DEPARTMENT OF STATE REVENUE

01-20211052.LOF

Letter of Findings: 01-20211052
Individual Income Tax
For Tax Years 2017, 2018, and 2019

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 Indiana Department of Revenue's (the "Department") 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 This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register.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 determined that S-Corporation did not have qualified research expenses and reduced the credit to zero, which in turn reduced the available credit for an individual shareholder to zero on his individual tax return. The Department disagreed with shareholder that S-Corporation performed qualified research activity; therefore, the protest is denied.

ISSUE

I. Individual Income Tax - Qualified Research Expense Projects, Research Expense Credits, and Documentation.

Authority: IC 6-3.1-4-2; IC 6-3.1-4-4; IC 6-3.1-4-7; IC 6-8.1-5-1; IC 6-8.1-5-4; *Indiana Dept. of State Revenue v. Rent-A-Center East, Inc*., 963 N.E.2d 463 (Ind. 2012); *Lafayette Square Amoco, Inc. v. Indiana Dept. of State Revenue*, 867 N.E.2d 289 (Ind. Tax Ct. 2007); *Little Sandy Coal Company, Inc. v. Commissioner of Internal Revenue*, 62 F.4th 287 (7th Cir. 2023); 26 U.S.C.A § 41; Treas. Reg. § 1.41; Treas. Reg. § 1.6001-1.

Taxpayer protests the denial of a claimed credit.

STATEMENT OF FACTS

Taxpayer is a shareholder in an out-of-state S-Corporation (hereinafter "Company"). The Indiana Department of Revenue ("Department") audited Company related to tax years 2017, 2018, and 2019, and determined that Company was not entitled to claim any research expense credits. As a result, Company was assessed additional sales tax and corporate income tax as well as penalties and interest. Because Company is an S-Corporation and the Department determined Company had no allowable research expense credits, the adjustments "flowed through" to individual shareholders, including Taxpayer.

The Department reviewed Taxpayer's tax returns for the related audit period. Taxpayer claimed flow-through research expense credits on his original individual income tax returns. Because the Department determined Company did not have qualified research activities and reduced the related research expense credits to zero, there were no credits to flow through to Taxpayer. The Department adjusted Taxpayer's originally claimed research expense credits to zero for all three tax years and assessed Taxpayer accordingly.

Specifically, the Department determined tax year 2017 was out of statute. Reducing the research expense credit for tax year 2018 to zero resulted in an assessment for additional tax. The adjustment for tax year 2019 did not result in additional tax due because the research expense credit reduction was offset by an increase in Company's withholding tax amounts related to Taxpayer.

A consulting firm ("Consultant") represented Company during the audit review. Consultant filed a protest on behalf of Taxpayer protesting the reduction of research expense credits to zero and the assessment of additional tax related to the three tax years. An administrative hearing was held in which Consultant explained the basis for the protest. This Letter of Findings results. Additional facts will be provided as necessary.

I. Individual Income Tax - Qualified Research Expense Projects, Research Expense Credits, and Documentation.

DISCUSSION

The issue is whether Company has established that it conducted qualified research, which in turn would flow through as research expense credits for Taxpayer on his individual tax returns.

In tax years 2017, 2018, and 2019, Company reported approximately $260,000 in qualifying research expenses ("QRE"), which translated into approximately $15,000 in research expense credits ("REC"). Because the REC amounts flow through to the shareholders of an S-Corporation, Taxpayer claimed approximately $2,300 in RECs on his individual income tax return for the three-year audit period.

The Department conducted an audit of Company and reduced all REC amounts to zero for tax years 2017, 2018, and 2019. After a review of the materials submitted, the Department determined only two projects qualified as potential research activities because they were completed in Indiana; however, the Department ultimately determined that under 26 U.S.C.A § 41(d), Company did not meet any portion of the four-part test set forth in the statute because the work performed by Company was part of the routine course of business provided by a mechanical contractor. Because Company was not performing any QRE activity, there could not be any related REC for Company or its shareholders (i.e., Taxpayer).

As a result of the adjustments from the Company audit, the Department reduced the REC on Taxpayer's individual income tax return to zero for tax years 2017, 2018, and 2019. Because of the reductions in REC, Taxpayer received an assessment related to tax year 2018. For tax year 2019, the adjustments were offset by an increase in withholding taxes collected by Company on Taxpayer's behalf, and no additional taxes were assessed. For tax year 2017, the Department determined the tax year was out of statute, so no changes were made. Taxpayer protests the Department's determination that Company had no QRE activity, which resulted in no RECs available to Taxpayer and an assessment of additional tax.

As a threshold issue, it is the Taxpayer's responsibility to establish that the existing tax assessment is incorrect. A proposed assessment is prima facie evidence that the Department's claim for the unpaid tax is valid. IC 6-8.1-5-1(c). The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made. *Id.*; *See e.g., Indiana Dept. of State Revenue v. Rent-A-Center East, Inc*., 963 N.E.2d 463, 466 (Ind. 2012); *Lafayette Square Amoco, Inc. v. Indiana Dept. of State Revenue*, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007).

A taxpayer that incurs Indiana qualifying research expenses in a tax year is entitled to a research expense tax credit for the taxable year. IC 6-3.1-4-2(a). Section 41 of the Internal Revenue Code and related regulations apply to the interpretation and administration by the Department for the REC. IC 6-3.1-4-4. This includes allocation and pass through of credit to applicable taxpayers. *Id*. If a pass-through entity does not have a state income tax liability against which the research expense tax credit may be applied, a shareholder of the pass-through entity is entitled to a research expense tax credit on his/her taxes. IC 6-3.1-4-7(a).

