

DEPARTMENT OF STATE REVENUE

**Letter(s) of Findings Number(s): 02-20190999; 01-20191000*; 01-20190966;
01-20191001; 01-20191003; 01-20191004; 01-20191005; 01-20191006; 01-20191055
Individual and Corporate Income Tax
For Tax Years 2015-2017**

NOTICE: IC § 6-8.1-3-3.5 and IC § 4-22-7-7 requires 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 This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register.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

Company could not substantiate the amount of its research and expense tax credit. The Department was correct in denying Company's research and expense credits and, in turn, issuing proposed assessments for additional income tax to its Shareholders who claimed the credits on their individual income tax returns.

ISSUE**I. Adjusted Gross Income Tax - Research Expense Tax Credits.**

Authority: IC § 6-3.1; IC § 6-3-1-3.5; IC § 6-3.1-4-1; IC § 6-3.1-4-2; IC § 6-8.1-5-1; IC § 6-8.1-5-4; *IDOPCP, Inc. v. Comm'r*, 503 U.S. 79 (1992); *New Colonial Ice Co. v. Helvering*, 292 U.S. 435 (1934); *Trinity Industries, Inc. v. U.S.*, 757 F.3d 400 (5th Cir. 2014); *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); *Union Carbide Corp. and Subsidiaries, v. C.I.R.*, 97 T.C.M. 1207 (2009); IRC § 41; Treas. Reg. 1.41-4 (TD 8930); Treas. Reg. 1.41-4 (TD 9104); Treas. Reg. 1.41-4; Treas. Reg. § 1.174-2; Letter of Findings 01-20171187, 01-20171188, 01-20171189, 01-20171190 (May 2, 2018); Letter of Findings 01-20170279, 01-20170288 (October 6, 2017) 20180131; 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 12, 2016); Ind. Tax Ct. Rule 7.

Taxpayer protests the disallowance of claimed research expense tax credits.

STATEMENT OF FACTS

An Indiana contractor of water storage tanks and towers (S Corporation, "Company") and eight of its shareholders with Indiana residency ("Shareholders") (collectively "Taxpayer") employed a consulting firm to conduct Research and Development Tax Credit Studies ("Studies") for 2015, 2016, and 2017 ("Tax Years"). These Studies determined that Taxpayer was eligible to claim certain Indiana research tax credits based on several pieces of information, including statements made by the executives of the business, contracts, calculations, schematics, drawings, 3D models, photographs, videos, payroll information, general ledger information, and Federal and State tax returns. Taxpayer's research credit amounts were claimed based upon employee wage expenses and the purchase of "various" supplies. Taxpayer included research expense credits in the Company's Indiana tax returns for the Tax Years based on these Studies. These credits thereby also reduced the tax liability of the Shareholders.

Taxpayer claimed that seven projects qualified for research and expense credits. Each of these projects involve the same goals and uncertainties. Taxpayer was either building or modifying water towers to increase the water pressure. The uncertainty claimed was which design, materials, or process to use in constructing or extending the water towers. For each project, Taxpayer would perform calculations to determine the correct design and materials, draft their design with a CAD program, make modification to the design to fit the customer specifications, and follow the government-mandated build plan to complete the project.

Individual projects included specific requirements that required modifications. Multiple projects required the use of stronger materials and modified support structures to account for the conditions in the local environment. Multiple out-of-state build sites also required modifications to the build process to account for government restrictions and

environmental factors such as moisture. One project required a new air vent to allow for faster water flow.

The Indiana Department of Revenue ("Department") conducted an audit of Taxpayer for the Tax Years and determined that Taxpayer failed to show that it performed qualified research as required to obtain research expense credits. The Department also found that Taxpayer failed to provide sufficient documentation to support their claimed research expense credits. Taxpayer could not provide documents connecting employees or supplies to specific research activities. The Department therefore denied Company's claims for the Indiana research expense tax credits and, as a result, increased the tax liability flow-through for Shareholders.

Taxpayer protested the Department's disallowance of the Indiana research and expense credits. An administrative hearing was conducted during which Taxpayer's representatives at the consulting firm explained the basis for the protest. This Letter of Findings results. Additional facts will be provided as necessary.

I. Corporate Income Tax - Qualified Research Expense Projects and Documentation.

DISCUSSION

The issues are whether Taxpayer conducted qualifying research activities in developing and modifying water towers and whether Taxpayer adequately documented the wage and supply expenses related to these activities.

