DEPARTMENT OF STATE REVENUE

01-20170279.LOF
01-20170288.LOF

Letter of Findings: 01-20170279; 01-20170288
Individual Income Tax
For the Years 2012 through 2015

NOTICE: IC § 6-8.1-3-3.5 and IC § 4-22-7-7 require 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 This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register.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

The Department disagreed with Indiana Swimming Pool Consultant that it was entitled to rely on the "Uncertainty Test" in evaluating whether Consultant was entitled to claim research and expense credits; under either the "Uncertainty Test" or the "Discovery Test," Swimming Pool Consultant failed to establish that it was entitled to credits for expenses attributable to the design of swimming pools and other water features.

ISSUES

I. Adjusted Gross Income Tax - Research Expense Credits Regulations.

Authority: IC § 6-3-1-3.5(b); IC § 6-3.1-4-1; IC § 6-3.1-4-2(a); IC § 6-3.1-4-4; IC § 6-8.1-5-1; IC § 6-8.1-5-1(c); IC § 6-8.1-5-4(a); *New Colonial Ice Co. v. Helvering*, 292 US. 435 (1934); *United States v. McFerrin*, 570 F.3d 672 (5th Cir. 2009); *Stinson Estate v. United States*, 214 F.3d 846 (7th Cir. 2000); *United Stationers, Inc. v. U.S.*, 163 F.3d 440 (7th Cir. 1998); *Norwest Corp. & Subsidiaries v. Comm. Of Internal Revenue*, 110 T.C. 454 (1998); *Conklin v. Town of Cambridge City*, 58 Ind. 130 (1877); *Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue*, 867 N.E.2d 289 (Ind. Tax Ct. 2007); *Indiana Dep't. of State Revenue, Sales Tax Division v. RCA Corp.*, 310 N.E.2d 96 (Ind. Ct. App. 1974); I.R.C. § 41(d); Treas. Reg. 1.41-4(a)(3)(i) (T.D. 8930); Treas. Reg. § 1.41-4(d); Internal Revenue Service *Comments on Research Credit Regulations*, 2001-10 I.R.B. 784; 69 F.R. 22-01; 66 F.R.. 280-01; 66 F.R. 66362-01; Letter of Findings 01-20160696; 01-20160697; 01-20160698; 01-20160700; 01-20160701; 01-20160702; 01-20160703 (June 27, 2017); Letter of Findings 01-20150385 (December 6, 2016); Letter of Findings 02-20130676 (January 16, 2015); Letter of Findings 01-20110213 (October 4, 2011).

Taxpayers argue that the Department erred in denying research and expense credits claimed by the company of which they were shareholders on the ground that the Department imposed a "discovery" test not found in Indiana law.

II. Adjusted Gross Income Tax - Qualified Research Expense Projects.

Authorized: IC § 6-3.1-4-1; IC § 6-3.1-4-4; IC § 6-8.1-5-4(a); *United States v. McFerrin*, 570 F.3d 672 (5th Cir. 2009); *Stinson Estate v. United States*, 214 F.3d 846 (7th Cir. 2000); *Conklin v. Town of Cambridge City*, 58 Ind. 130 (1877); *Indiana Dep't. of State Revenue, Sales Tax Division v. RCA Corp.*, 310 N.E.2d 96 (Ind. Ct. App. 1974); I.R.C. § 41(d)(2); I.R.C. § 41(d); I.R.C. § 6001; Treas. Reg. 1.41-4(a)(3)(i) (T.D. 8930); Treas. Reg. 1.41-4(a)(3)(ii) (T.D. 8930); Treas. Reg. 1.41-4(d) (TD 9104); Treas. Reg. 6001-1; *Audit Techniques Guide: Credit for Increasing Research Activities (i.e. Research Tax Credit) IRC § 41 - Substantiation and Recordkeeping*.

Taxpayers argue that the Department erred in disallowing research expense credits attributable to specific projects engaged in by the company of which they were shareholders.

STATEMENT OF FACTS

Taxpayers are individual shareholder/owners of an Indiana company in the business of consulting on the design and construction of swimming pools, water parks, and water treatment facilities. The Indiana consulting company also sells water treatment equipment, pool chemicals, and other items required to maintain and repair swimming pools.

For simplicity's sake, this Letter of Findings will hereinafter designate "Taxpayer" as the consulting company because "Taxpayer" is an S corporation with its business income "passed through" to the individual shareholders.

