

Base Period Short-Circuits Electrical Firm's Research Credit

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An electrical contracting company wasn't entitled to research credits because it used the wrong base period and didn't actually increase its spending on research over time, a federal judge held.

Quebe Holdings Inc. used the alternative base period that applies to start-up companies that didn't have qualified research expenses (QREs) in the 1980s, but Quebe did have QREs during that period and the evidence for its claim of the research credits was deemed inadmissible, Judge Thomas M. Rose of the U.S. District Court for the Southern District of Ohio concluded in a [January 17 order](#).

The decision in *United States v. Quebe* shows that companies that want to use [section 41\(c\)\(3\)\(B\)](#) — known as the start-up method — must have credible evidence that they are in fact a start-up company as defined by [section 41](#), Alex E. Sadler of Morgan, Lewis & Bockius LLP told *Tax Notes*.

Quebe, an S corporation owned by Dennis Quebe, has three subsidiaries that design and develop electrical systems for large commercial complexes. In 2013, after a tax consulting firm concluded that the company was entitled to section 41 research credits for the 2009 and 2010 tax years, Quebe amended its Forms 1120S, "U.S. Income Tax Return for an S Corporation," to claim credits of around \$156,000 and \$147,000 for 2009 and 2010, respectively.

Dennis Quebe and his wife likewise amended their personal returns to reflect the changes to the company's returns. Because those changes reduced the Quebes' tax liabilities, the IRS issued them refunds of \$120,000 for 2009 and \$129,000 for 2010.

The government filed a lawsuit against the couple in August 2015 to recover the refunds, contending they were erroneously issued because the company wasn't entitled to the section 41 credits.

In its motion for summary judgment, the government argued that the company improperly chose 2009 through 2010 as its base period for calculating the percentage of its gross receipts that it spent on research, rather than the default period of 1984 through 1988 required by [section 41\(c\)\(3\)\(A\)](#).

Section 41(c)(3)(B) permits taxpayers to choose an alternative base period, but that option is available only if a taxpayer had no gross receipts or QREs before 1984, or if it had fewer than three tax years in which it had both gross receipts and QREs during the default base period 1984 to 1988.

The government argued that the activities that Quebe claimed counted as qualified research in 2009 and 2010 — such as implementing change orders, value engineering, and determining pathways for conduit and wiring — were performed by two of the subsidiaries before 1984 and during the 1984-1988 default period.

Quebe disputed that the subsidiaries had QREs in the 1980s, arguing that they were engaged primarily in time- and materials-based contracts during that period, which Quebe contended can't count as QREs. The company said its QREs for 2009 and 2010 were predominantly based on fixed-fee contracts, which aren't excluded under section 41.

Consultant's Claim Dismissed

Rose wasn't persuaded by Quebe's arguments and granted the government's summary judgment motion. He noted that the company's assertion that it didn't engage in qualified research during the 1980s was based solely on the deposition of an individual from the tax consulting firm that conducted the study and advised Quebe on its eligibility for the research credits.

Because that individual had no personal knowledge of Quebe and couldn't speak to the business activities conducted by the subsidiaries in the 1980s, his testimony is inadmissible hearsay that can't be used to demonstrate the existence of a genuine issue of material fact, Rose said.

"Quebe reinforces that R&D credit claimants must have some evidentiary support for their base amount computation, although this principle is already well established by general substantiation principles and cases such as *Research Inc.* and *Union Carbide*," Sadler said.

The taxpayers in *United States v. Quebe*, No. 3:15-cv-00294 (S.D. Ohio 2018), were represented by Daniel J. Gentry of Coolidge Wall Co. LPA and attorneys with Zerbe, Miller, Fingeret, Frank & Jadav LLP.