DEPARTMENT OF STATE REVENUE

01-20171140.SLOF
01-20171141.SLOF

Supplemental Letter of Findings: 01-20171140; 01-20171141
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 This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register.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 Supplemental Letter of Findings.

HOLDING

The Department, on rehearing, continued to disagree with Indiana Swimming Pool Consultant that it was entitled to claim research and expense credits associated with the development of Consultant's swimming pools and water features; the Department held that it has consistently and correctly applied the "Discovery Test" in determining whether Indiana taxpayers were entitled to the credits and that Consultant had failed to provide the contemporaneous documentation necessary to verify its claim to the disputed credits.

ISSUE

I. Individual Income Tax - Research and Expense Credits.

Authority: IC § 6-3-1-3.5(b); IC § 6-3-2-1(b); IC § 6-3.1-4-1 *et seq.*; IC § 6-3.1-4-1 (2003); IC § 6-3.1-4-4; IC § 6-8.1-5-1(c); IC § 6-8.1-5-4(a); 26 U.S.C. § 41(d)(1); 26 U.S.C. § 41(d)(1)(A); 26 U.S.C. § 41(d)(1)(B)(i); 26 U.S.C. § 41(d)(1)(B)(ii); Treas. Reg. § 1.41-4; Treas. Reg. 1.41-4(a)(3)(i) (T.D. 8930); Treas. Reg. § 1.41-4(d); Treas. Reg. § 6001-1; *IDOPCP, Inc. v. Comm'r*, 503 U.S. 79 (1992); *Dep't of State Revenue v. Caterpillar, Inc.*, 15 N.E.3d 579 (Ind. 2014); *Indiana Dep't of Revenue v. Miller Brewing Co*., 975 N.E.2d 800 (Ind. 2012); *Indiana Dep't of State Revenue v. Rent-A-Center East, Inc.*, 963 N.E.2d 463 (Ind. 2012); *Chrysler Grp., LLC v. Review Bd. of Ind. Dep't of Workforce Dev*., 960 N.E.2d 118 (Ind. 2012); *Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue*, 867 N.E.2d 289 (Ind. Tax Ct. 2007); *Stump v. Ind. Dep't of State Revenue*, 777 N.E.2d 799 (Ind. Tax Ct. 2002); *Indiana Dep't of State Revenue, Sales Tax Division v. RCA Corp.*, 310 N.E.2d 96 (Ind. Ct. App. 1974); *Suder v. Commissioner of Internal Revenue*, T.C. Memo. 2014-201 (T.C. October 1, 2014); Letter of Findings 01-20150385 (December 12, 2017); 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 02-20140326 (October 30, 2015); Letter of Findings 01-20110213 (October 4, 2011); *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 denying research and expense credits claimed by the company of which they were shareholder/owners and that the previous Letter of Findings misapplied the relevant statute, regulations, and legal analysis.

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 Supplemental 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' individual 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 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. A Letter of Findings (01-20170288 and 01-20170279) was issued October 6, 2017. The Letters of Findings concluded as follows:

> 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.

Taxpayer disagreed with the Letter of Findings and requested a rehearing. The Department granted the Taxpayer's request. A rehearing was conducted during which Taxpayer's representatives explained the basis for the renewed protest. This Supplemental Letter of Findings results.

I. Individual Income Tax - Research and Expense Credits.

DISCUSSION

Taxpayer continued to disagree with the Department on two major issues. The Taxpayer disagreed with Department on the applicability of the "Discovery Test." In effect, the Department held that the Research and Expense Credits are attributable to qualified research "undertaken for the purposes of *discovering information* which is technological in nature." The Taxpayer also disagreed with the Department's conclusion that Taxpayer had not provided documentation establishing the extent to which its employees conducted qualifying research activities.

A. Disputed "Discovery" Test Issue.

Taxpayer argued that the RECs should have been gauged under a less restrictive "Uncertainty Test" in which qualified research is conducted "to eliminate uncertainty concerning the development or improvement of a business component."

The Department concluded that qualified RECs are measured under the "Discovery Test" and that the "Uncertainty Test" is a successor standard not adopted by Indiana during the period of time during which Taxpayer incurred the wage expenses at issue.

The two conflicting interpretations are explained in the original October 6 Letter of Findings:

> 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."

Taxpayer argues that the Department's reliance on the relevance and applicability of the Discovery Test is "untenable," unsupported by the law, and that the Department has "historically" relied upon and applied the Uncertainty Test. Taxpayer asserts that the Department has flip-flopped on this issue having previously relied on the now sought-after Uncertainty Test but has since abruptly reversed its historic position. According to Taxpayer, such a reversal by the Department requires formal notice and that such notice was not provided Taxpayer or other affected Indiana taxpayers.

