

12-799
TAX TYPE: INCOME TAX
TAX YEAR: 2008
DATE SIGNED: 6-4-2013
COMMISSIONERS: B. JOHNSON, M. CRAGUN, R. PERO
EXCUSED: D. DIXON

BEFMINERAL THE UTAH STATE TAX COMMISSION

TAXPAYER, Petitioner, v. AUDITING DIVISION OF THE UTAH STATE TAX COMMISSION, Respondent.	INITIAL HEARING ORDER Appeal No. 12-799 Account No. ##### Tax Type: Income Tax Year: 2008 Judge: Chapman
---	--

Presiding:
 Kerry R. Chapman, Administrative Law Judge

Appearances:
 For Petitioner: TAXPAYER, Taxpayer
 NAME-1, Witness
 For Respondent: RESPONDENT-1, from Auditing Division
 RESPONDENT-2, 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 March 13, 2013.

TAXPAYER (Petitioner” or “taxpayer”) is appealing Auditing Division’s (the “Division”) assessment of additional individual income tax for the 2008 tax year. On February 16, 2012, the Division issued a Notice of Deficiency and Audit Change to the taxpayer, in which it imposed additional tax and interest (calculated as of March 17, 2012)¹ for the 2008 tax year, as follows:

1 Interest continues to accrue while any liability remains unpaid.

<u>Year</u>	<u>Tax</u>	<u>Penalties</u>	<u>Interest</u>	<u>Total</u>
2008	\$\$\$\$\$	\$\$\$\$\$	\$\$\$\$\$	\$\$\$\$\$

The taxpayer claimed a \$\$\$\$\$ “Increasing Research Activities Credit” on his 2008 Utah income tax return. The Division determined that the taxpayer did not qualify for the credit and disallowed it, which resulted in the assessment.

TAXPAYER, however, claims that he is entitled to the credit. Although he did not claim a similar credit on his federal return for 2008, he states that he called the Internal Revenue Service (“IRS”) after receiving the Division’s assessment and that the IRS told him that he qualified for the credit. TAXPAYER explained that until January 2009, he worked as a professor at the SCHOOL, where he taught VARIOUS courses. TAXPAYER explained that for these courses, he would gather MINERAL samples (igneous and mineral rocks) from the nearby area. He would take the MINERAL samples to the SCHOOL laboratory to grind them and analyze them. He stated that he published his results and shared his research with people in the business community, such as mine owners. He stated that he was not compensated by the people with whom he shared his research and that the college did not fund his research. He stated that he conducted his research only in Utah and at his own expense. TAXPAYER claims that from his research, he has developed new technologies to extract MINERAL. He admitted, however, that he has not yet patented any of his new technologies.

TAXPAYER stated that in order to obtain MINERAL samples for his research, he purchased YEAR AND MODELOF VEHICLE in 2008. He stated that he used the VEHICLE exclusively to obtain MINERAL samples for the nearly two months between October 2008, when he purchased the VEHICLE, and January 2009, when he was laid off from his position at the SCHOOL. TAXPAYER explained that when he purchased the VEHICLE in 2008, he budgeted \$\$\$\$\$ for it. Because Utah allows a “Tax Credit for Research Activities in Utah” that is equal to 5% of a taxpayer’s qualified research expenses, TAXPAYER took a \$\$\$\$\$ credit

(\$\$\$\$ multiplied by 5%) on his 2008 Utah return. Because he bought the VEHICLE in 2008 for research activities he conducted only in Utah, TAXPAYER asks the Commission to find that he qualifies for the \$\$\$ credit he claimed on his 2008 return and to reverse the Division's audit. In the alternative, should the Commission determine that he does not qualify for the credit, he asks the Commission to waive the interest that has been imposed because it has taken several years for the Division to impose its assessment.²

