STATE OF NEW MEXICO
ADMINISTRATIVE HEARINGS OFFICE
TAX ADMINISTRATION ACT

IN THE MATTER OF THE PROTEST OF
PROCESS EQUIPMENT & SERVICE COMPANY INC.
TO THE TAXATION AND REVENUE DEPARTMENT'S
DENIAL OF REFUND ISSUED UNDER LETTER
ID NO. L0040880432

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IN THE MATTER OF THE PROTEST OF
PROCESS EQUIPMENT & SERVICE COMPANY INC.
TO DENIAL OF TECHNOLOGY JOB R & D TAX CREDIT ISSUED UNDER
LETTER ID NO. L0049360688

v. AHO Case No. 18.10-270R, **D&O No. 20-02**

NEW MEXICO TAXATION AND REVENUE DEPARTMENT

DECISION AND ORDER

On April 11, 2019, Chief Hearing Officer Brian VanDenzen, Esq., conducted a merits administrative hearing in the matter of the tax protest of Process Equipment & Service Company, Inc. (Taxpayer) pursuant to the Tax Administration Act and the Administrative Hearings Office Act. At the hearing, Attorneys Gene Creely and Frank Crociata appeared representing Taxpayer. Taxpayer called Jim Rhodes, Marcus Mims, C.P.A., and Michael DePrima as witnesses in this matter. Staff Attorney David Mittle appeared, representing the opposing party in the protest, the Taxation and Revenue Department (Department). Department protest auditor Milagros Bernardo appeared as a witness for the Department.

Taxpayer presented duplicate exhibit numbers by each relevant year, resulting in Exhibits #1-17 for 2014 and Exhibits #1-15 for 2016. The hearing officer erred in allowing such confusing, duplicative numbering, as in retrospect the exhibit numbering system needlessly complicated the record. In order to minimize this confusion, the year in parenthesis will be added

to Taxpayer exhibits e.g. Taxpayer Exhibit (2014) #1, Taxpayer Exhibit (2016) #1. Taxpayer Exhibits (2014) #1-17 and Exhibits (2016) #1-15 were admitted into the record. Department Exhibit A was admitted into the record.

In quick summary, this protest involves the Department's denial of Taxpayer's 2014 and 2016 claims for technology jobs and research and development tax credits. The Department denied the claims because it determined that Taxpayer's methodology of demonstrating qualified expenditures was inadequate under the statutory language and evidence presented. Ultimately, after making findings of fact and discussing the issue in more detail throughout this decision, the hearing officer finds that Taxpayer did adequately demonstrate entitlement to the claimed credits and therefore Taxpayers' protest must be granted. IT IS DECIDED AND ORDERED AS FOLLOWS:

FINDINGS OF FACT

Jurisdictional Background

1. On December 31, 2015, Taxpayer applied for a technology jobs tax credit totaling $88,014.00 from the period of January 1, 2014 to December 31, 2014, hereinafter referred to as the 2014 credit. [Taxpayer Exhibit (2014) #1; Administrative Record, hearing request packet].

2. On February 3, 2017, the Department denied Taxpayer's claim for 2014 credit. [Taxpayer Exhibit (2014) #11; Administrative Record, hearing request packet].

3. On May 4, 2017, Taxpayer protested the Department's denial of the 2014 credit. [Taxpayer Exhibit (2014) #16; Administrative Record, hearing request packet].

4. On June 1, 2017, the Department acknowledged receipt of Taxpayer's protest of the denial of the 2014 credit. [Administrative Record, hearing request packet].

5. On July 14, 2017, the Department requested a hearing with the Administrative Hearings Office on Taxpayer's protest of the 2014 claim. [Administrative Record, hearing request packet].

6. On December 29, 2017, Taxpayer applied for a technology jobs tax credit totaling $79,827.500 from the period encompassing 2016, hereinafter referred to as the 2016 credit. [Taxpayer Exhibit (2016) #1; Administrative Record, hearing request packet].

7. On May 31, 2018, the Department denied Taxpayer's claim for 2016 credit. [Taxpayer Exhibit (2016) #10; Administrative Record, hearing request packet].

8. On August 29, 2018, Taxpayer protested the Department's denial of the 2016 credit. [Taxpayer Exhibit (2016) #15; Administrative Record, hearing request packet].

9. On September 11, 2018, the Department acknowledged receipt of Taxpayer's protest of the denial of the 2016 credit. [Administrative Record, hearing request packet].

10. On October 26, 2018, the Department requested a hearing with the Administrative Hearings Office for Taxpayer's protest of the denial of the 2016 credit. [Administrative Record, hearing request packet].

Substantive Findings

11. Jim Rhodes is chairman of the board of Taxpayer and Vice President of Engineering, Research and Development, and Quality Management Systems. Mr. Rhodes has an engineering degree from New Mexico State University and has worked for Taxpayer for some 40-plus years. [04-11-19 CD 00:34:30-00:36:50].

12. Taxpayer has 415 employees at its office in Farmington. [04-11-19 CD 00:37:10-25].

13. Taxpayer designs and manufactures oil and gas production equipment, separators, dehydrators, treaters, sand separators, combustors, and indirect heaters. Taxpayer is a problem-solver for oil and gas companies. [04-11-19 CD 00:37:26-00:38:20; Taxpayer Ex. (2014) #8.2; Taxpayer Ex. (2016) #7.2; Taxpayer (2014) Ex. #12].

14. Taxpayer has three mechanical engineers, two civil engineers, a chemical engineer, industrial engineer, electrical engineer, a master electrician, IT staffing, and six fulltime drafters that work on research and development. [04-11-19 CD 00:38:21-47].

15. Research and development is the life-blood of Taxpayer's business. [04-11-19 CD 0:38:48-0:40:10].

16. Taxpayer's customers will contact Taxpayer seeking Taxpayer's research and development expertise in designing specific equipment necessary to work under specific conditions at the customer's unique wellsite. [04-11-19 CD 0:43:40-0:44:08].

17. On a custom project, Taxpayer begins with a predesign process involving simulations, the engineering team, design team meeting, and leading to development of a prototype at Taxpayer's expense. [04-11-19 CD 0:44:08-0:45:10].

