

DEPARTMENT OF STATE REVENUE

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Letter of Findings: 01-20210076; 01-20210077; 01-20210078
Indiana Individual Income Tax
For the Tax Year 2017

NOTICE: IC § 6-8.1-3-3.5 and IC § 4-22-7-7 require the publication of this document in the Indiana Register. This document provides the general public with information about the Department's official position concerning a specific set of facts and issues. This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register. The "Holding" section of this document is provided for the convenience of the reader and is not part of the analysis contained in this Letter of Findings.

HOLDING

Three (3) Shareholders provided additional but incomplete information to substantiate that they were entitled to claim a statutory exemption concerning income attributable to qualified utility patents. As such, Shareholders were only entitled to claim patril exemption based on the verifiable source documentation.

ISSUE

I. Indiana Individual Income Tax - Burden of Proof.

Authority: IC § 6-3-1-3.5; IC § 6-3-2-1; IC § 6-3-2-2; IC § 6-3-2-21.7; IC § 6-8.1-5-1; IC § 6-8.1-5-4; *Indiana Dep't of State Revenue v. Rent-A-Center East, Inc.*, 963 N.E.2d 463 (Ind. 2012); *Dep't of State Revenue v. Caterpillar, Inc.*, 15 N.E.3d 579 (Ind. 2014); *Miller Brewing Co. v. Indiana Dep't of State Revenue*, 903 N.E.2d 64 (Ind. 2009); *Scopelite v. Indiana Dep't of Local Gov't Fin.*, 939 N.E.2d 1138 (Ind. Tax Ct. 2010); *Wendt LLP v. Indiana Dep't of State Revenue*, 977 N.E.2d 480 (Ind. Tax Ct. 2012); *INDOPCO, Inc. v. Comm'r*, 503 U.S. 79 (1992); *Indiana Dep't of State Revenue, Sales Tax Division v. RCA Corp.*, 310 N.E.2d 96 (Ind. Ct. App. 1974); *Conklin v. Town of Cambridge City*, 58 Ind. 130 (1877).

Taxpayers protest the Department's assessment of individual income tax for 2017, claiming that they were entitled to the Qualified Patents Income Exemption.

STATEMENT OF FACTS

Taxpayers are three (3) out of six (6) shareholders ("Shareholders") of an Indiana S corporation ("Corporation"), which owns a Qualified Subchapter S Subsidiary ("Q Sub"). Both Corporation and Q Sub conduct business in Indiana. As an S corporation, the income and losses of Q Sub pass through and onto its sole shareholder, Corporation. Similarly, Corporation's income and losses pass through and onto its Shareholders, who, in turn, file their Indiana individual income tax returns, reporting and remitting their Indiana income tax accordingly.

In 2020, the Indiana Department Revenue ("Department") audited Corporation and Q Sub's business records and tax filings for 2017. Pursuant to the audit, the Department disallowed certain tax credits and exemptions claimed on the 2017 returns of the Q Sub and Corporation. As a result, the Department assessed Taxpayers additional income tax and interest. The Department, nonetheless, abated the penalty.

Taxpayers only protested the disallowance of exempt utility patent income. A hearing was held. Taxpayers' representative subsequently provided additional information to support their protest. This Letter of Findings ensues. Additional facts will be provided, as necessary.

I. Indiana Individual Income Tax - Burden of Proof.

DISCUSSION

Pursuant to the audit, the Department disallowed the qualified patents income exemption claimed by Taxpayers, the three (3) Shareholders. The Department's audit report, in part, explained:

Pursuant to IC [§] 6-3-1-3.5(a), adjusted gross income of an individual is federal adjusted gross income as

defined in Section 62 of the Internal Revenue Code, and modified per this regulation. The taxpayer[s] took a deduction for Qualified Patents Income Exemption Code 622 that was passed through on the IN K-1 of Corporation. The requirements for claiming this exemption are further discussed in IC [§] 6-3-2-21.7 and Income Tax Information Bulletin #104. It was indicated no Schedule IN-PAT was included with filed return. The Department did not allow this deduction on the S Corporation return and an adjustment is being made on the shareholder's Indiana income deductions

Taxpayers, to the contrary, claimed that they were entitled to the exemption. Therefore, the issue is whether Taxpayers provided sufficient supporting documents to demonstrate that they were entitled to claim the deduction of Qualified Patents Income Exemption.

