DEPARTMENT OF STATE REVENUE

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Letters of Findings: 01-20160678; 01-20160679;
01-20160682; 01-20160683
Individual Income Tax
For the Years 2010 through 2013

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 This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register.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 Building Design Construction Company that it was entitled to rely on the "Uncertainty Test" in evaluating whether Company was entitled to claim research and expense credits; under either the "Uncertainty Test" or the "Discovery Test," Company failed to establish that it was entitled to credits for expenses attributable to the design and construction of buildings.

ISSUES

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

Authority: IC § 6-3-1-3.5; IC § 6-3.1-4-1; IC § 6-3.1-4-2; IC § 6-3.1-4-4; IC § 6-8.1-5-1; IC § 6-8.1-5-4; *Indiana Dep't of State Revenue v. Caterpillar, Inc.*, 15 N.E.3d 579 (Ind. 2014); *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); Treas. Reg. § 1.41-4; 66 F.R. 280-01; 66 F.R. 66362-01; 69 F.R. 22-01; *Comments on Research Credit Regulations*, 2001-10 I.R.B. 784, 2001 WL 84197; 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).

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; IC§ 6-8.1-5-1; *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); *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); I.R.C. § 41; I.R.C. § 6001; Treas. Reg. 1.41-4; Treas. Reg. 6001-1; 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).

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

Taxpayer hired a third party consultant ("Consultant") who advised Taxpayer it qualified for the Indiana Research

and Expense Credit ("REC"). Consultant reviewed job records and interviewed the Taxpayer's Vice President/Shareholder, two Project Managers, Senior Project Manager/Shareholder, and Design Manager/Shareholder. In relying on Consultant's advice, Taxpayer filed amended returns claiming the RECs. Taxpayer only claimed wages as exempt, and the wages were allocated by using a project-based analysis. 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 Department's audit review resulted in the denial of the claimed RECs. Taxpayer and Consultant disagreed with the decision denying the RECs and submitted a protest to that effect. An administrative hearing was conducted during which Consultant, acting on behalf of Taxpayer, explained the basis for the protest. This Letter of Findings results.

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

DISCUSSION

The issue is whether the Department erred in denying Taxpayer's credits for increasing research expenses. The primary question is, for the years at issue, whether 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 Department determined that Taxpayer erroneously 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 therefore entitled to rely on the less restrictive "elimination of uncertainty" test found in T.D. 9104.

During the years 2010, 2011, 2012, and 2013, Taxpayer claimed approximately $1,400,000 in qualifying research expenses ("QREs") and an approximate corresponding $88,000 in Indiana Research Expense Tax Credits. The audit reviewed the basis for claiming the expenses to determine whether Taxpayer incurred the expenses and whether it was entitled to the resulting 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 1, 2001. However, the regulations that define qualified research have changed since January 1, 2001. The only regulations that were promulgated and in effect on January 1, 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 2, 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 2, 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.

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 Indiana Department of Revenue improperly applies Treasury Decision 8930's "Discovery Rule" by implying that [Taxpayer] did not perform activities that expand upon the field of science of engineering. The Discovery Rule, as abolished by Treasury Decision 9104, eliminated the requirement that activities be

> undertaken to obtain information that exceeds, expands, or refines the common knowledge of skilled professionals in the particular field of science or engineering in which the taxpayer is performing the research. [Taxpayer's] research need not exceed, expand, or refine the common knowledge of skilled professionals in the field of mechanical system process design. Instead, [Taxpayer] may draw upon known engineering principles from its past experiences to undertake research to eliminate uncertainty in the development of custom mechanical designs and processes for its clients.

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). When an agency is charged with enforcing a statute, the jurisprudence defers the agency's reasonable interpretation of that statute "over an equally reasonable interpretation by another party." *Indiana Dep't of State Revenue v. Caterpillar, Inc.*, 15 N.E.3d 579, 583 (Ind. 2014).

IC § 6-3.1-4-1 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)); *see also United States v. McFerrin*, 570 F.3d 672, 675 (5th Cir. 2009) (citing *Stinson Estate*) ("[t]ax credits are a matter of legislative grace, are only allowed as clearly provided for by statute, and are narrowly construed."); *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 therefor[e] 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).

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).

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. These regulations incorporate a less restrictive "uncertainty" test in which qualified research is intended to *eliminate uncertainty* concerning the development or improvement of a business component. Taxpayer asserts 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 set 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. 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. 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. Thus, the audit was correct in relying on the "Discovery Test" in determining whether Taxpayer's activities qualified for the research and expense credits. Taxpayer's argument that T.D. 9104 is applicable to the tax years at issue is misplaced. It is the Department's established position that T.D. 8930 applies to the Indiana REC prior to January 1, 2016. *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; Letter of Findings 02-20130676 (January 16, 2015), 20150325-IR-045150065NRA.

FINDING

Taxpayer's protest with respect to the interpretation of IC § 6-3.1-4-4 is respectfully denied.

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

DISCUSSION

The issue is whether Taxpayer is entitled to claim the Indiana REC and whether Taxpayer has adequately documented to what extent it may claim the REC.

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

> 1. Research with respect to which expenditures may be treated as an expense under section 174;
> 2. [r]esearch which 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*).