A. The Department's Audit.

The Department's audit concluded that Taxpayer's designing, constructing, and building of water towers fails each of the four parts of the test under IRC § 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)[;] and
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 constitute elements of a *process of experimentation* for a [qualified purpose.]

(*Emphasis added*).

The audit first explains that IRC § 174 requires the elimination of uncertainty, where uncertainty is defined by Treas. Reg. § 1.174-2(a) as when "information available to the taxpayer does not establish the capability or method for developing or improving the product or the appropriate design of the products." The audit determined that Taxpayer's decades of experience and specialization in constructing, designing, and repairing water storage tanks and towers would eliminate any genuine claim to such uncertainty, as such information would be firmly within the institutional knowledge of the Taxpayer.

Second, the audit points out that Taxpayer attempted to apply Treasury Decision 9104 instead of Treasury Decision 8930 to determine when research is performed for the purpose of discovering information. Under TD 8930, "research is undertaken for the purpose of discovering information only if it is undertaken to obtain knowledge that exceeds, expands, or refined the common knowledge of skilled professionals in a particular field of science or engineering." Treas. Reg. § 1.41-4(a)(3)(i) (TD 8930). Common knowledge of skilled professionals in a particular field of science or engineering is, in turn, defined as "information that should be known to skilled professionals had they performed, before the research in questions is undertaken, a reasonable investigation of the existing level of information in the particular field of science or engineering." Treas. Reg. § 1.41-4(a)(3)(ii) (TD 8930). The audit concludes that any uncertainty Taxpayer experiences in their projects fits within the definition of common knowledge and therefore the activities are not undertaken to discover information. Taxpayer does not attempt to exceed, expand, or refine common knowledge, but instead conducts an investigation to determine the existing levels of information before applying institutional knowledge and expertise to those facts and proceeding with its project.

Next, the audit says that Taxpayer must be able to tie qualified research expenses to a specific business component, which is either new or being improved. When the Department requested documents showing the qualified research expenses and their respective business components, Taxpayer provided an "employee nexus table" that showed which projects different employees worked on, but did not include information about how much time each employee worked on each project. Without this information, Taxpayer cannot identify the business

components on which it intended to use the information they obtained.

Finally, the audit discusses the requirement for a process of experimentation. A process of experimentation requires uncertainty as to "the capability and method for developing or improving the business component" Treas. Reg. § 1.41-4(a)(5) (TD 8930). Taxpayer has been working in its business for many years and is hired for its expertise in constructing and designing water towers. The audit found no uncertainty as to capability or method of completing these projects, meaning Taxpayer was not engaged in a process of experimentation. The Taxpayer also attempted to apply Treasury Decision 9104 instead of Treasury Decision 8930. The audit explains that, even if TD 9104 did apply, Taxpayer still cannot qualify because it did not provide documentation to support the claim of actual experimentation involving multiple designs, evaluations of alternatives, or a trial-and-error methodology.

The Department found that Taxpayer failed to meet any of the four requirements of qualified research. But the Department also found insufficient documentation to substantiate Taxpayer's claimed research expense credit. Even if the audit had found that Taxpayer engaged in qualified research, the expenditures Taxpayer claimed to be eligible were unsupported. Taxpayer did not show how much time each employee worked on qualified research activities or how their supplies were used for this research.

B. Taxpayer's Protest.

In protesting the audit, Taxpayer begins by once again arguing that TD 8930 is not the proper regulation to apply in this situation. But, assuming that TD 8930 is the applicable regulation, Taxpayer believes that the proposed assessments are still improper. TD 8930 does not require the information that is discovered to be wholly new to the world, but merely that it is "exceeding, expanding, or refining the common knowledge of skilled professionals." TD 8930. This expansion of knowledge does not need to be "more than evolutionary." *Id.* Taxpayer argues that they are improving already existing business components incrementally, which they claim is qualified research under TD 8930.

