DEPARTMENT OF STATE REVENUE

01-20180753.LOF

Letter of Findings: 01-20180753
Individual Income Tax
For the Years 2012, 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 This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register.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

HVAC 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," HVAC Contractor failed to establish that it was entitled to credits for expenses attributable to the development, construction, and installation of commercial grade heating and cooling systems because HVAC Contractor's research did not expand the common knowledge of other HVAC contractors.

ISSUE

I. Individual Income Tax - Qualified Research Expenses.

Authority: IC § 6-3.1-4-1; IC § 6-3-1-3.5(b); 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); *IDOPCP, Inc. v. Comm'r*, 503 U.S. 79 (1992); *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); *Suder v. Commissioner of Internal Revenue*, T.C. Memo. 2014-201 (T.C. 2014); *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); I.R.C. § 41(d)(2); 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); I.R.C. § 62; Treas. Reg. § 1.41-4(d) (TD 8930); Treas. Reg. § 1.41-4(d); Letter of Findings 01-20171187; 01-20171188; 01-20171189; 01-20171190 (May 1, 2018); 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).

Taxpayer argues that the Department erred in disallowing research and expense credits attributable to projects engaged in by the company of which he was the sole shareholder.

STATEMENT OF FACTS

Taxpayer is the sole shareholder of an Indiana company in the business of installing industrial, educational, governmental, and retail mechanical building systems. Specifically, the company designs, builds, and installs heating and air conditioning ("HVAC") systems including the sheet metal ductwork associated with those systems.

The company engaged a consulting firm to review the company's 2012, 2013, and 2014 business activities and prepare a report summarizing those activities. In a report issued 2016, the consulting firm concluded that the company conducted qualified research activities entitling it to claim Indiana research expense tax credits which in turn passed on to the shareholder and reduced his own income tax liability. As a result, the company submitted amended 2012, 2013, and 2014 Indiana income tax returns claiming income tax credits. The company also claimed credits on its 2015 income tax return.

Taxpayer - as the sole shareholder of the S Corporation - reported the "flow-through" credits on his amended individual income tax returns. As a result of the amended tax returns, the Indiana Department of Revenue ("Department") issued Taxpayer income tax refund checks.

The Department thereafter conducted an income tax audit of the company. The audit resulted in a decision denying all the company's originally claimed research credits along with the credits which had "flowed through"

and been claimed on Taxpayer's individual returns. On the ground that it had erroneously issued Taxpayer the original refund checks, the Department assessed Taxpayer additional income tax.

Taxpayer disagreed with the Department's decision disallowing the credits and the assessment. Taxpayer 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. Individual Income Tax - Qualified Research Expenses.

DISCUSSION

The issue is whether Taxpayer's company conducted qualifying research activities and whether it can document the extent to which the company conducted those activities.

A. Department's Audit Examination.

1. Qualifying Research Projects.

During the years 2012, 2013, 2014 and 2015, Taxpayer's company claimed approximately $2,000,000 in qualifying research expenses ("QREs") entitling it to approximately $120,000 in Indiana Research Expense Tax Credits.

The Department's audit concluded that the company'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*).

The audit report noted that Taxpayer claimed the QRE costs as "either wages and/or costs of goods sold and not as research and development costs on their income tax returns." In addition, the audit report pointed out that Taxpayer claimed the costs as "ordinary and necessary business expenses" under I.R.C. § 162.

The audit concluded that the claimed expenses did not qualify for the credits because Taxpayer was "not discovering information that is technological in nature" but was simply "conducting a reasonable investigation of the existing level of information" such as each customer's building requirements, building codes, existing utility services, site location conditions all of which led to decisions on how best to complete each HVAC projection. The audit report summarizes:

> The information being gathered is considered common knowledge of a skilled professional and is not considered qualified research.

Anticipating Taxpayer's objection as to which regulatory regime was relevant in determining Taxpayer's qualification for the credit, the audit report found that under either regime, Taxpayer's pre-construction activities did not rise to the level of "qualified research." As such, the audit concluded that Taxpayer fell short of the second I.R.C. § 41(d) test; "research undertaken for the purpose of discovering information which is technological in nature."

