10-2436
CORPORATE FRANCHISE
TAX YEARS: 2007, 2008
SIGNED: 12-12-2011
COMMISSIONERS: R. JOHNSON, M. JOHNSON, M. CRAGUN
EXCUSED: D. DIXON
GUIDING DECISION

BEFORE THE UTAH STATE TAX COMMISSION

PETITIONER, Petitioner, v. AUDITING DIVISION OF THE UTAH STATE TAX COMMISSION, Respondent.	**FINDINGS OF FACT, CONCLUSIONS OF LAW, AND FINAL DECISION** Appeal No. 10-2436 Account No. ##### Tax Type: Corporate Franchise Audit Period: 06/01/07 & 05/31/08 Judge: Chapman

Presiding:
R. Bruce Johnson, Commission Chair
Kerry R. Chapman, Administrative Law Judge

Appearances:
For Petitioner: PETITIONER REP. 1, Attorney
PETITIONER REP. 2, Attorney
For Respondent: RESPONDENT REP., Assistant Attorney General

STATEMENT OF THE CASE

This matter came before the Utah State Tax Commission for a Formal Hearing on December 5, 2011. Based upon the evidence and testimony presented, the Tax Commission hereby makes its:

FINDINGS OF FACT

1. The tax at issue is Utah corporate franchise and income tax.

2. The audit period is June 1, 2007 to May 31, 2008.

3. PETITIONER and its unitary subsidiaries ("taxpayer" or "PETITIONER") filed a worldwide combined report for the audit period.

4. COMPANY 1 ("COMPANY 1") was part of the PETITIONER unitary group. COMPANY 1 develops, manufactures, markets, and distributes (WORDS REMOVED) in the United States and throughout the world. COMPANY 1 has its manufacturing facility, main distribution center, and primary administrative offices in CITY 1.

5. Under Utah Code Ann. §59-7-612, taxpayers are entitled to take a credit against their Utah corporate franchise tax liability for certain qualified research expenses.

6. PETITIONER represents that COMPANY 1 incurred Utah qualified research expenses during the tax year ending May 31, 2007. In claiming the Utah tax credit for research activities conducted in this state on its combined return, PETITIONER based its calculation on the federal Alternative Simplified Credit ("ASC") method under Internal Revenue Code §41(c)(5). The Utah tax credit for research activities as calculated by PETITIONER was claimed in tax year endiing May 31, 2008 because UCA §59-7-612(1)(b) (2007) required the taxpayer to "claim the credit . . . for the taxable year immediately following the taxable year for which the taxpayer qualifies for the credit."

7. For tax years beginning before January 1, 2008, the Utah credit for research activities conducted in this state is 6% of the taxpayer's Utah qualified research expenses for the current taxable year that exceed the base amount. UCA §59-7-612(1)(a)(i). In House Bill 52, passed during the 2008 legislative session, the Legislature changed the rate from 6% to 5%. PETITIONER had used a 5% rate in calculating its Utah research credit based on expenses incurred in tax year ending May 31, 2007 and claimed the resulting credit of $$$$$ in tax year ended May 31, 2008. Using the 6% rate and continuing to base its calculation on the federal ASC method would have resulted in PETITIONER claiming a Utah credit of $$$$$ for tax year ending May 31, 2008.

8. On August 12, 2010, the Auditing Division ("Division") issued a Statutory Notice of Deficiency ("Statutory Notice") to PETITIONER for the audit period. In the Statutory Notice, the Division

disallowed the credit based on PETITIONER's use of the federal ASC method, which accounted for $$$$$ of the tax deficiency.[1] The Division maintains that the federal ASC method is not available as a means of calculating the credit under Utah law.[2]

9. On September 7, 2010, PETITIONER timely appealed from the audit findings, asserting that calculating a credit based on the federal ASC method is permitted under Utah law.

10. Both parties agreed to waive the Initial Hearing in this matter and proceed directly to the Formal Hearing.

11. If the Commission rules in favor of PETITIONER by finding that the Utah credit can be based on the federal ASC method, PETITIONER will be entitled not only to an abatement of $$$$$ of the amount imposed in the Statutory Notice, but also to a refund of $$$$$ (because of the difference between the 5% rate PETITIONER used in calculating the credit claimed on its return and the 6% rate that was in effect for the tax year at issue). 12. If the Commission rules in favor of the Division by finding that the Utah credit cannot be based on the federal ASC method, PETITIONER will be responsible to pay the remaining $$$$$ tax deficiency as asserted in the Statutory Notice.

