

## DEPARTMENT OF STATE REVENUE

01-20200017.LOF; 01-20200018.LOF; 01-20200019.LOF  
 01-20200020.LOF; 01-20200021.LOF; 01-20200022.LOF  
 01-20200023.LOF; 01-20200024.LOF; 01-20200025.LOF

**Letter of Findings: 01-20200017; 01-20200018; 01-20200019; 01-20200020;  
 01-20200021; 01-20200022; 01-20200023; 01-20200024; 01-20200025**

**Individual Indiana Income Tax  
 For the Years 2015 and 2016**

**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 This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register.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**

The Department disagreed with Indiana Shareholders that they met their burden of establishing that their brewing company provided the specific, contemporaneous documentation sufficient to establish that Shareholders were entitled to the flow-through qualifying research expense credits attributable to the brewery's development and manufacture of new beer formulations.

**ISSUE****I. Indiana Individual Income Tax - Qualified Research Expense Projects and Documentation.**

**Authority:** IC § 6-3-1-3.5(b); IC § 6-3.1-4-1; IC § 6-3.1-4-2(a); IC § 6-8.1-5-1(c); IC § 6-8.1-5-4; *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); *Indiana Dep't of State Rev. v. Caterpillar, Inc.*, 15 N.E.3d 579 (Ind. 2014); *Wendt LLP v. Indiana Dep't of State Revenue*, 977 N.E.2d 480 (Ind. Tax Ct. 2012); *Scopelite v. Indiana Dep't of Local Gov't Fin.*, 939 N.E.2d 1138 (Ind. Tax Ct. 2010); *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. Commissioner of Internal Revenue*, 697 F.3d 104 (2d. Cir. 2012); I.R.C. § 41; Treas. Reg. § 1.41-4; Treas. Reg. § 1.174-2(a); Treas. Reg. § 1.6001-1; 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); *Audit Techniques Guide: Credit for Increasing Research Activities (i.e. Research Tax Credit) IRC § 41 - Substantiation and Recordkeeping*; I.R.S. Technical Advice Memorandum (I.R.S. TAM 9522001, 1994 WL 805206 (June 2, 1995).

Taxpayers argue that their company conducted qualified, experimental research activities, that they can adequately document the wage, supply, and contract expenses related to those projects, and that they are therefore entitled to claim the benefit of the flow-through credits associated with their company's qualifying research activities.

**STATEMENT OF FACTS**

Taxpayers are individual owners/partners of an Indiana brewery which develops, brews, bottles, and sells various craft beers. The brewery is organized as a partnership and files form IT-65 Indiana partnership income tax returns. The brewery's income and losses pass through to its partners, who in turn, report the income and losses on their individual income tax returns.

The Indiana Department of Revenue ("Department") conducted an audit review of the brewery's 2015 and 2016 Indiana partnership income tax returns. Except for issues related to research expense credits ("RECs"), the audit found that the brewery's "Indiana adjusted gross income, including Indiana modifications, were materially correct as [originally] filed."

The audit found that the brewery claimed Indiana RECs during 2015 and 2016. The brewery indicated that the RECs were based on the results of a REC study prepared by a third-party consultant ("Consultant").

After reviewing the REC study and the claimed credits, the Department concluded that the brewery failed to establish that its development and manufacturing activities constituted "qualified research" and that the brewery failed to establish that the labor expenses - on which credits were based - directly related to the claimed qualifying activities. In reviewing the labor expenses, the Department concluded that the brewery's "time tracking" records did not represent the actual amount of time spent by brewery employees on qualified research activities and could not be used to factually support the Qualified Research Expenses ("QREs") claimed.

The audit also found that the brewery failed to establish that it was entitled to claim RECs based on the cost of supplies consumed during the course of the brewery's activities. The audit concluded that the claimed supply expenses "could not be substantiated . . . ."

