DEPARTMENT OF STATE REVENUE

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Letter of Findings: 02-20190530; 02-20190531; 02-20190532; 02-20190533; 01-20190534; 01-20190535; 01-20190536; 01-20190537
Corporate and Individual Income Tax
For the Years 2013, 2014, and 2015

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HOLDING

Indiana Pole Building Contractor failed to establish that it was entitled to claim Indiana's research expense credits; in reviewing activities which involved the design and construction of the pole buildings, the Department found that Pole Building Contractor did not discover information which was technological in nature or which expanded the common knowledge of other skilled contractors in the pole building business.

ISSUE

I. Corporate and Individual Income Tax - Qualified Research Expenses.

Authority: IC § 6-3.1-4-1; IC § 6-3-1-3.5(b); IC § 6-3-4-6(b); IC § 6-3.1-4-2(a); IC § 6-8.1-5-1(b); IC § 6-8.1-5-1(c); IC § 6-8.1-5-4; 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); *Union Carbine Corp. and Subsidiaries v. C.I.R.* 97 T.C.M. (CCH) 1207 (Tax Ct. 2009); *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); I.R.C. § 41(d); I.R.C. § 41(d)(1); 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. § 41(d)(2); Treas. Reg. § 1.174-2; Treas. Reg. 1.41-4; Treas. Reg. § 1.41-4(a)(3); Treas. Reg. § 1.41-4(a)(3)(i); Treas. Reg. § 1.41-4(a)(3)(ii); Treas. Reg. § 1.41-4(a)(5); 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 2, 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 12, 2016); Ind. Tax Ct. Rules 7(F)(6); *Pole Building*, https://en.wikipedia.org/wiki/Pole_building_framing (last visited May 24, 2019); *Wrapped Aviary Construction* System and Construction Method Thereof, http://www.freepatentsonline.com/y2017/0339925.html.

Taxpayer argues that the Department erred in disallowing research and expense credits attributable to the design and construction of Taxpayer's pole buildings.

STATEMENT OF FACTS

"Taxpayers" consist of related Indiana companies in the business of designing and constructing "pole buildings" along with certain individual shareholder/owners of those companies. For simplicity's sake, this Letter of Findings addresses the activities of the "lead company" which - the Department will assume - was most directly involved in designing and building the pole buildings.

The Indiana Department of Revenue ("Department") audited the "lead company" (hereinafter "Taxpayer") reviewing Taxpayer's income tax returns and business records. In its resulting audit report, the Department described Taxpayer's business as follows:

> [Taxpayer] is a full-service contractor that operates as both a retail merchant selling personal property with installation separately stated and as a service provider that enters into agreements with its customers for a

> single stated price for the addition of tangible personal property to a structure or a facility. [Taxpayer] specializes in primarily pre-engineered post-frame building design, manufacturing and construction of agricultural, livestock, suburban, commercial, and industrial structures.

That audit found that Taxpayer claimed research expense credits on its federal and Indiana income tax returns. The research expense credits were based on a 2013, 2014, and 2015 "Indiana Research & Development Tax Credit" study ("REC Study") prepared by a third-party consulting company ("Consultant"). Based on the results of that study, Taxpayer determined that it incurred approximately $5,000,000 in "qualifying research expenses" (QREs) during 2013, 2014, and 2015. Those QREs were entirely attributable to employee wage expenses.

Taxpayer filed 2013, 2014, and 2015 Indiana corporate income tax returns claiming a total of approximately $400,000 in research and expense credits ("RECs") some of which were apportioned and which then "flowed" through to Taxpayer's related companies and individual shareholders.

The Department's audit found that (1) Taxpayer's activities did not constitute "qualified research" and (2) even if the activities had qualified as "qualified research," Taxpayer had "not provided [] contemporaneous documentation . . . to support the employee research participation percentages that [Taxpayer] used to calculate the [QREs]."

The Department's decision resulted in the denial of the claimed RECs. As to Taxpayer, its related companies, and the individual shareholders, the audit concluded that "denial of the credit affects all members of the controlled group as one taxpayer."

