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U.S. Tax Court: Section 41 research tax credit denied, accuracy-related penalties imposed

The U.S. Tax Court today released a memorandum opinion holding that taxpayers were not entitled to a section 41 research tax credit and were liable for section 6662(a) penalties.

The case is: *Betz v. Commissioner*, T.C. Memo 2023-84 (July 6, 2023). Read the Tax Court's [opinion](#) [PDF 988 KB] (114 pages)

Summary

The taxpayers were shareholders in an S corporation engaged in the business of designing and supplying air pollution control systems that eliminate harmful airborne manufacturing byproducts. The S corporation had extensive institutional knowledge and experience in supplying systems that met the specifications of customers in manufacturing industries.

On its 2014 information return, the S corporation claimed a \$501,531 research tax credit under section 41 in connection with 19 projects, based both on the costs of producing the systems it supplied and the wages it paid to certain of its employees for activities performed in connection with the projects. The S corporation did not use a time-tracking system for its employees' activities and thus estimated the amounts of employee time spent performing qualified services.

On their personal federal income tax returns for 2014, the taxpayers claimed a flowthrough of the credit and later carried forward the remaining portion of the credit to their 2015 and 2016 returns.

Following a lengthy trial, the Tax Court found that for all 19 projects, the taxpayers failed to carry their burden of establishing that the products were pilot models. Accordingly, the S corporation's purported "qualified research expenditures" (QREs) for costs of production failed to satisfy section 41(d)(1)(A) and were not creditable.

The Tax Court further found that for all 19 projects, the taxpayers failed to carry their burden of establishing that the wages of certain of the S corporation's employees were incurred in connection with the performance of "qualified services" and thus the S corporation's purported QREs for wages were not creditable.

The Tax Court also found that for five of the projects, the S corporation did not retain substantial rights in the results of its research under its applicable contracts with its customers. Accordingly, the S corporation's purported QREs for those five projects were incurred in connection with "funded research" within the meaning of section 41(d)(4)(H) and were not creditable.

Finally, the Court held that the taxpayers were liable for accuracy-related penalties under section 6662(a) for tax years 2014, 2015, and 2016.

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