> [T]axpayer's activities are not qualified research under either version of the regulation . . . . [because] both the customer and [T]axpayer know that the [T]axpayer has the education/experience to prepare the appropriate design based on customer requirements and site conditions when they [initially] entered into the contracts.

The Department's audit also found that Taxpayer's activities - on which it based its claim to the research credit - failed the I.R.C. § 41(d) "business component" test. The Department rejected Taxpayer's argument that each individual construction project constituted a "business component" and found that Taxpayer was unable to "tie" the claimed activities to any individual component of an HVAC project. In other words, the audit found that Taxpayer's activities did not lead to the development of a unique "new or improved business component."

The Department's audit found that Taxpayer's claimed activities did not constitute a qualifying "process of experimentation" under I.R.C. § 41(d). The audit found no indication that in constructing and installing the HVAC equipment, Taxpayer evaluated "more than one alternative." The audit report reasoned that Taxpayer had "been in the heating and cooling field a long time and has several long time, educated and experienced employees . . . ." Therefore, Taxpayer was not undertaking an experimental process by which it determined whether or not it could complete the project. Taxpayer's process involved the review of the different avenues under which the project would be completed.

Whether under Treasury Decision 8930 (T.D. 8930, 66 F.R. 280-01), 2001 WL 34028585 (eff. Jan. 3, 2001) incorporating the "discovery test" or under Treasury Decision 9104 (T.D. 9104, 69 F.R. 22-01, 2004 WL 18938) (eff. Jan. 2, 2004) incorporating the less restrictive "uncertainty test," the audit concluded that Taxpayer was not undertaking a "process of experimentation" qualifying it for the credits.

2. Wage Expense Documentation.

The Department's audit concluded that Taxpayer's company did not retain records necessary to substantiate that the company was entitled to credits based on wages paid to the company's employees. The audit report stated that the company claimed credits based upon its own employee interviews.

> The credit study completed by [consulting company] states the employee qualified research participating percentages were estimated based on manager interviews.

The audit rejected the company's reliance on employee interviews:

> [The] use of estimations of employee qualified research participation percentages on post activities management interviews is in conflict with [Treas. Reg. § 1.41-4(d) (TD 8930)].

The cited regulation sets our record keeping and documentation requirements 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*).

The Department concluded that even if Taxpayer's company had conducted qualifying research activities, it had not developed, maintained, or presented records necessary to substantiate those activities before or at the early stages of the experimentation.

B. Taxpayer's Response.

1. Qualifying Research Projects.

Taxpayer states that his company engaged in qualifying research activities during 2012 to 2015. In completing the construction projects, Taxpayer states that the company was required to consider "unique combinations of various factors" necessitating both "research" and "experimentation." For example, the company was required to consider and resolve issues related to:

- The size and intended use of each building;
- Applicable fire protection and energy consumption building codes;
- Site conditions of each building location;
- The optimal size and design of each building's mechanical systems;
- The design and layout of each building's metal ductwork system;
- The integration with existing mechanical systems;

• Installing the mechanical systems while minimizing disruptions to the client's neighbors and the client's own continuing operations.

Taxpayer cites to a specific project to design and construct a heating and air conditioning system for a government building. According to Taxpayer, the company faced uncertainty designing and installing a "variable refrigerant flow system" (VRF). Taxpayer explains:

> This system was a first of its kind for [the company], as neither the architect nor the engineering team had ever designed a VRF system before. VRF systems are typically utilized in Asia, whereas a variable air volume . . . system is customary in America. [Taxpayer's company] performed research as to the VRF system and found that the VRF system varies significantly from the American . . . system.

In another instance, Taxpayer's company was tasked with installing a rooftop heating and air conditioning system. Taxpayer states that the company "faced uncertainty regarding the structural design layout that would withstand the loads of the roof top [HVAC] units and the type of material that would allow for the greatest strength of the [roofing] system."

In yet another instance, Taxpayer's company installed a heating and air conditioning system for an indoor swimming pool. Since the system was destined to be used in the swimming pool's "corrosive atmosphere," the company was required to evaluate alternative materials such as polypropylene coated wire. Taxpayer's company "evaluated alternative layouts of equipment and system components to develop a configuration that met system requirements within the constraints of the specific [swimming pool] site."