Taxpayer disagreed with the Department's decision denying the REC credits and submitted multiple protests on behalf of itself, the related companies, and the individual shareholders. An administrative hearing was conducted during which Taxpayer's representatives explained the basis for the multiple protests. Because the Department's REC analysis is the underlying and dispositive issue for each of the multiple protests, this Letter of Findings addresses those various protests in this single document.

I. Corporate and Individual Income Tax - Qualified Research Expenses.

DISCUSSION

The issue is whether Taxpayer has established that it conducted qualifying research activities in improving pole building design and construction, whether Taxpayer can document the extent to which it conducted that research, and whether Taxpayer can document the amounts of labor expenses related to its research activities.

This Letter of Findings takes note of - but does not necessarily rely on - the definition of "pole building" found at *Pole Building*, https://en.wikipedia.org/wiki/Pole_building_framing (last visited May 24, 2019) which provides in part:

> "[P]ole building" is a simplified building technique adapted from the labor-intensive traditional timber framing technique. It uses large poles or posts buried in the ground or on a foundation to provide the vertical structural support, along with [horizontal structural members] to provide horizontal support . . . . Pole buildings do not require walls but may be open shelters, such as for farm animals or equipment or for use as picnic shelters . . . . The most common use for pole buildings is storage buildings as it was on [] farms, but [] may be for the storage of automobiles, boats, and RVs along with many other household items that would normally be found in a residential garage, or commercially as the surroundings for a light industry or small corporate offices with attached shops.

A. Department's Audit Examination.

1. Qualifying Research Projects.

During the years 2013, 2014, and 2015, Taxpayer claimed approximately $5,000,000 in qualifying research expenses ("QREs") entitling it to approximately $400,000 in Indiana RECs. Those expenses were solely attributable to employee wage expenses.

The Department's audit concluded that Taxpayer's efforts to improve the design and construction of its pole buildings did not "overcome the 4-part test" provided under I.R.C. § 41(d) which defines "qualified research" as research:

A. [W]ith respect to which expenditures may be treated as an expense under section 174[;]

B. [W]hich is undertaken for the purposes of *discovering information*

(i) which is technological in nature (also known as the Discovery Test)[;] and
(ii) [T]he application of which is intended to be useful in the development of a *new or improved business component* of the taxpayer; and

C. [S]ubstantially all of the activities which constitute elements of a process of experimentation for a [qualified purpose.]

(*Emphasis added*).

At the outset, the Department notes that Taxpayer also claimed the RECs on its 2013 and 2014 *federal* income tax returns. The audit report explains the results:

The [federal] credit was denied for [2013 and 2014] in a report issued [Taxpayer] on 10/12/2016/. In all instances where documentation was requested; including interview notes, project notes, and time tracking reports detailing a specific process of experimentation; documentation was not provided to substantiate any of the qualified research activities claimed by [Taxpayer].

The audit report states that, as a result of the federal decision denying the credits, Indiana law (IC § 6-3-4-6(b)) required Taxpayer to amend its corresponding Indiana returns but that Taxpayer failed to do so. However, Taxpayer *did* file a subsequent 2015 Indiana return again claiming the RECs.

Addressing the Indiana credits, the Department's own audit found that Taxpayer had erroneously based its claim to the credits on the application of "TD 9104 in calculating its Indiana research expense credit on its Indiana income tax returns." According to the audit report:

The regulations that the [T]axpayer has asserted that it has relied on to calculate its credits were not promulgated and in effect until well over eleven months after the statutorily prescribed income in IC [§] 6-3.1-4-4.

The Department's audit then reviewed Taxpayer's third-party REC Consultant Study. The study indicated that Taxpayer "performed several thousand [construction] projects during the audit period." Taxpayer's Consultant explained that Taxpayer engaged in 379 projects which required Taxpayer to engage in qualifying research activity. Consultant "sampled" 379 projects from which the Consultant's statistician chose a sample of 26 projects. As the basis for the credits eventually claimed, the Consultant then selected 21 projects which, according to the Consultant, required process improvements entitling Taxpayer to the claimed credits.