The Indiana Department of Revenue ("Department") conducted an audit review of both Taxpayer's corporate income tax returns and of the shareholders' income tax returns. The audit noted that the original returns claimed approximately $2,000 in research and expense credits ("RECs"). After being notified of the Department's audit, Taxpayer filed amended income tax returns claiming additional amounts RECs for 2012, 2013, 2014, and 2015.

The Department's audit review resulted in the denial of the claimed RECs. Taxpayer disagreed with the decision denying the RECs and submitted a protest to that effect. An administrative hearing was conducted during which Taxpayer's representatives explained the basis for the protest. This Letter of Findings results.

I. Adjusted Gross Income Tax - Research Expense Credits Regulations.

DISCUSSION

Simply stated and for the years at issue, does Indiana's version of the Research Expense Credit impose the T.D. 8930 "Discovery Test" or the less restrictive T.D. 9104 "Uncertainty Test?"

The issue is whether the Department erred in denying Taxpayer's credits for increasing research expenses. The Department determined that Taxpayer mistakenly relied on regulations published in Treasury Decision 9104 (T.D. 9104, 69 F.R. 22-01, 2004 WL 18938) in calculating its Indiana research expense credits. The Department found that T.D. 9104 was not promulgated and was not in effect until well over eleven months after the Indiana legislature adopted the research expense provisions provided at IC § 6-3.1-4-4.

The Department maintains the applicable regulations are found in Treasury Decision 8930 (T.D. 8930, 66 F.R. 280-01), 2001 WL 34028585. The Department explains that T.D. 8930 "is the only set of regulations that were promulgated and in effect on January 1, 2001, the year in which Indiana's version of the credit was promulgated."

According to the Department, T.D. 8930 imposes a "discovery requirement." According to Taxpayer, the Internal Revenue Service ("I.R.S.") eliminated the "discovery requirement" and that Taxpayer was entitled to rely on the less restrictive "elimination of uncertainty" test found in T.D. 9104.

A. Department's Audit Examination.

During the years 2012, 2013, and 2014, Taxpayer claimed approximately $1,600,000 in qualifying research expenses ("QREs") entitling it to approximately $61,000 in Indiana Research Expense Tax Credits. The audit reviewed the basis for claiming the expenses to determine whether Taxpayer incurred the $1,600,000 in expenses and whether it was entitled to the resulting $61,000 in credits. In its review referencing the "January 1, 2001" language found at IC § 6-3.1-4-4, the audit report provides:

> Outside of a few minor additions, IRC section 41 is essentially the same as it was on January 01, 2001. However, the regulations that define qualified research have changed since January 01, 2001. The only regulations that were promulgated and in effect on January 01, 2001, were the regulations published in Treasury Decision 8930 (TD 8930) defining qualified research. These regulations were promulgated and published as proposed regulations on December 02, 1998, and were published as final regulations in December 2000 with an effective date of 01/03/2001. The definitions within this Treasury Decision were relied upon by both taxpayers and the department during this time. Current regulations defining qualified research are contained in Treasury Decision 9104 (TD 9104). These regulations were promulgated and published as proposed regulations on 12/26/2001 and were published as final regulations in December 2003 with an effective date of January 02, 2004.

The audit report noted that IC § 6-3.1-4-4 "was amended by the Indiana legislature effective January 1, 2016, deleting the reference to January 1, 2001, to recouple with the current Internal Revenue Code and regulations" but that this amendment was only effective for tax years beginning either on or after January 1, 2016. Of course, this recoupling did not take effect until well after the years under consideration here.

B. Taxpayer's Response.

Taxpayer argues that the "Discovery Test," T.D. 8930, was never "good law" and that a "plain reading of Indiana Code 6-3.1-4-4, in light of the 2016 repeal of the Discovery Test makes clear that the Indiana statute was never

meant to apply the Discovery Test." Taxpayer concludes:

> The discovery test has never applied for purposes of the Indiana research expense credit or under federal law. Indiana ties the interpretation of the research expense credit to federal law and the discovery test has never been good law at the federal level, as the Treasury Department, the United States Court of Appeals for the 5th Circuit, and the United States Tax Court have all affirmed. Moreover, in published guidance IDOR has repeatedly interpreted the research expense credit to not apply the discovery test. Additionally, Indiana case law prohibits IDOR from suddenly applying the discovery test without issuing formal guidance announcing the change in its longstanding practice wherein the IDOR consistently applied T.D. 9104. Finally, the language and legislative history to Indiana Code 6-3.1-4-4 make plain that the section was never meant to impose the discovery test.