18. If the customer accepts Taxpayer's prototype custom-engineered solution, the customer will typically purchase many units of that product and Taxpayer will market those units to other customers. [04-11-19 CD 0:45:10-0:45:52].

19. These custom-designed and engineered products generally form the basis of Taxpayer's research and development credit at issue in this protest. [04-11-19 CD 0:45:52-0:46:11].

20. Taxpayer engaged CliftonLarsonAllen (CLA) as its accounting firm for the purposes of seeking the research and development credit based on the recommendation of its

local accounting firm, which had informed Taxpayer it believed it might be entitled to such a credit. [04-11-19 CD 0:46:12-0:47:42].

21. CLA sent numerous staff to review Taxpayer's records and interview Taxpayer's staff and business in order to develop a methodology to quantify Taxpayer's time and wages related to Taxpayer's research and development activities. [04-11-19 CD 0:47:43-0:48:55].

22. CLA reviewed drafting logs, interviewed staff, and relying on known drafting time of drawings per drafter, determined a percentage of projects that qualify as a research and development project and a percentage of projects that were not qualified as research and development project. [04-11-19 CD 0:48:55-0:51:00; 1:50:00-1:55:32; 3:29:53-3:34:00].

23. Mr. Rhodes walked through the methodology in detail using drafting logs. [Taxpayer Ex. (2014) #2; 04-11-19 CD 1:50:00-1:55:32].

24. Taxpayer used drafting logs that were created contemporaneously during the time period where the work was performed. [04-11-19 CD 0:51:00-0:54:29; Taxpayer Ex. (2014) #2].

25. Taxpayer has consistently used the methodology both in its federal and state tax filings related to research and development credits since 2011. [04-11-19 CD 0:56:42-0:57:12; 1:01:24-1:02:05].

26. Taxpayer's methodology only accounts for research and development projects that made it to the drafting stage and excludes research and development projects where no viable product resulted from development. [04-11-19 CD 0:57:13-0:58:30].

27. In 2014, Taxpayer was engaged in sixteen identified research and development projects resulting in some sort of product, with each project more fully identified and described in the evidentiary record[1]. [Taxpayer (2014) #4; 04-11-19 CD 0:59:07-1:00:01].

[1] Although the hearing officer considered listing out all 16 of the 2014 projects in this finding of fact (as well as the 11 2016 projects referenced in the next finding of fact), the hearing officer choose not to in order avoid any potential

28. In 2016, Taxpayer was engaged in eleven identified research and development projects resulting in some sort of product, with each project more fully identified and described in the evidentiary record. [Taxpayer (2016) Ex. #5; 04-11-19 CD 1:00:02-1:01:23].

29. Taxpayer conducted qualified research in 2014 and 2016. [Taxpayer (2014) Ex. #10.6; Taxpayer (2016) Ex. 9; Taxpayer (2015) Ex. #5].

30. Taxpayer did not employ a project time keeping system in 2014 or 2015. [04-11-19 CD 1:05:52-1:06:00; Taxpayer does not maintain a detailed project time-keeping system, which while ideal, is burdensome to implement simply for research and development tracking, as it is time-consuming and burdensome to implement for Taxpayer's research and development process. [04-11-19 CD 2:40:06-2:41:19].

31. Taxpayer builds the price of the product based on the cost of direct labor, the cost of materials, and administrative costs and does not bill the customer for the research and development time, and thus does not use a project time keeping system. [04-11-19 CD 1:06:00-1:07:21].

32. A project time keeping system would have little use to Taxpayer's actual business operational needs and Taxpayer would only use a project time keeping system for the purpose of the tax credit. [04-11-19 CD 1:06:00-1:08:42; 04:09:45-04:09:56].

33. As a small business, Taxpayer would likely not have the resources, personnel, or desire to employ a project time keeping system for the limited purpose of substantiating a small research and development tax credit. [04-11-19 CD 1:05:52-1:11:49].

34. Taxpayer uses a cost accounting method for the purposes of the research and development tax credit. [04-11-19 CD 1:13:00-17].

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issue with trade secrets given that the names of the identified project does not add significant import to the analysis of the issues in this protest.

35. Taxpayer informally uses that same methodology as CLA used for the tax credit to determine the continuing viability of a research and development project by comparing the drafting time shown on the drafting logs against the potential results/outcome/viability of the project. [04-11-19 CD 1:13:17-1:16:48].

36. Taxpayer is developing a process system and has a time keeping system for direct labor charged to a customer, just not for research and development. [04-11-19 CD 1:18:07-1:18:34].

37. Mr. Rhodes was unaware of how Taxpayer compensated CLA. [04-11-19 CD 1:25:10-35].

38. Mr. DePrima is an employee and principle of CLA. Mr. DePrima is an attorney with an LLM in taxation practicing in the area of specialty tax services, primarily research and development credits since 2009. Mr. DePrima has been regional head of CLA's research and development practice for the Mountain West since 2018. [04-11-19 CD 2:20:43-2:21:40].

39. CLA has used a consistent methodology to apply for the credit, both at the state and federal level, for Taxpayers over the years it has been engaged by Taxpayer. [04-11-19 CD 2:22:20-2:23:10; 2:29:39-2:30:20; 2:36:00-2:39:25; 3:40:00-3:40:44; 4:28:41-4:29:58].

40. The instructions on the technology jobs tax credit do not provide specific guidance on how to prove the credit. [04-11-19 CD 2:29:30-39; Taxpayer Ex (2014) #13; Taxpayer (2016) Ex. #12].

41. CLA uses a two-prong approach in preparing the credit application for Taxpayer where it looks at change codes on the drafting logs from the drafting group and then interviews engineers to determine the research and development project percentages. Based on those percentages, CLA uses the wages data to determine the amount of the credit application in the

taxable year [04-11-19 CD 2:33:00-2:36:04; 3:29:53-3:40:44; 3:49:37-3:50:44; 04:05:26-4:06:55; Taxpayer Ex (2014) #8; Taxpayer Ex. (2014) #3; Taxpayer (2016) Ex. #6.24; Taxpayer (2016) Ex. #7].

42. In 2014, CLA used this methodology to determine the percentage of Taxpayer's wages that were related to research and development. [04-11-19 CD 3:48:37-3:49:35; 3:51:08-3:54:26; Taxpayer Ex. (2014) #1; Taxpayer Ex. (2014) #2; Taxpayer Ex. (2014) #3; Taxpayer Ex. (2014) #17].

