STATE OF ARIZONA

Department of Revenue
Office of the Director
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Janet Napolitano
Governor

Gale Garriott
Director

CERTIFIED MAIL [redacted]

The Director's Review of the Decision of the Hearing Officer Regarding:	)	**O R D E R**
[redacted] and SUBSIDIARIES	)	**Case No. 200700189–C**
ID No.[redacted]	)	

On April 30, 2008, the Hearing Officer issued his decision regarding the protest of [redacted] ("Taxpayer"). Taxpayer timely filed an appeal; therefore, the Director of the Department of Revenue issued a notice of intent to review the decision.

In accordance with the notice given the parties, the Director has reviewed the Hearing Officer's decision and now issues this Order.

Statement of Case

The Corporate Audit Division ("Division") issued a Notice of Proposed Refund Denial ("NPRD") to Taxpayer for tax year ending 2002. Taxpayer protested the denial, and the Hearing Officer denied the protest. On appeal, Taxpayer argues that by establishing even a dollar of research expense in the base period in 1994, the Arizona Credit of Increased Research Activities ("INCREASED R&D Credit") under A.R.S. § 43-1168 should be available to it in 2002 because it substantially increased its research and development expenditures. Taxpayer also argues that the *Cohen* doctrine allows an estimation of the expenses giving rise to the credit and that there is no requirement that there be contemporaneous documentation. The Division maintains that Taxpayer has not proved any research expense in Arizona prior to 2002, therefore, the credit is zero and that the *Cohen* Rule is not applicable.

Findings of Fact

The Director adopts and incorporates into this order from the findings of fact set forth in the decision of the Hearing Officer and makes additional findings as follows:

1. The Taxpayer, established in [redacted], is a bank that provides consumer and business lending services.
2. In [redacted], Taxpayer acquired [Bank 1] (est. [redacted]) and changed its name to [Bank 1].
3. In [redacted], Taxpayer established [Bank 2].
4. In [redacted], Taxpayer acquired [Bank 3] (est. [redacted]). Taxpayer then merged [Bank 3] with [Bank 2] and the surviving entity was named "[Surviving Bank]."
5. In 2001, Taxpayer relocated its headquarters from [redacted] to [redacted].
6. On or about July 29, 2003, Taxpayer filed its original Arizona income tax return for the year ending December 31, 2002, but did not claim an INCREASED R&D Credit.
7. Taxpayer filed an amended federal tax return for the tax year ending December 31, 2002 in or around July 2006. In the amended federal return, Taxpayer increased its federal taxable income and also claimed a federal research and development credit for the 2002 tax year. The Internal Revenue Service ("IRS") issued a refund to Taxpayer based on the amended federal return.
8. On or about July 6, 2006, Taxpayer filed an amended Arizona tax return ("Amended AZ Return") to report the change in federal taxable income ([redacted]) and to claim an INCREASED R&D Credit ([redacted]) for the tax year ending December 31, 2002. The refund sought by the Amended AZ Return was [redacted], exclusive of interest.
9. There is no evidence Bank 3 claimed an INCREASED R&D Credit for 1994 or after.
10. The tax year ending December 31, 2002 is the first tax year for which Taxpayer claimed INCREASED R&D Credits in Arizona.
11. Taxpayer bases its proof on a Tax Credit Study performed by [Representative] in 2006 (the "Study). The employees interviewed by [REPRESENTATIVE] did not

have any personal knowledge of the work performed in the acquired entities or the amounts expended on qualified research activities. Because actual amounts were not available, the Study utilized a regression analysis to estimate the amounts expended on qualified research activities prior to 2002.

12. There is no credible evidence that Taxpayer, or the companies it acquired, had qualified research expenses prior to 2002.
13. On or about September 19, 2006, the Division issued Taxpayer an NPRD for the refund sought by the Amended AZ Return.
14. Taxpayer timely protested the Division's refund denial.

