) – was hired to prepare the Idaho research credit claim (a copy of the engagement letter was provided), but a formal study was not conducted. This explanation of research activity and Petitioner's involvement was provided: "Engineering and designing new products prior to releasing them for production. Coding original software to manage inventory functions with retailers. All research was 'in-house'; therefore involvement was handled by employees."

Several "exhibits" were also provided: Exhibit T listed the number of hours employees spent during FY 2019 and FY 2020 conducting research<sup>3</sup>; Exhibit B listed "qualified wages" for 47 employees during FY 2019 and 60 employees during FY 2020<sup>4</sup>; and Exhibit C listed "other expenses."<sup>5</sup> Regarding specific information requested about each employee who conducted qualified research, the reply indicated that the company was sold to new owners on December 19,

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<sup>3</sup> A note in the exhibit indicated that the hours were "calculated by multiplying employee R&D qualifying time % by 2080 hours per year."

<sup>4</sup> These amounts appear to have been calculated in a manner similar to the times shown in Exhibit T, by multiplying the employees' W-2 Box 1 wages by their "R&D qualifying time percentage."

<sup>5</sup> The information for both years showed a date of transaction and an amount, but provided no detail as to what the expense was for other than "R&D/Testing." The information for FY 2020 also listed a vendor for each transaction.

2021, the necessary records were retained by the new owners, and certain information was no longer accessible by the old owner claiming the Idaho research credit.

The R&D process starts with an idea from anyone in the design department or brand managers, they are then submitted for approval, if approved, then a designer/engineer will begin the design process, identify uncertainties. The designer/engineer, will then design 3d renderings/drawings/schematics in CAD or other computer modeling programs. The next step is creating a prototype for testing/experimentation, this is accomplished by 3d printing and/or by sending it out to be built. After this filed testing begins and different alternatives are tried to eliminate uncertainty, there are typically 5-7 iterations throughout the experimentation phase. After this durability testing begins and there are usually 3-4 more iterations as the product durability uncertainties are removed by trying alternatives. Using the processes described we are able make measurable improvements to finally produce a finished product ready for production. When the design phase is finished and uncertainties removed, the product moves into the production phase. Some of types of products that are designed include [REDACTED], [REDACTED], [REDACTED], [REDACTED], [REDACTED], [REDACTED], [REDACTED] etc.

<sup>6</sup> It is unclear who the written statement is from. It was provided via electronic upload. There is no indication on the statement itself, and the email address associated with the upload does not belong to AIF NS or the business owner.

On May 17, 2024, Audit issued a modified Notice to Petitioner and AIF NS. The modified Notice maintained disallowance of the Idaho research credit in full for FY 2019 and FY 2020. The modified Notice included information about qualifications for the credit, background information about Petitioner's business, and an analysis of Petitioner's activities relative to the credit's eligibility requirements. Audit stated the following in its determination that Petitioner did not qualify for the Idaho research credit:

- A taxpayer must be uncertain about whether it can achieve its objective through research. You didn't provide any documentation addressing uncertainties in your activities or the new information that was discovered to resolve the uncertainties.
- You provided no information on how your projects meet the technological information test other than to state some of your projects are designed using CAD or computer modeling programs with prototypes being create [sic] using a 3d printer or sent out to be built.
- You provided no information that shows how your activities satisfy the process of experimentation test.
- You provided no information that shows your activities developed a new or improved business component.
- The information you provided is not sufficient to substantiate the research and development expenditures claimed on your FYE 9/30/20 and 9/30/21 returns under IRC section 41.

Audit also determined that [REDACTED] used an incorrect figure in calculating the Idaho research credit.

The modified Notice also reduced the additional tax due from the ITC adjustment for FY 2019. After reviewing purchase documentation and separating qualifying purchases into two categories (new and used equipment), Audit applied a limitation of \$150,000 to the used equipment.

Audit received a protest to the modified Notice on June 11, 2024<sup>7</sup>. This protest responded to nine specific paragraphs in Audit's Explanation of Adjustments. In two responses, the author

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<sup>7</sup> Like the March 29 protest to the original Notice, it is unclear who this response is from.

stated that information, the lack of which was used as a reason to disallow the Idaho research credit, was never requested during Audit's examination. One response indicated that Audit had misunderstood Petitioner's business and the products it designs and sells. Three referred to information previously submitted. One specifically disagreed with Audit's conclusion about Petitioner's base period. The remaining two responses were combined and revolved around incomplete or unavailable documentation and the fact that Internal Revenue Code (IRC) and Treasury Regulations do not contain any specific requirements for recordkeeping when it comes to the research tax credit.