C. Statement of Law and Burden of proof.

1. Burden of Proof.

Tax assessments are *prima facie* evidence that the Department's assessment of tax is presumed correct; the taxpayer bears the burden of proving that the assessment is incorrect. IC § 6-8.1-5-1(c); *Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue*, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007).

IC § 6-3.1-4-4 provides that, "'Research expense tax credit' means a credit provided under this chapter against any tax otherwise due and payable under IC 6-3." Similar to deductions, exemptions, and exclusions, tax credits - such as RECs - "are matters of legislative grace." *Stinson Estate v. United States*, 214 F.3d 846, 848 (7th Cir. 2000). The taxpayer who claims the tax credit is required to retain records necessary to substantiate a claimed credit. 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) (citing *Conklin v. Town of Cambridge City*, 58 Ind. 130, 133 (1877)).

Citing *Stinson Estate*, the circuit court in *United States v. McFerrin* summarized that "[t]ax credits are a matter of legislative grace, are only allowed as clearly provided for by statute, and are narrowly construed." *United States v. McFerrin*, 570 F.3d 672, 675 (5th Cir. 2009). *See also New Colonial Ice Co. v. Helvering*, 292 US. 435, 440 (1934) ("Whether and to what extent deductions shall be allowed depends upon legislative grace; and only as there is clear provision therefore can any particular deduction be allowed.")

In order to obtain the benefit of the RECs at issue, both Indiana and federal law require that a taxpayer maintain and produce contemporaneous records sufficient to verify those credits. *See* Treas. Reg. § 1.41-4(d). Moreover, Indiana mandates that every person subject to a listed Indiana tax keep books and records, including all source documents "so that the [D]epartment can determine the amount, if any, of the person's liability for that tax by reviewing those books and records." IC § 6-8.1-5-4(a).

2. Indiana Research Expense Credits.

For income tax purposes, Indiana follows the federal tax scheme with certain modifications. IC § 6-3-1-3.5(b). Indiana provides tax credits outlined in IC 6-3.1 which a taxpayer may claim to reduce its taxable income. One of the tax credits is the "Indiana qualified research expense" tax credit under IC § 6-3.1-4-2(a), which states that, "A taxpayer who incurs Indiana qualified research expense in a particular taxable year is entitled to a research expense tax credit for the taxable year." IC § 6-3.1-4-1 defines the credit. In part, this statute - in effect for the taxable years in question -provides:

> "Indiana qualified research expense" means qualified research expense that is incurred for research conducted in Indiana. "Qualified research expense" means qualified research (as defined in Section 41(b) of the Internal Revenue Code as in effect on January 1, 2001).

3. Indiana 2001 Regulations.

The issue is which regulations were in effect at the time the Indiana legislature promulgated IC § 6-3.1-4-4: T.D. 8521 (eff. May 16, 1989); T.D. 8930 (eff. Jan. 3, 2001); or T.D. 9104 (eff. Jan. 2, 2004).

The Department maintains that T.D. 8930 was in effect for the years at issue. If so, the regulations impose a "Discovery Test" in which qualified research must be "undertaken for the purposes of *discovering information*

which is technological in nature." (*emphasis added*).

Taxpayer maintains that T.D. 9104 is relevant because it has "persuasive value." If so, these regulations incorporates a less restrictive "uncertainty" test in which qualified research is "intended to *eliminate uncertainty* concerning the development or improvement of a business component." (*emphasis added*).

Taxpayer concludes that "only T.D. 8521 was in effect on January 1, 2001, so it controls under Ind. Code § 6-3.1-4-4."

The issue in this section is whether the Department should apply the "Discovery Test" for years 2012 through 2015 versus the "Uncertainty Test" based on the wording found in IC § 6-3.1-4-4. The Department denied Taxpayer's protest based on Taxpayer's 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 challenges the validity of the IC § 6-3.1-4-4 reference to the 2001 federal regulations. This reference to the 2001 I.R.C. and regulations was added by P.L. 192-2002, § 89 in 2002, which was the first time that IC § 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 I.R.C. § 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 I.R.C. § 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 at 290.

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 I.R.C. § 41(d); however, the IRS and the 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 . . . ." *Id.* at 282. (quoting H.R. Conf. Rep. No. 99-841, at II 71 n.3 (1986)).

T.D. 8930 additionally notes that the discovery requirement is 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." *Id.* at 283. (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.

Id.

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 reflects the fact 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 Seventh 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.

F.R. 66362-01 at 66363-64.

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 presumably have been aware that the IRS and the Treasury Department were reviewing the 2001 Final Regulations shortly after their promulgation, by means of 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 referenced any date at all. The application of the discovery requirement was a reasonable interpretation of I.R.C. § 41(d) from the date the 1986 Act was enacted until the promulgation of the 2004 Final Regulations.