Conclusions of Law

The Director adopts and incorporates into this order from the conclusions of law set forth in the decision of the Hearing Officer and makes other conclusions as follows:

1. A.R.S. § 43-1168 allows a credit against income taxes for increased research activities as determined under I.R.C. § 41, subject to some modifications.
2. I.R.C. § 41(f)(3)(A) allows a taxpayer to utilize the qualified research activities of an acquired business when calculating the increased research and development credit for the acquiring company.
3. The first step in the calculation of the credit is to determine the "excess, if any, of the qualified research expenses for the taxable year over the base amount as defined in I.R.C. § 41(c) of the internal revenue code." A.R.S. § 43-1168 (A)(1).
4. I.R.C. § 41(c)(1) defines the "base amount" as the product of the (1) fixed-base percentage and (2) the average annual gross receipts of the taxpayer for the four taxable years preceding the taxable year for which the credit is being determined.
5. I.R.C. § 41(c)(2) states that the base amount cannot be less than 50 percent of the qualified research expenses for the credit year.
6. "Fixed-base percentage" for a "start up company" (a company which has no qualified research expenses until after 1989) depends on the number of years for which the taxpayer has had qualified research expenses prior to the credit year.

7. For the first 5 years a taxpayer has qualified research expenses, the fixed-base percentage is 3% and for the 9th year it is 2/3 of the percentage which the aggregate qualified research expenses of the taxpayer for the 5th, 6th, 7th and 8th such taxable year is of the aggregate gross receipts of the taxpayer for such years. I.R.C. § 41(c)(3)(B)(ii)(I) and (V).
8. Any person subject to tax or required to file an income tax return must keep sufficient records to establish credits claimed. I.R.C. § 6001.
9. The burden of proof is upon the petitioner as to all issues of fact. A.A.C. R15-10-118(A).
10. Taxpayer has not presented sufficiently reliable evidence to establish that it (or the companies it acquired) engaged in qualified research activities prior to 2002.
11. Even if Taxpayer could prove that its acquired companies engaged in qualified research activities, Taxpayer was unable to establish the amount of expenses associated with such activities in years in the putative base period years.
12. Estimates may be used to establish a deduction or credit where it has been proved that expenses were paid, but the exact amount has not been established due to the lack of records. *Cohan v. Commissioner*, 39 F.2d 540, 543-544 (2d Cir. 1930).
13. The *Cohan* doctrine cannot be used to estimate the amount of an item that was not already established because doing so "would be in essence to condone the use of that doctrine as a substitute for burden of proof." *Coloman v. Comm'r*, 540 F.2d 427, 431-32 (9th Cir. 1976).
14. Estimates in absence of contemporaneous supporting documents are allowed only where the taxpayer has already established that is it engaged in qualified research activities and the only issue in dispute is the exact amount paid or incurred in those activities. *U.S. v. McFerrin, 102 AFTR 2d 2008-6269 (DC TX, 2008).*
15. Because there was no direct or actual knowledge presented by the Study, the Hearing Office assigned little weight to the testimony of the existence and extent of [Bank 3]'s qualified research activity prior to 2002.

16. Taxpayer has not established that [Bank 3] had engaged in qualified research activities nor that the Bank expended any amount on "qualified research activities" as the term is defined in statute.
17. A refund denial, like an additional assessment of income tax, is presumed correct and the burden is on the taxpayer to overcome such presumption. *See Arizona State Tax Commission v. Kieckhefer,* 67 Ariz. 102, 191 P.2d 729 (1948).
18. The Hearing Officer properly denied Taxpayer's protest of the refund denial.

DISCUSSION

At issue is Taxpayer's claim for a credit against income taxes for increased research activities and the propriety of the Division's denial of Taxpayer's refund claim for the credit. A.R.S. § 43-1168 allows a credit against income taxes for increased research activities as determined under I.R.C. § 41, subject to some modifications. One of the additional requirements of A.R.S. § 43-1168 is that the qualified research must be conducted in this state. A.R.S. § 43-1168(A)(1).

Taxpayer claims that it had [redacted] of qualified research in Arizona beginning in 1994. Although Taxpayer was not established until [redacte], Taxpayer asserted that it can use the activities of [Bank 3] to calculate the base year. Taxpayer acquired [Bank 3] in [redacted], but the latter was established in [redacted]. I.R.C. § 41(f)(3)(A) allows a taxpayer to utilize the qualified research activities of an acquired business when calculating the increased research and development credit for the acquiring company.

