DEPARTMENT OF STATE REVENUE

01-20150385.LOF

Letter of Findings Number: 01-20150385
Adjusted Gross Income Tax
For Tax Years 2009-2014

NOTICE: IC § 6-8.1-3-3.5 and IC § 4-22-7-7 requires the publication of this document in the Indiana Register. This document provides the general public with information about the Department's official position concerning a specific set of facts and issues. This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register. The "Holding" section of this document is provided for the convenience of the reader and is not part of the analysis contained in this Letter of Findings.

HOLDING

HVAC Contractor was properly denied research tax credits for wages paid to employees because its projects did not qualify for the credit. Contractor's "projects" did not meet the criteria for the research and expense credit, and Contractor could not provide documentation to substantiate the credit.

ISSUES

I. Adjusted Gross Income Tax–Research Credits.

Authority: IC § 6-3-1-3.5; IC § 6-3-2-1; IC § 6-3.1-4-1; IC § 6-3.1-4-4; IC § 6-8.1-5-1; IC § 6-8.1-5-4; Dep't of State Revenue v. Caterpillar, Inc., 15 N.E.3d 579 (Ind. 2014); Indiana Dep't of Revenue v. Miller Brewing Co., 975 N.E.2d 800 (Ind. 2012); Indiana Dep't of State Revenue v. Rent-A-Center East, Inc., 963 N.E.2d 463 (Ind. 2012); Scopelite v. Indiana Dep't of Local Gov't Fin., 939 N.E.2d 1138 (Ind. Tax Ct. 2010); Wendt LLP v. Indiana Dep't of State Revenue, 977 N.E.2d 480 (Ind. Tax Ct. 2012); Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289 (Ind. Tax Ct. 2007); IDOPCP, Inc. v. Comm'r, 503 U.S. 79 (1992); Indiana Dep't. of State Revenue, Sales Tax Division v. RCA Corp., 310 N.E.2d 96 (Ind. Ct. App. 1974); United Stationers, Inc. v. U.S., 163 F.3d 440 (7th Cir. 1998); United States v. McFerrin, 570 F.3d 672 (5th Cir. 2009); Cohan v. Comm'r, 39 F.2d 540 (2d Cir. 1930); Union Carbide Corp. and Subsidiaries v. Comm'r, T.C. Memo 2009-50 (U.S. Tax Ct. 2009); Norwest Corp. & Subsidiaries v. Comm. Of Internal Revenue, 110 T.C. 454, 489 (1998); Fudim v Comm'r, T.C. Memo. 1994-235 (U.S. Tax Ct. 1994); 45 IAC 3.1-1-66; 45 IAC 3.1-1-2; 45 IAC 3.1-1-7; I.R.C. § 41; I.R.C. § 174; I.R.C. § 1366; I.R.C. § 61; Treas. Reg. § 1.41-4; Treas. Reg. § 1.174-4; Treas. Reg. § 174-2; H.R. Conf. Rep. No. 106-478; IRS, Audit Technique Guide: Credit for Increasing Research Activities, www.irs.gov/pub/irs utl/rc2005atg2irsgovrepublished1_2008.pdf (last visited May, 6 2015); Black's Law Dictionary (9th ed. 2009); H.R. Conf. Rep. No. 106-478; Comments on Research Credit Regulations, 2001-10 I.R.B. 784; 69 F.R. 22-01; 66 F.R. 66362-01.

Taxpayer protests the disallowance of claimed research credits.

II. Tax Administration–Penalty.

Authority: IC § 6-8.1-10-2.1; 45 IAC 15-11-2.

Taxpayer protests the imposition of the negligence penalty.

STATEMENT OF FACTS

Husband and Wife ("Taxpayer") are shareholders of an S-Corporation ("S-Corp") incorporated and operating in Indiana. The S-Corp fabricates and installs HVAC systems for both commercial and residential properties. In 2013, Taxpayer employed a consulting firm to conduct a Research and Development Tax Credit Study ("Study") determining whether they were eligible to claim certain Indiana research tax credits. Taxpayer's consultants ("Consultants") based their study on several items of information including statements made by the executives of the business, contracts, drawings, calculations, and employee's W2s. Taxpayer's research credit amounts were claimed based upon employee wage expenses only and no other costs were claimed. Taxpayer's filed amended returns for the years 2009 through 2014 to reflect the results of the Study.

In 2014, the Indiana Department of Revenue ("Department") conducted an audit for those years. During the audit, the Department determined that Taxpayer failed to show it qualified for the research and development tax credit

and to provide substantial contemporaneous documentation to show that the employees conducted "qualified research" thus, denying Taxpayer's claim for the Indiana research expense tax credit.

Taxpayer protests the Department's disallowance of the Indiana research credit. An administrative hearing was conducted during which Taxpayer's representatives explained the basis for the protest. This Letter of Findings results. Additional facts will be provided as necessary.

I. Adjusted Gross Income Tax–Research Credits.

DISCUSSION

Indiana imposes an adjusted gross income tax on all residents. IC § 6-3-2-1. A taxpayer's Indiana income is determined by starting with its federal income and making certain adjustments. IC § 6-3-1-3.5. Income from an S corporation flows through to the individual shareholder's personal income and is reported by the shareholders on their personal income tax returns. See I.R.C. § 1366. See also 45 IAC 3.1-1-66; 45 IAC 3.1-1-2(14); 45 IAC 3.1-1-7(6). Simply stated, an S Corporation - such as Taxpayer's company - is "[a] corporation whose income is taxed through its shareholders rather than through the corporation itself." Black's Law Dictionary 394 (9th ed. 2009). Pursuant to IC § 6-3-1-3.5, the Indiana income tax rules piggyback on the federal income tax statutes and regulations. Therefore, the federal rules and case law are generally applicable to determine an individual shareholder's tax liability. Any additional income received by the S-Corp as a profit passes through to the individual shareholders as income.