Finally, Taxpayer argues that the Department has published guidance in which it repudiated the Discovery Test and that the Department may not, at this late date, retroactively flip-flop its position by applying a standard of analysis which it had previously rejected. To that end, Taxpayer cites to Letter of Findings 02-20130676 (January 16, 2015), 20150325 Ind. Reg. 045150065NRA. The "Holding" portion of that decision stated:

> Food product developer and manufacturer's research activities, related to the development of new food products and improvement of existing food products, constituted qualified research expenses. Improvements to food textures, smells, or flavors could relate to functional aspects of a business component.

More specifically and on the narrow question of the food manufacturer's protest, the 2015 Letter of Findings

concluded:

> To the *limited extent* that the audit concluded that research activities related to food taste, texture, smells or flavor are precluded pursuant to Treas. Reg. § 1.41-4(a)(5)(ii), Taxpayer's protest is sustained. To the extent that the Department verifies Taxpayer's research activities are related to the development of food taste, texture, smells, or flavor - *and which meet the requirements of qualified research activities* - the Audit Division will adjust the assessment. (*emphasis added*).

In effect, the Letter of Findings found that the original audit erred when it concluded that qualified research related to the development of food taste qualities did not qualify as a research activity; could a food manufacturer conduct research on the "taste" of foods and food additives? One will search the Letter of Findings in vain for any reference to the "Uncertainty Test" or the "Discovery Test."

Taxpayer also cites to Letter of Findings 01-20110213 (October 4, 2011), 20111228 Ind. Reg. 045110749NRA, as an example of the Department flip-flopping on the issue of the "Discovery Test." In that decision, the Department agreed with Taxpayer that expenses related to the development of telephone software updates constituted qualified research. The issue was whether the software enhancements constituted an improvement to an existing business component or whether the improvement resulted from "research conducted after the beginning of commercial production of the business component." The Letter of Findings concluded:

> [T]he work in adding new, mandated fields, adding additional remote access features, and other substantive features in the software required a process of experimentation to ensure that the data was properly formatted, that the addition of new fields and features were integrated with the previously-written components of the software, and that the portions of the program could be used on different platforms. Though the line of software was an existing business component, the addition of new fields is analogous to the examples provided under Treas. Reg. § 1.41-4(c) related to the production or development of a new product, the expenses of which can be qualified research expenses.

Again, the 2011 Letter of Findings makes no determination, conducts no analysis, and reaches no conclusion as to either the relevance or applicability of the "Discovery Test" or the "Uncertainty Test."

The Department is unable to agree with Taxpayer that the Department has been anything other than transparent and consistent on the issue. To the contrary, the Department has staked out its position repeatedly and in detail which will not be repeated here. *See* Letter of Findings 01-20160696; 01-20160697; 01-20160698; 01-20160700; 01-20160701; 01-20160702; 01-20160703 (June 27, 2017), 20170830 Ind. Reg. 045170363NRA; Letter of Findings 01-20150385 (December 6, 2016), 20170222 Ind. 045170090NRA.

The audit was correct in relying on the "Discovery Test" in determining whether Taxpayer's activities qualified for the research and expense credits.

FINDING

Taxpayer's protest is respectfully denied.

II. Adjusted Gross Income Tax - Qualified Research Expense Projects.

DISCUSSION

The issue is whether Taxpayer has established that it is entitled to claim RECs attributable to consultation work related to the construction of swimming pools, fountains, and playground water features and whether Taxpayer has adequately documented to what extent it may claim those RECs.

A. Qualified Research.

1. Audit Results.

As a basis for arriving at its conclusions, the audit cited to I.R.C. § 41(d) which defines the term "qualified research" as research:

1. [w]ith respect to which expenditures may be treated as an expense under section 174[;]
2. [w]hich is undertaken for the purposes of *discovering information* which is technological in nature (also

known as the Discovery Test)[;]
3. [t]he application of which is intended to be useful in the development of a new or improved business component of the taxpayer; and
4. [s]ubstantially all of the activities which constitutes elements of a process of experimentation for a qualified purpose. (*emphasis added*).

The audit report explained that "[f]or a taxpayer's activities to be considered qualified research, [the activities] must meet all four tests of I.R.C. section 41(d) including the 'Discovery Test.'" According to the Department's audit report, "The only regulations that were promulgated as in effect on January 1, 2001, were the regulations published in [T.D. 8930]." The audit report points to what it concluded were the pertinent regulations.