The Department's audit's decision disallowing the credit did not result in an assessment of additional income tax for the brewery because the brewery was organized as a partnership. As the audit report notes, the brewery's "research credits are passed through to the partners . . . responsible for reporting the partnership income and credits on their individual income tax returns." As a result of the brewery audit, Taxpayers were assessed additional individual income tax. Taxpayers disagreed with the assessments and each submitted a protest to that effect. An administrative hearing was conducted during which Taxpayers' representatives explained the basis for the protest. This Letter of Findings results. As a matter of efficiency, and since each individual protest is identical, this document will all protests submitted by Taxpayers.

## **I. Indiana Individual Income Tax - Qualified Research Expense Projects and Documentation.**

### **DISCUSSION**

The issue is whether Taxpayers have established that their brewery conducted qualifying research activities and whether the brewery can document the extent to which it conducted those qualifying activities and, as a result, are entitled to the amount of credits originally claimed.

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

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

During the years 2015 and 2016, Taxpayers' brewing facility ("Brewery") claimed approximately \$1.2 million dollars in QREs entitling the Brewery to approximately \$84,000 in RECs. The claimed "qualifying expenses" stemmed from the Brewery's labor costs and the costs stemming from the consumption of supplies during QRE activities.

The Department's audit concluded that the Brewery's activities did not "overcome the 4-part test" required 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).**

I.R.C. § 41(d) sets out this four-pronged test for verifying qualified research activities. First, the research must have qualified as a business deduction under I.R.C. § 174. I.R.C. § 41(d)(1)(A). Second, the research must be undertaken to discover information "which is technological in nature." I.R.C. § 41(d)(1)(B)(i). Third, the taxpayer must intend to use the information to develop a new or improved business component. I.R.C. § 41(d)(1)(B)(ii). Finally, the taxpayer must pursue a "process of experimentation" during substantially all of the research. I.R.C. § 41(d)(1)(C). All four tests must be satisfied in order to qualify for the credit.

The Department's audit reviewed the Consultant's study which formed the basis for the claimed expenses and

credits. The study began with a review of all the new brewing formulations developed during 2015 and 2016. The Consultant's statistician developed a sample of 26 of the 205 projects conducted in 2015. The statistician also drew a sample consisting of 20 of the 59 projects conducted in 2016. The Consultant's study determined that "[o]f the 26 and 20 statistically sampled projects, all of the projects were deemed internal R&D (namely research and development) and satisfied the requirements of IRC Section 41(d) and were deemed qualified per [Consultant]."

The Consultant then identified "contemporaneous documentation as invoices for facility improvements; design drawings for facility improvements; and batch records . . . ." In order to determine the actual amount of qualifying credits, Consultant reviewed "W-2 information by employee; test batches; and contracts for each outside contractor performing qualified research and development services in the state of Indiana."

The next step was to determine the amount of qualifying wage expenses directly associated with the deemed qualifying research projects. According to the study, that determination was made by interviewing the Brewery's chief financial officer and production manager. The audit report noted the following:

[Brewery] provided [Consultant] with information regarding the amount of time each employee spent conducting qualifying activities, as well as directly supporting and supervising during the study period.

Those deemed qualifying activities by the Consultant "includ[ed] developing and testing new formulations, developing new and improved brewing processes for new beers, and implementing process improvements for the brew house to increase overall production." Those process improvements included labor and supply costs associated with the development and implementation of a new canning line. However, Consultant eliminated non-qualifying expenses "such as overhead, administrative activities, scheduling, resource management and budgeting . . . ."

Having deemed certain activities as qualifying and determining a qualifying percentage for each of those projects, the Consultant calculated the amount of labor expended on those project. In other words, Consultant determined - for example - that 54 percent of the time spent on a project consisted of qualifying activity.

With those percentages in mind, the audit report indicates that Brewery;

[C]laimed wages as QRE[]s in 2015 and 2016. The determined qualified percentages were multiplied by the corresponding employee's tax year wages to obtain final QRE wages for each employee for each year. These final wage QRE[]s for each applicable employee were then summed to determine the total wage QRE[]s for each tax year.