Taxpayer concludes that for each of the HVAC projects, Taxpayer undertook a process of "experimenting" utilizing principles of engineering and physics to determine the optimum means by which to achieve each customer's desired outcome. In coming to that conclusion, Taxpayer rejects entirely the Department's reliance on the "discovery" test because the test was "abolished" by T.D. 9104. According to Taxpayer:

> [Qualifying research] need not exceed, expand, or refine the common knowledge of skilled professionals in the field of mechanical system process design.

2. Wage Expense Documentation.

Taxpayer's company did not maintain contemporaneous records of wage expenses associated with its various HVAC construction projects. However, Taxpayer states that the Department's audit erred in finding that the company entirely 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 own method of conducting after-the-fact employee interviews and preparing surveys were sufficient to validate its claim.

In addition, Taxpayer states that the Department's audit failed to properly evaluate the wage expense information provided the Department. According to Taxpayer, the Department "is barred from demanding specific documents, and disallowing [the credits] due to their lack of production."

Taxpayer concludes that he, his company's vice president, and the company's project manager "all gave credible, oral testimony regarding the activities and allocations utilized to calculate the [expenses]." Taxpayer criticizes the Department for not giving the employee testimony the weight it warranted.

C. Burden of Proof, Analysis, and Conclusion.

1. Proving that Taxpayer is Entitled to the Credit.

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 § 6-3.1-4-1 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. 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 (5th Cir. 2009). *See also New Colonial Ice Co. v. Helvering*, 292 US. 435, 440 (1934) ("Whether and to what extent deductions shall be allowed depends upon legislative grace; and only as there is clear provision therefor can any particular deduction be allowed.")

2. The Credit's Regulatory Regime.

At the outset, the Department rejects Taxpayer's argument that T.D. 8521 or T.D. 9104 were in effect for the years at issue. The Department has addressed and repeatedly rejected this foundational issue. The Department has staked out its position in detail which will not be repeated here. *See* Letter of Findings 01-20171187; 01-20171188; 01-20171189; 01-20171190 (May 1, 2018); Letter of Findings 01-20170279; 01-20170288 (October 6, 2017) 20180131 Ind. Reg. 045180014NRA; 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), 20160330 Ind. Reg. 015160108NRA; Letter of Findings 02-20140326 (October 30, 2015), 20151230 Ind. Reg. 045150135NRA; Letter of Findings 01-20110213 (October 4, 2011), 20111228 Ind. Reg. 045110749NRA.

As repeatedly and consistently stated in its decisions on this issue, "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."

3. Indiana's Research and Expense Tax Credit.

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). I.R.C. 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).

4. Analysis and Conclusions.

The Department is unable to agree that Taxpayer has met his statutory burden under IC § 6-8.1-5-1(c) of establishing that the company's 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 the company's design and implementation of commercial grade HVAC projects led to the discovery and deployment of improved methods of developing HVAC technology when thereafter became part of the body of common knowledge of other skilled HVAC 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)(1). 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' building projects 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 the company's design and construction of commercial grade HVAC projects led to the discovery and deployment of improved HVAC technologies which thereafter became part of the body of common knowledge of other HVAC companies.

Setting aside issues related to whether the company was engaged in qualified research, Taxpayer disagrees with the audit's finding that Taxpayer failed to adequately document the company's employees' specific activities related to those projects. Taxpayer admitted that the company 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 the company incurred. While the Department recognizes Taxpayer's efforts to estimate the qualifying wages of its employees, the Department rejects Taxpayer's argument that the Department is "barred from demanding specific documentation" 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. "[A]n income tax deduction is a matter of legislative grace and that the burden of clearly showing the right to the claimed deduction is on the taxpayer." *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**." *RCA Corp.*, 310 N.E.2d at 100-01. (**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 and testimonial evidence to support the estimated percentages" provided during that case. *Suder v. Commissioner of Internal Revenue*, T.C. Memo. 2014-201 (T.C. 2014). 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 do 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.

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