TAXPAYER proffered evidence to show the amount that he paid for the VEHICLE in 2008 and the amounts that he has expended on it since his purchase. TAXPAYER purchased the VEHICLE for \$\$\$ on October 16, 2008. TAXPAYER explained that the VEHICLE, which had ##### miles on it, was not running at the time he purchased it. As a result, he "budgeted" \$\$\$ to purchase and repair the VEHICLE. After purchasing the VEHICLE, he immediately spent \$\$\$ for an engine and another \$\$\$ to have someone install the engine. The total costs he expended on the VEHICLE in 2008, as shown by evidence proffered at the Initial Hearing, totals \$\$\$\$. He also proffered evidence to show that he has expended another \$\$\$ on the VEHICLE in years subsequent to 2008 (i.e., 2009 through 2012). In total, the evidence he proffered at the Initial Hearing shows that he spent approximately \$\$\$ on the VEHICLE between 2008 and 2012.³

The Division contends that the taxpayer does not qualify for a Utah tax credit for research activities conducted in Utah for the 2008 tax year and asks the Commission to sustain its assessment. The Division has

2 TAXPAYER also asked if the Commission would find that he overpaid \$\$\$ of sales and use tax on a repair transaction involving his VEHICLE. The presiding officer informed TAXPAYER that the sales and use tax matter was not before the Commission in this income tax appeal and that if he wanted to pursue the sales and use tax matter, he could submit a request to Taxpayer Service Division to determine whether or not he qualifies for a sales and use tax refund.

3 On March 18, 2013, TAXPAYER mailed in two additional receipts that he had not proffered at the Initial Hearing to show that he spent an additional \$\$\$ in November 2008 to register the VEHICLE at issue. These expenses would increase the total amount expended on the VEHICLE in 2008 to \$\$\$ and the total amount spent between 2008 and 2012 to approximately \$\$\$\$. The Commission generally does not allow a party to submit post-hearing evidence if the Commission has not specifically requested it. It also appears that the taxpayer submitted this additional evidence to the Commission without submitting a copy of it to the opposing party. Regardless, the Commission does not find in this decision that any expenses the taxpayer spent on the VEHICLE qualify for the exemption. Accordingly, the taxpayer's post-hearing information would

determined that the taxpayer does not qualify for the credit for research activities conducted in Utah because he does not meet at least two of the criteria needed to qualify for the credit. First, the Division contends that the VEHICLE the taxpayer purchased and for which he claimed the Utah credit is not a “qualified research expense,” as defined in Utah Code Ann. §59-10-1012(3) and Internal Revenue Code (“IRS”) §41(b). Second, the Division states that the taxpayer’s activities are not “qualified research” as defined in Section 59-10-1012(3) and IRC §41(d). If the Commission were to agree with the Division on either of these arguments, the taxpayer would not qualify for the credit, even if all other criteria were met.

Even if the Commission were to find that the VEHICLE was “qualified research expense” and that the taxpayer’s activities were “qualified research,” the Division contends that the Utah credit is limited to 5% of the taxpayer’s “expenses for the current taxable year.” The Division contends that the credit is not, as the taxpayer proposes, based on the amount he “budgeted” during the current year. Lastly, the Division contends that any interest at issue should not be waived. The Division explains that interest is waived only in instances where the tax assessment arose because of Tax Commission error.

APPLICABLE LAW

Utah Code Ann. §59-10-1012 (2008) provides a Utah tax credit for research activities conducted in Utah, 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:

....

(iii) a tax credit equal to:

(A) for the taxable year beginning on or after January 1, 2008, but beginning on or before December 31, 2008, 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:

(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

have no bearing on the Commission’s decision.

the tax credits authorized under Subsection (1).

(3) For purposes of this section:

....

(c) "qualified research" is as defined in Section 41(d), Internal Revenue code, except that the term includes only basic 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

(ii) contract research expenses incurred in this state; . . .

....

Internal Revenue Code ("IRC") §41 (2008) provides information that is applicable to the Utah tax credit for research activities conducted in Utah, as follows in pertinent part:

....