Treas. Reg. 1.41-4(a)(3)(i) (T.D. 8930) 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. (*emphasis added*).

This regulation then goes on to state "research is not undertaken for the purpose of discovering information merely because an expenditure may be treated as an expense under section 174."

Treas. Reg. 1.41-4(a)(3)(ii) (T.D. 8930) defines common knowledge:

> Common knowledge of skilled professionals in a particular field of science or engineering means 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.

The audit report described Taxpayer's business activities as follows:

> [Taxpayer] is a distributor of water treatment equipment, chemicals and other related items. They design, construct and service swimming pools, water parks and water treatment systems.

The audit concluded that Taxpayer was not engaged in "qualified research" under T.D. 8930 because Taxpayer was not engaged in activities that required it to obtain information that "exceeds, expands or refines the common knowledge of skilled engineering professionals." The audit report stated:

> The taxpayer has been in business for over thirty years and has several long time employees with education and experience in the design and construction of water treatment systems, swimming pools and water parks. Per statements in the [Taxpayer's] credit study report, the taxpayer must consider customer requirements; existing infrastructure and equipment (if applicable), utilities, site conditions; drainage; municipal, county and state water requirements; municipal, county, and state codes and regulations regarding site and structural constraints. Because of these variables, the credit study indicates that the taxpayer is uncertain of the final design and or optimal methods to complete the project.

. . . .

> The taxpayer is conducting a reasonable investigation of the existing level of information (customer requirements, existing equipment, types of filtration equipment, site conditions and local and state codes pertaining to drinking and waste water treatment and monitoring, and drainage practices) and making decisions on how to proceed in completing the project it was contracted to complete. The information being gathered is considered common knowledge of a skilled professional and is not considered qualified research.

The audit found that Taxpayer's activities did not meet the definition of qualified research under I.R.C. § 41(d) because the activities were not "undertaken for the purpose of discovering information which is technological in nature . . ." and because - for an experienced company - Taxpayer's activities were an exercise but not an expansion of its "common knowledge."

In addition, the audit concluded that under either the "Discovery Test" or the "Uncertainty Test," Taxpayer's activities did not rise to the level of "qualified research."

> Even in light of the current IRS regulations (TD 9104), the taxpayer activities fail the second test. Based on

> Treas. Reg. 1.41-4(a)(3) (TD 9104), the taxpayer must be discovering information to eliminate uncertainty and that uncertainty exists only if the information available to the taxpayer does not establish the capability or method for developing or improving the business component or the appropriate design of the business component.

2. Taxpayer's Response.

Taxpayer disagrees arguing that its consultation process involves projects which require it to "develop innovative solutions to a combination of various aspects spanning the disciplines of structural, electrical, and plumbing engineering . . . ." According to Taxpayer, these design solutions include consideration of "client requirements and site conditions" including:

> Topography, configuration, climate, and existing infrastructures and utilities; Subsurface conditions such as soil type, soil stability, and water table; Municipal, city, and state water, wastewater, and storm water monitoring and qualify requirements; and Municipal, county, and state codes and regulations regarding site and structural constraints.

Taxpayer states that it has "developed new and improved design solutions and construction methods for each swimming pool project with respect to a variety of functional and performance criteria." Based on the specific needs of any particular project, Taxpayer states that it "was uncertain as to the capability, methodology, and appropriate design to achieve [each project's] requirements/specifications . . . ." Faced with those specific needs, Taxpayer states that it "developed alternative designs and construction methods, as well as alternative materials to achieve project requirements" including the use of "computer-aided design ('CAD') to evaluate the appropriateness of each alternative design."

In order to bolster its claim that it was engaged in qualified research, Taxpayer pointed to a number of swimming pool projects and the difficulties involved in those projects. For example, Taxpayer explained that it engaged in the design of one "highly complex project" which required it to determine the "appropriate design of the [project's] pump systems," to determine the "capability of the electrical and mechanical systems," and to develop the "optimal sequence to install each system in order to maximize productivity . . . ." Taxpayer elaborates:

> In overcoming project uncertainties, [Taxpayer] engaged in an iterative design process wherein the existing pool system was demolished and a new pool design layout was developed. After demolishing the existing pool system, [Taxpayer] assessed the existing water system to determine whether it could be refurbished for integration into the new design. During the assessment, [Taxpayer] found the existing filtration system to be outdated, below grade, and incapable of performing the necessary functionalities at the required performance levels.

As a result of Taxpayer's efforts, the swimming pool was downsized and a new and resized water supply was designed.

