

Supplemental Letter of Findings: 02-20191105
Corporate Income Tax
For the Years 2016 and 2017

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 This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register.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 disagreed with out-of-state Investment Company that it met its burden of establishing that it was entitled to claim a research expense credit on the Investment Company's 2016 and 2017 corporate income tax returns; although there was evidence that Investment Company's claim to the credit represented qualifying research activities, the Investment Company failed to maintain contemporaneous records documenting those activities.

ISSUE

I. Indiana Corporate Income Tax - Research Expense Credit.

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); I.R.C. § 41(d); I.R.C. 41(d)(1)B(i); I.R.C. 41(d)(1)B(ii); I.R.C. § 41(d)(1); I.R.C. § 41(d)(1)(C); I.R.C. § 6001; *New Colonial Ice Co. v. Helvering*, 292 U.S. 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); *Conklin v. Town of Cambridge City*, 58 Ind. 130 (1877); *Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue*, 867 N.E.2d 289 (Ind. Tax Ct. 2007); *Indiana Dep't. of State Revenue, Sales Tax Division v. RCA Corp.*, 310 N.E.2d 96 (Ind. Ct. App. 1974); Treas. Reg. § 1.41-4(d); Treas. Reg. § 1.6001-1; *Indiana Department of Revenue, Indiana Research Expense Credit (2019)*, <https://www.in.gov/dor/files/rec-handbook.pdf>, (last visited August 5, 2019).

Taxpayer argues the Department erred in disallowing research expense credits claimed on Taxpayer's 2016 and 2017 corporate income tax returns.

STATEMENT OF FACTS

Taxpayer is an out-of-state, employee-owned, private equity investment company. Taxpayer filed a 2016 "Indiana S Corporation Income Tax Return" (IT-20S). On the 2016 return, Taxpayer claimed approximately \$18,000 in flow-through research expense credits based on - according to Taxpayer - spending approximately \$360,000 on qualifying research activities. On the 2017 return, Taxpayer claimed approximately \$20,000 in research expense credits based on - according to Taxpayer - spending approximately \$407,000 on qualifying research activities. For both 2016 and 2017, Taxpayer based its claims on qualifying wage - not supply or contract - expenses.

Those research and development expenses were incurred at its leased space at an Indiana "innovation center" in which Taxpayer designed and built custom, automated manufacturing devices.

The Indiana Department of Revenue ("Department") reviewed the returns and disallowed the credits. That disallowance resulted in the issuance of proposed assessments of additional corporate 2016 and 2017 income tax. Taxpayer disagreed with the Department's proposed assessments and submitted a protest to that effect. In its protest submission, Taxpayer asked that the Department render a "final determination without a hearing." After reviewing Taxpayer's original return and its protest submission, Letter of Findings 02-20182449 (May 20, 2019), 20190731 Ind. Reg. 045190353NRA, was issued May 20, 2019. However, the Letter of Findings addressed only the 2016 credit disallowance and failed to address the 2017 disallowance.

Taxpayer disagreed with the May 20 decision and requested and was granted a rehearing. The rehearing was conducted by telephone, and this Supplemental Letter of Findings results.

I. Indiana Corporate Income Tax - Research Expense Credit.

DISCUSSION

The Department disallowed Taxpayer's claimed 2016 and 2017 research expense credit. Taxpayer disagreed claiming that it was entitled to the credits.

The issue is whether Taxpayer has met its statutory burden of establishing that the Department's disallowance of the research and expense credits ("REC") and the subsequent issuance of additional income tax was wrong.

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).

For corporate 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).

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).

In 2016, the General Assembly clarified Indiana's application of the credit in IC § 6-3.1-4-4.

The provisions of Section 41 of the Internal Revenue Code and the regulations promulgated in respect to those provisions 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.