43. In 2016, CLA used this methodology to determine the percentage of Taxpayer's wages related to research and development. [04-11-19 CD 3:49:35-3:50:44; Taxpayer Ex. (2016) #1; Taxpayer Ex. (2016) #4].

44. A majority to CLA's clients do not use a research and development project time-keeping system and that has not been an impediment to claiming a federal research and development credit. [04-11-19 CD 2:40:06-2:42:40].

45. Taxpayer does not allocate indirect general and administrative costs (referred to in testimony as "G & A costs") for either the state or federal research and development credit. [04-11-19 CD 2:45:50-2:47:25].

46. CLA's method for the research and development credit is not designed as a formal cost accounting methodology nor is it designed to aid Taxpayer in measuring financial performance. [04-11-19 CD 3:08:00-3:10:03; 4:04:57-4:05:27].

47. CLA is paid hourly for its work with Taxpayer on the research and development credit work. CLA generally includes a cap in its fees under a particular engagement letter. CLA does not charge a contingency fee to any client. [04-11-19 CD 3:10:25-3:12:09].

48. CLA does not receive a contingency fee as fixed percentage of the amount of credit granted, however the billing of Taxpayer's hourly rate is reserved until the outcome of the credit application is known. [04-11-19 CD 4:24:27-4:28:09].

49. Marcus Mims is a certified public accountant employed at CLA as a principal in State and Local Tax. Mr. Mims has an accounting degree and has around 30-years of experience in accounting. [04-11-19 CD 3:28:23-3:29:53].

50. Mr. Mims is the account manager for Taxpayer and has been since 2011. [04-11-19 CD 3:29:53-3:30:20].

51. Taxpayer is not seeking an additional technology jobs credit in 2014 but is seeking that additional credit in 2016. [04-11-19 CD 3:58:23-4:03:16; Taxpayer Ex. (2016) #1].

52. In developing a methodology for the research and development credit, CLA focused only on wages. [04-11-19 CD 3:34:06-16].

53. CLA believes that the methodology it developed was fair, reasonable, true, and correct. [04-11-19 CD 4:08:25-4:08:53].

54. Taxpayer initially applied the 80% federal rule to the wages but no longer seeks the application of that rule.

55. Milagros Bernardo is protest auditor with the Department and was familiar with Taxpayer's protest. [04-11-19 CD 4:36:30-4:36:50].

56. The Department does not require a taxpayer to use an expensive time keeping system to grant a credit but it does require a contemporaneous and reliable time tracking system. [04-11-19 CD 4:36:50-4:37:20].

57. The Department requires Taxpayer to use a cost-accounting methodology used for allocation of expenditure be the same as the accounting methodology used by Taxpayer in other business activities. [04-11-19 CD 4:37:20-4:38:10].

58. Protest Auditor Bernardo acknowledged that Taxpayer's accounting activities, processing tax returns, the submission of tax credit applications, and using the methodology to make business decisions about the viability of a project all constitute part of Taxpayer's other business activities. [04-11-19 CD 4:49:11-4:50:05; 4:57:38-4:58:32].

59. While the Department approved previous credit claims substantiated by the same methodology at issue here, the Department previously advised Taxpayer during a review of the credit in a previous period that relying on drafting logs was not an acceptable method for allocation of wages, as it assumes that all drawings require the same amount of work. [04-11-19 CD 4:54:00-4:56:48; Taxpayer Ex. (2014) #10.6-7; Taxpayer Ex. (2016) #9.8].

DISCUSSION

This protest involves Taxpayer's application for the research and development tax credit in 2014 and 2016, which the Department denied because it determined that Taxpayer failed to substantiate its qualified expenditures using a method it also employed for other business purposes, which the Department asserts is required under the applicable statutory definition. Resolution of this protest turns both on a question of statutory construction and related question of proof.

Burden of Proof and Principles of Statutory Construction

Although in some respects similar to deductions and exemptions, credits generally involve more favorable tax treatment than either a deduction or an exemption. "Where an exemption or deduction from tax is claimed, the statute must be construed strictly in favor of the

taxing authority, the right to the exemption or deduction must be clearly and unambiguously expressed in the statute, and the right must be clearly established by the taxpayer." *See Sec. Escrow Corp. v. State Taxation & Revenue Dep't*, 1988-NMCA-068, ¶8, 107 N.M. 540, 760 P.2d 1306. *See also Wing Pawn Shop v. Taxation & Revenue Dep't*, 1991-NMCA-024, ¶16, 111 N.M. 735, 809 P.2d 649. *See also Chavez v. Comm'r of Revenue*, 1970-NMCA-116, ¶7, 82 N.M. 97, 476 P.2d 67. Because of the more favorable tax treatment of a credit over a deduction or exemption, the New Mexico Court of Appeals has found that tax credits are legislative grants of grace to a taxpayer that must be narrowly interpreted and construed against a taxpayer. *See Team Specialty Prods. v. N.M. Taxation & Revenue Dep't*, 2005-NMCA-020, ¶9, 137 N.M. 50 (internal citations omitted). Under the rationale of *Team Specialty Prods*, Taxpayer carries the burden of proving that it is entitled to the claimed credit.

Nevertheless, although a credit must be narrowly interpreted and construed against a taxpayer, it still should be construed in a reasonable manner consistent with legislative language. *See Sec. Escrow Corp.*, 1988-NMCA-068, ¶9, 107 N.M. 540 (although construed narrowly against a taxpayer, deductions and exemptions—similar to credits—are still to be construed in a reasonable manner). The "main goal of statutory construction is to give effect to the intent of the legislature." *Dell Catalog Sales L.P. v. Taxation & Revenue Dep't*, 2009-NMCA-0001, ¶ 19, 145 N.M. 419, 199 P.3d 863 (internal citations omitted). Questions of statutory construction begin with the plain meaning rule. *See Wood v. State Educ. Ret. Bd.*, 2011-NMCA-20, ¶12. In *Wood*, ¶12 (internal quotations and citations omitted), the Court of Appeals stated "that the guiding principle in statutory construction requires that we look to the wording of the statute and attempt to apply the plain meaning rule, recognizing that when a statute contains language which is clear and unambiguous, we must give effect to that language and refrain from further statutory

interpretation." A statutory construction analysis begins by examining the words chosen by the Legislature and the plain meaning of those words. *State v. Hubble*, 2009-NMSC-014, ¶13, 206 P.3d 579, 584. Extra words should not be read into a statute if the statute is plain on its face, especially if it makes sense as written. *See Johnson v. N.M. Oil Conservation Comm'n*, 1999-NMSC-21, ¶ 27, 127 N.M. 120, 126, 978 P.2d 327, 333.