In a second consulting project, Taxpayer was engaged to "design and develop an indoor aquatic center . . ." which included both a lap and diving pool. Taxpayer explains that its efforts were directed to the "elimination of uncertainty." Taxpayer explains that it engaged in efforts to determine the "appropriate design of the pump system," the appropriate design for the [ultra violet] system," "the capability of the heating system," and to determine the "optimal sequence to install each system in order to maximize productivity of the systems."

Taxpayer further explains that this particular project required it to engage in a "process of experimentation."

> To overcome project uncertainties, [Taxpayer] engaged in an iterative design process involved evaluation of alternative design layouts and design elements. During the initial phase of the design, [Taxpayer] was challenged with deconstructing the existing, outdated mechanical system while leaving intact all other components and ensuring sufficient spacing for installation of the new system. The deconstruction involved both the demolition of the old sand filtration system, link seals, and piping and electrical systems associated with the filtration system.

3. Hearing Analysis.

The Department is unable to agree that Taxpayer has met its statutory burden under IC § 6-8.1-5-1(c) of establishing that its efforts in consulting on and designing the swimming pool and water features constitute "qualified research" activities under either the "Discovery Test" or the "Uncertainty Test." Simply demonstrating

that "uncertainty" in achieving a particular result has been eliminated and that a particular result has been achieved, is insufficient to satisfy the "process of experimentation" requirement.

Notwithstanding Taxpayer's expertise or diligence, there is nothing in the various project descriptions which establishes that Taxpayer was undertaking efforts "for the purpose of discovering information which is technological in nature . . . ." I.R.C. § 41(d)(2). To the contrary, the project descriptions illustrate Taxpayer efforts to integrate long-standing structural, construction, electrical, and plumbing principles which - if not entirely routine - do not rise to the level of "experimentation" or "discovery."
It is a well-founded principle of Indiana law that where 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." *RCA Corp.*, 310 N.E.2d at 100-01.

In addition, the Department finds no reason to depart from the audit's conclusion that even under the current ("uncertainty") IRS regulations, Taxpayer activities fail to meet the standard. As explained in the audit report:

> Based on Treas. Reg. 1.41-4(a)(3) (TD 9104), the taxpayer must be discovering information to eliminate uncertainty and that uncertainty exists only if the information available to the taxpayer does not establish the capability or method for developing or improving the business component or the appropriate design of the business component. As previously stated, the taxpayer has been in business for thirty years and has several long time employees with education and experience in the design and construction of water treatment systems, swimming pools and water parks. The customer is relying on and paying for this education and experience when they hire the taxpayer. Neither the customer nor the taxpayer would enter into these contracts to do the jobs if the taxpayer was not capable of completing the jobs or the different construction methods to complete the jobs. Even though the taxpayer may not know every detail of the final design when it first signs the contracts with the customer, both the customer and the taxpayer know that the taxpayer has the education/experience to prepare the appropriate design based on the customer's requirements and site conditions when they enter into the contracts.

Nothing in this decision should be construed as minimizing Taxpayer's expertise or diligence in undertaking these consulting projects. However, in evaluating its own qualification for the tax credit, Taxpayer mistakenly conflates diligence, complexity, institutional experience, and its own competence with "research undertaken for the purpose of *discovering information* . . . to obtain knowledge that exceeds, expands, or refines the common knowledge of skilled professionals in a particular field of science or engineering." Treas. Reg. 1.41-4(a)(3)(i) (T.D. 8930).

Taxpayer has failed to establish that the audit was incorrect in finding that Taxpayer's activities in consulting in and designing swimming pools and water projects was an exercise in exploiting the "common knowledge" of Taxpayer's skilled professionals.

B. Documentation and Substantiation.

Setting aside issues related to Taxpayer's consulting projects, Taxpayer disagrees with the audit's finding that Taxpayer failed to adequately document its employees' specific activities related to those projects. The audit found that Taxpayer failed to sufficiently document the nature and extent of those employee activities. Taxpayer disagrees arguing that it has assiduously and thoroughly determined the extent to which its employees engaged in qualified research activities. The issue is whether Taxpayer has documented that it paid its employees $1,600,000 to engage in qualified research expense activities.