B. Disputed "Documentation" Issue.

The second issue - regardless of the "test" involved - was whether Taxpayer adequately documented the wage expenses which formed the basis for the claimed RECs. In other words, did Taxpayer provide information which substantiated the amount of RECs it believed it was entitled to?

Taxpayer argued that it adequately documented the claimed wage expenses. In support of that conclusion, Taxpayer pointed to the "Tax Credit Study" prepared by its own tax consultants which purportedly provided verification of the wage expenses. Although Taxpayer admitted that it had no specific, contemporaneous records documenting the wage expenses, Taxpayer cited its Tax Credit Study which sampled the available records to determine the extent to which each employee was involved in the various projects. As explained by Taxpayer in the original Letter of Findings:

> 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."

The October 6 Letter of Findings ("LOF") did not agree that the Tax Credit Study was sufficient to document the claimed expenses.

> 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).

C. Taxpayer's Burden of Proof.

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

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

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

(**Emphasis added**) (Internal citation omitted).

D. Research Expense Credit Statement of Law.

Taxpayer filed amended returns for the years at issue claiming the now disputed tax credits. In determining whether a taxpayer is entitled to claim any tax credit, the Department bears in mind the responsibility the law imposes on the protestant establishing its entitlement to that credit. "Tax credits are a matter of legislative grace, and taxpayers bear the burden of proving they are entitled to claim tax credits." *IDOPCP, Inc. v. Comm'r*, 503 U.S. 79, 84 (1992). Moreover, where such a credit is claimed, "the party claiming the same must show a case, by sufficient evidence, which is clearly within the **exact letter of the law**." *Indiana Dep't of State Revenue, Sales Tax Division v. RCA Corp.*, 310 N.E.2d 96, 100-01 (Ind. Ct. App. 1974) (**Emphasis added**). Thus, Taxpayer's claims

against any tax must be supported by records necessary to substantiate the claimed credits.

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

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

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

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

> (d) Qualified research defined.-For purposes of this section-
> (1) In general.-The term "qualified research" means research-
> (A) with respect to which expenditures may be treated as expenses under section 174,
> (B) which is undertaken for the purpose of discovering information-
> (i) which is technological in nature, and-
> (ii) the application of which is intended to be useful in the development of a new or improved business component of the taxpayer, and
> (C) substantially all of the activities of which constitute elements of a process of experimentation for a purpose described in paragraph.

26 U.S.C. § 41(d)(1).

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

E. Taxpayer's "Uncertainty" Test Argument.

In support of its position that it research projects should be measured under the Uncertainty Test, Taxpayer cites to Supplemental Letter of Findings 02-20140326 (October 30, 2015), 20151230 Ind. Reg. 045150436NRA.

The issue in the 2015 protest was whether taxpayer was entitled to claim RECs based on expenses incurred in overcoming the "uncertainty" involved in developing the taxpayer's cryogenic storage and transfer products. The Department's audit found that taxpayer was not entitled to the RECs. As explained in the October 2015 LOF, "Specifically, the supplemental audit found that Taxpayer's projects were adaptation of existing business components, were tailored to specific requests/orders of its customers, and were conducted outside of Indiana." In other words, the taxpayer's activities did not implicate the "discover[] of information that [was] technological in nature." *Id.* § 41(d)(1)(B)(i).

However, Taxpayer points to the statement of law cited in the October 2015 LOF. As explained by Taxpayer in its rehearing request, "IDOR recites the rule of law it applies regarding Qualified Research. There IDOR expressly cites to Treasury Regulation 1.41 and states the rule of law is:"

> (a) Qualified research–
>
> (3) Undertaken for the purpose of discovering information–

> (ii) Application of the discovering information requirement. A determination that research is undertaken for the purpose of discovering information that is technological in nature **does not require the taxpayer be seeking 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 emphasis**).

Taxpayer explains:

> [I]n this LOF, IDOR expressly applies a rule of law that is in complete contradiction of the Discovery Test. Indeed, the law IDOR applies (T.D. 9104) specifically tracks the language of the Discovery Test and wholly rejects it. Accordingly, it is clear IDOR did not apply the Discovery Test in this [October 2015] LOF precisely as argued by Taxpayer.

Taxpayer accurately quotes the October 2015 LOF, but the authority on which it relies is incorrect because the October 2015 erred when it quoted T.D. 9104.

The 2001 Final Regulations - on which the Department has consistently relied - 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.

As explained in the October 6, 2017 LOF first addressing Taxpayer's original protest, the Department, in its published decisions on that matter, has not changed its position on the issue.