A.R.S. § 43-1168 (A)(1) provides the formula for the calculation of the credit. The first step is to determine the "excess, if any, of the qualified research expenses for the taxable year over the base amount as defined in I.R.C. § 41(c) of the internal revenue code." I.R.C. § 41(c)(1) defines the "base amount" as the product of the (1) fixed-base percentage and (2) the average annual gross receipts of the taxpayer for the four taxable years preceding the taxable year for which the credit is being determined. I.R.C. § 41(c)(2) states that the base amount cannot be less than 50 percent of the qualified research expenses for the credit year, which would be [redacted] according to Taxpayer's claim.

"Fixed-base percentage" is also defined in I.R.C. § 41(c). Because Taxpayer does not claim there were any qualified research expenses until after 1989, statutorily Taxpayer is considered a "start up company." The percentage used by a start up company depends on the number of years for which the taxpayer has had qualified research expenses. For example, for the first 5 years a taxpayer has qualified research expenses, the fixed-base percentage is 3%. I.R.C. § 41(c)(3)(B)(ii)(I). Taxpayer calculated its fixed-base percentage based on being in the 9th year, for which the percentage is:

> 2/3 of the percentage which the aggregate qualified research expenses of the taxpayer for the 5th, 6th, 7th and 8th such taxable year is of the aggregate gross receipts of the taxpayer for such years. I.R.C. § 41(c)(3)(B)(ii)(V).

According to the Taxpayer, the percentage for 2002 (year 9) is .28%. According to the Division the fixed-base percentage is 3% because Taxpayer has not proved there were any qualified research expenses prior to 2002. This dispute will be addressed below.

The fixed-base percentage is multiplied by the average annual gross receipts of the taxpayer for the four taxable years proceeding the taxable year for which the credit is being determined. The four years in question are 1998 through 2001 and Taxpayer states that the four-year average gross receipts are [redacted]. Multiplying the latter by the fixed-base percentage of .28% that Taxpayer calculates, results in [redacted]. Because this is less than 50% of the qualified research expenses for the credit year ([redacted]), the base amount is 50% of the qualified research expenses for 2002 or [redacted]. According to Taxpayer's calculation the qualified research expenses ([redacted]) less the base amount ([redacted]) is [redacted]. A.R.S. § 43-1168(A)(1)(b) states that the credit is 20% of the amount so calculated or [redacted].

Multiplying the fixed-base percentage of 3% that the Division asserts times the four-year average gross receipts provided by Taxpayer ([redacted]), the base amount is [redacted]. Because this is greater than 50% of the qualified research expenses for 2002 ([redacted]), [redacted] is the base amount. According to the Division's calculation the qualified research expenses ([redacted]) less the base amount ([redacted]) results in a negative number, therefore, there is no INCREASED R&D Credit.

The Hearing Officer found that the issue in this case was one of proof – can the Taxpayer prove the qualified research expenses and gross receipts it claims occurred in the 5th through 8th years? Proof of these expenses and receipts is necessary to establish the fixed base percentage. On appeal, Taxpayer argues that by establishing even a dollar of research expense in the base period, the INCREASED R&D Credit is available to it in 2002 because Taxpayer substantially increased its research and development expenditures.

To test Taxpayer's single dollar theory, assume that in 2001 Taxpayer had $1 of qualified research expense. Year two, just like year one has a 3% fixed-base percentage. Assuming the qualified research expenses and four-year average gross receipts for 2002 are as stated by Taxpayer, the calculation of the credit will be exactly the same as calculated by the Division set forth above. The analysis is the same for the third, fourth and fifth year of research. Therefore, even if Taxpayer were able to establish one dollar of research expense, Taxpayer would not be entitled to any INCREASED R&D Credit.

Later years, such as year nine as claimed by the Taxpayer, the fixed-base percentage is calculated as a percentage of the ratio between aggregate qualified research expenses and the aggregate gross receipts of the taxpayer for specified base period years. As with any ratio, the resulting amount will increase as the numerator increases or the denominator decreases. Therefore, as the aggregate qualified research expenses increase or the aggregate gross receipts decrease for the base period years the result will increase. Conversely, as the aggregate qualified research expenses decrease or the aggregate gross receipts increase for the base period years the result will decrease.

The fixed base percentage Taxpayer used on its amended return, .28%, was small due to the small amount of estimated expenses in the numerator. A greater expense amount in the numerator would increase the percentage if the aggregate gross receipts in the denominator stay the same. If the resulting fixed base percentage is large enough the credit will be zero, as is demonstrated by the above calculation with the 3% fixed base percentage. Clearly, actual numbers are necessary to compute the fixed base percentage; therefore, it is not enough to just state that there is at least one dollar of research expense.