As a threshold issue, it is the taxpayer's responsibility to establish that the existing tax assessment is incorrect. As stated in IC § 6-8.1-5-1(c), "The notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." Indiana Dep't of State Revenue v. Rent-A-Center East, Inc., 963 N.E.2d 463, 466 (Ind. 2012); Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007).

"[W]hen [courts] examine a statute that an agency is 'charged with enforcing . . . [courts] defer to an agency's reasonable interpretation of [the] statute even over an equally reasonable interpretation by another party.'" Dep't of State Revenue v. Caterpillar, Inc., 15 N.E.3d 579, 583 (Ind. 2014). Therefore, when the statute is plain and unambiguous there is no need to delve into the legislative history of the statute.

> Our settled procedure of statutory construction begins with a determination as to **whether the legislature has spoken clearly and unambiguously on the point in question.** If so, our task is relatively simple: we need not "delve into legislative intent" but must give effect to "the plain and ordinary meaning of the language."
> Indiana Dep't of Revenue v. Miller Brewing Co., 975 N.E.2d 800,803 (Ind. 2012).
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> (**Emphasis added**) (Internal citation omitted).

Taxpayer filed amended returns for the years at issue claiming a tax credit. "Tax credits are a matter of legislative grace, and taxpayers bear the burden of proving they are entitled to claim tax credits." IDOPCP, Inc. v. Comm'r, 503 U.S. 79, 84 (1992). Moreover, where such a credit is claimed, "the party claiming the same must show a case, by sufficient evidence, which is clearly within the **exact letter of the law**." Indiana Dep't of State Revenue, Sales Tax Division v. RCA Corp., 310 N.E.2d 96, 100-01 (Ind. Ct. App. 1974) (**emphasis added**). Thus, Taxpayer's claims against any tax must be supported by records necessary to substantiate a claimed credit.

Taxpayer protests that the Department erred in denying the research and development tax credit for the years at issue. As stated above, Indiana follows the federal tax scheme with certain modifications. IC § 6-3-2-1(b); IC § 6-3-1-3.5(b). Indiana also provides certain tax credits which a taxpayer may claim to reduce its tax liability. See generally, IC § 6-3.1 and IC § 6-3.5. One of the tax credits available under Indiana tax law is the Indiana Qualified Research Expense Tax Credit under IC § 6-3.1-4-1 et seq. The 2003 statute, which was effective until December 31, 2015, and is relevant to the tax years at issue (the "2003 Indiana Statute"), provides:

> The provisions of Section 41 of the Internal Revenue Code **as in effect on January 1, 2001, and the regulations promulgated in respect to those provisions and in effect on January 1, 2001**, are applicable to the interpretation and administration by the department of the credit provided by this chapter, including the allocation and pass through of the credit to various taxpayers and the transitional rules for determination of the base period.

IC § 6-3.1-4-4 (2003) (**Emphasis added**).

Further, "qualified research expense" under the 2003 Indiana Statute is "as defined in Section 41(b) of the Internal Revenue Code as **in effect on January 1, 2001**[.]" IC § 6-3.1-4-1 (2003) (emphasis added). "Qualified research" is defined in the Internal Revenue Code ("IRC") under section 41(d). IRC subsection 41(d) defines qualified research in pertinent part as follows:

> (d) Qualified research defined.-For purposes of this section-
> (1) In general.-The term "qualified research" means research-
> (A) with respect to which expenditures may be treated as expenses under section 174,
> (B) which is undertaken for the purpose of discovering information-
> (i) which is technological in nature, and-
> (ii) the application of which is intended to be useful in the development of a new or improved business component of the taxpayer, and
> (C) substantially all of the activities of which constitute elements of a process of experimentation for a purpose described in paragraph (3).
> Such term does not include any activity described in paragraph (4).

26 U.S.C. § 41(d)(1).

This provision sets out a four-pronged test for qualified research. First, the research must have qualified as a business deduction under § 174. See id. § 41(d)(1)(A). Second, the research must be undertaken to "discover information which is technological in nature." Id. § 41(d)(1)(B)(i). Third, the taxpayer must intend to use the information to develop a new or improved business component. Id. § 41(d)(1)(B)(ii). Finally, the taxpayer must pursue a "process of experimentation" during substantially all of the research. Id. § 41(d)(1)(C).

During the protest process, Taxpayer provided documentation for four projects out of ten used in Consultant's sample, to show that Taxpayer was engaging in qualified research. The audit report discussed all of the projects in general after reviewing Taxpayer's documentation. This Letter of Findings will describe all four projects and explain whether the projects qualify. All four projects will be discussed and then analyzed together against the four-part test described in IRC § 41. It should be noted that while the audit report relied on the 2001 federal regulations and 2004 regulations in some instances, Taxpayer's projects will be analyzed through the lenses of both the 2001 and 2004 federal regulations. All references to federal regulations will be for 2001 unless otherwise stated. In order to qualify for the research and expense credit, Taxpayer must meet the four-part test listed above, provide documentation that it meets the test, and provide documentation that the credits earned are directly linked to qualified research.

The Department's audit report analyzed Taxpayer's documentation under each step of the four-part step under the 2001 federal regulations and at times the 2004 regulations. Throughout the audit and protest process Taxpayer explained that it qualified for the research and development tax credit and provided documentation for its projects. Overall the Department determined that Taxpayer did not engage in qualified research and development.

A. Project 9R1057

Customer I engaged Taxpayer to design and install air make up and exhaust fan controls in order to reduce the level of humidity throughout Customer I's plant. Taxpayer provided a picture of the exhaust, fan control, air handling unit controller, and rough design sketches.