(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

(B) contract research expenses.

(2) In-house research expenses

(A) In general. The term "in-house research expenses" means—

....

(ii) any amount paid or incurred for supplies used in the conduct of qualified research, and

....

....

(C) Supplies. The term "supplies" means any tangible property other than—

(i) land or improvements to land, and

(ii) property of a character subject to the allowance for depreciation.

....

(4) Trade or business requirement disregarded for in-house research expenses of certain startup ventures. In the case of in-house research expenses, a taxpayer shall be treated as meeting the trade or business requirement of paragraph (1) if, at the time such in-house research expenses are paid or incurred, the principal purpose of the taxpayer in making such expenditures is to use the results of the research in the active conduct of a future trade or business—

(A) of the taxpayer, or

(B) of 1 or more other persons who with the taxpayer are treated as a single taxpayer under subsection (f)(1).

....

(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,
 - (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.

(D) Surveys, studies, etc. Any—

- (i) efficiency survey,

- (ii) activity relating to management function or technique,
- (iii) market research, testing, or development (including advertising or promotions),
- (iv) routine data collection, or
- (v) routine or ordinary testing or inspection for quality control.

....

UCA §59-1-401(13) (2013) provides that “[u]pon making a record of its actions, and upon reasonable cause shown, the commission may waive, reduce, or compromise any of the penalties or interest imposed under this part.”

Utah Admin. Rule R865-1A-42(2) (“Rule 42”) (2013) provides guidance concerning the waiver of interest, as follows:

(2) Reasonable Cause for Waiver of Interest. Grounds for waiving interest are more stringent than for penalty. To be granted a waiver of interest, the taxpayer must prove that the commission gave the taxpayer erroneous information or took inappropriate action that contributed to the error.

UCA §59-1-1417 (2013) provides that the burden of proof is upon the petitioner in proceedings before the Commission, with limited exceptions 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

The primary issue is whether or not the taxpayer qualifies for the \$\$\$\$ credit for research activities conducted in Utah that he took on his 2008 Utah return. If the Commission sustains the Division's disallowance of the credit, a second issue exists, specifically whether "reasonable cause" exists to waive the interest that had been imposed.

Tax Credit. The taxpayer stated that the IRS told him that his VEHICLE expenses qualified for the tax credit for research activities. The IRS, however, has not approved a tax credit for federal tax purposes because the taxpayer did not claim a federal tax credit. The IRS also has not provided a letter or other written documentation to the taxpayer showing that the taxpayer's VEHICLE expenses qualify for the federal tax credit. Without such documentation, the Commission does not know what information was discussed by the taxpayer and the IRS. As a result, the Commission will need to compare the facts to the controlling Utah and federal law.

Section 59-10-1012(1)(a)(iii)(A) authorizes a 2008 state research credit equal to 5% of a taxpayer's "qualified research expenses for the current taxable year[.]" Section 59-10-1012(2) provides that definitions provided in IRC §41 will be applied when calculating the Utah tax credit. Furthermore, Section 59-10-1012(3)(c) and (d) provide that for purposes of the Utah tax credit, the IRC §41 definitions of "qualified research" and "qualified research expenses" are applicable.

"Qualified research expenses" are defined in §41(b)(1) to include "in-house research expenses" and "contract research expenses." The taxpayer did not incur any contract expenses. Accordingly, his VEHICLE expenses must qualify as "in-house research expenses" in order for him to qualify for the Utah tax credit. "In-house research expenses" includes certain wages, payments for supplies, and payments for right to use computers. IRC §41(b)(2)(A). The taxpayer did not pay any wages or incur any amounts to use computers. Accordingly, the taxpayer must show that his purchase of the VEHICLE: 1) is an amount paid for "supplies;"

and 2) that the supplies (i.e., the VEHICLE) were used in the conduct of “qualified research.” IRC §41(b)(2)(A)(ii). If either of these conditions is not met, the taxpayer does not qualify for the Utah tax credit.