As a threshold issue, all tax assessments are prima facie evidence that the Department's claim for the unpaid tax is valid; the taxpayer bears the burden of proving that any assessment is incorrect. IC § 6-8.1-5-1(c); *Indiana Dep't of State Revenue v. Rent-A-Center East, Inc.*, 963 N.E.2d 463, 466 (Ind. 2012). "[E]ach assessment and each tax year stands alone." *Miller Brewing Co. v. Indiana Dep't of State Revenue*, 903 N.E.2d 64, 69 (Ind. 2009). Thus, the taxpayer is required to provide documentation explaining and supporting their challenge that the Department's assessment is wrong. 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).

Indiana imposes a tax "on the adjusted gross income of every resident person, and on that part of the adjusted gross income derived from sources within Indiana of every nonresident person." IC § 6-3-2-1(a). Indiana generally follows the federal tax scheme with certain modifications. IC § 6-3-2-1; IC § 6-3-1-3.5. IC § 6-3-1-3.5(a) provides the starting point to determine the taxpayer's taxable income and to calculate what would be the taxpayer's Indiana income tax after applying certain additions and subtractions to that starting point. IC § 6-3-2-2(a) specifically outlines what is income derived from Indiana sources subject to Indiana income tax.

Indiana also provides certain tax credits, deductions, or exemptions which a taxpayer may claim to reduce his or her tax liability. One of the tax exemptions available for the Tax Year at Issue under Indiana tax law is the Qualified Patents Income Exemption outlined in IC § 6-3-2-21.7, which states:

- (a) This section applies to a qualified patent issued to a taxpayer after December 31, 2007.
- (b) As used in this section, "invention" has the meaning set forth in 35 U.S.C. 100(a).
- (c) As used in this section, "qualified patent" means:
 - (1) a utility patent issued under 35 U.S.C. 101; or
 - (2) a plant patent issued under 35 U.S.C. 161;

after December 31, 2007, for an invention resulting from a development process conducted in Indiana. The term does not include a design patent issued under 35 U.S.C. 171.

- (d) As used in this section, "qualified taxpayer" means a taxpayer that on the effective filing date of the claimed invention:
 - (1) is either:
 - (A) an individual or corporation, if the number of employees of the individual or corporation, including affiliates as specified in 13 CFR 121.103, does not exceed five hundred (500) persons; or
 - (B) a nonprofit organization or nonprofit corporation as specified in:
 - (i) 37 CFR 1.27(a)(3)(ii)(A) or 37 CFR 1.27(a)(3)(ii)(B); or
 - (ii) [IC 23-17](#); and
 - (2) is domiciled in Indiana.

(e) Subject to subsections (g) and (h), in determining adjusted gross income or taxable income under [IC 6-3-1-3.5](#) or [IC 6-5.5-1-2](#), a qualified taxpayer is entitled to an exemption from taxation under [IC 6-3-1](#) through [IC 6-3-7](#) for the following:

- (1) Licensing fees or other income received for the use of a qualified patent.
- (2) Royalties received for the infringement of a qualified patent.
- (3) Receipts from the sale of a qualified patent.
- (4) Subject to subsection (f), income from the taxpayer's own use of the taxpayer's qualified patent to produce the claimed invention.

(f) The exemption provided by subsection (e)(4) may not exceed the fair market value of the licensing fees or other income that would be received by allowing use of the qualified taxpayer's qualified patent by someone other than the taxpayer. The fair market value referred to in this subsection must be determined in each taxable year in which the qualified taxpayer claims an exemption under subsection (e)(4).

(g) The total amount of exemptions claimed under this section by a qualified taxpayer in a taxable year may not exceed five million dollars (\$5,000,000).

(h) A taxpayer may not claim an exemption under this section with respect to a particular qualified patent for more than ten (10) taxable years. Subject to the provisions of this section, the following amount of the income, royalties, or receipts described in subsection (e) from a particular qualified patent is exempt:

- (1) Fifty percent (50[percent]) for each of the first five (5) taxable years in which the exemption is claimed for the qualified patent.
- (2) Forty percent (40[percent]) for the sixth taxable year in which the exemption is claimed for the qualified patent.
- (3) Thirty percent (30[percent]) for the seventh taxable year in which the exemption is claimed for the qualified patent.
- (4) Twenty percent (20[percent]) for the eighth taxable year in which the exemption is claimed for the qualified patent.
- (5) Ten percent (10[percent]) each year for the ninth and tenth taxable year in which the exemption is claimed for the qualified patent.
- (6) No exemption under this section for the particular qualified patent after the eleventh taxable year in which the exemption is claimed for the qualified patent.