QRE is the amount of money paid or incurred by a taxpayer during the taxable year for in-house research expenses and contract research expenses. 26 U.S.C.A § 41(b)(1). Activities that constitute qualified research are defined under 26 U.S.C.A § 41(d)(1) as research expenditures that may be treated as specified research or experimental expenditures under Section 174, research undertaken for the purpose of discovering information that is technological in nature and the application of which is intended to be useful in the development of a new or improved business component, and research in which substantially all the activities constitute elements of a process of experimentation relating to a new or improved function, performance, reliability, or quality of Taxpayer's business.

Taxpayer argues that Company performed QRE and met all four tests of under Section 41(d). Taxpayer provides specifics related to two projects: "Project 1" and "Project 2." Related to "Project 1," Taxpayer provided the following explanation:

> [Company] made several changes to the existing piping and designed a new system. [Company] increased the pipe size on the cooling water line to improve functionality and reliability. Piping was extended from its original location to achieve constructability. Further, piping needed to be rerouted in order to accommodate the existing building steel, pumps were added, and damaged pumps were replaced.

For "Project 2," Taxpayer stated:

> [Company] designed and developed a new water line system for a customer. Specifically, [Company] undertook this project to improve the functionality and quality of its customer's new process. [Company] itself

> delivered newly designed water line piping and other mechanical systems as a product to its customer to improve the overall design.
>
> Specifically, [Company] redesigned the bean line for its customer, replacing all 4-inch diameter piping with 8-inch diameter piping around existing equipment and structures. The pipe needed to be bent in order to complete a circular loop and to install new supply, return, flanges, and cleanout routes. Various alternatives were considered, but the ultimate solution was to replace the existing pipe with a larger diameter piping to improve flow and efficiency.

The Department has no reason to doubt that skill is required by Company and its employees to make improvements to existing piping and other mechanical elements for each of these projects. However, the Department is unable to determine what new and innovative business components were developed and implemented during the course of either project. As summarized in the audit report, "A contractor's adaptation of an existing business component to a taxpayer's particular requirement or need is not qualified research. [Company] is an experienced, full service, mechanical contractor...[Company] has provided no information that would distinguish its contractor projects from those of a contractor adapting its existing business components to its particular or a particular customer's requirement or need, which is a specifically excluded activity." The Department agrees that Company and its employees were most likely faced with "uncertainties" in completing both projects and how best to change the piping from one size to another or modify existing design elements, but the Department does not agree that resolving the uncertainties "established the capability of method of developing [a] business component." Treas. Reg. § 1.41(a)(3)(i).

Even if a taxpayer has QRE, the taxpayer must fulfill the recordkeeping requirements in order to claim related REC. Under the federal code, a taxpayer claiming REC under Section 41 must retain records in "sufficiently usable form and detail to substantiate that the expenditures claimed are eligible for the credit." Treas. Reg. § 1.41-4(d). A person required to file a return with respect to income, "shall keep such permanent books of account or records, including inventories, as are sufficient to establish the amount of gross income, deductions, credits, or other matters required to be shown by such person in any return of such tax or information." Treas. Reg. § 1.6001-1(a). Additionally, Indiana requires general record keeping under 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.

Taxpayer argues that the documentation provided by Company during the audit and protest meets the recordkeeping requirements discussed in the federal and state statutes. The Department disagreed.

If Company seeks to obtain the benefit of REC, then Company is required to meet the requirements of Treas. Reg. § 1.41-4(d). Taxpayer argues that "oral testimony" is an adequate method of providing REC documentation and because "[Company] responded to all requests from Exam [Audit] timely and provided requested documentation to substantiate its claim for the REC" that the requirements were met. Company's estimates of wages for QRE were calculated by taking ten percent of the annual income of the employees. A breakdown of QRE wages by project was not provided during the audit. As a result, Taxpayer could not relate the QRE to the relevant business component as required by federal law.

Taxpayer is correct that estimates may be used in determining QRE and REC, but the Department also requires more specific details and documentation. As recently noted by the United States Court of Appeals,

> [Petitioner] failed to provide a principled way to determine the portion of employee activities that constituted elements of a process of experimentation. Instead, [Petitioner] offered arbitrary allocations for nonproduction employee wages that estimate the portion of the employee's time spent on qualified research.

Little Sandy Coal Company, Inc. v. Commissioner of Internal Revenue, 62 F.4th 287, 312 (7th Cir. 2023).

Further, the Court stated,

> The lesson for taxpayers seeking to avail themselves of the research tax credit is to adequately document that substantially all of such activities were research activities that constitute elements of a process of experimentation. Generalized descriptions of uncertainty, assertions of novelty, and arbitrary estimates of time performing experimentation are not enough.

Id. at 312.

Company's claim that it had QRE and related REC relies on estimates, and the estimates are not based on any type of contemporaneous records as required under the statutes.

In summary, Company had no qualifying research that made it eligible for research expense credits. Since Company had no research, then Taxpayer was not entitled to any REC on his individual income tax return. Additionally, even if there was QRE and related REC, Company lacked contemporaneous documentation to support either. Taxpayer has not met the burden under IC 6-8.1-5-1(c) of establishing the assessments were wrong.

FINDING

Taxpayer's protest is denied.

April 12, 2023

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An html version of this document.