

16-1707

TAX TYPE: INCOME TAX

TAX YEAR: 2013 & 2014

DATE SIGNED: 4/18/2018

COMMISSIONERS: J. VALENTINE, M. CRAGUN, R. PERO, R. ROCKWELL

GUIDING DECISION

BEFORE THE UTAH STATE TAX COMMISSION

TAXPAYER-1 & TAXPAYER-2, Petitioners, v. AUDITING DIVISION OF THE UTAH STATE TAX COMMISSION, Respondent.	INITIAL HEARING ORDER Appeal No. 16-1707 Account No. ##### Tax Type: Individual Income Tax Tax Years: 2013 & 2014 Judge: Chapman
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Presiding:

Kerry R. Chapman, Administrative Law Judge

Appearances:

For Petitioner: REPRESENTATIVE-1 FOR PETITIONER, Attorney
REPRESENTATIVE-2 FOR PETITIONER, Attorney
TAXPAYER-1, Taxpayer

For Respondent: REPRESENTATIVE-1 FOR RESPONDENT, Assistant Attorney General
REPRESENTATIVE-2 FOR RESPONDENT, Assistant Attorney General
RESPONDENT, from Auditing Division

STATEMENT OF THE CASE

This matter came before the Utah State Tax Commission for an Initial Hearing pursuant to the provisions of Utah Code Ann. §59-1-502.5, on October 4, 2017. The Petitioners submitted post-hearing information on October 20, 2017, and the Respondent submitted post-hearing information on November 14, 2017.

TAXPAYER-1 & TAXPAYER-2 (“Petitioners” or “taxpayers”) are appealing Auditing Division’s (the “Division”) assessments of additional Utah individual income taxes for the 2013 and 2014 tax years. On

October 24, 2016, the Division issued Notices of Deficiency and Audit Change (“Statutory Notices”) to the taxpayers, in which it imposed additional tax and interest (calculated through November 23, 2016),¹ as follows:

<u>Year</u>	<u>Tax</u>	<u>Penalties</u>	<u>Interest</u>	<u>Total</u>
2013	\$\$\$\$\$	\$\$\$\$\$	\$\$\$\$\$	\$\$\$\$\$
2014	\$\$\$\$\$	\$\$\$\$\$	\$\$\$\$\$	\$\$\$\$\$

For the 2013 and 2014 tax years, TAXPAYER-1 was the sole shareholder of THE COMPANY (the “Company”), which is an S corporation. Headquartered in CITY-1, the Company provides pre-construction, construction management, design/build, and general contracting services to clients. The Company has performed work on numerous construction projects both in and outside of Utah since it began operations in 2007.

For the years at issue, the taxpayers filed joint Utah resident returns on which they claimed the Utah tax credit authorized under Utah Code Ann. §59-10-1012 (2014) for increasing research activities conducted in Utah (the “Utah research tax credit”). On their 2013 and 2014 Utah returns, the taxpayers claimed Utah research tax credits of \$\$\$\$\$ for the 2013 tax year and \$\$\$\$\$ for the 2014 tax year. The Utah research tax credits that the taxpayers claimed were associated with expenses incurred by the Company. The Division has determined that the taxpayers are not entitled to any portion of the Utah research tax credits that they claimed, which resulted in the Division issuing its assessments.

For each of the 2013 and 2014 tax years, however, the taxpayers claim that they properly claimed a Utah research tax credit because the Company had qualified research expenses (“QREs”) and because the amount of the QREs exceeded the “base amount” provided for in federal and Utah law. Specifically, the taxpayers contend that \$\$\$\$\$ of the Company’s 2013 Utah wages and \$\$\$\$\$ of its 2014 Utah wages constituted QREs. After the Initial Hearing, the taxpayers submitted information indicating that based on these

1 Interest continues to accrue until any tax liability is paid. No penalties were imposed.

QREs, they had miscalculated the Utah research tax credits that they had originally claimed and that the correct credit amounts should be \$\$\$\$\$ for the 2013 tax year and \$\$\$\$\$ for the 2014 tax year. For these reasons, the taxpayers ask the Commission to find that they are entitled to Utah research tax credits of \$\$\$\$\$ for the 2013 tax year and \$\$\$\$\$ for the 2014 tax year and to adjust the Division's assessments accordingly.

