

BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of)
)
 ,) DOCKET NO. 2-134-845-440
)
 Petitioner.) DECISION
)
 _____)

The Idaho State Tax Commission (“Commission”) reviewed your case and this is our final decision. We uphold the Notice of Deficiency Determination (“Notice”) dated February 6, 2020, for taxable years 2015, 2016, 2017, and 2018. The amount of tax, penalty and interest shown in the Notice is \$0, as the adjustments flow through to the individual shareholders. Therefore, no DEMAND for payment is made or necessary.

BACKGROUND

For each year under review, (“Petitioner”) claimed a credit for research activities conducted in Idaho under Idaho Code section 63-3029G. The Audit Division reviewed a random sample of twenty-five (25) projects on which Petitioner claimed the credit during the years 2015 through 2017.

After review, the auditors determined that the sample projects did not meet the requirements for the credit and issued the Notice denying the research credit on all tax periods at issue. Petitioner filed a timely protest on April 7, 2020, through its authorized representative. Petitioner was informed of its appeal rights and requested a hearing with the oversight Commissioner, which was held on January 21, 2021. Having reviewed the file, the Commission hereby issues its final decision.

ISSUE

The issue on appeal is whether Petitioner has met the requirements for the Idaho research

credit pursuant to Idaho Code section 63-3029G.

LEGAL BACKGROUND

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 (“I.R.C.”) section 41, except that the research must also 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 I.R.C. section 41(d). Research activity is “qualified research” under I.R.C. section 41(d) only if it satisfies all of the four (4) tests discussed below. *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). The four (4) tests must be applied separately to each “business component” of the taxpayer. I.R.C. § 41(d)(2)(A). A “business component” is any product, process, technique, formula, or invention which is to be used by the taxpayer in its trade or business. I.R.C. § 41(d)(2)(B). As discussed below, some research purposes and activities are specifically excluded from “qualified research.” I.R.C. § 41(d)(3)–(4).

(1): The “Section 174 Test”

First, the expenditures connected with the research must be eligible for treatment as expenses under section 174. I.R.C. § 41(d)(1)(A). Expenses represent research and development costs in the experimental or laboratory sense if they are intended to discover information that would eliminate uncertainty concerning the development or improvement of a product. Treas. Reg. § 1.174-2(a)(1). Uncertainty exists only if the information available to the taxpayer does not establish the capability or method for developing or improving the product or the appropriate design of the product. *Id.*

(2): The “Technological Information Test”

Second, the research must be undertaken for the purpose of discovering technological information. I.R.C. § 41(d)(1)(B)(i). In order to satisfy this requirement, the process of experimentation must fundamentally rely on principles of the physical or biological sciences, engineering, or computer science. Treas. Reg. § 1.41-4(a)(4).

(3): The “Business Component Test”

Third, the taxpayer must intend that the information to be discovered will be useful in the development of a new or improved business component of the taxpayer. I.R.C. § 41(d)(1)(B)(ii).

(4): The “Process of Experimentation Test”

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

Specific Exclusions from “Qualified Research”

Research activity is not “qualified research” if the purpose of the research relates to style, taste, cosmetic, or seasonal design factors. I.R.C. § 41(d)(3)(B). Further, some activities are specifically excluded from “qualified research,” including: 1) research conducted after the beginning of commercial production of the business component and 2) research related to the

adaptation of an existing business component to a particular customer's requirement or need.
I.R.C. §§ 41(d)(4)(A)–(B).

DISCUSSION

Petitioner is engaged in the business of making custom cabinets. Petitioner designs each custom cabinet project in consultation with builders, agents, and/or homeowners. An initial plan for a project is created from an architectural design or architectural picture using computer aided design (CAD) software, which is modified in due course to meet the needs of the customer.