APPLICABLE LAW

1. Utah Code Ann. §59-7-612[3] provides a Utah tax credit for research activities conducted in Utah, as follows in pertinent part:

> (1) (a) For taxable years beginning on or after January 1, 1999, but beginning before December 31, 2010, a taxpayer meeting the requirements of this section shall qualify for the following nonrefundable credits for increasing research activities in this state:
> (i) a research tax credit of 6% of the taxpayer's qualified research expenses for the

1 PETITIONER did not dispute the portion of the deficiency that did not relate to the credit at issue.
2 Both parties agree that if the federal ASC method is not available as a means of calculating the credit under Utah law, PETITIONER is not otherwise eligible for the Utah credit for this audit period.
3 The 2007 version of Utah and federal law is cited in this decision, unless otherwise indicated. Section 59-7-612 was substantively amended effective January 1, 2008. However, the 2008 amendments to Section 59-7-612 have no effect on the decision in this matter.

current taxable year that exceed the base amount provided for under Subsection (4); and

. . . .

(b) If a taxpayer qualifying for a credit under Subsection (1)(a) seeks to claim the credit, the taxpayer shall:

(i) claim the credit or a portion of the credit for the taxable year immediately following the taxable year for which the taxpayer qualifies for the credit;

(ii) carry the credit or a portion of the credit forward as provided in Subsection (4)(f); or

(iii) claim a portion of the credit and carry forward a portion of the credit as provided in Subsections (1)(b)(i) and (ii);.

(c) The credits provided for in this section do not include the alternative incremental credit provided for in Section 41(c)(4), Internal Revenue Code.

. . . .

(3) Except as specifically provided for in this section:

(a) the 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 credits authorized under Subsection (1).

(4) For purposes of this section:

(a) the base amount shall be calculated as provided in Sections 41(c) and 41(h), Internal Revenue Code, except that:

(i) the base amount does not include the calculation of the alternative incremental credit provided for in Section 41(c)(4), Internal Revenue Code;

. . . .

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

(a) General rule. For purposes of section 38, the research credit determined under this section for the taxable year shall be an amount equal to the sum of-

(1) 20 percent of the excess (if any) of-

(A) the qualified research expenses for the taxable year, over

(B) the base amount, . . .

. . . .

(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").

(2) Minimum base amount. In no event shall the base amount be less than 50 percent of the qualified research expenses for 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.

. . . .

(4) Election of alternative incremental credit.

(A) In general. At the election of the taxpayer, the credit determined under subsection (a)(1) shall be equal to the sum of-

(i) 3 percent of so much of the qualified research expenses for the taxable year as exceeds 1 percent of the average described in subsection (c)(1)(B) but does not exceed 1.5 percent of such average,

(ii) 4 percent of so much of such expenses as exceeds 1.5 percent of such average but does not exceed 2 percent of such average, and

(iii) 5 percent of so much of such expenses as exceeds 2 percent of such average.

(B) Election. An election under this paragraph shall apply to the taxable year for which made and all succeeding taxable years unless revoked with the consent of the Secretary.

(5) Election of alternative simplified credit.

(A) In general. At the election of the taxpayer, the credit determined under subsection (a)(1) shall be equal to 12 percent of so much of the qualified research expenses for the taxable year as exceeds 50 percent of the average qualified research expenses for the 3 taxable years preceding the taxable year for which the credit is being determined.

(B) Special rule in case of no qualified research expenses in any of 3 preceding taxable years.

(i) Taxpayers to which subparagraph applies. The credit under this paragraph shall be determined under this subparagraph if the taxpayer has no qualified research expenses in any one of the 3 taxable years preceding the taxable year for which the credit is being determined.

(ii) Credit rate. The credit determined under this subparagraph shall be equal to 6 percent of the qualified research expenses for the taxable year.

