DEPARTMENT OF STATE REVENUE

01-20221035.LOF
01-20221036.LOF
01-20221037.LOF

Letter of Findings: 01-20221035; 01-20221036; 01-20221037
Individual Income Tax
For Tax Years 2017 and 2018

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 This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register.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 claimed credit to zero, which in turn reduced the available credit for individual shareholders to zero on their individual tax returns. The Department disagreed with shareholders 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.

Taxpayers protest the denial of a claimed credit.

STATEMENT OF FACTS

Taxpayers are shareholders in an Indiana S-Corporation (hereinafter "Company"). The Indiana Department of Revenue ("Department") audited Company related to tax years 2017 and 2018 and determined that Company was not entitled to claim any research expense credits. 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 Taxpayers.

The Department reviewed Taxpayers' tax returns for the related audit period. Taxpayers claimed flow-through research expense credits on their 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 Taxpayers. The Department adjusted Taxpayers' originally claimed research expense credits to zero for both tax years and assessed Taxpayers accordingly.

A consulting firm ("Consultant") represented Company during the audit review. Consultant filed a protest on behalf of Taxpayers protesting the reduction of research expense credits to zero and the assessment of additional tax related to the two 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 Taxpayers on their individual tax returns.

In tax years 2017 and 2018, Company reported approximately $2,700,000 in qualifying research expenses ("QRE"), which translated into approximately $164,000 in research expense credits ("REC"). Because the REC amounts flow through to the shareholders of an S-Corporation, Taxpayers collectively claimed the approximately $164,000 in RECs on their individual income tax return for the two-year audit period.

The Department conducted an audit of Company and reduced all REC amounts to zero for tax years 2017 and 2018. Due to the large volume of records, Taxpayers and the Department agreed to a review of four sample projects that were selected at random. After a review of the materials submitted, 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 the engineering and construction industry. Because Company was not performing any QRE activity, there could not be any related REC for Company or its shareholders (i.e., Taxpayers).

As a result of the adjustments from the Company audit, the Department reduced the REC on Taxpayers' individual income tax return to zero for tax years 2017 and 2018. Taxpayers protest the Department's determination that Company had no QRE activity, which resulted in no RECs available to Taxpayers. The Department's audit of Company did not result in a material adjustment to income expenses; therefore, no changes were made to Taxpayers' reported income.

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 QREs 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.

Taxpayers argue that Company performed qualifying research and met all four tests under Section 41(d). Taxpayers provide specifics related to the four projects: "Project 1," "Project 2," "Project 3," and "Project 4."

Regarding "Project 1," Taxpayers provided the following explanation:

> The project was to be incorporated into an existing bowling center doing a large expansion to include laser tag and arcade. This project had unique issues due to the layout requirements and guidelines from the city. Specifically, the slope of the roof and the placement of the props and pieces. Taxpayer had to assess the ceiling restrictions because of the placements and roof requirements. Additionally, Taxpayer was adding custom features for an interactive laser tag and smart lighting. For the DMX lighting they have to undergo an evaluation of options each time based on project specifications, specifically for the cause and effect of the desired environment. For this project, [Company] designed an element which incorporated a robot arm with a specific lighting tag. This design process included elements of identifying the proper placement, lighting requirements and fixture design to support the game element. Taxpayer also had to consider the power requirements needed to provide a fully functional and reliable game element as well as the proper conduit routing to make it perform as required without impacting game play. The design required identifying the best and safest route as well as the triggerable effects to achieve the performance requirements. For the . . . project, a set of movies were included as part of the game function. Accordingly, the design feature included ceiling considerations and challenges as to that design. Specifically, [Company] had to incorporate overhead

> support beams and verify the design of the steel frame had proper placement based on the load requirements and head clearance levels to maintain functional requirements.

For "Project 2," Taxpayers described:

> The concept was for an urban mission field, and it was a custom design for this specific customer. Taxpayer's design had to create a concept of incorporating the city architecture, which required designing and fabricating the game play elements and physical features. That included the creation of a center prop piece that was 16-17 feet tall. This feature had to be designed to be reliable to repeated game play wear and tear.

For "Project 3," Taxpayers stated:

> This project was to create a game play element in a futuristic space station. Challenges included in this design was the client's requirements to have its accessibility codes, fire codes and electrical codes. The design work done in the Taxpayer's facility but the ultimate destination for the game was to be in [another country].

For "Project 4," Taxpayers detailed:

> This was a custom golf course . . .. The client wanted to incorporate elements from a wizard adventure in the style of Harry Potter and Lord of the Rings. The design had to include wizards and castle [sic]. The engineering size planning had to incorporate elements which complied with ADA accessibility throughout.

The Department has no reason to doubt that skill is required by Company and its employees to design and incorporate custom 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, "The taxpayer provided no evidence to substantiate that the research expenditure contributed to the development of a new or improved business component. Rather, based on the description of each project the taxpayer is duplicating/adapting existing business components and processes that the taxpayer and other companies in the taxpayer's industry employ on a regular basis."

Even if a taxpayer has QREs, the taxpayer must fulfill the recordkeeping requirements in order to claim related RECs. Under the federal code, a taxpayer claiming RECs 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.

Taxpayers argue 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 the REC, then Company is required to meet the requirements of Treas. Reg. § 1.41-4(d). Taxpayers argue 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 QREs 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, Taxpayers could not relate the QREs to the relevant business component as required by federal law.

Taxpayers are correct that estimates may be used in determining QREs and RECs, but the Department also requires more specific details and documentation. As recently noted by the United States Court of Appeals in an REC case:

> [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.

This is the same reasoning the Department has explained in multiple final determinations issued over the course of several years regarding claimed RECs and the need to have thorough supporting documentation. Company's claim that it had QREs and related RECs relies on estimates, and the estimates are not based on any type of contemporaneous records as required under the statutes.

In summary, Company has not established that it had qualifying research that made it eligible for RECs. Since Company has not established that it had qualifying research, Taxpayers were not entitled to claim any RECs on their individual income tax return. Additionally, even if there were QREs and related RECs, Company lacked contemporaneous documentation to support its position regarding either. Therefore, since the claimed RECs flow from Company to Taxpayers, and since Company has not established that it had qualifying QREs and RECs, Taxpayers have not met the burden under IC 6-8.1-5-1(c) of establishing the assessments were wrong.

FINDING

Taxpayer's protest is denied.

June 5, 2023

Posted: 08/30/2023 by Legislative Services Agency
An html version of this document.