Petitioner claimed the research credit using the cost of wages and materials on approximately 69% of its projects during the years 2015 through 2017, the original scope of the audit. Petitioner claimed that 91%, 86%, and 85% of its employees, respectively in each year, were engaged in qualified research, including installers, drawer builders, foremen, banders, floaters, and back-end shop employees. Petitioner asserts that its business component, i.e. product, is each individual custom cabinet project.

Petitioner summarizes its argument for the research credit using conclusory statements, as noted here:

Taxpayer's research was undertaken to ensure that each unique cabinet system was fully functional, structurally sound, and could meet all the high standards of quality and reliability expected by Taxpayer's customers. As each system was unique and had to account for the site-specific challenges of the particular space it was designed for, Taxpayer undertook a process of experimentation to resolve uncertainty related to the function, reliability and quality of each new or improved cabinet system. Therefore, Taxpayer's business components were new or improved products, and Taxpayer's research was undertaken for a permitted purpose within the meaning of § 41(d)(3).

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A Notice of Deficiency Determination issued by the Commission is presumed to be accurate. *Parsons v. Idaho State Tax Commission*, 110 Idaho 572, 574-575 n.2, 716 P.2d 1344,

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

The Commission finds that Petitioner did not meet its burden of proving error in the Commission's Notice. The goal of the research tax credit is to provide incentives for companies to invest in research that might not otherwise be undertaken due to its high risks. *Tax & Accounting Software Corp. v. United States*, 301 F.3d 1254, 1266 (10th Cir. 2002). The research tax credit is not intended for research projects that only expand a wealth of knowledge in a particular industry. *Wicor, Inc. v. United States*, 116 F. Supp. 2d 1028, 1034 (E.D. Wis. 2000), *aff'd*, 263 F.3d 659 (7th Cir. 2001). The knowledge gained from the research must exceed that which is known in the field in which the taxpayer is performing the research and experimentation. *Id.* Here, the information used in the design and manufacture of custom cabinets appears to be well-known in the cabinet-making industry.

The Commission finds that Petitioner's research is excluded from "qualified research" because it is an adaptation of its existing business component—i.e. the custom cabinetry model

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

Petitioner’s Research Fails the Section 174 and Process of Experimentation Tests

Petitioner has not met its burden of proving the specific uncertainty in the installation, manufacturing process, and construction techniques that its research activity was intended to eliminate; therefore, the Commission finds that the research activity does not pass the Section 174 Test. Uncertainty exists only if the information available to the taxpayer does not establish the capability or method for developing or improving the product or the appropriate design of the product. Treas. Reg. § 1.174-2(a)(1). It appears to the Commission that building custom cabinetry to be “fully functional” and “structurally sound” was within the information available to Petitioner and was technically feasible without engaging in specific research.

Nonetheless, “uncertainty concerning the development or improvement of the business component (e.g., its appropriate design) does not establish that all activities undertaken to achieve that new or improved business component constitute a process of experimentation.” Treas. Reg. § 1.41-4(a)(5)(i). The design of a custom cabinet, where the design was uncertain at the outset of the project, could have been determined by means other than a process of experimentation.

Ultimately, Petitioner has not established that its research activities were a part of a process of experimentation. *See* I.R.C. § 41(d)(1)(C). The documents provided do not establish how Petitioner formulated or tested hypotheses, engaged in systematic trial and error or evaluated alternatives during the years in issue. *Union Carbide Corp. & Subs. v. Commissioner, supra, 2009*

WL 605161, at *81. Petitioner was required to show through its records that each research project had a methodical plan setting forth a series of trials to test a hypothesis, analyze the data, and retest the hypothesis so that the research conducted was part of a process of experimentation in the scientific sense. *Id.*

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

THEREFORE, the Notice dated February 6, 2020, and directed to Petitioner is hereby AFFIRMED. An explanation of the Petitioner’s right to appeal this decision is enclosed.

DATED this _____ day of _____ 2021.

IDAHO STATE TAX COMMISSION

CERTIFICATE OF SERVICE

I hereby certify that on this _____ day of _____ 2021,
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.
