

## DEPARTMENT OF STATE REVENUE

01-20171187.LOF; 01-20171188.LOF

01-20171189.LOF; 01-20171190.LOF

**Letter of Findings: 01-20171187; 01-20171188; 01-20171189; 01-20171190**  
**Individual Income Tax**  
**For the Years 2013, 2014, and 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 This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register.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**

General Building Contractor failed to establish that it was entitled to rely on the "Uncertainty Test" in evaluating whether Contractor was entitled to claim research and expense credits; under either the "Uncertainty Test" or the "Discovery Test," Contractor failed to establish that it was entitled to credits for expenses attributable to the construction of commercial buildings.

**ISSUES****I. Adjusted Gross Income Tax - Research Expense 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(c); IC § 6-8.1-5-4(a); *New Colonial Ice Co. v. Helvering*, 292 U.S. 435 (1934); *United States v. McFerrin*, 570 F.3d 672 (5<sup>th</sup> Cir. 2009); *Stinson Estate v. United States*, 214 F.3d 846 (7<sup>th</sup> Cir. 2000); *United Stationers, Inc. v. U.S.*, 163 F.3d 440 (7<sup>th</sup> 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 01-20170279; 01-20170288 (October 6, 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).

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 § 6-3-1-3.5(b); IC § 6-3.1-4-1; IC § 6-3.1-4-2(a); IC § 6-8.1-5-1(c); IC § 6-8.1-5-4(a); *IDOPCP, Inc. v. Comm'r*, 503 U.S. 79 (1992); *Suder v. Commissioner of Internal Revenue*, T.C.M. (CCH) 354 (T.C. 2014); *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. § 41(d)(a); I.R.C. § 41(d)(1)(A); I.R.C. § 41(d)(1)(B)(i); I.R.C. § 41(d)(1)(B)(ii); I.R.C. § 41(d)(1)(C); Treas. Reg. § 1.41-4(d) (TD 8930); Treas. Reg. § 1.174-2(a); Treas. Reg. § 6001-1.

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 general contractor and construction management company. The company constructs food processing, warehouse, distribution, manufacturing, retail, medical, and other institutional buildings.

For simplicity's sake, this Letter of Findings will hereinafter designate "Taxpayer" as the general contractor 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 Taxpayer's original returns claimed approximately \$1,100,000 in qualified research expenses ("QREs") during the three years under audit entitling Taxpayer to claim approximately \$71,000 in research expense tax credits ("RECs").

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 Regulations.**

### **DISCUSSION**

The overarching issue in this Letter of Findings is whether the Department erred in denying Taxpayer's credits for increasing research expenses. In this portion of the Letter of Findings, the question is whether Indiana's version of the Research Expense Credit imposes the T.D. 8930 "Discovery Test" or the less restrictive T.D. 9104 "Uncertainty Test"?

The Department determined that Taxpayer had mistakenly relied on regulations published in Treasury Decision 9104 (T.D. 9104, 69 F.R. 22-01, 2004 WL 18938) in calculating its claimed Indiana research expense credits. The Department found that the federal requirements in T.D. 9104 were not promulgated and were not in effect until well over eleven months after the Indiana General Assembly 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 on each taxpayer 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, 2014 and 2015, Taxpayer claimed approximately \$1,100,000 in qualifying research expenses ("QREs") entitling it to approximately \$71,000 in Indiana Research Expense Tax Credits. (The 2012 QREs were "carried-forward" to the three years under audit). The audit reviewed the basis for claiming the expenses to determine whether Taxpayer incurred the \$1,100,000 in expenses under circumstances called for by the law and whether it was entitled to the resulting \$71,000 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 and after January 1, 2016. Of course, this recoupling did not take effect until well after the years under consideration here; in other words, the audit found that the "discovery test" was in effect from the date Indiana adopted IC § 6-3.1-4-4 until and including December 31, 2015.

## **B. Taxpayer's Response.**

Taxpayer argues that the assessment results from "a misapplication of the law." Taxpayer explains that TD 8930 (the "Discovery Test") was not in effect and that the regulations in effect at the time the Indiana General Assembly promulgated IC § 6-3.1-4-1 (Indiana's Research and Expense Credit), were the regulations in effect January 1, 2001.

As a result of this misapplication of the Discovery Test according to Taxpayer, the "IDOR erroneously analyzed Taxpayer's research activities through the lens of TD 8930."

## **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 (7<sup>th</sup> Cir. 2000).

The taxpayer who claims the tax credit is required to retain records necessary to substantiate a claimed credit. 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). (See also IC § 6-8.1-5-4(a) which requires that taxpayers *keep* records). 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<sup>th</sup> 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.")

### **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*).

(*Emphasis added*).