(i) To receive the exemption provided by this section, a qualified taxpayer must claim the exemption on the qualified taxpayer's annual state tax return or returns in the manner prescribed by the department. **The qualified taxpayer shall submit to the department all information that the department determines is necessary for the determination of the exemption provided by this section. (Emphasis added).**

IC § 6-8.1-5-4(a) further requires, "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. . . ." Accordingly, in order to obtain the benefit of the above exemption, both federal and Indiana law require that the taxpayer maintain and produce *contemporaneous* records sufficient to verify the amount the taxpayer claims. As the Indiana Supreme Court explained, "an income tax deduction is a matter of legislative grace and . . . the burden of clearly showing the right to the claimed deduction is on the taxpayer." *Dep't of State Revenue v. Caterpillar, Inc.*, 15 N.E.3d 579, 583 (Ind. 2014) (citing *INDOPCO, Inc. v. Comm'r*, 503 U.S. 79, 84 (1992)). That is, "Exemptions from taxation are not, and ought not to be, especially favored by the courts; and where such an exemption 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)).

Therefore, a taxpayer, who has an invention resulting from a development process conducted in Indiana, may claim the above qualified patents income exemption for each qualified patent issued after December 31, 2007, for a total of ten taxable years pursuant to IC § 6-3-2-21.7(h), provided that the qualified patent in question does not expire during the ten-year life of the exemption. Subject to the limitation under IC § 6-3-2-21.7(g), during the total ten-year life of the exemption, for each qualified patent, the taxpayer may claim fifty (50) percent income from that qualified patent to be exempt from the Indiana income tax for the first five (5) taxable years. IC § 6-3-2-21.7(h)(1). Thereafter, the exemption is incrementally reduced by ten percent each year for the following three years. IC § 6-3-2-21.7(h)(2) through (4). Only 10 percent income will be exempt for the ninth and tenth year. IC § 6-3-2-21.7(h)(5). Thereafter, no exemption will be allowed for any qualified patents after the eleventh taxable year. IC § 6-3-2-21.7(h)(6). IC § 6-3-2-21.7(h) does not mandate that the ten-year life of the exemption begins when the qualified patent is issued.

Admittedly, the taxpayer may apply for, and the United States Patent and Trademark Office may issue the taxpayer, different qualified patents at different times in different years. As such, the taxpayer could claim this exemption concerning more than one qualified patent on the same Indiana income tax return. Those qualified patents - claimed on the same tax return - also may not all be for the same taxable year during the ten-year life of the exemption. In other words, the taxpayer may include a newly issued qualified patent on a return as the first taxable year, which would have been exempted at a 50 percent. Meanwhile, on the same return, the taxpayer may also claim an existing qualified patent for the same exemption for the eighth taxable year of the ten-year life, which would have been only exempted at a 20 percent. Since IC § 6-3-2-21.7(h) offers the exemption for a total of

ten taxable years, the taxpayer claiming this exemption must establish and maintain verifiable records to properly claim this exemption each year for each qualified patent pursuant to IC § 6-3-2-21.7(i) and IC § 6-8.1-5-4(a).

In this instance, the Department disallowed the Qualified Patents Income Exemption claimed by Shareholders because (1) Corporation and Q Sub did not properly file their 2017 returns to claim the exemption, and (2) the amount claimed could not be verified during the audit.

Throughout the protest process, Taxpayers reiterated that they were entitled to claim the exemption for seven patents issued under IC § 6-3-2-21.7 on their 2017 returns. In addition to the 2017 returns of Q Sub and Corporation, Taxpayers submitted several 2017 Schedule IN K-1 forms, one Schedule IN-PAT form, two letters from their patent attorney, and an Excel file, explaining the amount exempted concerning each of seven patents on the Q Sub's 2017 return to support their protest.

It should be noted that there is no dispute that Taxpayers in this instance are talented inventors. A review of the supporting documentation submitted as well as publicly verifiable information demonstrated that since 1990s, Taxpayers - through their patent attorney - applied for, and the United States Patent and Trademark Office issued, more than twenty (20) patents, utility or otherwise. Each patent, having a life of 20 years, was issued at different times, including January 1997, March 2008, April 2009, November 2010, January 2013, and January 2017. Among those patents, several patents were improvements of the initial patents. Several patents were issued before January 1, 2008, and several patents have expired. The Q Sub, as the assignee of these patents, claimed the above exemption concerning seven (7) patents issued in March 2008, November 2008, April 2009, November 2010, January 2013, and January 2017, respectively.