1. Qualified Research

The audit report 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 many years and has several long time employees with education/experience in the building design and construction business. The taxpayer designs and constructs new buildings or adds to or re-purposes existing buildings. Per the statements in the [Consultant's] credit study report, the taxpayer must consider customer requirements, the existing building (if applicable), building codes, the availability of utilities, site conditions, construction methods, subcontractor coordination, project schedule and safety. Because of these many variables, the credit study indicates the taxpayer is uncertain of the final building design or optimal construction methods to construct the design.
>
> . . . .
>
> As a design/build construction contractor, the taxpayer may have uncertainty in the final design or construction methods to be used at the outset of the construction project. However, the taxpayer is not discovering information that is technological in nature. The taxpayer is conducting a reasonable investigation of the existing level of information (customer requirements, existing buildings, building codes, existing utilities, site conditions and safety) and makes decisions on how to proceed in completing the project it was contracted to complete. In other words, given a set of facts, the taxpayer's personnel know what to do and how to proceed. 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" as skilled professionals in the design and construction industry.

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 fa[i]l the second test. Based on TD 9104, the taxpayer must be discovering information to eliminate uncertainty and that uncertainty exists 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.

During the audit and protest, Consultant argued that Taxpayer's work qualifies for the REC. Consultant sampled Taxpayer's "qualified" projects and presented two projects during the hearing. One of the projects was built in Michigan, and Taxpayer did not provide any documentation to link the project to work done in Indiana. Throughout the hearing Taxpayer argued that it conducted research during both the design and build of each project. However, for Indiana REC the qualified activities **must** occur in Indiana. Since Taxpayer could not provide clear documentation that linked qualifying activities for the Michigan project to Indiana, the Michigan project is automatically excluded pursuant to IC § 6-3.1-4-1 and will not be further discussed in this decision.

The second design/build project was a project for a major remodeling of a grocery store to convert the space into a pharmacy central floor station. Consultant stated, "Specifically, [Taxpayer] needed to design and install the mechanical and electrical systems for the building including HVAC, plumbing, fire protection, lighting and appropriate power for equipment." When asked what Taxpayer does differently from other businesses in the design/build industry, Taxpayer once again relied upon the definition of uncertainty found in T.D. 9104 and could not explain how these activities qualified under the definition of uncertainty found in T.D. 8930.

2. Documentation

While Taxpayer must meet each part of the four part test it also must properly document each part and be able to document substantiation of the credit amount. Since Taxpayer must provide proof as to its qualification for REC, the Department must first determine whether Taxpayer was able to substantiate the credit with proper documentation. 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.

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 to 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 thereunder. (*Emphasis added*).

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 . . . .

Taxpayer disagrees with the audit's conclusion. As explained by Taxpayer, "The position set forth demonstrates that the Exam Team fails to understand the requirements a taxpayer must meet to substantiate the research credit." Consultant stated 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, Consultant cites to Treas. Reg. § 1.41-4(d) which - according to Consultant - "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.

Consultant goes onto to state that "Treasury regulations explicitly **prohibit** specific documentation requirements for research credits." Consultant further attempts to support its unorthodox statement by asserting 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.'" Consultant 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. Consultant goes onto provide arguments that Congress would have specifically provided for document requirement through legislative enactment.

Consultant is mistaken as to the standard the Department determined Taxpayer did not meet. First, IC § 6-3.1-4-1 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 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 (5th Cir. 2009). Thus, by Indiana's own documentation standards Taxpayer has not properly recorded or documented its substantiation of the REC. Therefore, *regardless of whichever federal regulation applies*, Taxpayer does not meet its burden under IC § 6-8.1-5-1(c) to qualify for the Indiana REC.

However, since Indiana piggybacks off the Federal code and regulations for REC the applicable federal standard will also be examined. As stated in Issue I, Indiana properly follows Treasury Decision 8930. 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. (*Emphasis added*).

Thus, it is not sufficient that Taxpayer only meet the requirements of Section 6001, a taxpayer in Indiana claiming the research and development credit for the years January 1, 2003 through December 31, 2015, must also keep *contemporaneous* documentation. Taxpayer did not keep contemporaneous documentation. Thus under the applicable federal regulation Taxpayer does not meet the requirements to substantiate its REC credit qualification **or** amount.

During the hearing Consultant was requested to provide clear documentation that links "qualified" wages to employees and a time keeping tracker of some kind. Consultant simply provided a two page letter stating that it had already provided sufficient documentation and that the 2001 federal regulations do not apply, and declined to provide any additional, substantive documentation. In addition the letter explicitly stated, "Taxpayer admittedly **cannot show qualification under the 2001 REC regulations** where Taxpayer is required to exceed, expand, or refine the common knowledge of skilled professional in the same field. Fortunately, however, the 2001 REC regulations do not apply to the time period in questions." (**Emphasis added**). Since Consultant could not provide documentation to show that Taxpayer engaged in qualified research, the issue of whether estimates of the credit will not be discussed in this decision. Please see Letter of Findings 01-20170279 and 01-20170288 for the Department's position regarding the use of estimates for qualified research and expense credits.

As stated numerous times by the Department and again in Issue I, the 2001 federal regulations apply for tax years 2003 through 2015. *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. Thus, by Department precedent, until tax year 2016, Indiana follows the 2001 federal regulations.

Taxpayer did not provide documentation in a usable form nor detailed form to substantiate the REC. As stated above, Consultant was asked to provide clear documentation that links "qualified" wages to employees and a time keeping tracker of any kind under law applicable to the tax years at issue, and Taxpayer provided no such evidence. Thus, Taxpayer cannot substantiate its claimed credit and therefore has not met the burden under IC § 6-8.1-5-1(c). 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. Furthermore, as stated above, Taxpayer does not qualify for REC, "Taxpayer admittedly **cannot show qualification under the 2001 REC regulations** . . . ." Thus, the Department denies Taxpayer's protest.

FINDING

Taxpayer's protest with respect to the documentation issue is denied.

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, or that Taxpayer documented to what extent it could claim the RECs based on wages paid to its employees.

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