In addition to the deemed qualifying wage expenses, Consultant's study indicated that Brewery incurred qualifying supply and contract labor expenses. The audit report explains:

[Consultant's] study also claimed supply costs and contract labor for QRE[]s in 2015 and 2016. The supplies utilized in brewing test batches were captured towards the research and development tax credit as they were completely used or consumed during the process of conducting research and development activities. The company utilized contractors in order to design and implement process improvements according to the study.

The Department further found that the study also included certain costs attributable to a canning line design and costs not related to brewing beer. The Department's audit then sought additional information from Brewery justifying the claimed expenses explaining to Brewery that "[a]fter looking at the initial documentation provided, it does not look like [Brewery] qualifies for the research and development credit [because] it appears that [Brewery] doesn't meet the four-part test for either the brewing of beer or the canning line design." The Department asked for copies of its employees' W-2s, a copy of the calculations used to "tie" employees' activities to particular research projects, and a detailed breakdown of supply costs.

Brewery responded citing in particular to I.R.S. Technical Advice Memorandum, I.R.S. TAM 9522001, 1994 WL 805206 (June 2, 1995) as authority for its position that Brewery's research, intended to modify and develop the "taste" of beer products, constitutes qualified research within the meaning of I.R.C. § 41, as follows:

To the extent that a food product developer tries to develop products with a new or improved function, performance, or reliability or quality **including new or improved textures, smells, or flavors**, the research activities to develop the products may relate to functional aspects of a business component as required in § 41(d)(1) and (3)(A). Thus, the research activities conducted for purposes described in § 41(d)(3)(A) and otherwise satisfying the definition of "qualified research" in § 41(d)(1) would not be treated as conducted for

an ineligible purpose under § 41(d)(3)(B).

**(Emphasis added).**

As to expenses associated with the design and implementation of its new canning line, Brewery explained:

[Brewery] encountered technical uncertainty as to the appropriate design of machinery and equipment configurations and integration to successfully improve beer production quality . . . [Brewery] evaluated designs in order to ensure that the new system achieved functionality requirements and to ensure that the design of the system integrated with existing equipment and spatial limitations in the facility. The Company developed iterative designs and evaluated each utilizing engineering calculations and analyses to determine the appropriate, final design.

**(a) Section 174 Business Deductions.**

The Department's audit review considered whether the Brewery's activities met each of the four-part tests set out in I.R.C. § 41. In considering first the "business deduction" test, the Department's audit report cited to Treas. Reg. § 1.174-2(a) which states in part:

Expenditures represent research and development costs in the experimental or laboratory sense if they are for activities intended to discover information that would eliminate uncertainty concerning the development or improvement of a product. Uncertainty exists if the information available to the taxpayer does not establish the capability or method for developing or improving the product or the appropriate design of the products.

In rejecting Brewery's position that its claimed expenses met the first of the four-part test, the Department pointed out that Brewery "has employees that have the experience to complete all of the uncertainties that [Consultant] cited in the research expenses credit studies." As such, the audit found that all the "process improvements" did not address uncertainties. The report stated that "there "is some uncertainty on the taste aspect" but that only the new beer ingredients "qualified for research and development" and rejected Brewery's argument that all ingredients added to the beer qualified for the credit.

**(b) Discovering Technological Information.**

As to the second of the four tests, the Department's audit did not agree that Brewery's business activities led to the discovery of information or technology which expanded upon and added to the common knowledge of other similar brewers. As authority for its position, the Department cited to Treas. Reg. § 1.41-4(a)(3)(i) (TD 8903) of the 2001 Final Regulations which states:

For purposes of section 41(d) and this section, research is undertaken for the purpose of **discovering information** only if it is undertaken to obtain knowledge that exceeds, expands, or **refines the common knowledge** of skilled professionals in a particular field of science or engineering.