The Division, however, disagrees with the taxpayers' determination that \$\$\$\$\$ of the Company's 2013 wages and \$\$\$\$\$ of its 2014 wages qualify as QREs. The Division contends that these wages do not qualify as QREs, as defined in federal and Utah law, which, if correct, would preclude the taxpayers from qualifying for a Utah research tax credit for either the 2013 or 2014 tax year. In addition, if the Commission were to find that all or a portion of the wages actually do qualify as QREs, the Division contends that the QREs do not exceed the base amounts provided for in federal and Utah law, which would also preclude the taxpayers from qualifying for a Utah research tax credit for either year at issue. For these reasons, the Division asks the Commission to find that the taxpayers are not entitled to a Utah research tax credit for either 2013 or 2014 and to sustain its assessments for these years.

APPLICABLE LAW

Utah Code Ann. §59-10-1012 (2014)² provides for a nonrefundable tax credit for "increasing research activities" conducted in the state, as follows in pertinent part:

- (1) (a) A claimant, estate, or trust meeting the requirements of this section may claim the following nonrefundable tax credits:
 - (i) a research tax credit of 5% of the claimant's, estate's, or trust's qualified research expenses for the current taxable year that exceed the base amount provided for under Subsection (3);
....
 - (iii) a tax credit equal to 7.5% of the claimant's, estate's, or trust's qualified research expenses for the current taxable year.
....
- (2) Except as specifically provided for in this section:

² The 2014 version of the substantive law is cited in this decision, unless indicated otherwise. Unless otherwise noted, the substantive law remained the same for both 2013 and 2014.

- (a) the tax credits authorized under Subsection (1) shall be calculated as provided in Section 41, Internal Revenue Code; and
- (b) the definitions provided in Section 41, Internal Revenue Code, apply in calculating the tax credits authorized under Subsection (1).
- (3) For purposes of this section:
 - (a) the base amount shall be calculated as provided in Sections 41(c) and 41(h)
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 - (c) "qualified research" is as defined in Section 41(d), Internal Revenue Code, except that the term includes only qualified research conducted in this state;
 - (d) "qualified research expenses" is as defined and calculated in Section 41(b), Internal Revenue Code, except that the term includes only:
 - (i) in-house research expenses incurred in this state; and
 -

For purposes of Section 59-10-1012, UCA §59-10-1002(1) defines "claimant," as follows:

- (1) (a) Except as provided in Subsection (1)(b) or Subsection 59-10-1003(2), "claimant" means a resident or nonresident person that has state taxable income.
- (b) "Claimant" does not include an estate or trust.

Internal Revenue Code ("IRC") §41 provides for a federal credit for increasing research activities, as follows in pertinent part:

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- (b) Qualified research expenses. For purposes of this section--
 - (1) Qualified research expenses. The term "qualified research expenses" means the sum of the following amounts which are paid or incurred by the taxpayer during the taxable year in carrying on any trade or business of the taxpayer--
 - (A) in-house research expenses, and
 -
 - (2) In-house research expenses.
 - (A) In general. The term "in- house research expenses" means--
 - (i) any wages paid or incurred to an employee for qualified services performed by such employee,
 -
 - (B) Qualified services. The term "qualified services" means services consisting of--
 - (i) engaging in qualified research, or
 - (ii) engaging in the direct supervision or direct support of research activities which constitute qualified research. If substantially all of the services performed by an individual for the taxpayer during the taxable year consists of services meeting the requirements of clause (i) or (ii), the term "qualified services" means all of the services performed by such individual for the taxpayer during the taxable year. . . .
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- (c) Base amount.

- (1) In general. The term "base amount" means the product of--
 - (A) the fixed-base percentage, and
 - (B) 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").

....