It is a canon of statutory construction in New Mexico to adhere to the plain wording of a statute except if there is ambiguity, error, an absurdity, or a conflict among statutory provisions. *See Regents of the Univ. of New Mexico v. New Mexico Fed'n of Teachers*, 1998-NMSC-20, ¶28, 125 N.M. 401. "Tax statutes, like any other statutes, are to be interpreted in accordance with the legislative intent and in a manner that will not render the statutes' application absurd, unreasonable, or unjust." *City of Eunice v. State Taxation & Revenue Dep't*, 2014-NMCA-085, ¶8 (internal citations and quotations emitted). If the plain language interpretation would lead to an absurd result not in accord with the legislative intent and purpose it is necessary to look beyond the plain meaning of the statute. *See Bishop v. Evangelical Good Samaritan Soc'y*, 2009-NMSC-036, ¶11, 146 N.M. 473. The purpose of interpreting statutes is to "give effect to the Legislature's intent, and in determining intent [the courts] look to the language used and consider the statute's history and background. *Valenzuela v. Snyder*, 2014-NMCA-061, ¶16, 326 P.3d 1120. *See also Peabody Coalsales Co. v. N.M. Taxation & Revenue Dep't*, No. A-1-CA-36632, 2019 N.M. App. Unpub. LEXIS 230, at ¶9 (Ct. App. June 12, 2019, non- precedential). Provisions must be read in "a fair, unbiased, and reasonable construction, without favor or prejudice to either the taxpayer or the State, to the end that the legislative intent is effectuated and the public interests to be subserved thereby are furthered." *Chavez v. Comm'r of Revenue*, 1970-NMCA-116, ¶ 7, 82 N.M. 97, 476 P.2d 67 (internal citations omitted). In searching for

legislative intent, reviewing a legislative purpose statement provides guidance for interpreting the plain statutory language that exist in the statute. *In re Jade G.*, 2001-NMCA-058, ¶¶ 17-20, 130 N.M. 687 (Court looked at Legislative purpose statement for guidance in interpreting the disputed plain language of the statute, though court found that the purpose statement itself cannot confer powers beyond what is contained in the statutory language).

It is also a principle of statutory construction that statutes should be read in harmony with other statutory provisions dealing with the same subject matter. *See State v. Trujillo*, 2009-NMSC-012, ¶22, 146 NM 14. *See also Hayes v. Hagemeier*, 1963-NMSC-095, ¶9, 75 N.M. 70 ("All legislation is to be construed in connection with the general body of law."). *See also N.M. Indus. Energy Consumers v. N.M. Pub. Regulation Comm'n*, 2007-NMSC-053, ¶ 20, 142 N.M. 533 (Legislature presumed to be aware of knowledge of relevant statutes and the common law and thus statutes must be read in harmony with other statutes *in pari materia*). Statutes are also interpreted with the assumption that the Legislature was in full knowledge of relevant statutory and common law. *State ex rel. Quintana v. Schnedar*, 1993-NMSC-033, ¶ 4, 115 N.M. 573 (internal citations omitted).

Overview of the Technology Jobs and Research and Development Credit.

At issue in this protest is Taxpayer's application for research and development tax credits in 2014 and 2016 under the Technology Jobs and Research and Development Credit, NMSA 1978, Section 7-9F-1 through 13 (2015)[2]. According to NMSA 1978, Section 7-9F-2 (2015), the purpose of the Technology Jobs and Research Development Credit is "to provide a favorable tax climate for technology-based businesses engaging in research, development and experimentation and to promote increased employment and higher wages in those fields in New Mexico." The Technology

[2] The act was amended in 2015 and that version of the statute will be expressly referenced unless there is a material difference in the previous version that would apply to the 2014 application for the credit.

Jobs and Research Development Credit establishes a basic credit of 4% in 2014 and 5% in 2015 of the amount of qualified expenditures made by a taxpayer at a qualified facility. *See* §7-9F-5. The credit also provides an additional credit of 4% in 2014 and 5% in 2015 of the amount of qualified expenditures made by a taxpayer at a qualified facility. *See* §7-9F-5.

NMSA 1978, Section 7-9F-6 (B) establishes the eligibility requirements for the credit. Basically, a taxpayer conducting qualified research at a qualified facility is eligible for the credit if they have an increase in annual payroll expense by $75,000.00 not previously used to support the increase and there is $75,000.00 increase in annual payroll expense for every $1,000,000.00 in qualified expenditures. In pertinent part, under Section 7-9F-3 (I), qualified research is research with the purpose of discovering information that is technological in nature, the application of which is intended to be useful in the development of a new or improved business component of the taxpayer, and substantially all the activities focus on new or improved functionality, performance, reliability, or quality than style, taste, or cosmetic design. There is no real dispute in this protest that Taxpayer engaged in qualified research and development activities at a qualified facility[3].

Competing Interpretations of Qualified Expenditures under the Credit.

The issue in this case primarily relates to the meaning of the qualified expenditure portion of the credit, how much overlap between qualified expenditures for purposes of the state credit and qualified research expenses under the federal credit codified under 26 U.S.C.S. § 41, and whether Taxpayer adequately demonstrated proof of qualified expenditures. Section 7-9F-3 (G) (emphasis added) defines "qualified expenditure" as

> an expenditure or an allocated portion of an expenditure by a taxpayer in connection with qualified research at a qualified facility, including expenditures for depletable land and rent paid or incurred for land, improvements, the allowable amount paid or incurred to operate or maintain a facility, buildings, equipment, computer software, computer software

[3] The Department conceded these points in its prehearing statement, p.2.