In turn, the Department's own audit reviewed project details for 5 of the 21 sampled pole building projects. The audit also selected another 5 projects not included in the Taxpayer's original sample of 21 projects. In part, the sampled projects included:

- Woodworking Shop;
- Cattle Barn;
- Monoslope Cattle Feeding Facility;
- Freestall Barn;
- 1,296 Square Foot Building Shell;
- 12,500 Square Foot Addition to Existing Building;
- Dairy Facility;
- Rural Metal Clad Building.

The Department's audit then sought additional wage expense information from Taxpayer's Consultant. The audit report cites to the Consultant's study explaining the method by which the Consultant originally calculated these wage expenses.

To generate the percentages of time spent by employees conducing qualified activities on qualified projects, [Consultant] utilized the qualified phases, divisions, and tasks from the time tracking system to generate the amount of hours each employee spent on R&D activities. Then, [Consultant] divided each employee's

> respective amount of research and development hours by the total amount of hours each employee worked during tax year 2015 to generate the percentage of qualified time spent on R&D.

The Consultant provided two electronic spreadsheet files intended to support the wage expense calculation. According to the audit report, those files included a list of individual employees, the Consultant's calculation of qualified hours, and the percentage of qualified time for each employee. However, the Department found fault with this documentation because it contained "no information detailing what each employee did" and the files did not "identify what type of [pole building] research, if any, was conducted."

The audit concluded that the wage expense documentation provided was not contemporaneously prepared as required by Treas. Reg. § 1.41-4(d), (TD 8930) which provides that each REC claimant "[p]repare[] documentation before or during the early stages of the research project."

As to the wage expense documentation, the audit concluded that Taxpayer failed to provide "contemporaneous documentation . . . to validate time spent on research activities, only spreadsheets compiled after the fact." The audit found this insufficient because the information was not prepared contemporaneously with the research projects cited and because the information provided only addressed activities conducted in 2013 "which was one of the years that was denied by the Internal Revenue Service (IRS)."

(a) Research Expenditures.

The audit found that Taxpayer's record of expenditures did not meet the first test - verifying qualified research and experimental expenditures - based on the definition set out in Treas. Reg. § 1.174-2. The audit found that Taxpayer "did not track any research and development expenses and the auditor was unable to verify the amount claimed on the returns . . . ." In addition, the audit report states that "all the expenses the [T]axpayer is claiming as QRE's were directly charged to jobs being completed by the [T]axpayer, and [were] deducted as ordinary and necessary business expenses under IRC section 162."

(b) Discovering Technological Information.

The audit also found that Taxpayer failed the second test as set out in Treas. Reg. § 1.41-4(a)(3) which requires that research "must be undertaken for the purpose of discovering information that is technological in nature." As explained in Treas. Reg. § 1.41-4(a)(3)(i), "[R]esearch 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 . . . ."

The audit relied on Treas. Reg. § 1.41-4(a)(3)(ii) for the definition of "common knowledge."

> Common knowledge of skilled professionals in a particular field of science or engineering means information that should be known to skilled professionals had they performed, before the research in question is undertaken, a reasonable investigation of the existing level of information in the particular field of science or engineering.

In this case, the audit found that overcoming difficulties arising in Taxpayer's design and construction of pole buildings did not meet the second "common knowledge" test. The audit stated "[Taxpayer] has been in business for many years . . . and has several long-time employees with education and experience in the engineering, design, and construction business." The audit report states that "[T]axpayer is certain of its capability to design and construct a building, and never had to abandon a project because [Taxpayer] could not resolve any outstanding issues." The audit verified that Taxpayer could not name "any projects that had to be abandoned and client's money refunded . . . . Taxpayer is inferring a 100[percent] success rate which is very unrealistic given the nature of research and development."

The audit concluded that "[T]axpayer is not discovering information that is technological in nature. It is conducting a reasonably basic investigation of the current level of information (customer requirements, existing buildings, building codes, existing utilities, site conditions and safety) and [then] makes decisions on how to proceed in completing the pole building project it was contracted to complete." Any information obtained by Taxpayer in the design and construction of the pole buildings is "considered common knowledge of a skilled professional and is not considered qualified research."