Later in June 2024, Petitioner appointed two additional representatives from [REDACTED] " [REDACTED] [REDACTED] (AIF SM) and [REDACTED] [REDACTED] (AIF WM). Audit exchanges phone calls and emails with AIF WM, offering to review additional documentation or to move the matter to the Tax Commission's Appeals unit (Appeals) to continue the protest. No additional documentation was provided, so Audit forwarded the case to Appeals.

On August 7, 2024, Appeals sent letters to Petitioner and the three AIFs providing the options available for redetermining a protested Notice. AIF WM requested an informal hearing, which was held via videoconference on November 6, 2024. In attendance were AIFs WM and SM and five representatives from the Tax Commission.

During the hearing, AIFs WM and SM reiterated their disagreement with Audit's conclusions in the Modified Notice. They said they were not contracted to conduct a research credit study but instead to calculate the federal and Idaho research credit Petitioner qualified for. They stated they did not claim credit for non-qualifying activities (e.g., style-driven modifications). They said that, while Petitioner may look like a [REDACTED] company on the surface, the business is much deeper than that. They have a laboratory in their facility in [REDACTED] which allows access to a

limited group of people. Petitioner has developed close to 200 products from concept to mass production. AIFs indicated the Idaho research credit claimed had nothing to do with [REDACTED] or style, but was all engineering and R&D.

AIFs described two specific products. First was [REDACTED] with an [REDACTED] [REDACTED] [REDACTED] that took many years of research. Petitioner invented and perfected it. The second was a [REDACTED] [REDACTED] to make a [REDACTED] [REDACTED] [REDACTED] [REDACTED] [REDACTED] AIFs were asked about patents and whether Petitioner had any for their products. AIFs said they would find out and provide that information.

When asked about their process for collecting information used to calculate the credit, AIFs stated that they held group meeting with employees and went through the activities they engaged in. The employees provided estimates of the percentage of their time of the number of hours they spent on qualifying activities. This information was then “married with” payroll information to determine the qualifying wages for the credit. AIFs provided a written survey for the employees. They would ask about the four-part test<sup>8</sup> for each product they were working on. If the product passed the test, it was included; if it failed any of the tests, it was excluded.

When asked about how uncertainty was documented, AIFs stated that information was in the interviews with Petitioner’s lead engineers. When asked “ What documentation do you have of the laboratory testing?” AIFs replied, “The best answer is we don’t.” They stated that that information would normally be available in an audit like this one, but because of the sale of the company in 2021 and the lack of an “attitude of cooperation between the buyer and the seller,” it was not. Appeals made a statement that “It feels like we’re being asked to take your word that

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<sup>8</sup> Information about the four-part test is provided in the Law & Analysis section of this decision.

[Petitioner's] word is accurate and truthful. There's no real source documentation we can get access to." AIFs did not disagree.

AIFs stated during the hearing that Petitioner agreed with the adjustment for ITC as presented in the modified Notice.

At the end of the hearing, AIF WM agreed to: provide information about patents; provide notes from employee interviews; verify from the list of products which ones were new, which ones were improvements, and which ones were adaptations of existing products; and try to find any employees who would be available for an interview. A timeline of 30 days was set for AIF WM's response.

On December 5, 2024, AIF WM sent Appeals a response addressing Appeals' request and providing the following:

- Information regarding six patents in Petitioner's name; two patents were filed in [REDACTED] and published in [REDACTED] [REDACTED] the rest – including one for the [REDACTED] [REDACTED] [REDACTED] – were granted before the beginning of the periods in question. There was no information about patents on [REDACTED]
- Questions, answers, and some documentation from seven employee interviews (R&D Engineering Survey) dated between November 12, 2020, and December 1, 2021; each described a particular product they worked on developing, the technical challenges they faced, how they overcame those challenges, how alternatives were evaluated, and how results were tracked. None included any information about their specific activities in the development of the products. All seven employees' wages were claimed as qualified expenses for FY 2020, but one was not for FY 2019.
- A refined list of 199 products to replace Exhibit NP.
- A signed statement from Petitioner's 2014-2022 Chief Operating Officer; this statement was nearly verbatim the same description of Petitioner's R&D process quoted earlier in this section.

Based on an analysis of applicable law and available information, the Tax Commission now makes its final determination as follows.

### **Law & Analysis**

The Notice and the subsequent modified Notice made adjustments for two issues. AIFs indicated agreement with the adjustment for ITC as presented in the modified Notice. That issue will not be discussed further in this decision.