- (3) Fixed-base percentage.
 - (A) In general. Except as otherwise provided in this paragraph, the fixed-base percentage is the percentage which the aggregate qualified research expenses of the taxpayer for taxable years beginning after December 31, 1983, and before January 1, 1989, is of the aggregate gross receipts of the taxpayer for such taxable years.
 - (B) Start-up companies.
 - (i) Taxpayers to which subparagraph applies. The fixed-base percentage shall be determined under this subparagraph if--
 - (I) the first taxable year in which a taxpayer had both gross receipts and qualified research expenses begins after December 31, 1983, or
 - (II) there are fewer than 3 taxable years beginning after December 31, 1983, and before January 1, 1989, in which the taxpayer had both gross receipts and qualified research expenses.
 - (ii) Fixed-base percentage. In a case to which this subparagraph applies, the fixed-base percentage is--
 - (I) 3 percent for each of the taxpayer's 1st 5 taxable years beginning after December 31, 1993, for which the taxpayer has qualified research expenses,
 - (II) in the case of the taxpayer's 6th such taxable year, 1/6 of the percentage which the aggregate qualified research expenses of the taxpayer for the 4th and 5th such taxable years is of the aggregate gross receipts of the taxpayer for such years,
 - (III) in the case of the taxpayer's 7th such taxable year, 1/3 of the percentage which the aggregate qualified research expenses of the taxpayer for the 5th and 6th such taxable years is of the aggregate gross receipts of the taxpayer for such years,
 - (IV) in the case of the taxpayer's 8th such taxable year, 1/2 of the percentage which the aggregate qualified research expenses of the taxpayer for the 5th, 6th, and 7th such taxable years is of the aggregate gross receipts of the taxpayer for such years, . . .

....

- (D) Rounding. The percentages determined under subparagraphs (A) and (B)(ii) shall be rounded to the nearest 1/100th of 1 percent.

....

- (d) Qualified research defined. For purposes of this section--
 - (1) In general. The term "qualified research" means research--
 - (A) with respect to which expenditures may be treated as expenses under section 174 [26 USCS § 174],
 - (B) which is undertaken for the purpose of discovering information--
 - (i) which is technological in nature, and

- (ii) the application of which is intended to be useful in the development of a new or improved business component of the taxpayer, and
 - (C) substantially all of the activities of which constitute elements of a process of experimentation for a purpose described in paragraph (3). Such term does not include any activity described in paragraph (4).
- (2) Tests to be applied separately to each business component. For purposes of this subsection--
 - (A) In general. Paragraph (1) shall be applied separately with respect to each business component of the taxpayer.
 - (B) Business component defined. The term "business component" means any product, process, computer software, technique, formula, or invention which is to be--
 - (i) held for sale, lease, or license, or
 - (ii) used by the taxpayer in a trade or business of the taxpayer.
 - (C) Special rule for production processes. Any plant process, machinery, or technique for commercial production of a business component shall be treated as a separate business component (and not as part of the business component being produced).
- (3) Purposes for which research may qualify for credit. For purposes of paragraph (1)(C)--
 - (A) In general. Research shall be treated as conducted for a purpose described in this paragraph if it relates to--
 - (i) a new or improved function,
 - (ii) performance, or
 - (iii) reliability or quality.
 - (B) Certain purposes not qualified. Research shall in no event be treated as conducted for a purpose described in this paragraph if it relates to style, taste, cosmetic, or seasonal design factors.
- (4) Activities for which credit not allowed. The term "qualified research" shall not include any of the following:
 - (A) Research after commercial production. Any research conducted after the beginning of commercial production of the business component.
 - (B) Adaptation of existing business components. Any research related to the adaptation of an existing business component to a particular customer's requirement or need.
 - (C) Duplication of existing business component. Any research related to the reproduction of an existing business component (in whole or in part) from a physical examination of the business component itself or from plans, blueprints, detailed specifications, or publicly available information with respect to such business component. . . .

. . . .

Treas. Reg. §1.41-4 provides guidance concerning what constitutes "qualified research," as follows in pertinent part:

(a) Qualified research --

....

(4) Technological in nature. For purposes of section 41(d) [26 USCS § 41(d)] and this section, information is technological in nature if the process of experimentation used to discover such information fundamentally relies 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.

(5) Process of experimentation --

(i) In general. For purposes of section 41(d) [26 USCS § 41(d)] and this section, 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. A taxpayer may undertake a process of experimentation if there is no uncertainty concerning the taxpayer's capability or method of achieving the desired result so long as the appropriate design of the desired result is uncertain as of the beginning of the taxpayer's research activities. 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.