Moreover, the audit found that Taxpayer's activities "were not qualified research under either the "Discovery" or "Uncertainty" versions of the regulation, (TD 8930 or TD 9104)." Under the more expansive "Treas. Reg. §

1.41(a)(3) (TD 9104), a taxpayer must be discovering information to eliminate uncertainty and that uncertainty exists only if the information available to the taxpayer does not establish the capability or method for developing the business component or the appropriate design of the business component." Under TD 9104, the audit found there was no uncertainty to overcome because "[n]either the customer nor the [T]axpayer would enter into these contracts . . . if the [T]axpayer was not capable of completing the jobs or the different construction methods to complete the jobs."

(c) New or Improved Business Component.

The audit explained that Taxpayer failed to meet the third, "business component," test. According to the audit report, "A business component is defined as any product, process, computer software, technique, formula or invention to be held for sale, lease, or license and used by the taxpayer in a trade or business of the taxpayer." In Taxpayer's case, the audit found that - based on Taxpayer's explanation - it "considers the whole design/building [pole building] construction project be the business component."

The audit report stated that Taxpayer's design and construction of pole buildings was not "tied" to any particular Taxpayer business pole building individual component because Taxpayer failed to provide contemporaneously prepared information to tie the pole building individual components to the claimed wage expenses. According to the audit report, Taxpayer failed to meet the Treas. Reg. 1.41-4(d) "contemporaneous record" requirement.

> A taxpayer claiming a credit under section 41 must retain records in sufficiently usable form and detail to substantiate that the expenditures claimed are eligible for the credit.

Taxpayer provided Excel files listing "QREs per project per employee" but none of the pole building projects were included in the file. As explained in the audit report:

> This [Excel] file did not contain specific information about the projects and employees. The file did not list any of the activities performed by each employee on each [pole building] project, and did not list activities as direct, indirect, or otherwise as required by Treas. Reg. § 1.41-2.

The audit report concluded that "[T]axpayer did not demonstrate that it met the third test that it intended to use the information to develop a new or improved business *component*." (*Emphasis added*).

(d) Undertaking a Process of Experimentation.

The audit found that Taxpayer failed to meet the fourth, "process of experimentation," test as defined under Treas. Reg. § 1.41-4(a)(5). The regulation states:

> A process of experimentation is a process to evaluate more than one alternative designed to achieve a result where the capability or method of achieving that result is uncertain at the outset. A process of experimentation does not include the evaluation of alternatives to establish the appropriate design of a business component, if the capability and method for developing or improving the business component are not uncertain . . . .

The audit found that Taxpayer employed personnel "with education/experience/knowledge in the [pole building] design and construction business" and that Taxpayer's "capability and method for developing or improving the [pole buildings] are certain [and] its evaluation of an alternative to establish the appropriate design is not a process of experimentation."

The audit again concluded that Taxpayer's pole building evaluations "would not meet the 'process of experimentation' under either version of the regulation, (TD 8930 or TD 9104)." To that end, the audit report cites to the preamble to Treas. Reg. § 1.41-4 (T.D. 9104) which provides:

> The final regulations state that the mere existence of uncertainty regarding the development or improvement of a business component does not indicate that all of taxpayer's activities undertaken to achieve that new or improved business component constitute a process of experimentation, even if the taxpayer, in fact, does achieve the new or improved business component . . . . [T]his clarification is intended to indicate that merely demonstrating that *uncertainty has been eliminated* (e.g., the achievement of the appropriate design of a business component when such design was uncertain as of the beginning of a taxpayer's activities) *is insufficient to satisfy the process of experimentation requirement.*

(*Emphasis added*).

The audit report points out what the audit regarded as Taxpayer's failure to demonstrate the requisite "process of experimentation." "[T]axpayer was specifically asked to provide documentation as to how its [pole building] construction process entailed research and development." However, the audit report states that Taxpayer was only able to make "generic" statements such as Taxpayer "engaged in an iterative design process" and that its employees "evaluat[ed] alternatives to eliminate uncertainty in designing and building each of the [pole buildings]."