**(Emphasis added).**

The Department rejected Brewery's argument that it was entitled to rely on Treas. Reg. § 1.41-4(a)(3) (TD 9104) which imposes a less restrictive "eliminate uncertainty" standard instead of the above-referenced "discovering information" standard. That regulation provides:

Research is undertaken for the purpose of discovering information if it 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.

**(Emphasis added).**

The audit report noted that TD 9104 "was promulgated and published as a proposed regulation in December 2001 and was published as a final regulation in December of 2003 with an effective date of January 2, 2004." As such, the regulation post-dated Indiana's adoption of IC § 6-3.1-4-4 with TD 8930 as "the only set of regulations that were promulgated and in effect on January 1, 2001." The audit concluded that Brewery was required to meet the "discovering information" and "common knowledge" criteria.

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 applying the "discovering information" and the "common knowledge" standard, the Department concluded that Brewery failed to meet the second of the four-part test. The audit report noted the following:

As a brewery, the [T]axpayer may have uncertainty in the final taste at the outset of the project. However, the [T]axpayer is not discovering information that is technological in nature. The [T]axpayer conducting a reasonable investigation of the existing level of information and is not doing anything to exceed or refine the common knowledge of brewers . . . . [T]axpayer's personnel know what to do and how to proceed. The information being gathered is considered the common knowledge of a skilled professional and is not considered qualified research.

Moreover, the audit found that Brewery'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 uncertainty but that only "new ingredients would qualify for the research and development expense credits [and that] ingredients used in the beer process every time would not qualify."

As to the development of Brewery's new and improved canning line, the audit found that such canning systems "have been proven to work in the industry. Even though the [T]axpayer may not know every detail of the final design, the [T]axpayer is certain of its capability from the onset."

Finally, as to whether applying the "discovering information" or the "eliminate uncertainty" standard, the audit report concluded that Brewery's claim failed because "[T]axpayer has not provided information so the auditor could determine the amount of the expenses qualified under the second test[.]"

**(c) New or Improved Business Component.**

As to the third of the four tests, the audit stated that each QRE expense must be expended "in the development of a new or improved business component of the taxpayer." As explained in the audit report, "A business component is . . . 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."

The Department's audit cited to The IRS's Audit Technique Guide, 2005 WL 405783 (June 2005) as authority for its position that "a taxpayer must be able to tie the qualified research it is claiming for the credit to the relevant business component." The audit report indicates that Brewery was asked to do just that - "tie" expenses to the relevant business component which in this case presumably are the new beer products. The audit report provides the response:

[Consultant] claimed that the company analyzed the amount of time its employees spent on qualified research activities and confirmed that, whether pertaining to new or improved beer formulations or manufacturing process improvements, substantially all (i.e., 80[percent] or more) of its activities related to a process of experimentation for each business component.

The audit found fault with Brewery's assertion.

The [Consultant's] study did not contain specific information about the projects and employees. The study did not list the time spent on projects, did not list any of the activities performed by each employee on each project, did not list activities as direct, indirect, or otherwise as required by Treas. Reg. § 1.41-2, nor did it list a wage allocation for each employee for each project. A breakdown of the QRE wages by project as required by the Audit Techniques Guide was not provided.

In apparent reference to Brewery's development of a new canning line, the audit report noted that the REC study "did not show that plant process business components were being treated separate from the business

The Federal Audit Guide states:

**Substantiation and Record Keeping:** 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.

The Service does not have to accept estimates of qualified research expenses if documentation exists to verify the actual amount of such expenses. As set forth above, taxpayers are required to keep records substantiating the amount of any reported, claimed, or affirmatively raised deductions or credits.

The courts will allow the use of an estimation method only where the taxpayer does not have contemporaneous records, and then only as long as the following two conditions are satisfied. First, the taxpayer must establish that it engaged in qualified research activities as defined in section 41(d). And second, the failure to maintain a proper system to capture relevant information cannot be an "inexactitude [] of their own making." Estimation methods are permitted only in cases where the sole issue is the exact amount paid or incurred in the qualified research activity. Accordingly, taxpayers must have factual support for every assumption underlying their estimates to meet their burden of proof. *Audit Techniques Guide: Credit for Increasing Research Activities (i.e. Research Tax Credit) IRC § 41 - Substantiation and Recordkeeping*, <https://www.irs.gov/businesses/audit-techniques-guide-credit-for-increasing-research-activities-ie-research-tax-credit-irc-s> (last visited January 14, 2020).