(ii) Qualified purpose. For purposes of section 41(d) [26 USCS § 41(d)] and this section, a process of 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. . . .

....

IRC §174(a)(1) provides that “[a] taxpayer may treat research or experimental expenditures which are paid or incurred by him during the taxable year in connection with his trade or business as expenses which are not chargeable to capital account. The expenditures so treated shall be allowed as a deduction.

Treas. Reg. §1.174-2 defines “research and experimental expenditures,” as used in IRC §174, as follows in pertinent part:

(a) In general.

(1) The term research or experimental expenditures, as used in section 174 [26 USCS § 174], means expenditures incurred in connection with the taxpayer's trade or business which represent research and development costs in the experimental or laboratory sense. The term generally includes all such costs incident to the development or improvement of a product. The term includes the costs of obtaining a patent, such as attorneys' fees expended in making and perfecting a patent application. Expenditures represent research and development costs in the experimental or laboratory sense if they are for activities intended to discover information that would eliminate uncertainty concerning the development or improvement of a product. Uncertainty exists if the information available to the taxpayer does not establish the capability or method for developing or improving the product or the appropriate design of the product. 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. . . .

. . . .

For the instant matter, UCA §59-1-1417(1) (2017) provides guidance concerning which party has the burden of proof, as follows:

- (1) In a proceeding before the commission, the burden of proof is on the petitioner except for determining the following, in which the burden of proof is on the commission:
- (a) whether the petitioner committed fraud with intent to evade a tax, fee, or charge;
 - (b) whether the petitioner is obligated as the transferee of property of the person that originally owes a liability or a preceding transferee, but not to show that the person that originally owes a liability is obligated for the liability; and
 - (c) whether the petitioner is liable for an increase in a deficiency if the increase is asserted initially after a notice of deficiency is mailed in accordance with Section 59-1-1405 and a petition under Part 5, Petitions for Redetermination of Deficiencies, is filed, unless the increase in the deficiency is the result of a change or correction of federal taxable income:
 - (i) required to be reported; and
 - (ii) of which the commission has no notice at the time the commission mails the notice of deficiency.

DISCUSSION

Pursuant to Subsection 59-1-1417(1), the taxpayers have the burden of proof in this matter. The Company that TAXPAYER-1 owns is a construction company that commenced operations in 2007. During 2007 and all subsequent years, the Company has constructed numerous projects both in and outside of Utah, has had gross receipts, and has paid wages. The Commission will first determine whether the taxpayers have shown that the \$\$\$\$ of 2013 Utah wages and the \$\$\$\$ of 2014 Utah wages that they classified as QREs

actually do qualify as QREs under federal and Utah law. If these amounts of wages do qualify as QREs, the Commission will next determine whether these amounts of QREs exceed the base amounts provided for in federal and Utah law before deciding whether the taxpayers qualify for Utah research tax credits for 2013 and/or 2014. On the other hand, if the taxpayers have not shown that these amounts of wages qualify as QREs, the Commission need not address the base amount issue to resolve the appeal. Nevertheless, under the latter circumstance, it may still be helpful for the Commission to make some cursory observations about the base amount issue.

I. Do the \$\$\$\$ of 2013 Wages and the \$\$\$\$ of 2014 Wages Qualify as QREs under Federal and Utah Law?

The taxpayers explained that they did not claim a research tax credit for federal tax purposes for either 2013 or 2014 because they were subject to the alternative minimum tax (“AMT”) for federal tax purposes for these years and because a person who is subject to the AMT cannot claim the federal research tax credit. Utah law, however, does not require that a person must claim a federal research tax credit for a specific tax year in order to claim a Utah research tax credit for that year. As a result, the Commission will determine whether the taxpayers’ evidence is sufficient to show that they are entitled to claim Utah research tax credits for the 2013 and 2014 tax years.

Subsections 59-10-1012(1)(a) and (1)(c) provide that if a claimant, estate, or trust has QREs, the claimant, estate, or trust may be able to claim Utah research tax credits based on the amounts of the QREs. Pursuant to Subsection 59-10-1002(1)(a), a “claimant” means a resident or nonresident person who has Utah taxable income. The taxpayers are Utah residents who have Utah taxable income and, as a result, are “claimants” who may qualify for Utah research tax credits if all conditions are met.