1. Audit Results.

At the outset, it is important to note the REC's claimed by Taxpayer all stemmed from wages paid to Taxpayer's employees. The audit found that "taxpayer has not provided records to substantiate qualification for the credit or to substantiate the amount of the credit" based on wages paid its employees. As authority for its decision, the audit cited to Treas. Reg. 1.41-4(d) (TD 9104) which provides "A taxpayer claiming a credit under section 41 must retain records in sufficiently usable form and detail to substantiate that the expenditures claimed are eligible for the credit." In addition, the audit cited to Treas. Reg. 6001-1 which states:

> Any person required to file a return of information with respect to income, shall keep such permanent books of accounts or records, including inventories, as are sufficient to establish the amount of gross income, deductions, credits, or other matters required to be shown by such persons in any return of such tax or information.

The audit also cited to Treas. Reg. 1.41-4(d) (TD 8930) which provides as follows:

> No credit shall be allowed under section 41 with regard to an expenditure relating to a research project unless the taxpayer - (1) Prepares 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 (except under section 6501(c)(1), (2), or (3)) 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 regulations there under.

Finally, the audit report cited to Indiana's own statute on the question of adequate documentation.

> 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 for that tax by reviewing those books and records. The records referred to in this subsection include all source documents necessary to determine the tax, including invoices, register tapes, receipts and canceled checks. IC § 6-8.1-5-4(a).

In reviewing Taxpayer's documentation, the audit found as follows:

> The taxpayer did not track or report . . . expenses as research and development expenses on its returns.
>
> [T]he auditor was unable to verify the amount claimed on the returns for the research credit based upon the limited and incomplete information provided . . . .

2. Taxpayer's Response.

Taxpayer disagrees with the audit's conclusion. As explained by Taxpayer, "The position set forth demonstrates the exam team's failure to understand the requirements a taxpayer must meet to substantiate the research credit." Taxpayer states that the only record keeping requirement is set out in I.R.C. § 6001 which provides:

> Every person liable for any tax imposed by this title, or for the collection thereof, shall keep such records, render such statements, make such returns, and comply with such rules and regulations as the Secretary may from time to time prescribe. Whenever in the judgment of the Secretary it is necessary, he may require any person, by notice served upon such person or by regulations, to make such returns, render such statements, or keep such records, as the Secretary deems *sufficient to show whether or not such person is liable for tax under this title.* The only records which an employer shall be required to keep under this section in connection with charged tips shall be charge receipts, records necessary to comply with section 6053(c), and copies of statements furnished by employees under section 6053(a). (*Taxpayer's emphasis*).

In addition, Taxpayer cites to Treas. Reg. § 1.41-4(d) which - according to Taxpayer - "imposes the record keeping standard for the Research Credit . . . ." The regulation provides:

> A Taxpayer claiming a credit under section 41 must retain records in sufficiently usable form and detail to substantiate that the expenditures claims are eligible for the credit.

Taxpayer explains that I.R.C. § 6001 and Treas. Reg. § 1.41-4(d) "provide very little guidance as to the meaning of 'sufficient to show whether or not such person is liable for tax under this title.'" Taxpayer therefore concludes that both provisions "should be broadly read," that legislative history supports that interpretation, that the "Internal Revenue Code Intentionally Fails to Call for a Specific Form of Evidence," that Congress would have legislatively acted if it required a specific form of documentary evidence, and that case law allow for the "use of estimates" in calculating RECs.

In its "Tax Credit Study" prepared by its consultants, Taxpayer explains how it identified qualifying wages. Taxpayer admits that it "did not maintain a time tracking system which tracked employee's time to specific projects." Instead, Taxpayer utilized an "alternative method to estimate the amount of qualified time spent by the employees performing qualified services." That alternative method included reviewing "contemporaneous project documentation" as well as "conduct[ing] employee interviews . . . ." Subsequently, Taxpayer conducted additional interviews to "obtain an allocation percentage representative of the level of qualified activities performed by said individuals." Underlying all of the wage calculations, is the assumption that each individual's work was related to a qualifying research project. In making that assumption, Taxpayer relied upon "statistical sampling procedures"

which in turn is based on "[t]he Mersenne-Twister Inversion random number generator . . . ."

In five pages of explanations, Taxpayer's Tax Credit Study details the relevance of the random number generator in determining the qualification of the sampled pool projects. In small part the survey explains:

> The Mersenne-Twister random number generator will then be used to create a vector of length 95 consisting of random numbers in the interval [0.1]. The i^{th} element of this vector will be assigned to the project in the sampling frame with *i* as its serial number. The 24 [pool] projects with the largest randomly generated number will be used as the sampling units. The seed for the random number generator will be 1151419.

Taxpayer concludes that if the "correct legal standard is applied to the facts . . . it is clear that [Taxpayer] performed qualified research activities during Tax Years 2012 through 2015."