The audit concluded that Brewery failed to establish that it met the third qualifying test because there was no evidence that Brewery "intend[ed] to use the information to develop a new or improved business component."

**(d) Undertaking a Process of Experimentation.**

Finally, as to the fourth test, the audit relied on Treas. Reg. § 1.41-4(a)(5) (TD 8930) which 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 concluded that under Treas. Reg. § 1.41-4(a)(5) (T.D. 8930), the businesses failed to meet the requirement that a claimant engage in a process of "experimentation" because "the [T]axpayer's capability and method for developing or improving the business component is very certain."

[T]axpayer has been in business for several years and has long time employees with education/experience in the whole beer production/equipment design projects. The [Brewery] has the capability and method to brew the flavor of beer being developed even if the finished product isn't exactly what the [Brewery] wants . . . . [Under] Treas. Reg. § 1.41-4(a)(5) (TD 8930), since the [Brewery's] capability and method for developing or improving the business [is] certain, the [Brewery's] evaluation of an alternative to establish the appropriate design is not a process of experimentation [and] the [Brewery's] evaluation of an alternative to establish the appropriate design is not a process of experimentation."

Moreover, the audit took note of the Brewery's objection to the Department's reliance on the TD 8930 "discovering information" standard. The audit report indicates that even if evaluated under the TD 9104, "eliminating uncertainty" standard, Brewery would have failed to meet the experimentation test. The audit concluded that Brewery's brewing activities "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 in relevant part:

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 also cited to the preamble to Treas. Reg. § 1.41-4 (TD 9104) which provides in part:

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 a 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.

....

[M]erely 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. A taxpayer bears the burden of demonstrating that its research activities satisfy the process of experimentation requirement.

The audit rejected Brewery's arguments because Brewery failed to "identify the one or more alternatives intended to eliminate the uncertainty" and failed to "explain how each project conducted a process of evaluating alternatives." Instead, Brewery simply provided generalized assertions as to its activities. For example, Brewery asserted that "the improved formulations of the various beers and process improvements required qualified research and development activities, including the identification of uncertainties and an iterative process by which such uncertainties could be overcome." The audit concluded that even under the TD 9104 "eliminating uncertainty" standard, such generalizations - as put forth by Brewery - were "not sufficient to show a process of experimentation."

The audit also rejected Brewery's assertions because, under Treas. Reg. § 1-41-4(a)(6), Brewery failed to establish that substantially all (i.e., 80[percent] or more) of its activities related to a process of experimentation for each business component.

#### **(e) Shrinking Back Brewery's Original REC Claim.**

The audit emphasized that an REC claimant must establish that activities related to each business "component" meet the four-part test. The audit noted that where a claimant was unable to wholly meet that requirement, Treas. Reg. § 1-41-4(b)(2) allows for "shrinking back" to a subset of the components that do meet the four-part test. When asked to develop a "shrink back" subset of qualifying activities on which the audit and Brewery could agree, Brewery declined. Brewery stood by its assertion that its underlying *component* (note the singular) was "to develop new and improved formulations and brewing techniques and to develop new and improved processes."

#### **2. Specific Brewery Activities Rejected by the Department's Audit as Qualifying for the Credit.**

The Department's audit rejected certain of Brewery's specific claimed activities. Citing to I.R.C. § 41(d)(4)(C), the Department rejected any activities involving "the reproduction of an existing business component." As repeatedly pointed out in the audit report, "[Brewery] already knows to brew beer" and that only potential qualified research would involve the incorporation of "new ingredients to make new beer flavors." The audit report notes:

[Brewery] has a basic formula for brewing beer and then [Brewery] expands with a new flavor or ingredient. The new flavor is potentially research whereas the basic beer formula is not.