> The Department is unable to agree with Taxpayer that the Department has been anything other than transparent and consistent on the [Discovery Test] 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.

See also Letter of Findings 01-20150385 (December 12, 2017), 201705531 Ind. Reg. 045170228.

To be absolutely clear on the matter, the Department erred when it quoted T.D. 9104 in the October 2015 LOF. However, the *analysis* contained in the October 2015 LOF comported fully with the Department's stance on the matter. As explained in the October LOF, the rule is found in Indiana law, IC § 6-3.1-4-4, and the regulations then in effect:

> IC § 6-3.1-4-4 in relevant part references, I.R.C. § 41 "as in effect on **January 1, 2001**, and the regulations promulgated in respect to those provisions and **in effect on January 1, 2001**, are applicable to the interpretation and administration by the department of the credit provided by this chapter, including the allocation and pass through of the credit to various taxpayers and the transitional rules for determination of the base period."

(**Emphasis in original**).

The Department does not accept Taxpayer's argument that analysis of the law or conclusions based on that law should be driven by what is essentially a clerical error in drafting the October 2015 LOF.

F. Taxpayer's "Documentation" Argument.

Taxpayer also cites to *Suder v. Commissioner of Internal Revenue*, T.C. Memo. 2014-201 (T.C. October 1, 2014) as supporting its position that it has provided information sufficient to establish that it was entitled to the RECs. Taxpayer explains:

> On October 1, 2014, the U.S. Tax Court provided additional insight into the kind of evidence that would be allowed in establishing a reasonable basis for estimating the expenses associated with qualified research expenses. It determined that a single witness could provide that basis. In doing so, the Tax Court noted that the witness had spent several years observing and working along [tax consultant] preparing [research and development] studies.

Taxpayer concluded that "taxpayers are not required to substantiate by specific records or by specific evidence corroborating the taxpayer's own statement of the amount of such expenses."

The original October 6 Letter of Findings disagreed with Taxpayer's assertion that it provided evidence sufficient to substantiate its entitlement to the claimed credits. The LOF cited to Treas. Reg. § 6001-1 which provides as follows:

> 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.

In addition, the LOF cited to Indiana's own record keeping requirements found at IC § 6-8.1-5-4(a):

> 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.

The LOF rejected Taxpayer's argument that the record-keeping requirements "should be broadly read" and reiterated the Department's own stance on the issue.

> 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).

In applying that standard, the Department rejected Taxpayer's "Tax Credit Study" was sufficient to establish an entitled to the RECs concluding that:

> 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).

The cited regulation, Treas. Reg. 1.41-4(d), provides:

> 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.

(*Emphasis added*).

In this Supplemental Letter of Findings, the Department reiterates its stance on the issue of "estimates." In determining the extent to which a taxpayer is entitled to claim RECs, a taxpayer is entitled to rely on estimates

which are based on quantifiable, contemporaneous documents prepared either before or during the time the research was conducted. In doing so it points to the IRS's own guidance on the matter. As set out in the original October 6 Letter of Findings:

> 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." *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).

In the face of the Treasury regulation, the Indiana statutes, and Indiana's case law on the topic, Taxpayer concludes that the Department should defer to the standard set out in *Suder* and accept the conclusions contained within its "Tax Credit Study." The Department must decline Taxpayer's invitation to do so and reminds Taxpayer that, in interpreting Indiana tax law, courts are required to defer to the judgment of the Indiana Department of Revenue and is not required to defer to the interpretation of the Federal Tax Court. *Caterpillar, Inc.*, 15 N.E.3d at 583. (In considering a statute that an agency is "charged with enforcing . . . we defer to the agency's reasonable interpretation of [the] statute even over an equally reasonable interpretation by another party."); See also *Chrysler Grp., LLC v. Review Bd. of Ind. Dep't of Workforce Dev*., 960 N.E.2d 118, 124 (Ind. 2012); *Stump v. Ind. Dep't of State Revenue*, 777 N.E.2d 799, 802 (Ind. Tax Ct. 2002).

Clearly - as set out in this Supplemental Letter of Findings and in numerous previous Letters of Finding - Indiana's REC statute and Indiana's application of the credit does not fully parallel the federal standard which therefore places on the Department the responsibility of interpreting and administering that Indiana credit. The Department concludes that its position on the matter is fully supported by the Indiana REC statute, the federal regulations in effect at the time Indiana implemented the credit statute, and by Indiana case law. The Department stands by its conclusion in the original October 6 Letter of Findings.

FINDING

Taxpayer's protest is respectfully denied.

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