Subsection 59-10-1012(2)(a) provides that the Utah research tax credit is to be calculated as provided in the Internal Revenue Code (“IRC”), while Subsection 59-10-1012(3)(d) provides that the term “qualified

research expenses” is as defined in the IRC. IRC §§41(b)(1)(A) and (b)(2)(A)(i) provide that QREs include “any wages paid or incurred to an employee for *qualified services* performed by such employee” (emphasis added), while IRC §41(b)(2)(B) provides that “qualified services” means, in part, “services consisting of . . . engaging in *qualified research*” (emphasis added).

Subsection 59-10-1012(3)(c) provides that “qualified research” is as defined in IRC §41(d), except that the term includes only “qualified research” conducted in Utah. “Qualified research” is defined in IRC §41(d) and Treas. Reg. §1.41-4. As a result, to determine whether the taxpayers are entitled to claim Utah research tax credits for the 2013 and 2014 tax years, the Commission must first determine whether the \$\$\$\$ of 2013 wages and \$\$\$\$ of 2014 wages that the Company paid to its employees for Utah projects and classified as QREs meet the federal definition of “qualified research.”

Pursuant to IRC §41(d)(1), the wages that the taxpayers deemed to be QREs must meet a number of tests before they constitute “qualified research” for which a research tax credit may be claimed, including: 1) under IRC §174, the wages must be “research or experimental expenditures” (as defined in Treas. Reg. §1.174-2(a)(1)); 2) the research for which the wages were paid must be undertaken for the purposes of discovering information that is technological in nature and the application of which is intended to be useful in the development of a new or improved business component of the taxpayer; and 3) substantially all of the research activities for which the wages were paid must constitute elements of a process of experimentation for a purpose described in IRC §41(d)(3), but not include any activity described in IRC §41(d)(4).

IRC §41(d)(3) provides that research may qualify for the credit if it relates to a new or improved function, performance, or reliability or quality, but in no event may qualify if it relates to style, taste, cosmetic, or seasonal design factors. IRC §41(d)(4) provides, in part, that “qualified research” shall not include any research that is related to the adaptation of an existing business component to a particular customer’s requirement or need. In addition, IRC §41(d)(2) provides an overarching requirement that the IRC §41(d)(1)

tests “**shall be applied separately with respect to each business component of the taxpayer**” (emphasis added) (while also defining “business component” as any product, process, computer software, technique, formula, or invention used by the taxpayer in the taxpayer’s trade or business).

The taxpayers’ information is insufficient to show that all of the wages that it deemed to be QREs for 2013 or 2014 were expended for “qualified research.” First, in regards to the wages that the taxpayers classified as QREs, the taxpayers did not identify the wages that were associated with each separate business component that meets all of the IRC §41(d) tests. Instead, the taxpayers determined that all of the Company’s construction projects involve “qualified research” to some degree because all construction projects (including both new construction and renovations) have unique problems and uncertainties that have not arisen on a prior project and which often require experimentation in order to discover information to eliminate these uncertainties. While the taxpayers provided descriptions of Utah construction projects it performed in 2013 and 2014 and described unique problems and uncertainties associated with the projects, the taxpayers did not indicate how much of the total wages they deemed to be QREs was expended for each construction project, much less how much of these wages was expended for each product, process, computer software, technique, formula, or invention associated with each construction project.

Instead, the taxpayers estimated the percentage of time that each of its employees spent in performing “qualified research” on projects in Utah during each tax year (based on the responsibilities that each employee is typically responsible for on a project), after which the taxpayers multiplied that percentage by the employee’s annual wages to estimate the amount of that employee’s wages that constituted “qualified research.” These employees included a vice-president of preconstruction, virtual construction managers, architects, project managers, assistant project managers, estimators, project executives, project engineers, and superintendents. For those employees that only worked on Utah projects, the taxpayers estimated that as much as 80% of the employee’s wages was expended for “qualified research.” With this methodology, the taxpayers

determined that the Company expended \$\$\$\$ of wages that qualified as QREs for 2013 and \$\$\$\$ of wages that qualified as QREs for 2014.