The audit also rejected any activities related to the refinement or improvement of any "beers that are already in commercial production" citing also to I.R.C. § 41(d)(4)(C).

The audit rejected any RECs stemming from the activities of Brewery's in-house artist.

The audit rejected any claimed RECs associated with the development and implementation of Brewery's new canning line. As explained in the audit report, "[Brewery] has provided no information that would distinguish its beer production/equipment design projects from those of a typical brewing company."

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### 3. Documenting and Substantiating Brewery's RECs.

Even assuming that Brewery could establish that it was engaged in qualifying research activities, the Department's audit found that the Brewery failed to adequately document the wage and labor expenses which formed the primary basis for the claimed RECs. Specifically, the audit found that Brewery failed to meet the documentation and substantiation standard under Treas. Reg. § 1.41-4(d) (T.D. 8930). This regulation sets out the record keeping and documentation requirement for expenses related to the REC:

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's audit also considered Treas. Reg. § 1.41-4(d) (TD 9104), the current governing regulation, which states:

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. For the rules governing record retention, see section 1.6001-1.

In turn, Treas. Reg. § 1.6001-1(a) provides:

Any person required to file a return of information with respect to income shall keep such permanent books of accounts or records, including inventories, as are sufficient to establish the amount of gross income, deductions, credits, or other matters required to be shown in any return of such tax or information.

As noted above the audit report relied on Chapter 7 of *Audit Techniques Guide: Credit for Increasing Research Activities (i.e. Research Tax Credit) IRC § 41 - Substantiation and Recordkeeping*. Specifically, the report quotes the guide as follows:

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.

The audit report also pointed to Indiana's own general record keeping requirement found at IC § 6-8.1-5-4(a).

Every person subject to a listed tax must keep books and records so that the department can determine the amount, if any, of the person's liability for that tax by reviewing those books and records. The records referred to in this subsection include all source documents necessary to determine the tax, including invoices, register tapes, receipts and canceled checks.

The Department's audit concluded that under either Treas. Reg. § 1.41-4(d) (TD 9104) or Treas. Reg. § 1.41-4(d) (T.D. 8930), Brewery was unable to provide the requisite contemporaneous records establishing that they were entitled to claim the credits. Further, Brewery failed to meet Indiana's own general record keeping requirement, IC § 6-8.1-5-4(a), that it "keep books and records . . ." sufficient to determine the amount of tax owed by [Brewery]."

### B. Taxpayers' Response to the Audit's Conclusions.

#### 1. Brewery's Qualifying Research Projects.

Taxpayers - speaking on behalf of Brewery - disagree with the Department's conclusions that Brewery did not establish that it conducted qualifying research activities and that even if Brewery had done so, the information provided the audit was insufficient to document the extent of those activities.

Taxpayers indicate that Brewery faced numerous uncertainties in undertaking projects which led to the development of new and improved beers and that overcoming and resolving these uncertainties fulfilled each branch of the four-pronged I.R.C. § 41(d) test. Taxpayers explain:

[Brewery] undertook . . . projects to develop new and improved formulations and brewing techniques for beers and to develop new and improved processes. [Brewery] developed new formulations, along with fermentation and aging techniques and processes in order to improve the quality of their products. The improved formulations of the various beers and processes allowed [Brewery] to achieve the highest quality product for its customers. [Brewery] undertook projects, such as the conveyor addition for the canning line and tank farm addition to improve production processes and functionality in their facility.

As to "uncertainty," Taxpayers explain that their brewery encountered "numerous technical uncertainties" including the "appropriate design of new [beer] formulations" including combinations of various ingredients needed to obtain the desired quality and flavor outcome. Taxpayers explain that Brewery also faced "uncertainties" in the updated design of its canning machinery and equipment to "to improve beer production quality . . ."