### **3. Indiana 2001 Regulations.**

The issue is which regulations were in effect at the time the Indiana General Assembly 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 incorporate 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, and that 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 2013 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 (7<sup>th</sup> 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 federal Seventh Circuit Court of Appeals' 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 General Assembly would have presumably 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.

The Department is unable to agree with Taxpayer that the Department has been anything other than transparent and consistent on the issue. The Department has staked out its position repeatedly and in detail which will not be repeated here. *See* Letter of Findings 01-20170279; 01-20170288 (October 6, 2017); 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. Reg. 045170090NRA; Letter of Findings 02-20130676 (January 16, 2015); Letter of Findings 02-20140326 (October 30, 2015); Letter of Findings 01-20110213 (October 4, 2011).

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

## FINDING

Taxpayer's protest is respectfully denied.

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

### DISCUSSION

Taxpayer argues that under either the Discovery or Uncertainty Test, its construction activities qualify it for the credit and that it can document the amount of credit that it claimed.

#### A. Department's Audit Examination.

##### 1. Qualifying Research Projects.

The Department's audit concluded that there was no evidence "to validate [T]axpayer's claim that qualified research activities are being performed on any of the [T]axpayer's jobs throughout the audit period." Moreover, the audit report notes any credit proposal by a contractor - engaged in activities for its construction clients - "would be specifically excludable or limited under I.R.C. 174 of the Internal Revenue Code." Specifically, the audit cited to Treas. Reg. § 1.174-2(a) which provides in relevant part:

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

(*Emphasis added*).

The audit explained that "[w]hen a taxpayer incurs expenses in building a product and not in developing the concept of a product, these are disallowed cost of goods sold expenses."

The audit concluded that Taxpayer erred in relying on the "uncertainty test" and that under correct application of the regulation in effect at the time Taxpayer conducted these activities - TD 8930 - Taxpayer's claim failed because it was not conducting research "for the purpose of discovering information . . . that exceeds, expands, the common knowledge of skilled professionals in a particular field of science or engineering."

In Taxpayer's case:

The [T]axpayer has been in business since 1972, provides design-build, general contracting, and construction management services, and utilizes the experience of its employees to provide new construction, renovation and maintenance services to a variety of industries. The [T]axpayer has a broad range of experience with a professional staff that has many decades in building design and construction.

Rather than "discovering" information that expands the "common knowledge" of construction companies, the audit found that Taxpayer was "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."

The audit concluded that Taxpayer's activities did not "overcome the 4-part test" required under I.R.C. § 41(d) which defines "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*).

## **2. Wage Expense Documentation.**

The Department's audit found that Taxpayer was also unable to substantiate the amount of credits attributable to experimental wages and labor costs. Taxpayer admitted that it "did not have a project accounting system that allows it to track qualified research by business component" but argues the record keeping requirements should be liberally construed and that its method of estimating these costs was reasonably accurate under the circumstances. However, the Department's audit rejected Taxpayer's argument that the record keeping requirements should be broadly construed, the Department's audit report 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.

The report also cited to Treas. Reg. § 1.41-4(d) (TD 8930) which sets out record keeping and documentation requirement for expenses related to the research credit:

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 addition, the audit report 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 Department concluded that even if Taxpayer had conducted qualifying research activities, it had not developed, maintained, or presented records necessary to substantiate those activities.

## **B. Taxpayer's Response.**

### **1. Qualifying Research Projects.**

Taxpayer states that it undertakes building projects and that the expenses associated with those projects qualify for the REC. For example, Taxpayer undertook to build a milk processing facility which required Taxpayer to conduct experimentation and research. Taxpayer states that it "encountered significant uncertainties" relating to the following issues all of which required Taxpayer's experimentation:

- Determining the final design of the building;
- Examining the site conditions associated with the proposed building site;
- Coordinating the construction of the building with the activities taking place at the client's existing, nearby facility;
- Assuring that the building met the client's security concerns;
- Implementing a new conveyor system between the new building and the client's existing facility;
- Identifying and implementing the "proper layout of the [new] facility."

In addition, Taxpayer states that it encountered difficulties in the original foundation design, location of the existing utilities, and whether to use metal or concrete walls. In addition, Taxpayer encountered difficulties addressing the safety requirements inherent in the manufacture of a food product fit for human consumption.

As a second example, Taxpayer points to its construction of an office expansion for another client. As Taxpayer explains:

Taxpayer provided all of the structural and civil engineer services necessary to provide an office space ready for occupancy and capable of functioning for its intended purpose.

