

BEFORE THE ARIZONA DEPARTMENT OF REVENUE

In the Matter of	)	DECISION OF
[REDACTED]	)	HEARING OFFICER
UTI # [REDACTED]	)	Case No. 201100061-I
_____	)	

Pursuant to Taxpayers' request, it was ordered that the protest of [REDACTED] (Taxpayers) to an assessment of income tax and interest by the Individual Income Tax Audit Section (Section) of the Arizona Department of Revenue (Department) for tax year 2005 be resolved through the submission of written memoranda.

Taxpayers and the Section timely filed their respective opening and response memoranda. Taxpayers did not file a reply memorandum. This matter is now ready for ruling.

FINDINGS OF FACT

1. Taxpayers timely filed their Arizona income tax returns for tax years 2004 and 2005.
2. On their 2005 income tax return Taxpayers claimed an income tax credit for increased research expenses pursuant to Arizona Revised Statutes (A.R.S.) § 43-1074.01 in the amount of \$[REDACTED] consisting of \$[REDACTED] carried over from tax year 2004 and \$[REDACTED] calculated for tax year 2005.
3. Taxpayers did not claim any credit for increased research expenses pursuant to A.R.S. § 43-1074.01 for tax year 2004.
4. Taxpayers did not file an amended state income tax return for tax year 2004 claiming a credit for increased research expenses.
5. Taxpayer [REDACTED] contracted with the [REDACTED] and [REDACTED] in 2004 to carry out statistical research on [REDACTED] test score performance.

6. Taxpayers received \$[REDACTED] in 2004 as a result of the work performed for the [REDACTED] and [REDACTED] under the contracts.
7. The Section reviewed Taxpayers' 2005 income tax return and issued a proposed assessment dated April 14, 2010 disallowing Taxpayers' claimed credit of \$[REDACTED].
8. The assessment included interest at the statutory rate but no penalties.
9. Taxpayers timely protested the assessment stating that they learned of the credit for increased research expenses in 2005 and decided to use the credit as a carryover credit to avoid amending their 2004 return.
10. In their protest, Taxpayers recalculated their credit claim stating that the corrected credit to be carried over from 2004 was \$[REDACTED]. Total credit claimed for tax year 2005 was \$[REDACTED].

#### CONCLUSIONS OF LAW

1. A.R.S. § 43-1074.01 allows a credit for increased research activities in an amount determined pursuant to section 41 of the Internal Revenue Code (IRC).
2. The credit is allowed for expenses incurred from and after December 31, 2000 for research conducted in this state and paid for by the Taxpayer. A.R.S. § 43-1074.01(A)(2) and (4).
3. The deductions and credits provided for in title 43, A.R.S., are to be taken for the taxable year in which "paid or accrued" or "paid or incurred", dependent upon the method of accounting upon the basis of which the taxable income is computed. A.R.S. § 43-905.
4. The credit for increased research activities is established in the year the activities are performed and expenses are incurred by claiming the credit in an income tax return filed for that year.

5. If the allowable credit exceeds the taxes otherwise due on a return, the credit not used to offset Arizona income taxes may be carried forward to the next fifteen consecutive taxable years as a credit against subsequent years' income tax liability. A.R.S. § 43-1074.01(B).
6. Taxpayers did not file an Arizona income tax return for 2004 that established their entitlement to a credit in 2004.
7. Taxpayers had no credit established in 2004 that was available to be carried over to subsequent years.
8. The term "qualified research" under section 41 of the IRC does not include any research to the extent funded by any grant, contract, or otherwise by another person or governmental entity. IRC § 41(d)(4)(H)
9. Taxpayers' statistical research work for the [REDACTED] and [REDACTED] were funded by a contract with the [REDACTED] and [REDACTED].
10. Taxpayers' activities were not deductible under IRC § 41.
11. Taxpayers' activities are not deductible under A.R.S. § 43-1074.01.
12. The Section's disallowance of Taxpayers' credit for tax year 2005 was proper.
13. The proposed assessment issued by the Section for tax year 2005 is upheld.

## DISCUSSION

Taxpayers contracted with the [REDACTED] and [REDACTED] in 2004 to carry out statistical research on [REDACTED] test score performance. Taxpayers were paid \$[REDACTED] for their work. Taxpayers did not claim a credit for increased research activities on their 2004 Arizona individual income tax return.

When Taxpayers filed their 2005 income tax return, they claimed an income tax credit for increased research expenses in the total amount of \$[REDACTED] consisting of \$[REDACTED] carried over from tax year 2004 and \$[REDACTED] calculated for tax year 2005. The Section audited Taxpayers' 2005 return and disallowed the total credit.

Taxpayers protested the assessment stating that they learned of the credit for increased research expenses in 2005 and decided to use the credit as a carryover credit to avoid amending their 2004 return. Taxpayers also recalculated their credit claim in their protest stating that the corrected credit to be carried over from 2004 was \$[REDACTED]. Thus the total credit claim at issue for tax year 2005 is \$[REDACTED]. For the reasons that follow, Taxpayers are not entitled to any credit in 2005 for increased research expenses.

First, the credit is allowed in an amount determined under section 41 of the IRC. Taxpayers were paid for the research activity pursuant to contracts with the [REDACTED] and [REDACTED]. Qualified research under section 41 of the IRC does not include any research to the extent funded by any grant, contract, or otherwise by another person or governmental entity. Therefore the research did not qualify for the credit.

Second, even if the research were qualified under § 41 of the IRC, Taxpayers did not claim a credit on their 2004 state income tax return. The credit is allowed for expenses incurred from and after December 31, 2000 for research conducted in this state and paid for by the Taxpayer. The Arizona income tax is based on a year period. Deductions and credits are to be taken in the year they were incurred. Thus available credits incurred during the taxable year are available for use when a taxpayer files his return for that taxable year. If the credit is not fully used in the year it was established, the unused portion may be carried forward to the next fifteen consecutive years.

Because the credit is a single credit established in the year the expenses were incurred, if the credit is not established in that year, there is no credit available to be carried forward. That is the situation here. Taxpayers have not shown that a credit had been properly claimed for the 2004 tax year for there to be any available carryover to tax year 2005. Therefore, Taxpayers' carryover credit was properly disallowed in any event.

The proposed assessment also included interest. A.R.S. § 42-1123(C) provides that if the tax "or any portion of the tax is not paid" when due "the department shall collect, as a part of the tax, interest on the unpaid amount" until the tax has been paid.

Based on the foregoing, the Taxpayers' protest of the Section's assessment dated April 14, 2010 is denied.

DATED this 5th day of August, 2011.

ARIZONA DEPARTMENT OF REVENUE  
HEARING OFFICE

[REDACTED]  
Hearing Officer

Original of the foregoing sent by  
certified mail to:

[REDACTED]

Copy of the foregoing delivered to:

Arizona Department of Revenue  
Individual Income Tax Audit Section