DEPARTMENT OF STATE REVENUE

02-20191222.LOF
01-20191223.LOF
01-20191224.LOF

Letters of Findings: 02-20191222; 01-20191223; 01-20191224
Indiana Income Tax
For the Years 2010-2016

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 This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register.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

HOLDING

Corporation, resident shareholder, and non-resident shareholder failed to establish that they qualify for claimed research expense credits.

ISSUE

I. Indiana Income Tax - Research Expense Credits.

Authority: IC 6-3.1 *et seq*.; IC 6-3-1-3.5; IC 6-3.1-4-4; IC 6-8.1-5-1; *Little Sandy Coal Company, Inc. v. Commissioner of Internal Revenue*, 62 F.4th 287 (7th Cir. 2023); *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); *Tell City Boatworks, Inc. v. Indiana Department of Revenue* 162 N.E.3d 603 (Ind. Tax Ct. 2020) *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); IRC § 41; IRC § 174; Treas. Reg. § 1.41-4; Letter of Findings 01-20200018 (July 23, 2020); *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-i-e-research-tax-credit-irc-41-table-of-contents).

Taxpayers protest the denial of claimed research expense credits.

STATEMENT OF FACTS

Taxpayers are a corporation ("Corporation") and two shareholders, hereafter referred to collectively as "Taxpayers." Corporation elected to be taxed as a sub-q entity, meaning Corporation's income and losses pass through to its shareholders.

The Indiana Department of Revenue ("Department") conducted an audit of Taxpayer's returns for the years 2010 through 2016. Following its audit, claimed research expense credits were disallowed by the Department. Tax years 2010-2014 are beyond the statute of limitations, so the Department disallowed research credits for tax years 2015 and 2016 only. The disallowance of credits claimed by the Corporation increased the amount of taxable income and, because Corporation is a pass-through entity with an out-of-state shareholder, assessments were issued to both Corporation and its shareholders.

Taxpayers disagreed with the assessments and submitted protests. An administrative hearing was conducted, during which Taxpayers' representatives explained the basis for the protests and provided supplemental documentation. This Letter of Findings results. Additional facts will be provided below, as necessary.

I. Indiana Income Tax - Research Expense Credits.

DISCUSSION

Taxpayers disagree with Department's audit findings and claim they have qualified research expenses ("QREs") for the years at issue. Taxpayers provided supplemental documentation to further describe their activities.

Notices of proposed assessment issued by the Department are *prima facie* evidence that the Department's assessments are correct; the burden of proving the assessment is incorrect rests with the taxpayer. 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 or 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, when an agency is charged with enforcing a statute, the court defers to the agency's reasonable interpretation of that statute "over an equally reasonable interpretation by another party." *Indiana Dep't of State Rev. v. Caterpillar, Inc.*, 15 N.E.3d 579, 583 (Ind. 2014).

Indiana's income tax incorporates the federal definition of adjusted gross income with state-specific modifications. IC 6-3-1-3.5(b). Once a taxpayer's adjusted gross income is determined, tax credits outlined in IC 6-3.1 may be claimed to reduce taxable income. Like deductions, exemptions, and exclusions, tax credits are matters of legislative grace. *Stinson Estate v. United States*, 214 F.3d 846, 848 (7th Cir. 2000). They should be narrowly construed and the burden rests with the taxpayer to demonstrate that it qualifies for any given credits. *Id.*

Indiana statutes provide a framework for research expense tax credits which largely rely on federal interpretations of QREs to determine qualification for the credits. I.C. § 6-3.1-4-4; IRC § 41. I.R.C. § 41(d) is the applicable statute and defines "qualified research" as research:

(A) with respect to which expenditures may be treated as expenses under section 174,
(B) which is undertaken for the purposes of discovering information --
  (i) which is technological in nature, and
  (ii) the application of which is intended to be useful in the development of a new or improved business component of the taxpayer, and
(C) substantially all of the activities of which constitute elements of a process of experimentation for a [qualified purpose.]

This four-pronged test determines whether qualified research activities took place. 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 the research. I.R.C. § 41(d)(1)(C). All four prongs must be satisfied to qualify for the credit.

Before examining each element of the four-pronged test, one general argument must be dispelled. Taxpayers protest that the Department incorrectly relied on Treasury Decision ("T.D.") 8930 instead of T.D. 9104 in reaching its conclusions. However, the Department's audit references both standards and notes that Taxpayers do not meet either one. Taxpayers therefore misstate the Department's reliance on T.D. 8930 in this case. Additionally, this Letter of Findings will refer solely to T.D. 9104 in its determination.

A. Section 174

IRC § 174 permits the deduction of research or experimental expenses that are incurred in connection with a taxpayer's trade or business. Such expenses represent research if they are for activities intended to discover information that would eliminate uncertainty concerning the development or improvement of a product. Treas. Reg. § 1.174-2(a)(1). In its audit, the Department concluded that the work conducted by Taxpayers was within the scope of normal engineers completing work for various clients. These activities were carried out based on the expertise and education of the employees; uncertainty was not present.

In this protest, Taxpayers claim specific HVAC systems and the methods of implementing those systems were both uncertain. However, regarding the development of an HVAC system, the activities listed by Taxpayers are within known industry practices and Corporation is experienced enough to be familiar with these activities. Taxpayers did not demonstrate any doubt in its capability to develop the final design of its HVAC systems. Designing a new system using established methods is meaningfully distinct from discovering new information to eliminate uncertainty about the system's development. Taxpayers fail to meet this test.