In constructing the office expansion, Taxpayer states that it undertook "experimentation to meet project requirements." Taxpayer explains that it experimented with building design, safety requirements, site conditions, and "functional performance specifications." Taxpayer states that it also addressed "uncertainties" with the existing office structure. For example, Taxpayer faced "uncertainties" involving the thickness of the existing office floor and the floor of the proposed expansion and that reconciling the differences in floor thickness required Taxpayer to conduct research and experimentation.

As yet another example, Taxpayer faced uncertainties in the construction of a "tool rack" building. Taxpayer was engaged to convert this warehouse space into a combination manufacturing facility and office space. Taxpayer explains that this project required it to "create three distinct spaces" in an existing facility and "upgrade the entire facility to increase functionality and comply with federal standards." For example, Taxpayer states that was required to strengthen structural columns in order to assure the facility's structural stability and that it was required to reroute utility services all of which required Taxpayer to conduct research and experimentation.

## **2. Wage Expense Documentation.**

Although Taxpayer admits that it did not maintain contemporaneous records of its wage expenses, Taxpayer states that the Department's audit erred in finding that Taxpayer lacked the records necessary to substantiate these expenses. Taxpayer states that neither federal nor Indiana law "contain any specific requirement that a taxpayer capture the costs of its research under a certain approach" and that its method of conducting after-the-fact employee interview and preparing surveys are sufficient to validate its claim.

Taxpayer points out that various courts have affirmed "the use of estimates to quantify expenses associated with qualified research activities." For example, Taxpayer cites to *Suder v. Commissioner of Internal Revenue*, T.C.M. (CCH) 354 (T.C. 2014). Taxpayer explains its reliance:

[In *Suder*] the Tax Court found that [] one individual's testimony, taking into account his institutional knowledge of the company's employees and their respective activities, constituted a reasonable basis to estimate all qualified employee wage expenses.

Taxpayer states that it reviewed its "contemporaneous documentation" and conducted various employee interviews to determine whether it had conducted qualifying research and to determine the amount of expense credits to which it was entitled. Taxpayer states that its estimates - employee allocation percentages and time spent on qualified research activities - were "extremely conservative."

## **C. Analysis and Conclusion.**

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).

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.

I.R.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).

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 to address the routine uncertainties confronted in the construction of commercial buildings 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. The Department is unable to agree that Taxpayer has established that its design and implementation of commercial buildings projects lead to the discovery and deployment of improved methods of constructing buildings when then became part of the body of common knowledge of other skilled electrical contractors.

In addition, there is nothing in the various construction 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's 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." Certainly Taxpayer faced difficulties in constructing its clients' buildings but there is nothing to establish that Taxpayer's resolution of those "difficulties" resulted in a "new or improved business component" or developed "information which [was] technological in nature." The Department does not agree that Taxpayer has established that its design and construction of commercial buildings projects led to the discovery and deployment of improved construction techniques which thereafter became part of the body of common knowledge of other construction companies.

Setting aside issues related to whether Taxpayer was engaged in qualified research, Taxpayer disagrees with the audit's finding that Taxpayer failed to adequately document its employees' specific activities related to those projects. Taxpayer admitted that it did not maintain a system of project accounting in order to quantify the company's research expenses accurately but instead relied on interviews and estimates to substantiate the amount of qualified research activities it incurred. While the Department recognizes Taxpayer's efforts to estimate the qualifying wages of its employees, the Department rejects Taxpayer's argument that it is "barred from demanding specific documentations" and the law forbids "stringent documentation requirements." Instead, the Department finds the law on this issue clear.

Treas. Reg. § 1.41-4(d) (TD 8930) sets out the record keeping and documentation requirement for expenses related to the research credit:

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.

Indiana provides its own record keeping requirements.

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).

It is 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. Treas. Reg. § 1.41-4(d) (TD 8930).

Indiana case law speaks to the issue of the documentation required to establish one's entitlement to credits such as that sought by Taxpayer. "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, every taxpayer's claims against any tax must be supported by records necessary to substantiate the claimed credits and those records are required to be "kept" "before or during the early stages of the research project"

The Department acknowledges Taxpayer's conscientious and detailed efforts to verify and quantify its original wage expenses but must decline Taxpayer's invitation to defer to the cited authorities' standard typified in the *Suder* decision and wholeheartedly accept Taxpayer's expense analysis without the "sufficient and credible documentary evidence to support the estimated percentages" provided during that case. *Suder*, T.C. Memo. 2014-201 at 22. As it has in previous administrative decisions on this issue, Taxpayer is reminded that 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.

#### FINDING

Taxpayer's protest is respectfully denied.

#### SUMMARY

The Department finds that Taxpayer's activities did not result in the discovery of new and improved methods of constructing buildings, that it was not engaged in qualified research entitling it to the research and expense credit, and that any claim to credits required the claimant to maintain relevant documentation before or during the early stages of it qualifying activities.

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