(C) Election. An election under this paragraph shall apply to the taxable year for which made and all succeeding taxable years unless revoked with the consent of the Secretary. An election under this paragraph may not be made for any taxable year to which an election under paragraph (4) applies.

. . . .

(h) Termination.

(1) In general. This section shall not apply to any amount paid or incurred-

(A) after June 30, 1995, and before July 1, 1996, or

(B) after December 31, 2007.

(2) Computation of base amount. In the case of any taxable year with respect to which this section applies to a number of days which is less than the total number of days in such taxable year, the base amount with respect to such taxable year shall be the amount which bears the same ratio to such amount (determined without regard to this

> paragraph) as the number of days in such taxable year to which this section applies bears to the total number of days in such taxable year.

DISCUSSION

At issue is the proper calculation of the Utah research credit allowed under Section 59-7-612(1)(a)(i). Specifically at issue is whether the Utah credit may be calculated using the "Alternative Simplified Credit" or "ASC" provided for in IRC §41(c)(5).

The Utah credit authorized in Section 59-7-612(1)(a)(i) is determined with "the base amount provided under [Section 59-7-612(4)]." Section 59-7-612(1)(c) expressly provides that the Utah credit does not include the "Alternative Incremental Credit" or "AIC" provided for in IRC §41(c)(4). Section 59-7-612(1), however, does not expressly provide that the Utah credit does not include the ASC provided for in IRC §41(c)(5).

Section 59-7-612(4)(a)(i) provides that "the base amount [used to determine the Utah credit] shall be calculated as provided in Sections 41(c) and 41(h), Internal Revenue Code, except that . . . the base amount does not include the calculation of the alternative incremental credit [AIC] provided for in Section 41(c)(4), Internal Revenue Code[.]" Section 59-7-612(4)(a), however, does not expressly provide that the base amount does not include the calculation of the ASC provided for in Section 41(c)(5).

The parties agree that the Utah provisions cited above clearly preclude the Utah credit from being calculated with the AIC provided for in IRC §41(c)(4) . The parties, however, disagree on whether the Utah credit can be calculated using the ASC provided for in IRC §41(c)(5). A short summary of the history of the federal and state research credits will help illustrate how the state issue concerning the ASC arose, as follows:

a) In 1991, the federal government enacted the federal research credit found in IRC §41.

b) In 1996, the federal government amended IRC §41 to include the AIC as an alternative to the "general" methodology used to calculate the federal research credit.

c) In 1998, Utah enacted a state research credit that was based, in part, on the federal credit and that expressly precluded the AIC from being used to calculate the Utah credit.

d) In 2006, the federal government amended IRC §41 to include the ASC as another alternative methodology to calculate the federal research credit.

e) Although Utah has not addressed the ASC in state law, the ASC issue was brought before Utah's Revenue and Taxation Interim Committee in 2009.[4]

The taxpayer argues that the ASC is a permissible methodology to use when calculating the state credit because, unlike the AIC, the Legislature has not expressly excluded the ASC in Section 59-7-612. The Division, on the other hand, argues that the AIC exclusionary language in Section 59-7-612 exists only for clarification purposes and that the AIC would be precluded from being used to calculate the Utah credit even if it were not specifically excluded in the state provision. Similarly, the Division argues that the ASC is also precluded from being used to calculate the state credit, even though the ASC alternative methodology is not specifically excluded in the state provision.

The Division's primary argument centers on the use of the term "base amount" in the state and federal provisions. The Division points out that the Utah provision provides for the state credit to be determined from the "base amount" that "shall be calculated as provided in Sections 41(c) and 41(h), Internal Revenue Code." Section 59-7-612(1)(a)(i) and (4)(a). The Division also points out that the federal provision defines "base amount" in IRC §41(c)(1) and provides for a minimum "base amount" in IRC §41(c)(2), but does not mention "base amount" in either IRC §41(c)(4), which provides for the AIC, or IRC §41(c)(5),

4 A transcript of an October 21, 2009 interim meeting shows that PERSON 1 discussed draft legislation that would exclude not only the AIC, but also the ASC from being used to calculate the Utah research credit. PERSON 1 also informed the committee that the "Tax Committee is interpreting the current law as disallowing both of the alternative methods" (i.e., the Division had determined that the AIC and ASC methods were both excluded under current law). She also informed the committee that legislation could be drafted to allow a taxpayer to use an alternative method to calculate the state credit.

which provides for the ASC. Because the state credit is determined from a "base amount" and because this term is not found in the ASC language of IRC §41(c)(5), the Division contends that the taxpayer cannot use the ASC to calculate its Utah tax credit.