B. Research for Discovering Information that is Technological in Nature

In its audit report, the Department concludes that, because Taxpayers had the knowledge to prepare the appropriate design, research could not be conducted for the purpose of discovering information that is technological in nature. Under T.D. 9104, the technological-in-nature test requires the development or improvement of the given business component. Taxpayers have not demonstrated how their actions developed a

new or improved business component. As stated in the Department's audit, "both the customer and taxpayer know that taxpayer has the education/experience to prepare the appropriate design." That is, Taxpayers' experience in the industry is sufficient to establish the design of the business component. Taxpayers are not discovering information; they are applying current knowledge. Taxpayers fail to meet this test.

C. Business Component Test

QREs must be useful to the development of a new or improved business component for the taxpayer. I.R.C. § 41(d)(1)(B)(ii). "Research is useful if it provides some level of functional improvement to the taxpayer." *Tell City Boatworks, Inc. v. Indiana Department of Revenue* 162 N.E.3d 603, 617 (Ind. Tax Ct. 2020). Taxpayers claim their engineering designs and methods for installing various HVAC projects constitute an improved business component. In its audit report, the Department cited the IRS Audit Technique Guide, 2005 WL 405783 (June 2005) and stated that "a taxpayer must be able to tie the qualified research it is claiming for the credit to the relevant business component." Taxpayers dispute the relevance of this authority, but the Department has repeatedly found the IRS Audit Technique Guide as persuasive. *See, e.g.,* Letter of Findings 01-20200018 (July 23, 2020) 20200930 Ind. Reg. 045200479NRA.

Here, Taxpayers have failed to demonstrate how each QRE was related to the improvement of a business component or how that improvement benefitted the taxpayer. In installing the HVAC systems, Taxpayers are undoubtedly improving the building. But under IRC § 41, the building is not Taxpayers' business component - the HVAC systems are. Designing and installing HVAC systems is within the normal scope of Taxpayers' employment; running experiments to develop improvements to HVAC systems generally is not and has not been demonstrated here. Therefore, Taxpayers fail this test.

D. Substantially all the Activities Constitute a Process of Experimentation

Under Treas. Reg. § 1.41-4(a)(5), a process of experimentation does not include evaluating alternatives to establish the appropriate design of a business component if the capability and method for developing or improving the business component is not uncertain. The Department's audit concluded that Taxpayers had ample capability and knowledge for developing its business components. Taxpayers assert that conceptual designs were drafted and altered based on suggestions from many parties, including the owner's specifications. Taxpayers claimed that a systematic trial and error process took place via calculations and reviewing specifications. However, Taxpayers did not provide evidence of a trial-and-error process. Arithmetic is not a process of experimentation; rather, it is fundamental to designing any item to customer specification, even for the most well-versed and experienced designer. *See Little Sandy Coal Co., Inc. v. Comm'r of Internal Revenue*, 62 F.4th 287, 309 (7th Cir. 2023) (forming models based on engineering calculations did not qualify as a process of experimentation). The mere fact that calculations occurred, or that an initial design was altered, does not demonstrate that a process of experimentation was undertaken.

E. Sufficiently Documenting Qualified Research

Without sufficient documentation, it is impossible to substantiate any of the four prongs Taxpayers claim to satisfy. If Taxpayers seek to claim research expense credits, Taxpayers must retain records in a "sufficiently usable form and detail to substantiate that the expenditures claimed are eligible for the credit." Treas. Reg. 1.41-4(d) (TD 9104). In the present case, the Department concluded that Taxpayers did not have sufficient records to substantiate qualification for the credit. Taxpayers claim that the Department can corroborate QREs through "the best information available to them," and that the Department can make an evaluation without reference to specific documentation.

IC 6-8.1-5-1 does authorize the Department to issue tax assessments based on the best information available. But the Department still requires specific details and documentation to support the amount of claimed expenses to determine the value of any potential QREs. The Seventh Circuit Court of Appeals explained this in a recent 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.
> . . .
> 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.

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

The Department finds this language clear, logical, and mirroring the Department's reasoning in published decisions of years past.

In this case, Taxpayers provided pictures, schematics, and tables, attempting to demonstrate that it undertook qualified research. They went on to explain generally their methodology for determining the amount of QREs that were incurred. But this methodology was, at best, an educated guess. It is far from retaining records that establish Corporation's QREs. It establishes neither how employees spent their time nor how Taxpayers' expenses related to the four tests described in IRC § 41(d). Rather, the documentation was generalized and provided no concrete data to corroborate that Corporation conducted qualifying research or incurred QREs.

Taxpayers have not established that Corporation conducted qualifying research and was eligible for research expense credits. Taxpayers did not meet any of the four tests under IRC § 41(d) and failed to corroborate claims with adequate documentation. Thus, they are unable to meet the burden of proving the proposed assessments wrong as required by IC 6-8.1-5-1(c).

FINDING

Taxpayers' protest is respectfully denied.

August 29, 2023

Finding Replaces: New

Posted: 11/01/2023 by Legislative Services Agency
An html version of this document.