Taxpayers argue that Brewery's activities qualified under the "technological in nature" test. Taxpayers state that Brewery undertook a "process of experimentation . . . rely[ing] on principles of the physical or biological sciences, engineering, or computer science." Taxpayers explain that Brewery employed "principles of chemistry to identify the appropriate ingredients and ratios to achieve project specifications" including "efficient and safe brewing techniques."

Taxpayers state that their Brewery's activities meet the third, "new or improved business component" test. Taxpayers explain that the Brewery undertook the R&D activities "to develop new and improved formulations and brewing techniques and processes in order to improve the quality of their products."

Finally, Taxpayers argued that the Brewery met the fourth, "process of experimentation" test. According to Taxpayers, Brewery "undertook a systematic process of experimentation in order to overcome . . . uncertainties" attributable to the development of new and improved beers and "designs for new machinery and equipment layouts."

Specifically, Taxpayers state that Brewery met the experimentation standard because it "considered alternative formulations and adjusted various factors such as the yeast strain and ratio . . . [and] experimented with various hop and malt varieties in order to achieve new flavor profiles."

## **2. Brewery's Supporting Documentation.**

Taxpayers argued that an estimate is sufficient; that they are not required to maintain or keep records to substantiate the amount of QREs and the claimed RECs.

## **C. Burden of Proof, Analysis, and Conclusion.**

### **1. Proving that Taxpayers are Entitled to the Flow-Through Credits.**

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). Poorly developed and non-cogent arguments are subject to waiver. *Scopelite v. Indiana Dep't of Local Gov't Fin.*, 939 N.E.2d 1138, 1145 (Ind. Tax Ct. 2010); *Wendt LLP v. Indiana Dep't of State Revenue*, 977 N.E.2d 480, 486 n.9 (Ind. Tax Ct. 2012). Also, "all statutes are presumptively constitutional." *Indiana Dep't of State Rev. v. Caterpillar, Inc.*, 15 N.E.3d 579, 587 (Ind. 2014). When an agency is charged with enforcing a statute, the jurisprudence defers to the agency's reasonable interpretation of that statute "over an equally reasonable interpretation by another party." *Caterpillar, Inc.*, 15 N.E.3d at 583.

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 Taxpayers' argument neither TD 8930 nor TD 9104 were the governing regulatory scheme relevant to the years at issue. Taxpayers' argument is that only an ambiguous pre-regulatory REC standard governs Taxpayers' protest. Taxpayers instead rely on the Tax Court's uncited October 2019 order for the following premise.

Treasury Decision 9104 contains the applicable treasury regulations and Treasury Decision 8903 is deemed to be inapplicable as a matter of law.

(Emphasis and Internal Punctuation Omitted).

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 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, Taxpayers point 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." Taxpayers cite 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.

Taxpayers' reliance on the *Tell City* stipulation of facts is somewhat misplaced. 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**). As noted at the outset, in order to qualify for the RECs, the claimant must engage in "Qualified research" as defined in the Internal Revenue Code, IC § 6-3-1-3.5(b).

As detailed above, I.R.C. § 41(d)(1) 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 I.R.C. § 41(d)(1)(A). Second, the research must be undertaken to "discover information which is technological in nature." *Id.* I.R.C. § 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.* I.R.C. § 41(d)(1)(C).

#### **4. Analysis and Conclusion.**

The Department and Taxpayers agree that Brewery is undertaking the sort of "lab coat and test tube" activities typically associated with a common understanding of that which constitutes precision, quantifiable, experimental research. The audit report, with certain limitations, seemed to generally agree only disagreeing with the extent of credits claimed and whether Brewery had adequately documented the extent and scope of those qualifying activities. For instance, the audit report disagrees that the Brewery's improvement of existing beer brands did not qualify for the credit but does not dismiss the possibility that activities associated with development and formulation of wholly new brands could qualify.