However, the taxpayers have not provided sufficient information to support the percentage of wages of each employee that they estimated to constitute “qualified research.” For example, the taxpayers estimated that 80% of the salary the Company paid to some of its estimators was for “qualified research.” TAXPAYER-1 explained that the Company does not keep track of what an employee does each day or on each project. However, he estimated that 20% of an estimator’s time is devoted to the “prequalification” of subcontractors to work on projects (which he did not deem to be “qualified research”), while 80% of an estimator’s time is for “constructability review” and for the design and budgeting of “conceptuals” (which he deemed to involve uncertainty and to be “qualified research”). The taxpayers did not explain why an estimator’s work relating to constructability reviews and for the design and budgeting of conceptuals would meet the IRC §41(d) tests.

Furthermore, because the taxpayers have not segregated the wages that they deemed to constitute “qualified research” by construction project or by each business component on a project, the Commission is left with no way to remove from the taxpayers’ calculations of QREs, those wages that may be associated with a separate business component that does not satisfy the IRC §41(d) tests. For example, TAXPAYER-1 explained that the Company’s construction of the CITY-2 Temple involved many uncertainties that needed to be resolved because of the unique nature of the building and the custom design elements that were incorporated into it. As an example, TAXPAYER-1 explained that the Company had to create moldings for the building that were unique and which had never been created for any other building. However, the taxpayers did not explain why creating unique moldings for a building does not relate to style or cosmetic factors, which are precluded from constituting “qualified research” under IRC §41(d)(3).³

3 Similarly, the Company’s employees added “some fancy colors” to art walls during the renovation of the Prestige Renovation building and repainted and re-carpeted during the renovation of the RETIREMENT CENTER. It appears that the taxpayers deemed these activities to constitute “qualified research.” It is difficult

In addition, TAXPAYER-1 explained that one of the Company's projects was to build a mile-long tunnel underneath the UNIVERSITY campus. He further explained that because of the time constraints associated with the project, the Company's employees had to use a concrete mix that would cure faster than the typical concrete mix. TAXPAYER-1 explained that to get concrete to cure faster, one generally adds air, water, chemicals, or fly ash to the concrete mix. TAXPAYER-1 stated that while his employees were deciding which of these items to add to the concrete mix to get it to cure faster, one employee suggested a particular chemical that he had heard of being used on other projects. As a result, the Company's employees used this chemical in the concrete mix to build the tunnel on this particular project. The Company's employees, however, did not develop the chemical that they decided to add to the concrete mix, and the taxpayers did not explain why the employees' decision to use this chemical would be considered "the development of a new or improved business component (as required under IRC §41(d)(1)(B)(ii) to be deemed "qualified research") and would not be related to the adaptation of an existing business component to a particular customer's requirement or need (which is precluded from constituting "qualified research" under IRC §41(d)(4)).

Similarly, TAXPAYER-1 stated that the Company's employees always come up with a better way to do something during every project, which the employees can then apply to the next project. However, once the Company's employees develop a better way to do something on one project, this "business component," if it meets the IRS §41(d) tests to constitute "qualified research," would not appear to constitute "qualified research" when it is used or adapted on the next project or projects. Where the Company does not keep records of the time that its employees spend on creating new or improved business components on each of its projects, as opposed to using or adapting previously-developed business components, TAXPAYER-1 estimates of the time each year that an employee performs "qualified research" appears, at best, to be speculative.

to discern how these portions of those projects would not relate to style or cosmetic factors.

In addition, some of the Company's activities that the taxpayers deemed to constitute "qualified research" were designing and organizing work schedules so as not to interfere with regular work hours. It is difficult to see how such activities are technological in nature so that they would meet the IRC §41(d)(1)(B)(i) test. Because the Company has not kept records of the time that its employees engaged in these activities, the Commission has no way to remove the wages associated with such activities from the QREs that the taxpayers calculated for each year.