The protest then examines each element of the four part test to refute the audit's findings. Taxpayer first argued that it eliminated uncertainty as defined in section 174 by developing new designs for water towers and the appropriate methods for constructing and implementing new technologies. Taxpayer also highlighted that the audit acknowledged the existence of at least minimal levels of uncertainty that Taxpayer resolved in their projects, which is sufficient to qualify under section 174. Next, Taxpayer argues that the projects were technological in nature because designing and improving water towers requires principles of engineering and physics. The claimed business components being improved are the water towers and the attached water tanks, according to Taxpayer, and the wages for these projects are supported by the "employee nexus chart" showing which employees worked on each of these projects. Although the Taxpayer did not track the amount of time employees worked on each of the various projects, they do not believe this is required to qualify for research expense credits. Finally, Taxpayer argues that its work included a process of experimentation because the type of projects it completed had never been done before. They state that CAD modeling and evaluating design alternatives qualifies them as engaging in a process of experimenting.

On the issue of documentation, Taxpayer provided several hundred pages of new documents that it believes supports the claimed projects to be qualified research. Even so, Taxpayer argues that it is not required to provide written documentation to substantiate their claimed credits because the Department may assess tax using the best information available under IC § 6-8.1-5-1(b). Taxpayer states that the Department has ruled in favor of a taxpayer in the past based on testimony alone.

C. Legal Standards and Analysis.

Tax assessments are *prima facie* evidence that the Department's assessment of tax is presumed correct; for every assessment, 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 research expense credits - "are matters of legislative grace." *Stinson Estate v. United States*, 214 F.3d 846, 848 (7th Cir. 2000).

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 U.S. 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.")

1. The 2015 Research Expense Credit Regulatory Regime.

At the outset, the Department rejects Taxpayer's argument that TD 8930 was not the governing regulatory scheme relevant to the 2015 tax year. The Department has addressed and repeatedly rejected this basic, foundational issue. The Department has time-after-time staked out its position in detail which need not be repeated here. See Letter of Findings 01-20171187, 01-20171188, 01-20171189, 01-20171190 (May 2, 2018), 20180725 Ind. Reg. 045180286NRA; 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 12, 2016), 20170222 Ind. Reg. 045170090NRA.

The Department has historically applied the 2001 final regulations, published under TD 8930 (the "2001 Final Regulations") for the 2015 tax year. Taxpayer's citation to an order in the Indiana Tax Court which relied on legal stipulations in that specific case does not affect the legal standard in this case. See Ind. Tax Ct. Rule 7(F)(6) ("A stipulation and the admissions therein shall be binding and have effect **only in the pending case and not for any other purpose**, and cannot be used against any of the parties thereto in any other case or proceeding.")(Emphasis added).

2. Indiana's Research and Expense Tax Credit.

For income tax purposes, Indiana follows the federal tax scheme with certain state-specific 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 research expense tax credit. In 2015, this statute provided:

"Indiana qualified research expense" means qualified research expense that is incurred for research conducted in Indiana. "Qualified research expense" means qualified research expense (as defined in Section 41(b) of the Internal Revenue Code as in effect on January 1, 2001).

After 2015, IC § 6-3.1-4-1 was modified to apply the current definition of "qualified research expense" from IRC § 41(b). In each case, this provision sets out the four-pronged test for determining whether a taxpayer conducted qualified research. First, the research must have qualified as a business deduction under § 174. See IRC § 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 undertake a "process of experimentation" during substantially all of the research. *Id.* § 41(d)(1)(C).

3. Analysis and Conclusions.

In order for its argument to prevail, Taxpayer's activities must meet the four-part test under IRC § 41(d) and must be substantiated by sufficient documentation to demonstrate the proper amount of research credit.

Although the Department recognizes the expertise required in designing and manufacturing such large and complex structures, Taxpayer has not established that they fundamentally expanded upon the "common knowledge" or the expertise shared by other skilled workers in this field, nor established that they expanded the "existing level of information in [Taxpayer's] field of science or engineering." Treas. Reg. § 1.41-4(a)(3)(ii) (TD 8930). Even assuming Taxpayer was able to show that they were expanding on the common knowledge, they did

not provide any evidence of "a methodical plan involving a series of trials to test a hypothesis, analyze the data, refine the hypothesis, and retest the hypothesis so that it constitutes experimentation in the scientific sense." *Trinity Industries, Inc. v. U.S.*, 757 F.3d 400, 414 (5th Cir. 2014); see also *Union Carbine Corp. and Subsidiaries v. C.I.R.* 97 T.C.M. (CCH) 1207 (Tax Ct. 2009) ("It is not sufficient that the taxpayer use a method of simple trial and error to validate that a process or product change meets the taxpayer's needs.")