B. Project 1X1057

Customer II engaged Taxpayer to design and install a new dust collection and removal system. Taxpayer noted that the system needed to abide by the Indiana Occupational Safety and Health Administration ("IOSHA") standards for dust removal. Taxpayer provided a picture of the final dust removal system, calculations, notes on parts for the system, design sketches, computer aided-design ("CAD") model, employee notes, "possible" revisions, and a third-party booklet titled "Dust Collection and Combustible Dust Strategies." Taxpayer used this booklet as guidance for Customer II.

C. Project 1X008

Customer III approached Taxpayer to design and install improvements to Customer III's HVAC system, electrical system, and control system in order to reduce Customer III's energy cost by implementing the new system. Taxpayer provided notes, calculations, and measurements on boilers, emails on Customer III's hardware and ductwork and censors, energy evaluations, documents on gas flow rate, and proposals signed by the engineering manger.

D. Project 9R0227

Customer IV engaged Taxpayer to "design and install replacement zoning and control systems." Taxpayer evaluated and determined the "existing system to design, develop, and install more efficient zoning control systems for [Customer IV]." Taxpayer provided notes from the site evaluation; an invoice noting the diagnostic status, control configuration, and testing; a second invoice recalibrating damper to ensure it is efficient; an unsigned proposal estimate; and invoices for total amount.

As stated above, the projects and supporting documentation are similar, involving the same or similar business components and similar methods. The projects will be analyzed under the four part test as well as under the applicable 2001 federal regulations and the 2004 federal regulations.

However, before analyzing each part of the test, the audit consistently stated that Taxpayer could not provide sufficient documentation to substantiate its tax credit claim. The Department determined during the audit that Taxpayer did not qualify for the research and development tax credit and that Taxpayer could not provide sufficient documentation to substantiate its claim for the credit. In this instance, the Department agrees with the audit report. Even if Taxpayer did meet all four parts of the four part test, Taxpayer nonetheless failed to substantiate the cost under I.R.C. § 41. During the audit and protest process, Taxpayer could not link specific employees to specific portions of the claimed research and development activities. Further, Taxpayer could not accurately calculate how much time any employee spent on any portion of the claimed research and development. Under IC § 6-8.1-5-4 "Every person subject to a listed tax must keep books and records so that the department can determine the amount, if any, of the person's liability. . . ." In addition, Treas. Reg. § 1-41-4(d)(1) (2001) states that for taxpayer to receive the research and development tax credit, a taxpayer must:

> Prepare[] documentation before or during the early stages of the research project, that describes the principal questions to be answered and the information the taxpayer seeks to obtain to satisfy the requirements of paragraph (a)(3) of this section and retains that documentation on paper or electronically in the manner prescribed in applicable regulations, revenue rulings, revenue procedures, or other appropriate guidance until such time as taxes may no longer be assessed [] for any year in which the taxpayer claims to have qualified research expenditures in connection with the research project; and (2) satisfies section 6001 and the regulations thereunder.

Thus, a taxpayer in Indiana claiming the research and development credit for the years January 1, 2003-December 31, 2015, must keep contemporaneous documentation. In this instance Taxpayer does not meet Indiana's standard under IC § 6-8.1-5-4. Taxpayer also did not meet the "contemporaneous documentation" threshold as described in the 2001 federal regulations. In addition, Taxpayer could not provide sufficient documentation to show the amount of time each claimed employee spent conducting the claimed activities. Therefore, Taxpayer did not meet the current I.R.S. standard.

The research and development credit is broken down into a four part test: 1) whether the expenditure can be treated as an expense under I.R.C. § 174; 2) whether the expenditure was part of an undertaking for the purpose of discovering information which is technological in nature; 3) whether the application is intended to be useful in the development of a new or improved business component; and 4) whether substantially all of the activities constitute elements of a process of experimentation. I.R.C. § 41.

1. Part 1-I.R.C. § 174 test.

"The term 'qualified research' means research with respect to which expenditures may be treated as expenses under section 174. . ." I.R.C. § 41(d)(1)(A). I.R.C. § 174 states,

> A taxpayer may treat research or experimental expenditures which were paid or incurred by him during the taxable year in connection with his trade or business as expenses which are not chargeable to a capital account. The expenditure so treated shall be allowed as a deduction.

Treas. Reg. § 1.174-2(a)(1) further defines "research and experimental expenditure,"

> The term research or experimental expenditures, as used in section 174, means expenditure incurred in connection with the taxpayer's trade or business which represents research and development costs in the experimental or laboratory sense. The term generally includes all such costs incident to the development or improvement of a product. The term includes the costs of obtaining a patent, such as attorney's fees expended in making and perfecting a patent application. Expenditures represent research and development costs in the experimental or laboratory sense if they are for activities intended to discover information that would eliminate uncertainty concerning the development or improvement of a product. **Uncertainty exits if the information available to the taxpayer does not establish the capability or method for developing or improving the product or the appropriate design of the product.** (Emphasis original) (**Emphasis added**).

As stated in the audit report, only wages of personnel were claimed as research expenses, no supplies or materials were claimed. The Department noted in the audit report that the wages were claimed on Taxpayer's federal return as "Cost of Goods Sold" rather than research and expense credits. In the audit, the Department noted that:

> [N]o documentation has been provided concerning the specific amount of labor cost expended in the performance of qualified R & D activities. Although the taxpayer has indicated they can link certain individuals to specific jobs, that detailed information was not provided during the audit, and no evidence was provided to substantiate the actual time spent by an employee on qualified research activities on a specific project.

The audit report also stated that:

> Most of the listed projects were to adapt and modify existing HVAC systems or to replace older systems. Using the project proposal provided for the claimed qualified research credits, it was determined wages claimed as QRE's are greatly higher than the total revenues for the reported research projects (jobs).