Upon review, Taxpayers' supporting documents showed that one utility patent in question was mentioned in the letter dated, January 30, 2017. In that letter, Taxpayers' attorney referenced the Letters Patent, No. 9XXXX46, as a utility patent issued on January 24, 2017. The Department is therefore prepared to agree that (1) Q Sub was entitled to claim the above exemption at 50 percent on the 2017 return, and (2) 2017 was the first taxable year pursuant to IC § 6-3-2-21.7(h)(1). Since Q Sub and Corporation are S corporations, Taxpayers in this instance were entitled to claim the exemption at 50 percent for the 2017 patent on their returns and 2017 was the first exemption year as a result.

It should also be noted that the Excel file contained useful information concerning the amount of income from the 2017 qualified patent, which Taxpayers may claim on the 2017 return. The information alone however cannot be verified without source documentation, such as invoices, sales contracts, payments receipts, or 1099 forms. As such, Taxpayers are required to provide the source documentation to substantiate the amount of their claim within 30 days from the date the Department issues this final determination.

As to the other six patents issued in 2008, 2009, 2010, 2013, Taxpayers' reliance of the above supporting documents, however, was misplaced. Specifically, first, Taxpayers' Schedule IN-PAT for 2017 stated that Q Sub claimed 50 percent of the income from qualified patents for the fourth taxable year of the ten-year exemption beginning 2014. But the attachment to the Q Sub's Schedule IN-PAT for 2017 stated that there were seven different patents: six (for patents issued in 2008, 2009, 2010, and 2013) were for the third exemption year, and one (for patents issued in 2017) was for the first exemption year. Had Taxpayers claimed the above exemption when the 2008 patent was first issued in 2008 and again for each subsequent taxable year, they would not be entitled to the 50 percent exemption. Taxpayers would have been only entitled to 10 percent in 2017 under IC § 6-3-2-21.7(h)(5). Likewise, the same applies to patents issued in 2009, 2010, and 2013. According to Taxpayers' supporting documents, there is no indication that Taxpayers elected not to claim for the 2008 patent on their 2008 returns when the patent was first issued. Similarly, there is no indication that Taxpayers elected not to claim for those patents on their subsequent returns (including 2009, 2010, 2011, 2012, 2013). Taxpayers' filing simply stated that the first exemption year was 2014. Taxpayers did not explain or establish with verifiable documentation that this was, in fact, the case.

Even if, for the sake of the argument, assuming that Taxpayers properly claimed that 2014 was the first-year exemption for the patents in questions on their 2014 returns, Q Sub, Corporation, and Taxpayers did not offer verifiable documents to show that they properly maintained and tracked their records for the same patents concerning the second and third taxable years. Since Taxpayers did not offer verifiable records to substantiate and establish a baseline - namely, the first exemption year for each patent that was issued in 2008, 2009, 2010, and 2013 - and subsequent taxable years, the Department is not able to agree that Taxpayers were entitled to claim the 50 percent exemption for patents issued in 2008, 2009, 2010, and 2013.

In short, the Department agrees that Taxpayers were entitled to claim the above exemption for the 2017 patent at

50 percent on their 2017 returns and 2017 was the first exemption year for that patent under IC § 6-3-2-21.7(h)(1). Taxpayers must provide verifiable source documents within 30 days so the Department can determine the correct amount subject to income tax. If this supporting documentation is not received by the Department within that timeframe, the Department will have no choice but to deny Taxpayers' protest on this issue. However, given the totality of the circumstances, in the absence of other verifiable supporting documentation, the Department is not able to agree that Taxpayers were entitled to claim the 50 percent exemption for patents issued in 2008, 2009, 2010, and 2013 on their 2017 returns. As such, the audit correctly disallowed the exemption.

FINDING

Taxpayers' protest is sustained, in part, and respectfully denied, in part. Without the verifiable information for income from the 2017 patent, the Department cannot determine the correct amount subject to income tax. As such, Taxpayers must provide verifiable source documents within 30 days. Otherwise, Taxpayers' protest is denied in full.

July 29, 2021

Posted: 09/29/2021 by Legislative Services Agency
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