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## Can a Construction Company Claim the Section 41 Research Credit?

**By: Aizhan Toibazarova, MST Student**

*Jeffrey A. Harper, et ux.*, T.C. Memo 2023-57, disagreed with the IRS' interpretation and application of the tax law regarding the "business component" test of IRC Section 41(d). Jeffrey Harper and Katherine Harper (the Harpers), shareholders of Harper Construction Co. (HCC), an S corporation, claimed Section 41 research credits of \$46,656 for 2012 and \$778,610 and 2013. The IRS contended that HCC's construction designs did not meet the criteria for the "business component" test, thereby disqualifying the S corporation, and thus the shareholders, from the research credits.

### **Background of the case**

HCC, a construction corporation headquartered in San Diego, specialized in military design-build projects over the past decade. During the tax years 2012 and 2013, HCC reported 53 separate projects as eligible for Section 41 research credit. The array of projects, including military housing and training facilities, presented unique challenges that necessitated the integration of different aspects of the construction process.

HCC's operational process traverses five distinct phases: job bid, conceptual design, design development, documentation, and construction. The journey commences with a bid presentation to potential clients, followed by the conceptual design phase, where layout proposals and material alternatives are explored. As the design evolves, detailed floor plans are completed, delineating building materials, systems, and implementation methods. Progressing through permitting and construction plans, HCC's projects come to life upon obtaining client and regulatory approvals.

A notable aspect in this case was the involvement and timing of a research credit study performed for HCC by a consulting firm. The study started in 2012 but was not completed until after the tax returns were filed. The study produced compelling findings reporting "Gross Federal R&D Tax Credits" totaling \$462,168 for 2012 and \$387,482 for 2013. Additionally, the study elucidated HCC's endeavors, highlighting its efforts to conceptualize innovative solutions encompassing architectural, civil, structural, mechanical, electrical, and plumbing engineering domains, among others.

### **Section 41 research credit**

Enacted in 1981, Section 41, Credit for increasing research activities, aims to further encourage businesses to invest in technological research. The provision offers a tax credit that is equal to 20% of qualified research expenses exceeding a "base amount," 20% of the basic research payments and 20% of the amounts paid or incurred during the taxable year by the taxpayer's business to an energy research consortium for energy research. Alternatively, taxpayers may elect to calculate the research credit using a simplified method by taking 14% of qualified

research expenses that exceed 50% of the average qualified research expenses for the preceding three taxable years.

HCC employed the regular method to compute the research credit, necessitating that their qualified research expenses be linked to qualified research activities that must satisfy four threshold tests:

1. The expenditures meet the defining of research or experimental expenditures under Section 174,
2. The purpose is to discover information that is technological in nature,
3. Application of the discovered information is intended to be useful to the development of a new or improved business component of the taxpayer,
4. Substantially all of the activities constitute a process of experimentation.

Research will not qualify if it falls under the eight excluded categories of Section 41(d)(4), such as post-commercial production research or adaptation of existing components.

Per the IRS motion, the court's focus was on the business component test defined in Section 41(d)(2)(B), which pertains to "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."

To satisfy this test, the qualifying research must contribute to the development of new or improved products or processes. The IRS argued that HCC did not meet the business component test based on the following reasons:

1. Only structures built by HCC satisfy the definition of "a new or improved product," but HCC did not own these structures.
2. HCC's designs are not "products" but rather tangible representation of construction services.
3. Completed construction projects and designs were not "held for sale" by HCC.
4. HCC's designs did not meaningfully impact its day-to-day operations as required by the statute.

### **Court's analysis**

The examination of the IRS's arguments noted in their motion for partial summary judgment required a favorable interpretation of factual materials and inferences for the Harpers. Key findings of the court follow.

1. The IRS's assertion that HCC's designs were not "new or improved" was countered by the evidence. HCC's comprehensive process of conceptual design and design

development led to novel ideas and continuous improvements resulting in functional improvements. The Court stated that minimum functional improvement fulfills the business component criterion according to the statute and the precedent cases.

2. While acknowledging that HCC's designs were not "products," the court affirmed that they could still qualify as processes, inventions, or techniques under the statute's definition of business components. The word "product" typically refers to tangible items meant for sale, but this does not exclude HCC's designs from meeting the business component requirement.
3. The IRS's claim about HCC's ownership of constructed facilities lacked evidence in the form of contracts. Though the status of ownership remains undetermined, it is irrelevant to the task before the court which is the consideration of processes, techniques, and potential inventions developed by HCC.
4. The IRS's argument that HCC's designs did not meaningfully affect its day-to-day operations was based on the idea that "use" implies consistent utilization. However, the statute does not support this interpretation and there was no evidence suggesting that the business component test defines "use" as habitual application.

## **Conclusion**

Given the existing record, it appeared to the court that HCC's research endeavors may have led to new or improved processes, techniques, and potentially inventions utilized within its construction business. The IRS provided no solid evidence that would have proved otherwise to support their findings on HCC's ineligibility for research credit. Therefore, the IRS's motion for partial summary judgment was denied, as no basis existed for a legal ruling that HCC projects failed the business component test. Thus, the case will proceed for further analysis to see if any of HCC's activities qualify for the research tax credit.