In its protest letter Taxpayer generally argued that I.R.C. § 174 uses a very broad definition of research and expense expenditures. Taxpayer next cited to I.R.C. § 41(d)(3), "research must be conducted for a qualified purpose which is defined as developing a (i) new or improved business component, (ii) performance, or (iii) reliability or quality." Taxpayer argues its new or improved product is a final, fully functioning HVAC system (or dust removal system). Because, "this system is a product, or business component generated by Taxpayer for its client in the ordinary course of business it satisfies the requirements of IRC § 41(d)(2)(B)."

Taxpayer argues that in order to meet the first of the four part test, Taxpayer must merely create a new or improved business component. Taxpayer is mistaken. As stated above, to meet part one of the four part test, the expenditure must qualify under I.R.C. § 174. I.R.C. § 41(d)(1)(A) and Treas. Reg. § 1.41-4(a)(2) (2001 and 2004). The Department compares Taxpayer's projects to the definition of research expenditures under I.R.C. § 174. As stated above, the expense cannot be associated with a capital account and must be undertaken to "discover information that would eliminate uncertainty concerning the development or improvement of a product." Treas. Reg. § 1.174-4(a)(1). Uncertainty exists "if the information reasonably available to the taxpayer does not establish the capability or method for development or improvement of the product." Id.

In this instance, Taxpayer's claimed activities did not meet the definition of "uncertainty" as stated in Treas. Reg. § 1.174-4(a)(1). It is a recurring theme throughout Taxpayer's protest that uncertainty existed from the outset and through the development of its business component. Taxpayer stated that uncertainty existed "regarding design and installation and determining optimal controls to meet functionality requirements and client specifications and determining the ideal method for integrating the new controls into an existing HVAC and air make up systems." However, information used by Taxpayer to install or modify its "business component" already existed. Information available included, building blueprints, the actual building, products which included manufacturing specifications, directions, and capabilities of the controls and equipment. Even in Project 1X1057 Taxpayer provided a booklet that stated the optimal way to remove dust from a manufacturing setting. Taxpayer had all the information regarding the optimal way to install and use each piece of its "business component." Its process was simply to assemble the right components to put together to achieve the desired result given a particular design. The information available did establish the capability and methods for developing a new HVAC system (or new dust removal system). Thus, Taxpayer does not meet the first of the four parts test under I.R.C. § 41.

2. Part 2-Discoving Information that is Technological in Nature

Research qualifies for the "research and expense credit" if it is "undertaken for the purpose of discovering

information-- (i) which is technological in nature. . ." I.R.C. § 41(d)(1)(B). Treas. Reg. § 1.41-4(a)(3)(i) (2001) goes on to explain that the phrase "undertaken for the purpose of discovering" information only if it is "undertaken to obtain knowledge that exceeds, expands, or refines the common knowledge of skilled professionals in a particular field of science or engineering." This does not require the taxpayer to be successful nor does it require the research to "be more than evolutionary," but rather that it is taken one step beyond what is commonly available to similarly situated professionals. Id. For the purposes of meeting part one of the test, Taxpayer is allowed to employ existing technologies and rely on existing principals. Treas. Reg. § 1.41-4(a)(3)(iii) (2001).

Treas. Reg. § 1.41-4(d)(3)(ii) (2001) defines "common knowledge" of skilled professionals in a particular field of science or engineering "as information that **should be known** to skilled professionals had they performed, before the research in question is undertaken, a reasonable investigation of the existing level of information in the particular field of science or engineering." (**Emphasis added**).

During its protest Taxpayer stated that to claim the credit a taxpayer must "demonstrate it experienced some uncertainty in its research project." Taxpayer cited Treas. Reg. § 1-41-4(d)(a)(3)(i) (2004) to define uncertainty to mean, "that the Company must show that at the onset of the project 'the information available . . . does not establish the capability or method for developing or improving the business component, or the appropriate design of the business component.'" Taxpayer stated that uncertainty existed at the beginning of each project regarding the appropriate design and methodology for constructing the component.

The Department's audit analyzed Taxpayer's projects under both the 2001 and 2004 regulations for this test. The audit noted that,

> [While technology and engineering] does play a role in the design and fabrication of the duct work, which must be adapted to the specific requirements of each job. However in accordance with IRC regulations in effect on January 1, 2001, the requirement is that qualified expenditures are undertaken for the purpose of discovering information to obtain knowledge that exceeds, expands, or refines he common knowledge of skilled professionals in a particular field of science or engineering.

The Department found that Taxpayer could not meet this level of scrutiny.

In the Department's analysis of Taxpayer's claimed activities under the 2004 regulations, the audit report stated, "The methods used by taxpayer are no different than what is normally expected of any HVAC contractor who combines prior experience with known factors such as facility square footage, facility heat gain and loss calculations, and manufacturer equipment ratings to place the right equipment in the best placement for optimal efficiency." The audit report stated that while some "trial and error occurred taxpayer is not discovering information in the development or improving upon an existing business component."

As stated above, Taxpayer's arguments and documentation will be analyzed under both the 2001 and 2004 federal regulations. During its protest Taxpayer provided documentation that included calculations, design schemes, and information about the equipment installed. Taxpayer could not identify which employees created the schemes or calculations, and Taxpayer could not provide how much time that employee used to create the schemes, calculations, or install the equipment. Taxpayer also does not claim to make any of the equipment used or write any of the equipment software. Taxpayer rather applied information that is already known and configures how to piece the equipment. Thus, it is clear that Taxpayer did not meet the requirement that the research must "exceed, expend, or refine the common knowledge of skilled professionals in a particular field of science or engineering," and does not meet part two of the test as defined under the 2001 federal regulations.