I.R.C. Section 41(d) provides that qualifying research activity must meet four tests:

- (1) Permitted purpose test: The research must intend to be useful in the development of a new or improved business component – I.R.C. 41(d)(1)(B)(ii).
- (2) Technological in nature test: The research be technological in nature – I.R.C. 41(d)(1)(B)(i).
- (3) Technical uncertainty test: The research must intend to eliminate uncertainty concerning the development or improvement of the business component – I.R.C. 41(d)(1)(A).
- (4) Process of experimentation test: The research must substantially involve a process of experimentation – I.R.C. 41(d)(1)(C).

Taxpayer explains that it is entitled to the credit based upon wage expenses incurred in developing several design/build projects.

Taxpayer explained that it designed and built an automated system that would load fiberglass door panels into a customer's assembly line replacing the customer's previous manual process. In developing the system, Taxpayer states that it tested various prototypes including a device that utilized vacuum cups, mechanical grips, and eventually a combination of various numbers of vacuum cups and mechanical grippers. Taxpayer explained it examined various alternatives that would meet the customer's requirements including a five-second cycle time and the necessary stability and precision.

Taxpayer states that its initial configurations failed to meet the customer's requirements. It abandoned an initial robotic system and developed a 3-axis gantry combined with a "lift" that would properly position the gantry into position to install the door panels.

Taxpayer points to a second project involving the development of an automatic pallet dismantling saw. Taxpayer described the scope of the project.

We sought to design and develop an automated system that could secure a pallet, analyze it to determine its composition, and transfer it to a bandsaw to cut the wood pallets apart. Due to the forces required to automate the process, we had to design and develop a larger bandsaw than anything available on the market. Prior to this development, companies would manually cut up pallets and recycle them, which was a time-consuming and dangerous process.

In developing the system, Taxpayer states it faced uncertainty in developing a mechanical system to secure each pallet, determine each pallet's size and composition, and constructing a bandsaw that would withstand the mechanical forces of an automated process. In meeting the customer's requirements, Taxpayer tested differently sized motors, a robotic system to identify the wood, a vacuum gripper system to transport and position each pallet, and a custom designed bandsaw.

As to Taxpayer's record keeping responsibility under Indiana law, the audit cited to this state's own general statutory record keeping requirement found at IC § 6-8.1-5-4(a) which provides:

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.

In addition, under the final regulations, a taxpayer must retain records in sufficiently usable form and detail to substantiate that the expenditures claimed are eligible for the credit. See I.R.C. § 6001; Treas. Reg. § 1.6001-1. The taxpayer must clearly establish full compliance with all of the relevant statutory and regulatory requirements. Failure to maintain records in accordance with these rules is a basis for disallowing the credit.

In Taxpayer's case, it did not maintain records contemporaneous with its claimed qualifying activities. Instead, Taxpayer relied upon the recollections of various personnel garnered by means of employee interviews.

Every 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.")

The Department has addressed the issue in its *Indiana Research Expense Credit Handbook*.

The Internal Revenue Service and Department of Revenue have held that interviewing employees to reconstruct the activities believed to qualify (or not qualify) is insufficient in determining what employees did and whether such expenses qualify for the research credit. Without additional substantiation, research credits

claimed may be adjusted or denied.

Indiana Department of Revenue, Indiana Research Expense Credit Handbook (2019),
<https://www.in.gov/dor/files/rec-handbook.pdf>, (last visited August 5, 2019).

Although Taxpayer has touched on and addressed each of the I.R.C. § 41(d) requirements, the Department does not agree that the after-the-fact employee interviews are sufficient to justify allowing the credits. In particular, Taxpayer failed to maintain contemporaneous source documents and records to substantiate its claimed qualified research expenses as required under the above federal and Indiana laws.

Bearing in mind that a taxpayer claiming the credit must establish that its claim falls "clearly within the exact letter of the law" and that Taxpayer bears the statutory burden under IC § 6-8.1-5-1(c) of establishing that the proposed assessments are "wrong," the Department does not agree that the Taxpayer has demonstrated the denial of the credits was unjustified.

FINDING

Taxpayer's protest is respectfully denied.

August 20, 2019

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An [html](#) version of this document.