> upgrades, consultants and contractors performing work in New Mexico, payroll, technical books and manuals and test materials… []. *If a "qualified expenditure" is an allocation of an expenditure, the cost accounting methodology used for the allocation of the expenditure shall be the same cost accounting methodology used by the taxpayer in its other business activities.*

The parties dispute both the statutory construction of the last sentence in terms of what evidence is required to substantiate a qualified expenditure and whether the evidence presented by Taxpayer in this matter was sufficient.

Taxpayer contends that because New Mexico's Technology Jobs and Research Development Credit is similar to federal law, 26 U.S.C.S. § 41, the proof needed to substantiate qualified expenditures should be the same as under federal law, which permits the use of allocations of time based on testimony and documents. Moreover, Taxpayer argued that since its federal R&D credit application, which was supported by the same methodology at issue in this protest, has routinely been accepted by the IRS since 2012, its state R&D credit based on a similar federal law should be accepted by the Department. Thus, Taxpayer contends that there is no requirement for project timekeeping system in order to claim the state credit, as that is not a requirement of federal law. Further, Taxpayer avers that New Mexico apply the federal "standard of proof" in determining credit eligibility and that testimony and documentation is sufficient for Taxpayer to establish entitlement to the credit.

The Department contends that if the New Mexico Legislature wanted to adopt the 1980 federal credit wholesale, it could have done so by adopting the federal statute as Maine[4] and New Jersey (*See* N.J. Stat. §54:10A-5.24) did. Instead, the Department contends that the Legislature chose to add the specific, different language requiring that a cost accounting method must be the

[4] While the Department did not provide a citation to Maine law, Maine's research expense tax credit is found at Me. Rev. Stat. tit. 36, § 5219-K (2007), presumably the provision the Department seeks to reference which adopts the federal definitions under IRS Code §41.

same as a methodology relied on in Taxpayer's other business activities, meaning the Legislature intended something other than what is required federally to substantiate the credit claim. The Department contends that Taxpayer's chosen methodology, which involves allocating time based on approximation of hours worked from drafting logs and interviews with employees is not a cost-accounting method used in Taxpayer's other business activities. The Department contends that Taxpayer's method cannot even be categorized as a cost-accounting method when Taxpayer's two witnesses from CLA could not agree that it amounted to that. The Department contends that the methodology does not actually assist with Taxpayer's other business activities, that the methodology is something that CLA develops to get the credit, and the cost accounting system is not the driver of Taxpayer's business.

Taxpayer counters that the portion of the statute requiring that cost accounting method be used in other business activities is simply an anti-distortion provision, and that Taxpayer is in no way seeking to distort its activities or game the system in that it is consistently employing the same method to demonstrate the research and development credit under federal law. In the alternative, Taxpayer asserts that even if the cost accounting methodology must be used in Taxpayer's other business activities, the evidence supported that Taxpayer did in fact use the methodology for other business purposes. Taxpayer contends that granting Taxpayer the credit in this case serves the Legislature's intended purpose of the credit in this case.

Comparing the State Credit to the Federal Credit

In comparing Section 7-9F-3 (G) to 26 U.S.C.S. § 41 (b), the operational equivalent provision, while there are similarities between the New Mexico and federal credit but there are also some notable differences. What New Mexico law refers to as "qualified expenditures" under Section 7-9F-3 (G) are called "qualified research expenses" under 26 U.S.C.S. § 41(b). "Qualified

research expenses" under 26 U.S.C.S. § 41(B) include in-house research expenses and contract research expenses. Like Section 7-9F-3 (G), 26 U.S.C.S. § 41(b)(2) includes employee wages paid or incurred as part of the qualified research expenses[5]. Under the permitted "in-house research expenses," 26 U.S.C.S. § 41(b)(2) includes the costs of supplies. There is some overlap between permitted supply costs under 26 U.S.C.S. § 41(b)(2) and the definition of "qualified expenditures" under Section 7-9F-3 (G): both permit credit for payment/license to use computer software and software upgrades. However, there is a difference in this area: Section 7-9F-3 (G) includes as a qualified expenditure depletable land and rent paid or incurred for land permits, while in contrast, 26 U.S.C.S. § 41(b)(2)(C) excludes land, improvements to land, or property subject to allowance for depreciation. In New Mexico, payment for consultants or contracts performing work in New Mexico is fully includable as a qualified expenditure for purposes of Section 7-9F-3 (G), while under federal law, generally only 65% of contract research expenses are includable. *See* 26 U.S.C.S. § 41(b)(3)(A).

The most salient difference between the definition of "qualified expenditures" under Section 7-9F-3 (G) and the definition "qualified research expenses" under 26 U.S.C.S. § 41(b) is the one identified by the Department: the federal "qualified research expenses" under 26 U.S.C.S. § 41(b) contains no provision mandating that a cost accounting allocation methodology must also be employed by a taxpayer in their other business activities. Yet, although not part of the definition of "qualified research expenses," the federal credit still contains a requirement for consistent treatment of expenses: "…the qualified research expenses taken into account in computing such percentage [for purposes of determining the base amount] shall be determined on a basis consistent with the determination of qualified research expenses for the credit year." 26 U.S.C.S. § 41(c)(5)(a).

[5] Section 7-9F-3 (G) uses the word "payroll" rather than the synonymous word "wages" referred to by 26 U.S.C.S. § 41(b)(2), but these are substantively identical in this context.

Moreover, the federal credit has a related anti-distortion provision: "[t]he Secretary may prescribe regulations to prevent distortions in calculating a taxpayer's qualified research expenses…" 26 U.S.C.S. § 41(c)(5)(b).

Under the federal credit, "taxpayers are required to retain records necessary to substantiate a claimed credit. If the taxpayer can establish that qualified expenses occurred, however, then the court should estimate the allowable tax credit." *See United States v. McFerrin*, 570 F.3d 672, 675 (5th Cir. 2009) (internal citations omitted). The estimate of the allowable tax credit may be based on testimony and other evidence in the record. *See id*. (internal citations omitted). Taxpayer argues that in light of the similarities between the state and federal credit, its presentation of the methodology supported by testimony is sufficient to satisfy the anti-distortion portion of the definition of "qualified expenditures" under Section 7-9F-3 (G).