Treas. Reg. § 1.41-4(d)(3)(i) (2004) regulations define uncertainty as, "the information available. . . does not establish the capability or method for developing or improving the business component, or the appropriate design of the business component." This definition is the same as Treas. Reg. § 1.174-2(a)(1), thus, the analysis is the same as stated in 1. Part 1-I.R.C. § 174 test. As stated in Part 1, merely claiming that uncertainty exists does not meet the threshold of uncertainty as defined under Treas. Reg. § 1.41-4(d)(3)(i) (2004). Therefore, Taxpayer does not meet part 2 of the test under the 2001 or the 2004 federal regulations.

3. Part 3-Business Component Test.

Research qualifies for the research and expense credit if it is "undertaken for the purpose of discovering information-- . . . (ii) the application of which is intended to be useful in the development of a new or improved business component of the taxpayer. . ." I.R.C. § 41(d)(1)(B). The audit report stated that "Taxpayer must intend to apply the research information being discovered to develop a new or improved business component." The

Department determined that Taxpayer provided no evidence to substantiate that the research expenditure contributed to the development of a new or improved business component. The Department determined that Taxpayer merely provided a customized system for each customer; the audit report stated "the ductwork produced for a particular building is unique to that building and is not transferable to another building." The Department determined that this is the normal course of business for this industry and therefore does not result in a new and resalable product that is owned by Taxpayer. Each project is its own unique system made up of existing business components. The audit report also stated:

> Even if one concedes the idea that the taxpayer is using the knowledge gained to develop an improved "process" regarding the ductwork, the QRE's claim by taxpayer are primarily made up of wages that would have occurred regardless of whether they were conducting research or not. This includes field installers and other construction site workers and supervisors. No evidence has been provided to tie any specific qualified research activity cost to a specific business component.

In its protest, Taxpayer stated I.R.C. § 41(d)(2)(B) defined business component as any new or improved "product, process, computer software, technique, formula, or invention . . . held for sale, lease or license, or used by the taxpayer in a trade or business." Taxpayer argued that each new system is its business component; it is the process of creating a new or more efficient system that Taxpayer sells to each individual customer. For example, Taxpayer's business component for Project 9R1057 was the development "air make up and exhaust fan controls, exhaust fan relays, and the Air Handling Unit controls and the new improved design for the installation of the HVAC system," in other words, the final, fully-functioning HVAC system.

In this instance, Taxpayer merely took an already existing component and customized it to meet the needs of each individual customer. The audit report explained how having customized and unique "business components" means that Taxpayer did not sell an actual product, but rather sold the service of providing customized system. This is borne out by the fact that each project needs to be configured for each customer's needs, requests, and particular designs. According to I.R.C. § 41(d)(4)(B), qualified research "does not include the adaption of an existing business component to a particular customer's requirement or need." Taxpayer already stated that the systems it creates are unique to each customer produced by adapting existing business components. Given this adaptation it is not clear what Taxpayer's business component is; thus Taxpayer does not meet part 3 of the four part test.

4. Part 4 - Process of experimentation.

Finally, part 4 provides that, an expenditure is qualified research if "substantially all of the activities of which constitute elements of a process of experimentation . . . ." I.R.C. § 41(d)(1)(C).

During the audit, the Department and Taxpayer only analyzed Taxpayer's projects under the 2004 regulations. Treas. Reg. § 1-41-4(a)(5) (2004) provides that qualified activities must include:

1) Identify the uncertainty regarding the development or improvement of a business component
2) Identify one or more alternatives intended to eliminate that uncertainty
3) Identify and conduct a process of evaluating the alternatives.

Furthermore, substantially all (80 percent or more) of the expense must be used in qualifying activities. Treas. Reg. § 1.41-4(a)(6) (2001 and 2004). The I.R.S. does note that the term "uncertainty" means something different in this regulation and the definition in I.R.C. § 174.

> The key difference regarding "uncertainty" in sections 41 and 174 is that, under 41, uncertainty must relate to a qualified purpose, and must be resolved through a 3-element process of experimentation, fundamentally relying on the principles of the hard sciences, engineering, or computer science. **The regulations clarify that merely demonstrating that uncertainty has been eliminated is insufficient to satisfy the process of experimentation test.** (**Emphasis added**).

IRS Audit Techniques Guide: Credit for Increasing Research Activities, page 3.

The audit report stated that "When [the taxpayer was] questioned about what type of experimentation took place during the initial design/job bidding process, the taxpayer stated that they rely on their prior experience and expertise along with the application of existing equipment and specifications and construction, to design the best fit for the customer's job specifications." Taxpayer only claimed wages when calculating the claim; the audit reported on one sheet metal installer as an example. The audit report stated, "Many of the installers that were

installing the equipment at construction job sites were classified as spending 80[percent] or more of their time in R&D, which equates to 100[percent] of the wages being classified as R&D. . . . This allows [installer] only 20[percent] of his time to install sheet metal into residential properties." The Department questioned Taxpayer regarding the installer's time spent installing the sheet metal. Taxpayer replied that installers would often have difficulty in placing the ductwork and/or equipment exactly as the plans provided and would have to modify the installation accordingly. The audit report stated that, "There is a difference between troubleshooting/modifying a construction job to make everything work, and conducting research to develop a new or improved business component."

During the protest, Taxpayer argued that throughout the development of the projects Taxpayer "systematically developed and evaluated multiple design alternatives to overcome the challenges faced and to meet the client's objectives." For example, Taxpayer claims that during project 9R1057:

> At the outset, [Taxpayer] evaluated several control systems to meet the functional requirements of the space. From this, [Taxpayer] developed detailed specifications to ensure accuracy and detail throughout the development of the project. Throughout the states of the development process, [Taxpayer] conducted in-house team meetings, reviews, and meetings with client. Through this process of experimentation, [Taxpayer] explored multiple options available to assess the optimal layout and integration of the HVAC system and the air make up exhaust controls.