In the tax years after 2015, Taxpayer correctly points out that qualified research no longer needs to expand upon the "common knowledge" or expertise shared by other skilled workers in their field. Instead, Treas. Reg. § 1.41(a)(3)(i)(2016) required the following:

For purposes of section 41(d) and this section, research must be undertaken for the purpose of discovering information that is technological in nature. Research is undertaken for the purpose of discovering information if it is intended to eliminate uncertainty concerning the development or improvement of a business component. Uncertainty exists if the information available to the taxpayer does not establish the capability or method for developing or improving the business component, or the appropriate design of the business component.

Taxpayer also fails to meet this standard. It only produced documents showing a single design schematic on each project and calculations confirming that design. No documents show that other designs were attempted, or even considered. Similarly, build plans that explain the process for modifying or building towers never demonstrated uncertainty or experimentation. Taxpayer had built or modified hundreds of water towers before the projects now claimed to include qualifying research. The Department has no reason to believe that the information available to Taxpayer could not establish the capability or method for developing or improving business component, or the appropriate design of the business component. Without any documentation showing failed designs, data from experiments, or any attempts to eliminate uncertainty, Taxpayer cannot show it eliminated uncertainty or that it engaged in a process of experimentation.

Setting aside the issues related to whether Taxpayer engaged in qualified research, Taxpayer disagrees with the audit's finding that it failed to adequately document the specific activities and wages attributable to Taxpayer's projects. Taxpayer acknowledges that the company did not maintain a system of contemporaneous project accounting in order to accurately quantify the company's research expenses. Instead, it relies solely on a chart offering percentages of total time various employees worked on qualified research. This chart was based on interviews with two executive staff members, the contents of which were not provided to the Department. No further information was provided to substantiate the amount of qualified research activities the company incurred.

Treas. Reg. § 1.41-4(d) (TD 8930) sets out the record keeping and documentation requirement for expenses related to the research credit in 2015:

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.

After 2015, Treas. Reg. § 1.41-4(d) required only that records be kept "in sufficiently usable form and detail to substantiate that the expenditures claimed are eligible for the credit". This requirement is similar to Indiana's own record keeping requirements, located at IC § 6-8.1-5-4(a), which state:

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.

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 2015, during which the Taxpayer was subject to stringent and detailed parameters from the IRS to obtain research expense credits. Treas. Reg. § 1.41-4(d) (TD 8930).

Indiana case law also 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.**" *Indiana Dep't. of State Revenue, Sales Tax Division v. RCA Corp.*, 310 N.E.2d at 100-01 (Ind. Ct. App. 1974)(**Emphasis added**). Thus, every taxpayer's claim against any tax must be supported by records necessary to substantiate the claimed credits and, for the 2015 tax year, those records are required to be prepared "before or during the early stages of the research project." Treas. Reg. § 1.41-4(d) (TD 8930).

Regardless of whether Taxpayer's employee wage chart was created contemporaneously, which it does not appear to have been, it is insufficient to verify which components of each project were completed by which employees, and how much of their compensation is attributable to such projects. Taxpayer identifies its business components as the water storage tanks and towers it contracted to build or modify. Contrary to Taxpayer's claim, the business component is not the entire project building or modifying a water tank. The majority of that work was routine; Taxpayer has spent years building or modifying water towers and has developed expertise in that area. Eliminating uncertainty through experimentation could only have occurred on smaller modifications to the tank or its build process. But these particular components on which research could have been completed were not identified by Taxpayer. Moreover, the wages and supplies that could have been attributed to those components were not documented in any way. The wage chart makes no distinction between time spent on the entirety of a build and time spent on research for a component of a build. Even if the Department agreed that some of the work done on these towers qualified as research, which it does not, Taxpayer has failed to substantiate the amount of time and supplies used on the business components within Taxpayer's projects.

To qualify for the claimed research expense tax credit, Taxpayer needed to perform qualified research and retain documentation allowing the Department to calculate the amount of supplies and employee wages attributable to research on each particular business component. Taxpayer failed to demonstrate that it performed qualified research and could not support the amount of wages or supplies used on any of the business components within its water tank projects. Therefore, Taxpayer failed to meet its burden under IC § 6-8.1-5-1(c).

FINDING

Taxpayer's protest is respectfully denied.

December 31, 2019

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