What the audit sought - and did not receive - were records for each business component which, in Taxpayer's case, were records of the experimental activities engaged in for each pole building project.

(e) Audit Summary - Section 41(d)'s Four Part Test.

The Department's audit report summarized its evaluation of Taxpayer's activities:

> The [T]axpayer is an experienced, full service, design/build contractor. Its website touts over 50 years of contractor experience. The [T]axpayer has provided no information that would distinguish its contractor projects from those of a contractor adapting its existing business components or existing readily-available products to [Taxpayer's] or a particular customer's requirement or need, which is a specifically excluded activity.

The audit report noted that the audit's conclusions were consistent with the results of the 2013 and 2014 federal audit of Taxpayer's federal REC claims.

2. Wage and Supply Expense Documentation.

The Department's audit concluded that Taxpayer did not prepare and retain records necessary to substantiate Taxpayer's argument that it was entitled to credits based on wages paid to Taxpayer's employees engaged in the research and development of its pole buildings.

Central to the audit's conclusion - that Taxpayer failed to prepare, retain, and provide documentation sufficient to support Taxpayer's claim to the RECs - the audit cited to Treas. Reg. § 1.41-4(d) (TD 8930).

> 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 thereunder.

(*Emphasis added*).

As noted previously, the Department's audit concluded:

> The [T]axpayer has not provided [the requisite] contemporaneous documentation . . . to support the employee research participating percentages that it used to calculate the qualified research expenses (QRE's).

The Department concluded that even if Taxpayer had conducted qualifying research activities, it had not prepared, maintained, retained, or presented records necessary to substantiate the claimed wage expenses associated with any qualifying research activities.

B. Taxpayer's Response.

1. Qualifying Research Projects.

Taxpayer disagrees with the Department's conclusion that it does not engage in qualifying research activities.

Taxpayer maintains that it faced numerous uncertainties in designing its pole buildings and that it employs a "methodical, systematic process in order to address the valid uncertainty of the appropriate design faced at the outset of [each] project." For example, Taxpayer states that it implements a "process of experimentation" in addressing the uncertainties which arise during the design and construction of the trusses used in its pole buildings. To that end, Taxpayer provided a line drawing of a bracket and a cross-section drawing of a roof truss.

Taxpayer explains that it also undertook efforts to develop new and improved sliding doors, door latch systems, rust-free metal screws, pre-engineered concrete framing, and the application of resin coatings on metal surfaces.

Taxpayer further explains that it routinely faced uncertainties in determining whether the pole barns should incorporate treated lumber, whether the buildings should incorporate 2 inch by 10 inch boards or 2 inch by 12 inch boards, whether certain door frames should be "beefed up," and whether its buildings require "wind bracing." Taxpayer further explains that some of its pole buildings require "custom brackets" the development of these brackets is indicative of Taxpayer's "iterative design process" following a "methodical, systematic process of effectuating a fully functional [pole building] design . . . ."

Specifically, Taxpayer points to its 2013 patent application for a "wrapped aviary construction system" which Taxpayer believes is "[t]he most significant evidence of [Taxpayer's] qualification for the Research and Development activities . . . ." The patent application describes a method of building a foundation and "internal support system" incorporating a "plurality of peripheral columns," "aviary cages," and "roof assembly." *Wrapped Aviary Construction* System and Construction Method Thereof, http://www.freepatentsonline.com/y2017/0339925.html (*Last visited May 26, 2019*),

Taxpayer concludes that it has met each and every one of the criteria set out in I.R.C. § 41(d). Taxpayer states that its expenses were related to its business, that it faced numerous pole building uncertainties, that its pole building research was technological in nature, and that its research activities resulted in the development of new or improved components and methods of designing and constructing its customers' pole buildings.