For this project, and for similar projects, Taxpayer provided a picture of the control equipment, detail of the unit controller, "Design Schematic stamped Rev 1," and a second design schematic of the exhaust.

Treas. Reg. § 1.41-4(a)(5) (2001) provides:

> For purposes of section 41(d) and this section, a process of experimentation is a process to evaluate more than one alternative designed to achieve a result where the capability of achieving that result is uncertain at the outset. A process of experimentation does not include the evaluation of alternatives to establish the appropriate design of a business component, if the capability and method for developing or improving the business component are not uncertain. A process of experimentation in the physical or biological sciences, engineering, or computer science may involve-
>
> (i) Developing one or more hypotheses designed to achieve the intended result;
> (ii) Designing an experiment (that, where appropriate to the particular field of research is intended to be replicable with an established experimental control) to test and analyzed those hypotheses (through, for example, modeling, simulation, or a systemic trial and error methodology);
> (iii) Conducting the experiment; and
> (iv) Refining or discarding the hypothesis as part of a sequential design process to develop or improve the business component.

During the protest Taxpayer did not provide any information or documentation to show that it was engaging in a process of experimentation. As stated above, trial and error does not constitute the process of experimentation. Thus, Taxpayer failed part 4 of the four part test.

While Taxpayer may experience "uncertainty" as to how to efficiently install a fan control or the design of the system to meet customer specifications, Taxpayer has not shown how modifying an existing component or troubleshooting while installing meets the test of process of experimentation. Taxpayer provided no documentation to show that it met the requirements of experimentation under the 2001 federal regulations, and has not substantiated that it is engaging in experimentation and not just conducting "trial and error" to meet part 4 under the 2004 federal regulations.

Overall, the Department determined that Taxpayer did not engage in qualifying research and development activities. Taxpayer failed to meet all four parts of the four part test under both the 2001 and the 2004 regulatory interpretation. However, even if Taxpayer did meet each part of the four part test under either interpretation, it still would not qualify for the credit. Taxpayer's claimed activities fall under three exceptions to taking the credit as described in I.R.C. § 41(d)(4): expenses related to adopting an existing business component, expenses taken after production begins, and expenses disallowed when funded by a contract.

1. Exception-Adaptation of an Existing Business Component

The law provides, "Any research related to the adaptation of an existing business component to a particular customer's requirement or need." I.R.C. § 41(d)(4)(B). The audit report determined that Taxpayer takes an

existing HVAC system and reconfigures or adapts it customers' "requirement or need."

Taxpayer argued that it does not merely adapt an existing business component during its projects. Taxpayer stated it cannot merely make an insignificant change to a HVAC system and plug it in as a solution to a given customer. Taxpayer stated that, "Each one of [its] projects is unique and custom to that particular client and the requirements for each projects are vastly different as well." Although Taxpayer states it does not adapt existing components, it stated that each project is unique means that the business components are customized for each customer. Thus, it is clear from Taxpayer's explanation of its "business component" that Taxpayer merely adapts existing business components to fit customers' needs during each project.

2. Exception-Research after Commercial Production

Activities that take place after production begins do not constitute research. I.R.C. § 41(d)(4)(A). Treas. Reg. § 1.41-4(c)(2) provides:

> Activities conducted after the beginning of commercial production of a business component are not qualified research. Activities are conducted after the beginning of commercial production of a business component if such activities are conducted after the component is developed to the point where it is ready for commercial sale or use, or meets the basic functional and economic requirements of the taxpayers to the component's sale or use.

The audit report stated that Taxpayer "extended the 'research activities' of selected personnel from the beginning of a job to the final installation of equipment at the job site, including the work of construction supervisors, sheet metal workers and field installers." The audit report concluded that pursuant to the regulation any expense that occurred after the production of the ductwork starts would be excluded from the research and development tax credit calculation.

A taxpayer is required to provide documentation explaining and supporting its challenge that the Department's denial is wrong. Poorly developed and non-cogent arguments are subject to waiver. Scopelite v. Indiana Dep't of Local Gov't Fin., 939 N.E.2d 1138, 1145 (Ind. Tax Ct. 2010); Wendt LLP v. Indiana Dep't of State Revenue, 977 N.E.2d 480, 486 n.9 (Ind. Tax Ct. 2012). Taxpayer provided no argument as to why it does not meet the exception. Thus, Taxpayer's protest for this exception is deemed waived.

3. Exception-Funded Research

Research funded by any grant, contract or another person does not qualify as research. I.R.C. 41(d)(4)(H). The audit report stated that "once a contract is awarded to the taxpayer, the end user (customer) is fully funding the project." Taxpayer did not protest this assertion by the audit report. In addition, Taxpayer stated in the hearing that the customer pays for the "business component" upon its completion. In addition, Taxpayer's statements the documents provided also show that customers pay for expenses including labor costs to install the "component." The invoice stated labor costs separately from the material costs. Thus, it is apparent that the expenses are funded by the customers.

Finally, as stated above, a taxpayer is required to provide documentation explaining and supporting its challenge that the Department's denial is wrong. Poorly developed and non-cogent arguments are subject to waiver. Scopelite v. Indiana Dep't of Local Gov't Fin., 939 N.E.2d 1138, 1145 (Ind. Tax Ct. 2010); Wendt LLP v. Indiana Dep't of State Revenue, 977 N.E.2d 480, 486 n.9 (Ind. Tax Ct. 2012). Taxpayer provided no argument as to why it does not meet the exception. Thus, Taxpayer's protest for this exception is deemed waived.