It is not implausible that the Company has activities that may constitute "qualified research" and qualify as QREs. As an example, TAXPAYER-1 proffered testimony about certain wind and water experiments that may meet the "experimental" requirements set forth in IRC §§41(d)(1)(A) and (d)(1)(C), Treas. Reg. §1.174-2(a)(1), and Treas. Reg. §1.41-4(a)(5)(i). However, the Commission is not convinced that all "problem-solving" aspects of constructing a building rise to the level of experimentation needed to constitute "qualified research."

The taxpayers indicated that the IRS has allowed federal research tax credits for construction companies. However, the taxpayers have not shown that the IRS has allowed federal research tax credits for construction companies where a taxpayer has estimated the annual wages of each employee that constitute "qualified research" instead of keeping records of each business component of each project and the time spent on each business component. In addition, the taxpayers have not shown that the IRS has allowed federal research tax credits for activities such as those that the Commission questioned earlier in this decision. Were there case law to show that the IRS or other states had approved QREs under the circumstances of the instant case, perhaps the taxpayers' arguments would be more convincing. The taxpayers, however, indicate that they are unaware of any federal or state cases involving construction companies and research tax credits.

For these reasons, the taxpayers have not shown that the wages that the Company expended on Utah projects and which might constitute "qualified research" amounted to \$\$\$\$ for the 2013 tax year and \$\$\$\$

for the 2014 tax year. Had the Company segregated its records into separate business components, perhaps the Commission could have found that some of the wages at issue constituted “qualified research” and QREs. However, based on the information proffered at the Initial Hearing, the taxpayers have not shown that the amounts of QREs on which it calculated its proposed Utah research tax credits are correct. As a result, the taxpayers have not shown that its proposed Utah research tax credit is correct for either the 2013 or 2014 tax year. Accordingly, the Division’s assessments are sustained.

II. Observations about the “Base Amount” Used to Derive Certain Research Tax Credits.

Subsection 59-10-1012(1)(a)(i) authorizes a Utah research tax credit equal to 5% of a claimant’s, estate’s, or trust’s QREs that exceed the “base amount” provided for under Subsection 59-10-1012(3), while Subsection 59-10-1012(3)(a) provides for the “base amount” to be calculated as provided for in IRC §§41(c) and (h). Because the taxpayers have not shown that they had QREs amounting to \$\$\$\$ for the 2013 tax year and \$\$\$\$ for the 2014 tax year, there is no need for the Commission to determine whether the taxpayers properly calculated the “base amount” for each of the 2013 and 2014 tax years. However, as already mentioned, the Commission will make some cursory observations about the IRC §41 meaning of “base amount.”⁴

⁴ At the hearing, the parties proffered that the taxpayers’ proposed Utah tax credits were calculated only under Subsection 59-10-1012(1)(a), which requires the “base amount” to be determined and factored into the calculation of the credit. Furthermore, in the taxpayers’ Initial Pre-Hearing Brief, the taxpayers stated that “[e]xcept under specific circumstances not applicable to this case, the research tax credit is calculated at 5% of the taxpayer’s ‘qualified research expenses’ for the current taxable year that exceed ‘base amount.’ See Utah Code Ann. §59-10-1012(1)(a).” However, in the taxpayers’ post-hearing brief, the taxpayers provided detailed calculations of their proposed tax credits, which show that a large majority of the taxpayers’ proposed 2014 Utah research tax credit was calculated under Subsection 59-10-1012(1)(c), not Subsection 59-10-1012(1)(a). The taxpayers have not explained why their 2013 Utah research tax credit should be calculated under Subsection 59-10-1012(1)(a) only, while their 2014 Utah research tax credit should be calculated under both Subsections 59-10-1012(1)(a) and (1)(c). Regardless, the Utah research tax credit authorized under both of these subsections is dependent on the taxpayer providing evidence to support their proposed QREs. Because the taxpayers have not shown that they had QREs amounting to \$\$\$\$ for the 2013 tax year and \$\$\$\$ for the

IRC §41(c)(1)(A) provides that one component of the “base amount” is the “fixed-base percentage,” while IRC §41(c)(3)(B)(ii) provides a rather complicated formula to determine the fixed-base percentage of a start-up company (such as TAXPAYER-1 Company that began operations in 2007). The formula in IRC §41(c)(3)(B)(ii) provides for the fixed-base percentage to be derived by adding up certain percentages associated with each of the prior years that a taxpayer has had QREs. The taxpayers claim that the Company had QREs for all years it has been in operations, but admits that they did not calculate the Company’s QREs for all of these years because it did not claim a federal or state research tax credit that required such a calculation prior to the 2010 tax year. However, under the assumption that the Company had QREs for all years back to 2007, the taxpayers claim that their fixed-base percentage for the 2013 tax year should be based on the percentages provided for a company in its 7th year of operations and that their fixed-base percentage for the 2014 tax year should be based on the percentages provided for a company in its 8th year of operations.