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 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 four separate tests<sup>9</sup>.

First, the research expenses must be eligible for treatment as expenses under IRC section 174 (the section 174 test)<sup>10</sup>. Second, the research must be undertaken for the purpose of discovering information that is technological in nature (the discovering technological information test)<sup>11</sup>. 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)<sup>12</sup>. Fourth, substantially all the activities must constitute elements of a process of experimentation for a new or improved function, performance, reliability or quality (the process of experimentation test)<sup>13</sup>. Each of these tests is discussed in more detail below. If the research fails any of these tests, it is not “qualified research” for the purposes of the research credit.

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<sup>9</sup> 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).

<sup>10</sup> IRC section 41(d)(1)(A).

<sup>11</sup> IRC section 41(d)(1)(B)(i).

<sup>12</sup> IRC section 41(d)(1)(B)(ii).

<sup>13</sup> IRC sections 41(d)(1)(C) and 41(d)(3).

A research activity is specifically excluded from “qualified research” if the purpose of the research relates to style, taste, cosmetic, or seasonal design factors<sup>14</sup>, if the research is conducted after the beginning of commercial production of the business component<sup>15</sup>, or if the research is related to the adaptation of an existing business component to a particular customer’s requirement or need<sup>16</sup>.

### **Section 174 Test**

IRC section 174<sup>17</sup> 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<sup>18</sup>. Treasury Regulation section 1.174-2(a)(1) defines the term “research or experimental expenditures” as used in section 174. It generally includes all such costs incident to the development or improvement of a product that “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. Treasury Regulation 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.” However, “because the taxpayer need only be uncertain as to ‘the capability *or* method *or* the appropriate design’ of the improvement, an uncertainty may exist even if the taxpayer knows that it is technically possible to achieve a goal but is uncertain of the

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<sup>14</sup> IRC section 41(d)(3)(B).

<sup>15</sup> IRC section 41(d)(4)(A).

<sup>16</sup> IRC section 41(d)(4)(B).

<sup>17</sup> IRC section 174: Prior to 2022, taxpayers could immediately expense Research and Development (R&D) expenditures under IRC section 174. For the tax years beginning on and after January 1, 2022, the Tax Cuts and Jobs Act (passed in 2017, signed into law and came into effect in 2022) requires R&D expenditures to be amortized over five years for domestic R&D expenditures.

<sup>18</sup> IRC section 174(a)(1).

method or appropriate design to use to reach that goal.”<sup>19</sup> Treasury Regulation 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.”

### **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 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 information sought does not have to be groundbreaking or expand the volume of knowledge available in the field of scientific study.

### **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. Each business component of the taxpayer must satisfy all 4 tests<sup>20</sup>. 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.”

### **Process of Experimentation Test**

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<sup>19</sup> *Union Carbide Corp. & Subs. v. Commissioner*, TC Memo 2009-50 (2009).

<sup>20</sup> IRC section 41(d)(2)

To overcome uncertainties, a taxpayer should use a systematic inquiry as part of the process of experimentation. To be a 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.”<sup>21</sup>

Treasury Regulation section 1.41-4(a)(6) states in part,

In order for activities to constitute qualified research under section 41(d)(1), substantially all of the activities must constitute elements of a process of experimentation that relates to a qualified purpose. The substantially all requirement ... is satisfied only if 80 percent or more of a taxpayer's research activities, measured on a cost or other consistently applied reasonable basis (and without regard to section 1.41-2(d)(2)), constitute elements of a process of experimentation for a purpose described in section 41(d)(3).

Recall that IRC section 41(d)(3) defines qualified research as that relating to a new or improved function, performance, reliability, or quality and specifically excludes research related to style, taste, cosmetic, or seasonal design factors.

Treasury Regulation section 1.41-4(a)(6) also requires that the “substantially all” test – a subtest to the process of experimentation test – be applied to *activities*, not *physical elements of the business component being developed or improved* since the extent of experimentation would not vary in proportion to the size of each element. For example, determining the design of smaller and more complex elements might require more experimentation than determining the design of larger but simpler elements.

The “substantially all” test is both a qualitative and quantitative test. Not only must the activities be of the proper type, but 80 percent of those activities must constitute a process of

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<sup>21</sup> *Union Carbide Corp. & Subs. v. Commissioner*, T.C. Memo 2009-50 (2009).

experimentation for an allowable purpose. In *Little Sandy*<sup>22</sup>, the 7<sup>th</sup> Circuit Court of Appeals determined that the correct fraction for determining whether the 80 percent mark is achieved in the process of experimentation test is “research activities that constitute elements of a process of experimentation divided by research activities not excluded under [IRC] section 41(d)(4) and whose expenses are deductible under Section 174.” Treasury Regulation section 1.41-4(a)(6) states that the activities must be “measured on a cost or other consistently applied reasonable basis (and without regard to section 1.41-2(d)(2)).”