Substantiation of State Qualified Expenditures distinct from Federal Law.

Again, the main disputed statutory provision is the meaning of the "qualified expenditure" definition under Section 7-9F-3 (G) as it relates to an allocation: "the cost accounting methodology used for the allocation of the expenditure shall be the same cost accounting methodology used by the taxpayer in its other business activities." Taxpayer's position is that this provision is generally equivalent to the anti-distortion provisions contained under 26 U.S.C.S. § 41(c)(5)(b), while the Department contends that the Legislature meant something different than the federal credit by employing this specific language not included in the federal credit.

In applying the principles of statutory construction discussed at the outset, the hearing officer agrees with the Department's assertion that by choosing different words than the federal credit, the New Mexico Legislature intended a credit unique to New Mexico rather than simply a carbon copy of federal law. The Legislature was presumed to be aware of the terms of 26 U.S.C.S. §

41, a statute dating to the early 1980's, when it first passed the state credit in 2000. *See Schnedar*, 1993-NMSC-033, ¶ 4, 115 N.M. 573 (internal citations omitted). Moreover, the Department cited two states that simply referred to the federal definitions as the basis of substantiating qualifying expenditures. If the Legislature wished to mimic the federal credit, it could have adopted a similar approach as these other states but it instead chose a different path

Despite Taxpayer's somewhat persuasive argument that simply applying the federal credit's standard of proof for expenditures would be the most efficient administrative and policy outcome, the hearing officer is not at liberty to read out the statutory difference between the state credit and federal law. *See* NMSA 1978, Section 7-1B-7 (prohibiting hearing officer from formulating tax policy other than adjudicating hearings). It is clear from the statutory language that the Legislature did in fact intend that a taxpayer's allocation methodology must be a method that is used for other business purposes. And to that extent, it is not good enough for a taxpayer to simply state that since the credit was approved federally, the methodology employed for the state credit is suffice.

Taxpayer Substantiated its Qualified Expenditures.

But despite agreeing with the Department that the Legislature intended the state tax credit to be distinct from the federal credit, the hearing officer finds that the Department's reading of the other business purpose provision is too narrow as applied to this taxpayer given the clear stated purpose of the act. Although Department's counsel disavowed that any formal project management system was required, based on the testimony of Ms. Bernardo, the Department protest auditor, the Department seemed to impose a requirement that the only way to satisfy Section 7-9F-3 (G)'s cost allocation method was by the use of a contemporaneous and reliable time recoding system. However, the language of Section 7-9F-3 (G) does not require a specific type of time recording system in order to demonstrate qualified expenditures.

Instead, Section 7-9F-3 (G) imposes a requirement that when a taxpayer seeks to allocate its expenditures, it use the same cost accounting methodology it uses for other business activities. In this case, there is conflicting evidence as to whether the methodology used by Taxpayer amounted to a formal cost accounting method, as Mr. DePrima and Mr. Mims of CLA had different views of that term. Their difference appeared to be largely to whether the methodology might meet the formal definition of a cost accounting method from the differing perspectives of a tax attorney (Mr. DePrima) versus how a certified public account (Mr. Mims) would understand that term. Whether it amounted a formalized cost accounting method from an accountancy perspective or not, CLA believed that the methodology employed was a fair, true, and reasonable accounting to Taxpayer's labor costs for the research and development costs.

Although the hearing officer has some basic understanding of what is meant by cost accounting, it is helpful to review some definitions of that concept. Black's Law Dictionary defines the "cost accounting method" as "[t]he practice of recording the value of assets in terms of their historical cost." *Accounting method,* Black's Law Dictionary (9th ed. 2009). Merriam-Webster's formal definition of cost accounting is "the systematic recording and analysis of the costs of materials, labor, and overhead incident to production." *Cost Accounting,* Merriam-Webster.com (January 30, 2019), https://www.merriam-webster.com/dictionary/cost%20accounting. In its prehearing briefing, Taxpayer cited an online Investopedia term definition to provide an overview of the concept of cost accounting: "Cost accounting is an accounting method that aims to capture a company's costs, such as depreciation of capital equipment. Cost accounting will first measure and record these costs individually, then compare input results to output or actual results to aid company management in measuring financial performance." *See* Taxpayer's March 21, 2019 Pre-Hearing Brief on "Standard of Proof Issue", p. 9, citing https://www/investopedia.com/terms/c/cost-

accounting.sp. For the purposes of Section 7-9F-3 (G), it is clear that the method Taxpayer used was designed to record and analyze Taxpayer's labor costs incident to the research and development projects it was engaged in, and to that extent it constituted a cost accounting method consistent with the plain language meaning of that term, as shown by the dictionary definitions.

The Legislature stated that the purpose of research and development credit is "to provide a *favorable tax climate for technology-based businesses engaging in research, development and experimentation* and to promote increased employment and higher wages in those fields in New Mexico." § 7-9F-3 (emphasis added). In order to effectuate that stated purpose, statutory interpretation must be done in a manner that results in a favorable tax climate for companies that engage in specified research, development, and experimentation. As Mr. Mims and Mr. DePrima indicated, most of their small business clients engaged in research and development projects do not use either a project management system or a project time keeping system because of the cost burden of developing, maintaining, and using such systems. It is highly unlikely that the Legislature would require a rigid project management system or a project time keeping system if the Legislature sought to create a favorable tax climate for technology-based businesses engaging in research and development in New Mexico. The Legislature would not include such a purpose statement if it intended the statute to be read so narrowly that a small, local company clearly engaged in research and development activities could not qualify because it did not devote its limited resources to an onerous, record-keeping or time management system beyond what it needs to actually conduct its research and development activities. The Legislature would not want to create an incentive where small and local New Mexico businesses engaged in research and development could not qualify for the credit, while larger companies with vast resources could deploy and manage an onerous system.

Here, Taxpayer had a system based on drafting logs, where it tracked how much work was being committed to new research and development projects. That is a system that Taxpayer uses for research and development business purposes. And that is the system that Mr. Rhodes testified he also used to determine the continuing viability of research and development projects. [F.O.F #35][6]. Using the drafting log review process, which is also part of Taxpayer's credit methodology, is part of Taxpayer's other business activities, satisfying both the plain meaning of the words "used by the taxpayer in its other business activities" language under Section 7-9F-3 (G) and the Legislature's intent of fostering a favorable tax climate for business engaged in research and development in New Mexico.