3. Hearing Analysis.

IC § 6-3.1-4-4 provides that "'Research expense tax credit' means a credit provided under this chapter against any tax otherwise due and payable under IC 6-3." Similar to deductions, exemptions, and exclusions, tax credits - such as RECs - "are matters of legislative grace." *Stinson Estate v. United States*, 214 F.3d 846, 848 (7^{th} Cir. 2000). The taxpayer who claims a tax credit is required to retain records necessary to substantiate a claimed credit. 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) (citing *Conklin v. Town of Cambridge City*, 58 Ind. 130, 133 (1877)). Citing *Stinson Estate*, the circuit court in *United States v. McFerrin* summarized that "[t]ax credits are a matter of legislative grace, are only allowed as clearly provided for by statute, and are narrowly construed." *United States v. McFerrin*, 570 F.3d 672, 675 (5^{th} Cir. 2009).

It is the Taxpayer's statutory obligation to maintain and produce to the Department records sufficient to verify the credits which it claims pursuant to IC § 6-3.1-4-1 and IC § 6-8.1-5-4. This is especially true in the case of the RECs for which the I.R.C. imposes stringent and detailed parameters and which - if Taxpayer seeks to obtain the benefit of those credits - Taxpayer is required to meet. I.R.C. § 6001; Treas. Reg. § 1-6001-1.

As to the information necessary to verify REC credits, in this regards the IRS's Audit Technique Guide provides useful guidance stating in relevant part:

> Substantiation and Record Keeping: Under the final regulations, *a taxpayer must retain records in sufficiently usable form and detail to substantiate that the expenditures claimed are eligible for the credit*. *See* I.R.C. § 6001; Treas. Reg. § 1.6001-1. The taxpayer must clearly establish full compliance with all of the relevant statutory and regulatory requirements. Failure to maintain records in accordance with these rules is a basis for disallowing the credit.
>
> The Service does not have to accept estimates of qualified research expenses if documentation exists to verify the actual amount of such expenses. As set forth above, taxpayers are required to keep records substantiating the amount of any reported, claimed, or affirmatively raised deductions or credits.
>
> 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 is 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. *Audit Techniques Guide: Credit for Increasing Research Activities (i.e. Research Tax Credit) IRC § 41 - Substantiation and Recordkeeping*, http://www.irs.gov/Businesses/Audit-Techniques-Guide:-Credit-for-Increasing-Research-Activities-(i.e.-Research-Tax-Credit)-IRC-§ 41 (last visited January 2, 2015) (*emphasis added*).

In Taxpayer's case, the IRS guidance bears repeating: "[A] taxpayer must retain records in sufficiently usable form and detail to substantiate that the expenditures claimed are eligible for the credit." In situations in which precise detail is lacking and in which the Taxpayer "estimates" the amount of the credits, "[T]axpayer must have factual support for every assumption underlying their estimates to meet their burden of proof."

Taxpayer's "Tax Credit Study" - prepared by its *tax* advisors - is based on a number of assumptions. The study

and its conclusions are predicated on the assumption that the documentation provided to its advisors is "complete and authentic." However, the study cautions that the advisors did not undertake to independently "verify [Taxpayer's] information, facts, statements, representations and covenants as true and accurate . . . ." In other words, Taxpayer's claim that it spent 1.6 million dollars on qualifying wages is largely based on its own say-so and on an arcane and wholly unverifiable process of determining that the preparatory work on swimming pool projects constituted qualifying activities. Taxpayer asks that the Department accept that its employees - such as its construction, manager, interns, vice-president of development, sales manager, general manager, president, and various administrators - engaged in research activities and that it can reliably document the amount of time these employees engaged in those activities. Neither Taxpayer's explanation nor its documents reliably and authoritatively support that contention. Taxpayer failed to maintain the contemporaneous records necessary to establish that its employees engaged in the claimed activities and - if those employees did engage in those activities - failed to definitively establish that they conducted research to the extent claimed. Taxpayer failed to prepare documentation "before or during the early stages of the research project" as required by Treas. Reg. 1.41-4(d).

FINDING

Taxpayer's protest is respectively denied because Taxpayer failed to establish that it is entitled to claim RECs attributable to consultation work related to the construction of its swimming pools and failed to adequately document to what extent it could claim those RECs.

SUMMARY

The Department does not agree that Taxpayer was entitled to rely on the "Uncertainty Test" in evaluating whether it was entitled to claim the RECs, that Taxpayer was entitled to claim the credits based on its consultation work, or that Taxpayer documented to what extent it could claim the RECs based on wages paid its employees.

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