4. Estimation of Tax Credit

Even though the Department has denied Taxpayer on the substantive issues, Taxpayer argues that the estimated percentages of employee wages based upon the Study and employee interviews are an acceptable basis for calculating its research credit. Taxpayer refers to some authorities which it believes support this position. Taxpayer maintained that "[they] are not required to substantiate by adequate records or by sufficient evidence corroborating [their] own statement of the amount of such expenses" pursuant to Cohan v. Comm'r, 39 F.2d 540 (2d Cir. 1930); referring to Fudim v Comm'r, T.C. Memo. 1994-235 (U.S. Tax Ct. 1994), United States v. McFerrin, 570 F.3d 672 (5th Cir. 2009), and Union Carbide Corp. v. Comm'r, T.C. Memo 2009-50 (2009 WL 605161) (U.S. Tax Ct. 2009).

Taxpayer also stated in its protest that the direct calculation method of determining qualifying research hours is

not required under the Internal Revenue Service ("IRS") Audit Techniques Guide: Credit for Increasing Research Activities ("Guide") published in June 2005. Taxpayer quotes from page 29 of the Guide:

> The courts will allow the use of an estimation method only where the taxpayer does not have contemporaneous records, and then only as long as the following two conditions are satisfied. First, the taxpayer must establish that it engaged in qualified research activities as defined in section 41(d). And second, the failure to maintain a proper system to capture relevant information cannot be an "inexactitude of their own making." Estimation methods are permitted only in cases where the sole issue is the exact amount paid or incurred in the qualified research activity. Accordingly, Taxpayers must have factual support for every assumption underlying their estimates to meet their burden of proof.

Taxpayer argues that these authorities support its position and that the Department must allow estimates as adequate support for Taxpayer's qualifying research credit calculations.

In the instant case, Taxpayer used estimations without any supporting documentation to show employees' time performing qualified research. The Department is not required to accept as fact any estimates of employees' time based on interviews.

In summary, Taxpayer has not established that the estimates are a valid basis for arriving at the wage figures used in its research credit calculations. The IRS Audit Guide requires that the taxpayer maintain contemporaneous documentation. Only in the instances where contemporaneous documentation is not available, due to no fault of the taxpayer, will the IRS exercise its discretion as to whether the estimates are sufficient in allowing the qualifying research tax credit per IRS guidelines.

5. Application of I.R.C. §41(d)(1)(B).

The issue in this section in whether the Department should apply the "Discovery Test" for years 2003-2015 versus the "Uncertainty Test" based on the wording in IC § 6-3.1-4-4. The Department denied Taxpayer's protest based on its failure to document that it met each part of the four part test. However, during the protest process Taxpayer protested the Department's application of the Discovery Test as put forth in Treas. Reg. 1.41-4(a)(3)(i) (2001). Taxpayer challenged the validity of the IC § 6-3.1-4-4 reference to the 2001 federal regulations. The reference to the 2001 IRC and regulations was added by PL 192-2002 (ss), § 89 in 2002, which was the first time that § 6-3.1-4-4 referenced a specific date. The Department has historically applied the 2001 final regulations, published under T.D. 8930 (the "2001 Final Regulations"). The 2001 Final Regulations define qualified research and development under IRC § 41 to include a discovery requirement. However, these regulations were not promulgated until January 3, 2001, not January 1, 2001 (the date referred in the statute), and no portion of the regulation was made retroactive.

T.D. 8930, published in the Federal Register on January 3, 2001, contains final regulations relating to the computation of the research expense tax credit under section 41(c) and the definition of "qualified research" under section 41(d). "These regulations reflect changes to section 41 made by the Tax Reform Act of 1986 (the 1986 Act), the Revenue Reconciliation Act of 1989, the Small Business Job Protection Act of 1996, the Taxpayer Relief Act of 1997, the Tax and Trade Relief Extension Act of 1998 (the 1998 Act) and the Tax Relief Extension Act of 1999 (the 1999 Act)." T.D. 8930, 66 F.R. 280-01, 2001 WL 34028585. The 2001 Final Regulations set forth the discovery requirement for defining qualified research under IRC § 41(d). Section 1.41-4(a)(3)(i) of the 2001 Final Regulations states:

> For purposes of section 41(d) and this section, research is undertaken for the purpose of discovering information only if it is undertaken to obtain knowledge that exceeds, expands, or refines the common knowledge of skilled professionals in a particular field of science or engineering.

T.D. 8930, 66 F.R. 280-01.

T.D. 8930 notes criticism by commentators to the proposed regulations (published in 1998) that this definition imposes a "discovery requirement" that was not mandated by IRC § 41(d); however, the IRS and Treasury Department elected to retain the discovery test because they "continue[d] to believe that section 41 conditions credit eligibility on an attempt to discover information that goes beyond the common knowledge of skilled professionals in the particular field of science or engineering" and that the legislative history of the Tax Reform Act of 1986 (the "1986 Act") supported such a definition. T.D. 8930, 66 F.R. 280-01. T.D. 8930 further explains that the 1986 Act narrowed the definition of the term "qualified research," and cites to legislative history explaining that "Congress was concerned that taxpayers had applied the original definition of qualified research 'too broadly,'"

and under the 1986 Act research must be undertaken "to discover information that is technological in nature . . . ." T.D. 8930 (quoting H.R. Conf. Rep. No. 99-841, at II071 n.3 (1986)) (emphasis in original).

T.D. 8930 additionally notes that the discovery requirement is also consistent with the legislative intent of the 1999 Act. The legislative history of the 1999 Act states "[e]mploying existing technologies in a particular field or relying on existing principles of engineering or science is qualified research, if such activities are otherwise undertaken for purposes of discovering information and satisfy the other requirements under section 41." T.D. 8930, 66 F.R. 280-01 (quoting H.R. Conf. Rep. No. 106-478, at 332) (emphasis in original). T.D. 8930 states:

> By referring separately to a requirement that the research be undertaken for purposes of discovering information, this legislative history again confirmed that the phrase 'discovering information' is a separate substantive requirement and not merely a phrase used to link the term research with the types of information required as the subject of the research.