Taxpayer's single dollar theory does not work and the Hearing Officer is correct - the issue is proof of the qualified research expenses and gross receipts Taxpayer claims.

Pursuant to I.R.C. §6001 and the accompanying regulations, any person subject to tax or required to file an income tax return must keep sufficient records to establish credits claimed. Additionally, pursuant to A.A.C. R15-10-118(A) the burden of proof is upon the petitioner as to all issues of fact. Taxpayer bases its proof on the Study performed by [REPRESENTATIVE] in 2006. As a part of the Study, [REPRESENTATIVE] interviewed Taxpayer's management team, executives and employees in 2006 to determine the types and amounts of INCREASED R&D activities engaged in by Taxpayer. The Study concluded that the qualified research activities from Taxpayer's acquired entities (primarily [Bank 3]) could be used to determine the base year calculations for purposes of the INCREASED R&D Credit.

The Study states:

> [A]ctual gross receipts and qualified research expenditures were not known for tax years 1994 and forward, thus they have been extrapolated from available data in the 2000-2004 time periods. Qualified research employees, for periods prior to 2002, were derived through discussions with [Employee 2] who was a Bank employee during the initial acquisition of [Bank 1]. Their wages were extrapolated from 2001 to 1994 using a 95% regression adjustment based on wage inflation. The base wage amount was that of a software developer employed in the 2003 tax period.

Thus, the employees interviewed by [REPRESENTATIVE] did not have any personal knowledge of the work performed in the acquired entities or the amounts expended on qualified research activities. At hearing Taxpayer's representative testified that some of the information that [Employee 2] provided came from discussions that he had with a person named [Employee 1], a former employee of one of the acquired companies, during the due diligence period of Taxpayer's acquisition of the company.

The Study is not based upon reliable evidence, and states that "actual gross receipts and qualified research expenditures were not known for tax years 1994 and forward." [REPRESENTATIVE] determined that [Bank 3] engaged in qualified research activity prior

to 2002 based primarily upon discussions with Taxpayer's CIO, [Employee 2], in 2006. However, [Employee 2] was not an employee of [Bank 3], and had no knowledge of [Bank 3]'s activities prior to its acquisition in 2001. Rather, Mr. [Employee 2] based his statements to [REPRESENTATIVE] in 2006 on his recollection of discussions he had in 2001 with [Employee 1], a former employee of [Bank 3]. Neither [Employee 1] nor [Employee 2] testified at the hearing. There is no way to determine whether Mr. [Employee 2]'s recollection of prior discussions with Mr. [Employee 1] was accurate, nor is there any evidence to determine whether the information provided by Mr. [Employee 1] was accurate.

While likely inadmissible in a state court proceeding, the [REPRESENTATIVE] Study was admitted by the Hearing Officer because all relevant evidence shall be admitted in an administrative hearing at the Department. A.A.C. R15-10-117(B). However, because there was no direct or actual knowledge presented by the Study, the Hearing Office assigned little weight to the testimony of the existence and extent of [Bank 3]'s qualified research activity prior to 2002.

Because actual amounts were not available, the Study utilized a regression analysis to estimate the amounts expended on qualified research activities prior to 2002. To do so, [REPRESENTATIVE] had to rely on the statements of [Employee 2] that qualified research activities were performed prior to 2002 and the employees who performed the research, and then estimate the wages of the employees involved in such activity. The Division argues that the estimates should be given no weight because there was no documentation to substantiate such estimates.

Citing *Cohan v. Commissioner*, 39 F.2d 540 (2d Cir. 1930), Taxpayer asserts that "[e]stimates are clearly allowable by both the Federal Government and the State of Arizona." In *Cohan*, the taxpayer (a theatrical producer/manager) claimed entertainment expense deductions, but because he did not keep adequate records, he could not establish the exact amount. *See id*. at 543-44. The court remanded the case to the Board of Tax Appeals in order to estimate the amount of the expenses. *See id*. However, in *Cohan*, the Board had already determined that the taxpayer had spent "considerable sums" on allowable expenses. *Id*. Thus, there was no question as to whether expenses were paid out or deductible; the only question was the amount of such expenses.