2. Wage Expense Documentation.

Taxpayer also disagrees with the Department's conclusion that Taxpayer failed to adequately document its employees' research activities and disagrees with the Department's audit finding that Taxpayer failed to provide contemporaneous wage expense documentation.

Taxpayer states that "Indiana law does not require taxpayer to substantiate [its claim] with documentation." According to Taxpayer's analysis of that law, the Department may rely on "the best information available" in order to determine a taxpayer's tax liability. Specifically, Taxpayer cites to 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.

In Taxpayer's opinion, the Department is entitled to base its assessment on information supplied by Taxpayer including the after-the-fact testimony of its employees. As explained by Taxpayer:

> [D]ocumentation was provided by project number detailing the employee, qualified hours, and a percentage of qualified time by employee. A determination of the activities undertaken by the qualified employees was based upon interviews conducted by the personnel referenced in the [audit report's] Explanation of Adjustment.

In sum, Taxpayer concluded that the documentation issue is governed by Indiana law found at IC § 6-8.1-5-1(b) which states in relevant part:

> **If the department reasonably believes that a person has not reported the proper amount of tax due**, the department shall make a proposed assessment of the amount of the unpaid tax **on the basis of the best information available to the department.**

(**Taxpayer's Emphasis**).

Given the "best information" standard, Taxpayer concludes that it has provided the Department not only the "best" but also the only available information documentation consisting almost entirely of the results of its employee interviews.

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; in every assessment case, each 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).

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.")

2. The Research Expense Credit's Regulatory Regime.

At the outset, the Department rejects Taxpayer's argument neither TD 8930 nor TD 9104 were not the governing regulatory scheme relevant to the years at issue. Taxpayer's argument is that only an ambiguous pre-regulatory REC standard governs Taxpayer's protest. 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); 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 12, 2016).

As repeatedly, consistently, and clearly staked out its position on this matter. 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." Simply stated, the REC requires that the taxpayer undertake activities "for the purposes of *discovering information* which is technological in nature." I.R.C. § 41(d)(2).

However, regardless of the Letters of Finding and the Department's historical position on the issue, Taxpayer points out that the Department "has recently taken the position provided in T.D. 9104 - not T.D. 8903 - were adopted by the version of the statute in effect during the year at issue." Taxpayer cites to *Stipulation of Facts and Withdrawal of Petitioner's Motion for Partial Summary Judgment and Request for Judicial Notice* filed by the Department in the Indiana Tax Court December 21, 2018, in *Tell City Boatworks, Inc. v. Indiana Department of State Revenue,* Cause No. 18T-TA-00004.

> Treasury Decision 8930, including without limitation the "Discovery Rule" set forth therein is not applicable in this matter to the analysis of whether the Taxpayer's business components met the definition of qualified research pursuant to Ind. Code 6-3.1-4 et seq. The proper standard to apply in this matter in evaluating whether a taxpayer's business component met the definition of qualified research pursuant to Ind. Code 6-3.1-4 et seq. is located in Treasury Decision 9104.

Taxpayer's reliance on the *Tell City* stipulation of facts is somewhat disingenuous. The *Tell City* stipulation, of course, is limited to "this case." The decision to stipulate in that case was a strategic decision submitted merely for the sake of judicial economy in the *Tell City* case because the distinction between the regulations was

irrelevant in that case. *See* Ind. Tax Ct. Rules 7(F)(6). Moreover the Department does not promulgate tax interpretations by means of court filings but through publication in the Indiana Register.

3. 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 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**).

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 ("I.R.C.") 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 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* I.R.C. § 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.

In order for its argument to prevail, Taxpayer's activities must meet the four-part test under I.R.C. § 41(d) including the requirement that Taxpayer's activities were undertaken for the "purposes of discovering information" and must eventually yield a "new or improved business *component*" each of which derives from a process of experimentation.

As explained by Taxpayer, its "business components" consists of the "whole design/building construction project." In other words, each pole building project is a singular "component." Taxpayer maintains that each garage, chicken barn, storage facility, office building, and machine shed it constructs constitutes a "component" which is completed pursuant to a process of experimentation. However, Taxpayer's position seems clearly at variance with Treas. Reg. § 1.41-4(a)(5) which provides "experimentation does not include the evaluation of alternatives to establish the appropriate design of a business components."