**Application to [REDACTED] [REDACTED] [REDACTED] [REDACTED]**

Estimates of qualifying research expenses are allowed in calculating the research tax credit, especially if complete records are not available due to some unforeseen circumstance, but only after it has been established that the taxpayer qualifies for the credit. According to the 7th Circuit Court of Appeals in *Little Sandy* (2023):

If a taxpayer can establish that qualified research occurred, we may estimate the qualified research expenses subject to the tax credit. See *McFerrin*, 570 F.3d at 679 (citing *Cohan v. Comm’r*, 39 F.2d 540, 544 [8 AFTR 10552] (2d Cir. 1930)). But this estimate relates to Section 41(b), which is a separate—albeit related—inquiry from Section 41(d). Only after a taxpayer establishes that qualified research has occurred under Section 41(d) may we estimate, if needed, the amount of qualified research expenses under Section 41(b). *Shami v. Comm’r*, 741 F.3d 560, 568 [113 AFTR 2d 2014-671] (5th Cir. 2014) (“[T]he Cohan rule is not implicated unless the taxpayer proves that he is entitled to some amount of tax benefit.”).

The overarching question in this case is whether Petitioner has demonstrated eligibility to claim the research tax credit.

AIAs WM and SM provided a general description of Petitioner’s product development process but did not provide much detail regarding the specific activities researchers would

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<sup>22</sup> *Little Sandy Coal Co. Inc. v. Commissioner*, 131 AFTR 2d 2023-955 (62 F.4<sup>th</sup> 287)

undertake. As noted earlier, the four-part test must be applied to each business component subject to research and development. AIFs WM and SM provided documentation regarding a few projects to demonstrate the information gathering process they used in calculating the credit. One of the four tests requires that substantially all (at least 80%) of the research activities constitute elements of a process of experimentation relating to a qualified purpose. However, the lack of source documents to corroborate the expenses being claimed as part of the credit is concerning. The Tax Commission is essentially being asked to take it on faith without documentation that [REDACTED] determination of which activities qualify and which do not is accurate and that at least 80% of those activities for each business component are part of a process of experimentation for a qualifying purpose.

AIFs WM and SM have correctly claimed that IRC section 41 does not contain any specific recordkeeping requirement for the research credit. Instead, taxpayers are subject to the recordkeeping requirement contained in Treasury Regulation section 1.41-4(d), which states that a taxpayer must “maintain records in sufficiently usable form and detail to substantiate” eligibility for the credit. The Tax Commission finds that the information provided during the audit and the administrative review process does not contain sufficient detail to establish that at least 80% of the product development activities are elements of a process of experimentation related to a qualified purpose. Therefore, Petitioner has not met all four tests and is not entitled to any research tax credit.

As the 7th Circuit Court of Appeals wrote, “... shortcut estimates of experimentation-related activities will not suffice. Something more, such as documentation of time spent on such activities, is necessary,” and “The lesson for taxpayers seeking to avail themselves of the research tax credit is to adequately document that substantially all of such activities were research activities

that constitute elements of a process of experimentation. Generalized descriptions of uncertainty, assertions of novelty, and arbitrary estimates of time performing experimentation are not enough.”<sup>23</sup>

AIFs WM and SM have requested leniency regarding the issue of documentation due to the sale of the business and subsequent lack of access to documentation. They asked that the Idaho research credit be granted in full as claimed. The Tax Commission is disinclined to grant such leniency.

### **Conclusion**

The Tax Commission has determined that Petitioner has not provided sufficient documentation to meet the four-part test. Petitioner is not eligible to claim the research tax credit.

THEREFORE, the modified Notice dated May 17, 2024, is hereby UPHELD and MADE FINAL.

For FY 2019 and FY 2020, the additional tax due and any related penalty and interest will be assessed on the business owner’s individual returns. As Petitioner is not required to pay any additional tax, no DEMAND for payment is made.

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

DATED this \_\_\_\_\_ day of \_\_\_\_\_ 2025.

IDAHO STATE TAX COMMISSION

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<sup>23</sup> *Little Sandy Coal Co. Inc. v. Commissioner*, 131 AFTR 2d 2023-955 (62 F.4<sup>th</sup> 287)

## 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]