“Supplies” are defined in IRC §41(b)(2)(C) to mean tangible property other than: 1) land or improvements to land; and 2) “property of a character subject to the allowance for depreciation.” The VEHICLE at issue is tangible property and is not land or improvements to land. As a result, the VEHICLE qualifies as “supplies” unless it is “property of a character subject to the allowance for depreciation.” Both parties admit that the taxpayer’s VEHICLE is property that can be depreciated for income tax purposes. The taxpayer, however, did not depreciate the VEHICLE. Because he did depreciate the VEHICLE, the taxpayer claims that the VEHICLE is not disqualified from being “supplies,” as defined by the IRC. The Division contends, however, that the VEHICLE is “property of a character subject to the allowance for depreciation” and, thus, is excluded from the definition of “supplies,” regardless of whether the taxpayer depreciated it.

The Division’s argument is more convincing. Had the definition of “supplies” excluded “property that the taxpayer depreciated,” the taxpayer’s argument might be more convincing. The definition instead excludes “property **of a character** subject to the allowance for depreciation” (emphasis added). The taxpayer’s VEHICLE is property “of a character” that is subject to depreciation. Accordingly, it is excluded from the definition of “supplies” under the IRC. As a result, the VEHICLE expenses at issue are not “in-house research expenses”, and thus, are not “qualified research expenses” under IRC §41 and Section 59-10-1012. As a result, the taxpayer’s VEHICLE expenses are not ones for which the taxpayer can take a tax credit for research activities conducted in Utah.

Even though the credit is disallowed because the taxpayer’s VEHICLE is not “supplies,” it is also not at all clear that the VEHICLE was “used in the conduct of qualified research,” another requirement under IRC §41(b)(2)(A)(ii). “Qualified research” is defined in IRC §41(d). IRC §41(d)(1)(B)(ii) requires the application of the taxpayer’s research to be useful in the development of a new or improved business component. IRC

Appeal No. 12-799

§41(d)(3)(A) provides that research must relate either to a new or improved function, performance, or reliability or quality. The taxpayer's explanation of his research and its applications were rather vague, and the taxpayer has the burden of proof in this matter. Without more information, it is unclear whether the taxpayer's research and its application are "qualified research," as defined in the IRC. For these reasons, the taxpayer does not qualify for any amount of tax credit for research activities in Utah. Because the tax credit is disallowed in its entirety, the Commission need not address whether the taxpayer appropriately determined that his 2008 expenses for the VEHICLE totaled \$\$\$\$\$.

Interest. The last issue is the taxpayer's request for a waiver of interest. Interest is assessed because the taxpayer has had use of money that should have previously been paid to the Tax Commission. Nevertheless, pursuant to Section 59-1-401(13), the Commission is authorized to waive penalties and interest upon a showing of "reasonable cause." The criteria to waive interest are found in Rule 42(2), which provides that interest is waived only if a taxpayer shows that the Commission gave erroneous information or took inappropriate action that contributed to the error. The taxpayer states that the Division's assessment occurred almost three years after he submitted his 2008 return. This circumstance, however, is insufficient "reasonable cause" to waive interest. Accordingly, the taxpayer's request for a waiver of interest should be denied. As a result, the Division's assessment should be sustained in its entirety.

Kerry R. Chapman
Administrative Law Judge

DECISION AND ORDER

Based on the forgoing, the Commission finds that the taxpayer was not entitled to a 2008 tax credit for research activities conducted in Utah. The Commission also denies the taxpayer's request for a waiver of interest. Accordingly, the Division's assessment is sustained in its entirety. 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 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
Salt Lake City, Utah 84134

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

DATED this _____ day of _____, 2013.

R. Bruce Johnson
Commission Chair

D'Arcy Dixon Pignanelli
Commissioner

Michael J. Cragun
Commissioner

Robert P. Pero
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.