The Division, on the other hand, claims that the Company should not be considered to have QREs until 2010 (i.e., the first year the taxpayers actually calculated QREs), which would result in the fixed-base percentage for the 2013 tax year being based on the percentages provided for a company in its 4th year of operations and the fixed-base percentage for the 2014 tax year being based on the percentages provided for a company in its 5th year of operations. This would also result in higher fixed-based percentages and higher base amounts for 2013 and 2014 than would result for a company in its 7th and 8th years of operations, which would then result in lower amounts of QREs that exceed the base amounts. The Division claims that if the Company is considered to be in its 4th year of operations in 2013 (instead of its 7th year) and in its 5th year of operations in 2014 (instead of its 8th year), the taxpayers’ base amount for each of the 2013 and 2014 tax years would exceed the \$\$\$\$\$ of QREs that the taxpayers calculated for the 2013 tax year and the \$\$\$\$\$ of QREs they calculated

2014 tax year, the Commission will not address any further in this decision whether Subsection 59-10-1012(1)(a) is only applicable to the 2013 tax year or whether Subsections 59-10-1012(1)(a) and (1)(c) are both applicable to the 2014 tax year.

for the 2014 tax year. As a result, the Division claims that even if the taxpayers had shown that all of the wages they deemed to be QREs actually were QREs, the taxpayers would still not be entitled to a Utah research tax credit under Subsection 59-10-1012(1)(a) for either tax year at issue.

The language of IRC §41(c)(3)(B)(ii)(I) provides that the fixed-base percentage is dependent on the “taxable years . . . for which the taxpayer has qualified research expenses,” not taxable years for which the taxpayer claimed QREs. As a result, it appears, at first glance, that the taxpayers’ position concerning the years of operations aspect of the “base amount” calculation may be more convincing than the Division’s position. However, it also appears that the taxpayers would need to show that the Company actually had QREs for the first few years of its operations in order for their position to be fully accepted. If there are further proceedings in this matter, the Commission would encourage both parties to develop their “base amount” arguments more thoroughly and provide case law or other precedent to support their arguments.

In summary, because the taxpayers have not shown that they had QREs of \$\$\$\$ for the 2013 tax year and \$\$\$\$ for the 2014 tax year, they have not shown that the Utah research tax credits they originally claimed or now propose are correct or that the Division’s assessments are incorrect. Accordingly, the Commission should deny the taxpayers’ appeal and sustain the Division’s assessments in their entirety.

Kerry R. Chapman
Administrative Law Judge

DECISION AND ORDER

Based on the foregoing, the Commission sustains the Division's 2013 and 2014 assessments in their entireties. It is so ordered.

This decision does not limit a party's right to a Formal Hearing. However, this Decision and Order will become the Final Decision and Order of the Commission unless any party to this case files a written request within thirty (30) days of the date of this decision to proceed to a Formal Hearing. Such a request shall be mailed, or emailed, to the address listed below and must include the Petitioner's name, address, and appeal number:

Utah State Tax Commission
Appeals Division
210 North 1950 West
CITY-1, Utah 84134

or emailed to:

taxappeals@utah.gov

Failure to request a Formal Hearing will preclude any further appeal rights in this matter.

DATED this _____ day of _____, 2018.

John L. Valentine
Commission Chair

Michael J. Cragun
Commissioner

Robert P. Pero
Commissioner

Rebecca L. Rockwell
Commissioner

Notice: If a Formal Hearing is not requested as discussed above, failure to pay the balance resulting from this order within thirty (30) days from the date of this order may result in a late payment penalty.