The Department argued in closing argument that one single sentence uttered by Mr. Rhodes over the course of a five-hour hearing is insufficient to establish that Taxpayer used the methodology for other business purposes. The hearing officer disagrees. Credible witness testimony can have as much weight as documentary exhibits, as both testimonial and documentary exhibits constitute the evidentiary record. In this case, the hearing officer found Mr. Rhodes to be highly credible and straightforward. Mr. Rhodes also walked through the drafting logs and his review process, noticing and volunteering that one of Taxpayer's exhibits was not the correct log he would have reviewed, which further bolstered his credibility [04-11-19 CD 1:49:30-1:54:22].

The Department also challenged the legitimacy of the credit claims because it claimed that CLA had a contingency fee arrangement for payment from Taxpayer depending on the amount of

[6] Based on their respective closings, both parties appeared to suggest that it was the hearing officer who raised, brought up or somehow solicited the testimony of Mr. Rhodes that he employed the drafting log methodology to consider the continuing viability of the research and development projects. [04-11-19 CD 5:07:58-5:08:25; 5:11:45-5:12:02]. However, a careful review of the audio shows that Mr. Rhodes' assertion first came in response to the Department's cross-examination of Mr. Rhodes on whether the methodology has any other business purpose. [04-11-19 CD 1:13:17-1:16:48]. The hearing officer did ask a follow up question about Mr. Rhodes statement to Department Protest Auditor Milagros Bernardo [04-11-19 CD 4:57:25-4:58:34], essentially asking her to respond to Mr. Rhodes' earlier testimony, but Mr. Rhodes initial testimony came in response to a Department question on cross-examination.

credit granted. It is not entirely clear that CLA in fact had a purely contingency fee arrangement in this case. Instead, it appeared that CLA had a hybrid arrangement where it had an hourly billable rate for the work it did but agreed not to bill the client until the amount of the credit approved was granted. While the delay in billing until credit approval is similar to a contingency fee, the hourly billing rate portion of the arrangement does not amount to a contingent percentage of the total amount of the credit granted, which is different than a typical contingency fee arrangement seen in the legal context. The Department cited no express state prohibition against hybrid delayed hourly billing arrangements for accounting firms, and instead focused more on attacking the reliability and legitimacy of the methodology. However, the methodology CLA developed was based on the actual research and development work that Taxpayer performed. And the credible, straightforward testimony of Mr. Rhodes alleviated any concerns that the method was not legitimate.

Taxpayer further argued that its use of the same methodology for claiming the federal credit constituted another business purpose under the language of Section 7-9F-3 (G). The hearing officer does not necessarily agree that using the methodology to claim another federal credit alone is sufficient to constitute another business purpose, especially in light of the above discussion about the differences between the state and federal credit. But while not dispositive, the fact that Taxpayer also uses the same methodology for federal credit purposes certainly adds credibility that Taxpayer's methodology is not distortive. In other words, while not by itself satisfying the statutory language, the fact that Taxpayer employs the same methodology to claim the federal credit is reassuring that the methodology legitimately reflects the nature of Taxpayer's research and development expenditures. The hearing officer is satisfied that Taxpayer met its burden to establish it was entitled to the technology jobs and research and development tax credit. Accordingly, Taxpayer's protest is granted and it is ordered that the Department approve the credit claim at issue

in this matter with the modification that Taxpayer may not use the federal 80% rule on wages, as Taxpayer acknowledged at hearing.

Invocation of the Witness Exclusion Rule.

Although not critical to the ruling, one other point of contention between the parties merits a brief discussion. The Department properly invoked the witness exclusion rule in this proceeding. In questioning, the Department established that Taxpayers' witnesses had discussed over the lunch hour a portion of Mr. Rhodes' morning testimony regarding an exhibit where there was a pagination discrepancy between Taxpayer's copy and the copy of that exhibit provided to the Department and the need to get a 2014 MOC Log admitted into the record. [04-11-19 CD 2:56:03-2:58:54; 4:03:30-4:04:22].

Under NMSA 1978, Section 7-1B-6 (D) (2019), the formal rules of evidence and civil procedure do not apply to tax protest hearings. Nevertheless, under the Administrative Hearings Office's general rules of practice, a party may invoke the exclusionary rule for non-testifying witnesses. *See* Regulation 22.600.1.19 (E) NMAC. That regulation reads that

> [a]t the hearing, either party can invoke the exclusionary rule, excluding all witnesses other than the real party in interest, their representative, one main case agent, and any designated expert witness from the proceeding until the time of their testimony. If the rule has been invoked, the witnesses shall not discuss their testimony with each other until the conclusion of the proceeding. When the rule has been invoked, any witness who remains in the hearing after conclusion of their testimony may not be recalled as a witness in the proceeding, except that any witness may observe the testimony of an expert witness and be recalled to provide any subsequent rebuttal testimony.

Regulation 22.600.1.19 (E) NMAC.

As the drafter of this regulation pursuant to authority under NMSA 1978, Section 7-1B-5 (A)(1) (2015), the undersigned hearing officer intended to codify long-standing practice procedures of the Administrative Hearings Officer and its predecessor, the Hearings Bureau of the Taxation and

Revenue Department[7], and to loosely model Rule 11-615 NMRA of the Rules of Evidence. In turn, Rule 11-615 NMRA is modeled on the Federal Rules of Evidence.

Cases interpreting Rule 11-615 NMRA thus are helpful in considering a violation of the witness exclusion rule. "The purpose of the rule excluding witnesses is to give the adverse party an opportunity to expose inconsistencies in the testimony and to prevent the possibility of one witness shaping his testimony to match that given by the other witnesses." *State v. Ortiz*, 1975-NMCA-112, ¶ 33, 88 N.M. 370 (internal quotes and citations omitted). Testimony regarding "simple objective facts" is "ordinarily not subject to tailoring, and if it were, it could have been exposed easily." *United States v. Prichard*, 781 F.2d 179, 183 (10th Cir. 1986). If there is a violation of the rule, the remedy is within the discretion of the judge and the controlling consideration is prejudice to the complaining party. *Id.* at ¶ 31.