In this case, Taxpayer has not established that [Bank 3] had engaged in qualified research activities nor that the Bank expended any amount on "qualified research activities" as the term is defined in statute. While *Cohan* might apply for purposes of estimating the amount expended on items which have clearly been established to be qualified research projects, *Cohan* cannot be applied for purposes of determining whether or not qualified research occurred. *See Coloman v. Comm'r*, 540 F.2d 427, 431-32 (9th Cir. 1976) (refusing to allow the *Cohan* doctrine to estimate the amount of item that was not established because doing so "would be in essence to condone the use of that doctrine as a substitute for burden of proof").

In the recent case *U.S. v. McFerrin, Arthur, 102 AFTR 2d 2008-6269 (DC TX, 2008),* the United States District Court for the Southern District of Texas addressed a claim for credit under I.R.C. § 41 where the taxpayers used estimates from a research and development tax credit study. Employees testified and approximately 70 boxes of documents and lists of allegedly qualifying research projects were submitted at trial. However, finding that the evidence did not show how many hours employees worked on any of the stated projects during the year at issue or how many hours of employees' work even involved research activities or what supplies were used in the supposedly qualifying research activities, the credit study's estimates were determined unreliable.

The *McFerrin* Court referred to page 20 of the IRS Credit for Increasing Research Activities Audit Technique Guide ("Audit Guide") which states that a taxpayer's failure to maintain records in accordance with the rules is a basis for disallowing the credit. Further, the Court stated that estimates in absence of contemporaneous supporting documents are allowed only where the taxpayer has already established that is it engaged in qualified research activities and the only issue in dispute is the exact amount paid or incurred in those activities. *See*, Audit Guide, p. 29.

The *Cohen* doctrine is inapplicable in this case and the Hearing Officer appropriately gave the estimates of the Study little weight. Further, the rejection of the Study's estimates is in line with the IRS's standards of proof as set forth by the Audit Guide.

On appeal Taxpayer also argues:

> [A]ny perceived deficiencies in the documentation relating to this issue, are not inexactitudes of the taxpayer's own making. Statutory and regulatory changes have been made to the definition of "qualified research" making reconstruction of the previous years' QREs a necessity in order to be in compliance with the consistency rule of IRC §41.
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> …
>
> Due to these substantial changes to the definition of "qualified research", any contemporaneous data collected during the base period based on the original definition is worthless due to the consistency requirement of I.R.C. § 41 (c)(5).
>
> …
>
> Therefore, the taxpayer must recreate the base period QREs using these new definitions, and that is impossible to do with contemporaneous data that does not exist. … The government cannot expect taxpayers to collect data on research using every possible definition of "qualified research", so if the definition changes in 20 years, there is still contemporaneous data to rely on.

Taxpayer's stated problem suggests that there is some contemporaneous data that supports a prior definition of qualified research. No such data or documentation has been presented. The problem is not due to the consistency rule, the problem is that Taxpayer has no probative evidence of qualified research under any definition.

A refund denial, like an additional assessment of income tax, is presumed correct and the burden is on the taxpayer to overcome such presumption. *See Arizona State Tax Commission v. Kieckhefer,* 67 Ariz. 102, 191 P.2d 729 (1948). Taxpayer has not met its burden of proving its entitlement to the INCREASED R&D CREDIT, therefore, has not shown it is entitled to a refund.

The Hearing Officer properly denied Taxpayer's protest of the denial of refund.

O R D E R

The Hearing Officer's decision is affirmed.

This decision is the final order of the Department of Revenue. Taxpayer may contest the final order of the Department in one of two manners. Taxpayer may file an appeal to the State Board of Tax Appeals, 100 North 15th Avenue, Suite 140 Phoenix, AZ 85007 or may bring an action in Tax Court (125 West Washington, Phoenix, Arizona 85003) within sixty (60) days of the receipt of this order. For appeal forms and other information from the Board of Tax Appeals, call (602) 364-1102. For information from the Tax Court, call (602) 506-3763.

Dated this 6th day of February, 2009.

ARIZONA DEPARTMENT OF REVENUE

Gale Garriott
Director

Certified original of the
foregoing mailed to:

[redacted]

Copy of the foregoing mailed to:

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cc: Corporate Income Tax Appeals Section
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