Nonetheless, and even if the Department were to agree that a "building" can constitute a "component," Taxpayer can point to nothing specifically it has done to discover information and then develop a "new or improved business component" beyond the exercising the common knowledge of other building contractors which regularly face routine - or even difficult - choices between the alternatives faced in constructing any building.

The Department takes nothing away from Taxpayer's capacity to construct innovative construction projects which meet the specific needs of its customers. Instead, Taxpayer's activities are better categorized as efforts to refine, understand, and apply upon long standing techniques of constructing buildings which overcome the difficulties in each particular construction site and which meets the demands and requirements of each of its customers.

Essentially, Taxpayer has not established that it has fundamentally expanded upon the "common knowledge" or "existing level of information in [Taxpayer's] field of science or engineering." Treas. Reg. § 1.41-4(a)(3)(ii).

Taxpayer demonstrated that it does conduct certain activities aimed at determining whether a particular "component" functions as intended. For example, Taxpayer documented that it tested the load capacity of a truss system. However, such an activity reflects a knowledgeable and detailed process of "trial and error" aimed improving or differentiating its products. Taxpayer's process - even if it did lead to the "discovery" or a new product - does not represent "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). As explained by that court, the "process of experimentation" requirement is not met by means "a method of simple trial and error to validate that a process or product change meets the taxpayer's needs." *Id.* (See also *Union Carbine Corp. and Subsidiaries v. C.I.R.* 97 T.C.M. (CCH) 1207 (Tax Ct. 2009) explaining "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.")

The Department is unable to agree that Taxpayer has met its statutory burden under IC § 6-8.1-5-1(c) of establishing that the its activities to improve upon its buildings and to meet the specific needs of its customers constitutes "qualified research" activities under either the "Discovery Test" or the "Uncertainty Test." Simply putting forward the "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 Taxpayer's efforts to construct a building that meets the customer's particular needs, is suitable for the site environment, exceeds construction code requirements, and is completed in a timely and economical fashion resulted the discovery of a new product which became part of the body of common knowledge of other skilled construction contractors.

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 and wages attributable to the purported research projects.

Taxpayer admitted that the company did not maintain a contemporary system of project accounting in order to quantify the company's qualifying research expenses. Taxpayer's Consultant interviewed Taxpayer's employees. It bears repeating here the Consultant's specific methodology. Consultant calculated the wage expenses in two phases.

- To generate the percentages of time spent by employees conducting qualified activities [Consultant] utilized the qualified phases, divisions, and tasks from the time tracking system to generate the amount of hours each employee spent on R&D activities.

- [Consultant] divided each employee's respective amount of research and development hours by the total number of hours each employee worked during tax year 2015 to generate the percentage of qualified time spent on R&D.

In other words, Taxpayer's Consultant used a statistical - and somewhat opaque - methodology to estimate the specific amount of qualifying wages.

While the Department recognizes Taxpayer's efforts to estimate the qualifying wages of its employees, the Department unconditionally rejects Taxpayer's argument that the Department is precluded from demanding specific, contemporaneous documentation and that "documentation is not necessary to prove taxpayer engaged in a particular activity in the tax year(s) at issue." Instead, the Department finds the law on this issue clear.

Treas. Reg. § 1.41-4(d) (T.D. 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.

In this case, Taxpayer asks that the Department broadly interpret the REC record keeping requirements by rejecting as unnecessary the audit's requests for "interview notes, project notes, and time tracking reports detailing a specific process of experimentation." The Department must decline Taxpayer's invitation to rely solely and authoritatively on the Consultant's spreadsheets prepared years after the qualifying activities were conducted especially, as in this case, when there is no evidence that the Taxpayer's efforts to develop and then monitor and control the quality of building projects constitutes a "process of experimentation" which led to technological innovations otherwise outside the knowledge of other skilled professionals.

FINDING

Taxpayer's protest is respectfully denied.

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