In this case, the violation of the rule appeared to be limited to figuring out why there was a pagination discrepancy between copies of the same exhibit and the need to enter another exhibit into the record over the lunch hour. Mr. DePrima testified that there was no additional discussion of the methodology. Other than the pagination discrepancy, there was no allegation in this case of a substantive difference between the copies of the exhibit and no allegation that the discrepancy was material to resolving this protest. Addressing the reason for a page discrepancy in copies of exhibits is the type of a simple, objective fact not conducive to testimony tailoring. Moreover, despite careful, prudent, and effective cross-examination by the Department's counsel, there was no evidence of tailoring testimony between witnesses on the material, disputed issues in dispute or any allegation of prejudice. In fact, Mr. DePrima and Mr. Mims had differing testimony about whether Taxpayer's methodology amounted to a formal cost accounting method. Other than raising the issue

[7] Under the Administrative Hearings Office Act of 2015, the Hearings Bureau was removed from the Taxation and Revenue Department and became the independent Administrative Hearings Office.

through questioning of multiple witnesses, the Department did not ask for or propose a remedy for the violation of the exclusionary rule. As such, the hearing officer did not find any prejudice from the violation of the exclusionary rule in discussing the exhibits and that there was no violation of the broader anti-tailoring of testimony purpose of the rule.

CONCLUSIONS OF LAW

A. Taxpayer filed timely, written protests of the Department's denials of the Technology Jobs and Research and Development Credit.

B. The hearing was timely set and held within 90-days of protest under NMSA 1978, Section 7-1B-8 (2015).

C. Taxpayer bears the burden of proving entitlement to the claimed credit, as a credit is an act of Legislative grace. *See Team Specialty Prods. v. N.M. Taxation & Revenue Dep't*, 2005-NMCA-020, ¶9, 137 N.M. 50 (internal citations omitted). Although a credit must be narrowly interpreted and construed against the taxpayer, it still should be construed in a reasonable manner consistent with legislative intent. *See Sec. Escrow Corp.*, 1988-NMCA-068, ¶9, 107 N.M. 540.

D. The "main goal of statutory construction is to give effect to the intent of the legislature." *Dell Catalog Sales L.P. v. Taxation & Revenue Dep't*, 2009-NMCA-0001, ¶ 19, 145 N.M. 419, 199 P.3d 863 (internal citations omitted). Provisions must be read in "a fair, unbiased, and reasonable construction, without favor or prejudice to either the taxpayer or the State, to the end that the legislative intent is effectuated and the public interests to be subserved thereby are furthered." *Chavez v. Comm'r of Revenue*, 1970-NMCA-116, ¶ 7, 82 N.M. 97, 476 P.2d 67 (internal citations omitted).

E. For the purposes of the requirements of the Technology Jobs and Research and Development Credit, there is no dispute at protest that Taxpayer satisfies the requirement of

being engaged in qualified research and development activities and that such activities occurred at a qualified facility. The only dispute is in the interpretation of the term "qualified expenditure" under NMSA 1978, Section 7-9F-3 (G) and whether Taxpayer presented sufficient evidence to demonstrate its qualified expenditures.

F. The Legislative purpose of the Technology Jobs and Research Development Credit is "to provide a favorable tax climate for technology-based businesses engaging in research, development and experimentation and to promote increased employment and higher wages in those fields in New Mexico." NMSA 1978, Section 7-9F-2 (2015).

G. Despite Taxpayer's argument that New Mexico should simply accept and adopt the proof required to establish entitlement to the similar the federal credit found under 26 U.S.C.S. § 41, New Mexico's Technology Jobs and Research and Development Credit is a distinct credit from the federal credit and thus a taxpayer may not simply assume that the methodology employed to claim the federal credit satisfies the requirements for New Mexico's credit.

H. The Department's argument that a taxpayer must employ a formal cost accounting method or time management system as part of an allocation of the credit is too narrow of a reading of Section 7-9F-3 (G)'s statutory language given the Legislature's stated purpose of creating a favorable tax climate for technology-based businesses like Taxpayer, a small, local company that specializes in researching and developing custom engineered solutions for its customers.

I. In seeking the credit, Taxpayer relied on an allocation of its qualified expenditure, requiring that under NMSA 1978, Section 7-9F-3 (G), Taxpayer's "cost accounting method used

for the allocation of the expenditure shall be the same cost accounting methodology used by the taxpayer in its other business activities."

J. Taxpayer established that it relied on its credit methodology for other business activities, satisfying the requirements of Section 7-9F-3 (G).

K. Taxpayer established entitlement to its claimed Technology Jobs and Research and Development Credit.

For the foregoing reasons, the Taxpayer's protest **IS GRANTED**. **IT IS ORDERED** that the Department grant Taxpayer the claimed 2014 and 2016 Technology Jobs and Research and Development Credit, as modified by Taxpayer's concessions during the protest process that it could not apply the federal 80% rule on wages.

DATED: January 31, 2020.

Brian VanDenzen
Chief Hearing Officer
Administrative Hearings Office
P.O. Box 6400
Santa Fe, NM 87502

NOTICE OF RIGHT TO APPEAL

Pursuant to NMSA 1978, Section 7-1-25 (2015), the parties have the right to appeal this decision by *filing a notice of appeal with the New Mexico Court of Appeals* within 30 days of the date shown above. If an appeal is not timely filed with the Court of Appeals within 30 days, this Decision and Order will become final. Rule of Appellate Procedure 12-601 NMRA articulates the requirements of perfecting an appeal of an administrative decision with the Court of Appeals. Either party filing an appeal shall file a courtesy copy of the appeal with the Administrative Hearings Office contemporaneous with the Court of Appeals filing so that the Administrative Hearings Office may begin preparing the record proper. The parties will each be provided with a copy of the record proper at the time of the filing of the record proper with the Court of Appeals, which occurs within 14 days of the Administrative Hearings Office receipt of the docketing statement from the appealing party. *See* Rule 12-209 NMRA.

CERTIFICATE OF SERVICE

On January 31, 2020, a copy of the foregoing Decision and Order was submitted to the parties listed below in the following manner:

First Class Mail *Interdepartmental Mail*

INTENTIONALLY BLANK ON DIGITAL COPY

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