The Department agrees that activities associated with the discovery or improvement of beer taste fall within the scope of potentially qualifying activities as provided for under the I.R.S. Technical Advice Memorandum which provides that the development of "new or improved textures, smells, or flavors" as satisfying the definition of "qualified research."

The Department and Taxpayers continue to disagree as to applicability the two competing regulatory regimes; does Indiana's REC provision impose a "discovery requirement" or the more loosely defined 9104 "resolving uncertainty" standard. For purposes of this Letter of Findings, the distinction is irrelevant because resolution of Taxpayers' protest does not turn on that distinction.

The Department, for sake of argument, also agrees that "discovery" or resolving "uncertainty" activities associated with the development of its canning line and equipment could *potentially* qualify for the credit under certain circumstances. In this instance, Brewery (and Taxpayers) are in the business of developing and selling beer and not canning machinery. The court in *Union Carbide Corp. and Subsidiaries v. Commissioner of Internal Revenue*, 697 F.3d 104 (2d. Cir. 2012) explained that:

Congress intended to allow taxpayers research credits for research performed to improve their production process, but Congress did not intend for all of the activities that were associated with the production process to be eligible for the research credit if the taxpayer was performing research only with respect to the process, not the product. *Id.* at 108.

In this case, Brewery undertook extensive activities to improve their canning line to improve their own production process.

That same court further noted that the credit could only be claimed for direct costs associated with improvements to the production process and not "for the use of personal property that are indirect research expenditures or general and administrative expenses . . . ." *Id.* The credit could only be claimed "for the cost that a taxpayer incurs

conducting qualified research that he would not otherwise incur." *Id.* at 109. It is this distinction which Taxpayers here failed to make, and which is at the core of Taxpayers' failure to qualify for the credit.

Taxpayers state that their "post-event, fact based estimation to reconstruct Brewery's qualified expenses was specifically approved by the Indiana Tax Court in *Erdmannsdorff v. Indiana Dept. of State Revenue*, 53 N.E.3d 621 (Ind. Tax Ct. 2016) as a means to substantiate their own tax position. In *Erdmannsdorff*, the petitioner - a seller of books, video tapes and other items - challenged the Department's assessment of income tax based on the "best information available" ("BIA") to the Department. *Id.* at 622-23. Petitioners had failed to maintain sales and business records but argued that they were entitled to summary judgment based on their own after-the-fact reconstructed inventories and credit card statements. *Id.* at 624-25. The court denied the request for summary judgment on the issue of the competing sources of information; the Department's BIA assessments and the petitioners' own reconstructed inventory and credit card information.

The Department does not find that the *Erdmannsdorff* dispositive of the issue raised here by Taxpayers. In that case, the petitioners presented the court with tangible, measurable - although disputed - evidence supporting its store inventory. In Taxpayers' case they correctly label their documentation as estimates and reconstructions neither of which meet the documentation standard necessary to qualify for the credit. As with any tax matter, there must be something tangible and measurable at the core of any claim to a credit or expense whether that be a withholding return, receipt, or pay stub.

Taxpayers' discussions with their employees, statistical adjustments, and sampling methodologies are all removed from the record-keeping requirement set out in Treas. Reg. § 1.6001-1 which requires the taxpayer to "keep such permanent books or accounts or records . . . as are sufficient to establish the amount of gross income, deductions, credits, or other matters . . . ."

It is Taxpayers' 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 Taxpayers. "[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.

Taxpayers essentially seek a form of "summary judgment" in which the Department administratively overturns the audit's finding that "the [Brewery] has not provided records to substantiate the amounts of the credits reported on its returns" and has not provided "contemporaneous documentation . . . to support the employee research participation percentages that [Brewery] used to calculate the qualified research expenses." Although the Department may intuitively agree that the Brewery likely conducted qualifying research, the Department is unable to agree that there is sufficient quantifiable and verifiable information to allow the credits in the amount requested and as here protested.

## FINDING

Taxpayers' protest is respectfully denied.

July 23, 2020

Posted: 09/30/2020 by Legislative Services Agency  
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