The Commission, however, does not find the Division's arguments persuasive. First, Section 59-7-612(4)(a) provides that the Utah credit "shall be calculated as provided in Sections 41(c) and 41(h), Internal Revenue Code." The AIC and the ASC are both part of IRC §41(c). Accordingly, it appears that these alternative methodologies are incorporated into the calculation prescribed in Section 59-7-612(4)(a) and can be used to determine the tax credit allowed under Section 59-7-612(1)(a)(i), unless either of the alternative methods are expressly excluded. The AIC is expressly excluded. The ASC, however, is not. The Legislature has shown that it knows how to exclude an alternative methodology, and it has not excluded the ASC. Accordingly, it appears that a taxpayer may use the ASC methodology to determine its Utah credit.

Second, in the federal provision, the AIC and ASC alternative methodologies are found under the section heading "Base amount." Although both Congress and the Utah Legislature have seen fit to allow a credit for certain research expenditures, in both cases, the credit is allowed only for qualified expenditures in excess of a certain amount. In the case of the general credit, this amount is explicitly identified as a "base amount" and is equal to a certain percentage of the average annual gross receipts of the taxpayer for the preceding four years. IRC §41(c)(1). In the case of the AIC, the credit is allowed for expenditures in excess of 1% of the average annual gross receipts for the preceding four years. IRC §41(c)(4)(A)(i). In the case of the ASC, the credit is allowed only for expenditures in excess of 50% of the average qualified research expenditures for the prior three years. §41(c)(5)(A). Thus in all three cases, credit is allowed only for expenditures in excess of some base amount.

Third, the federal provisions describing both the AIC and ASC reference the "credit determined under subsection (a)(1)," which itself refers to the "base amount." Although the term "base amount" is not

expressly referred to in IRC §41(c)(4), which provides for the AIC, or IRC §41(c)(5), which provides for the ASC, the term is incorporated into these subsections by reference. Because the ASC is part of IRC §41(c) and because use of the ASC to determine the Utah credit is not expressly excluded under Utah law, a taxpayer can use the ASC to calculate its Utah credit pursuant to Section 59-7-612(1)(a)(i) and (4)(a).

CONCLUSIONS OF LAW

1. The ASC, as provided in IRC §41(c)(5), may be used to calculate the Utah research credit authorized by Section 59-7-612(1)(a)(i).

2. The Utah research credit at issue should be calculated at the 6% rate found in the 2007 version of Section 59-7-612(1)(a)(i).

3. PETITIONER is entitled not only to an abatement of $$$$$ of the amount imposed in the Statutory Notice, but also to a refund of $$$$$.

_____
Kerry R. Chapman
Administrative Law Judge

DECISION AND ORDER

Based upon the foregoing, the Commission finds that the taxpayer is authorized to use the ASC to determine its Utah research credit. Accordingly, the Commission abates $$$$$ of the assessment the Division imposed in its Statutory Notice and finds that an additional $$$$$ should be refunded to the taxpayer. It is so ordered.

DATED this _____ day of _____, 2011.

R. Bruce Johnson
Commission Chair

Marc B. Johnson
Commissioner

D'Arcy Dixon Pignanelli
Commissioner

Michael J. Cragun
Commissioner

NOTICE OF APPEAL RIGHTS: You have twenty (20) days after the date of this order to file a Request for Reconsideration with the Tax Commission Appeals Unit pursuant to Utah Code Ann. §63G-4-302. A Request for Reconsideration must allege newly discovered evidence or a mistake of law or fact. If you do not file a Request for Reconsideration with the Commission, this order constitutes final agency action. You have thirty (30) days after the date of this order to pursue judicial review of this order in accordance with Utah Code Ann. §§59-1-601et seq. and 63G-4-401 et seq.

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