T.D. 8930, 66 F.R. 280-01.

T.D. 8930 also refers to case law applying the discovery test subsequent to the 1986 Act and prior to promulgation of the 1998 Proposed Regulations and the 2001 Final Regulations. In United Stationers, Inc. v. U.S., 163 F.3d 440 (7th Cir. 1998), the Seventh Circuit relied upon the plain language of § 41(d)(1)(B)(i) and the legislative history of the 1986 Act in determining that the taxpayer had not engaged in "qualified research" because it did not develop research programs for the purpose of discovering information. The Court stated, "Congress clearly intended . . . that qualifying research pass a high threshold of innovation and be of broad effect." Id. at 444; see also Norwest Corp. & Subsidiaries v. Comm. Of Internal Revenue, 110 T.C. 454, 489 (1998) (relying upon "ordinary meaning of the language used in the statute . . . as well as the legislative history surrounding the promulgation of the TRA 1986[.]")

Thus, T.D. 8930 clearly indicates that the Treasury Department and the IRS considered the criticisms of the discovery test, yet chose to retain the requirement "[i]n light of the case law and the legislative history[.]" T.D. 8930. The 2001 Final Regulations did not spontaneously implement the discovery test, but instead rely upon legislative, statutory, and case law guidance evidencing that Congress intended to implement such a test with the enactment of the 1986 Act, and reiterated this position in the Tax Relief Extension Act of 1999 (the "1999 Act"). Because the interpretation of the 1986 Act and the 1999 Act by the IRS and courts, the "discovery test" was meant to be applied based on the statutory interpretation alone. Thus, Indiana's adoption of the "discovery test" is consistent with IRS and the 7th Circuit interpretation of I.R.C. §41.

In response to taxpayer concerns regarding T.D. 8930, on March 5, 2001, the Treasury Department and the IRS published Notice 2001-19 announcing that the Treasury Department and the IRS would review T.D. 8930 and reconsider comments previously submitted in connection with the finalization of T.D. 8930. Comments on Research Credit Regulations, 2001-10 I.R.B. 784, 2001 WL 84197. Notice 2001-19 also provided that, upon completion of the review, the Treasury Department and the IRS would announce changes in the regulations in the form of proposed regulations. These proposed regulations were published in the Federal Register on December 26, 2001 (the "2001 Proposed Federal Regulations"). 66 F.R. 66362-01, 2001 WL 1640763. The resulting 2001 Proposed Federal Regulations departed from the "discovery test" and instead implemented the "uncertainty test":

> Uncertainty, for purposes of this requirement, exists if the information available to the taxpayer does not establish the capability or method of developing or improving the business component, or the appropriate design of the business component.

66 F.R. 66362-01, 2001 WL 1640763.

The final regulations, which replaced the "discovery test" with the current "uncertainty test" for defining qualified research under § 41(d), were promulgated on January 2, 2004 (the "2004 Final Regulations"). 69 F.R. 22-01, 2004 WL 18938.

The Indiana Legislature would have been aware that the IRS and the Treasury Department were reviewing the 2001 Final Regulations shortly after their promulgation, via Notice 2001-19 published on March 5, 2001, and that there were concerns about the application of the discovery test. However, the Indiana Legislature, in 2002, after the 2001 Proposed Regulations eliminating the discovery test had already been published in December 2001, consciously selected a date prior to these revised regulations. Had the Indiana Legislature intended to adopt the uncertainty test over the discovery test in the 2003 Indiana Statute, it could have either referred to a date after the promulgation of the 2001 Proposed Regulations, waited until after the final regulations were promulgated in 2004,

or not referred to any date at all. The application of the discovery requirement was a reasonable interpretation of IRC § 41(d) from the date the 1986 Act was enacted until the promulgation of the 2004 Final Regulations.

Taxpayer failed to show that it meets any part of the four part test. Taxpayer also failed to demonstrate that its expenses do not meet any of the exceptions described in I.R.C. § 41(d)(4). Thus based on the information above, Taxpayer has not met the burden of proving the proposed assessments wrong, as required by IC § 6-8.1-5-1(c).

FINDINGS

Taxpayer's protest is denied.

II. Tax Administration–Penalty.

Taxpayer requested that the Department abate the negligence penalty.

Pursuant to IC § 6-8.1-10-2.1(a), the Department may assess a negligence penalty if the taxpayer:

(1) fails to file a return for any of the listed taxes;
(2) fails to pay the full amount of tax shown on the person's return on or before the due date for the return or payment;
(3) incurs, upon examination by the department, a deficiency that is due to negligence;
(4) fails to timely remit any tax held in trust for the state; or
(5) is required to make a payment by electronic funds transfer (as defined in IC 4-8.1-2-7), overnight courier, or personal delivery and the payment is not received by the department by the due date in funds acceptable to the department.

45 IAC 15-11-2(b) further states:

> "Negligence" on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence. Further, failure to read and follow instructions provided by the department is treated as negligence. Negligence shall be determined on a case by case basis according to the facts and circumstances of each taxpayer.

The Department may waive a negligence penalty when "the taxpayer affirmatively establishes that the failure . . . was due to reasonable cause and not due to negligence." 45 IAC 15-11-2(c). The taxpayer "must demonstrate that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section." Id. The Department is mindful that "[r]easonable cause is a fact sensitive question and thus will be dealt with according to the particular facts and circumstances of each case." Id.

In this instance, Taxpayer has not demonstrated that its actions were reasonable as described in 45 IAC 15-11-2(c). Thus, Taxpayer's request for penalty abatement is denied.

FINDING

Taxpayer's protest of the negligence penalty is denied.

SUMMARY

Taxpayer's protest regarding the research and development expense tax credit is denied. Taxpayer's protest of the negligence penalty is denied.

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