DEPARTMENT OF STATE REVENUE

02-20182406.LOF

Letter of Findings: 02-20182406
Corporate Income Tax
For the Years 2014, 2015, and 2016

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HOLDING

Indiana Orchard failed to establish that it was entitled to claim Indiana's research expense credit; in reviewing activities which involved the development and formulation of wine or in pruning its crops, the Department found that Indiana Orchard did not discover information which was technological in nature or which expanded the common knowledge of other skilled professionals in the orchard business.

ISSUE

I. Corporate Income Tax - Qualified Research Expenses.

Authority: IC § 6-3.1-4-1; IC § 6-3-1-3.5(b); IC § 6-3.1-4-2(a); IC § 6-8.1-5-1(c); IC § 6-8.1-5-4(a); *IDOPCP, Inc. v. Comm'r*, 503 U.S. 79 (1992); *New Colonial Ice Co. v. Helvering*, 292 US. 435 (1934); *Union Carbine Corp. and Subsidiaries v. C.I.R.* 97 T.C.M. (CCH) 1207 (Tax Ct. 2009); *Trinity Industries, Inc. v. U.S.*, 757 F.3d 400 (5th Cir. 2014); *United States v. McFerrin*, 570 F.3d 672 (5th Cir. 2009); *Stinson Estate v. United States*, 214 F.3d 846 (7th Cir. 2000); *Suder v. Commissioner of Internal Revenue*, T.C. Memo. 2014-201 (T.C. 2014); *Conklin v. Town of Cambridge City*, 58 Ind. 130 (1877); *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); I.R.C. § 41(d); I.R.C. § 41(d)(1); I.R.C. § 41(d)(1)(A); I.R.C. § 41(d)(1)(B)(i); I.R.C. § 41(d)(1)(B)(ii); I.R.C. § 41(d)(1)(C); Treas. Reg. § 1.174-2; Treas. Reg. 1.41-4; Treas. Reg. § 1.41-4(a)(3); Treas. Reg. § 1.41-4(a)(3)(i); Treas. Reg. § 1.41-4(a)(3)(ii); Treas. Reg. § 1.41-4(a)(5); Treas. Reg. § 1.41-4(d) (TD 8930); Treas. Reg. § 1.41-4(d); *Audit Techniques Guide: Credit for Increasing Research Activities (i.e. Research Tax Credit) IRC § 41 - Substantiation and Recordkeeping* (2005); Letter of Findings 01-20180753 (June 15, 2018); Letter of Findings 01-20171187; 01-20171188; 01-20171189; 01-20171190 (May 1, 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 6, 2016); Letter of Findings 02-20130676 (January 16, 2015); Letter of Findings 02-20140326 (October 30, 2015); Letter of Findings 01-20110213 (October 4, 2011); *Wine Production*, https://www.britannica.com/topic/wine; *Brandy*, https://www.britannica.com/topic/brandy; *Grape*, https://www.britannica.com/plant/grape.

Taxpayer argues that the Department erred in disallowing research and expense credits attributable to pruning and wine development activities engaged in by the Taxpayer.

STATEMENT OF FACTS

Taxpayer is an Indiana corporation which operates an orchard. Taxpayer grows and sells apples, grapes, pumpkins, fruits, vegetables, and Christmas trees. Taxpayer also operates a retail farmers' market, winery, distillery, ice cream shop, cheese shop, and café.

The Indiana Department of Revenue ("Department") conducted an audit review of Taxpayer's income tax returns and business records. That audit found that Taxpayer claimed research expense credits on its federal and Indiana income tax returns. The research expense credits were based on a 2011, 2012, and 2013 "Indiana Research & Development Tax Credit" study ("REC Study") prepared by a third-party consulting company ("consultant"). Based on the results of the study, Taxpayer filed amended 2011, 2012, and 2013 Indiana corporate income tax returns.

The excess credits were "carried-forward" from the 2010, 2011, 2012 amended returns. Based on the amended returns, Taxpayer sought and received income tax refunds in 2014. As permitted under the three-year statute of

limitations, the Department's audit disallowed the carried-forward credits claimed on Taxpayer's 2014, 2015, and 2016 returns. The disallowance of the credits resulted in an assessment of additional corporate income tax for those three years. Taxpayer disagreed with the assessments and submitted a protest to that effect. An administrative hearing was conducted and this Letter of Findings results.

I. Corporate Income Tax - Qualified Research Expenses.

DISCUSSION

The issue is whether Taxpayer conducted qualifying research activities in improving wine formulations, developing distilled liquor, and improving plant pruning techniques, whether Taxpayer can adequately document the extent to which it conducted that research, and whether Taxpayer can adequately document the expenses related to its research activities.

A. Department's Audit Examination.

1. Qualifying Research Projects.

During the years 2012, 2013, 2014 and 2015, Taxpayer claimed approximately $1,600,000 in qualifying research expenses ("QREs") entitling it to approximately $120,000 in Indiana Research Expense Tax Credits ("RECs"). Those expenses were attributable to wage and supply costs.

The Department's audit concluded that the company's wine formulation and pruning activities did not "overcome the 4-part test" required under I.R.C. § 41(d) which defines "qualified research" as research:

> 1. [W]ith respect to which expenditures may be treated as an expense under section 174[;]
> 2. [W]hich is undertaken for the purposes of *discovering information* which is technological in nature (also known as the Discovery Test)[;] and
> 3. [T]he application of which is intended to be useful in the development of a *new or improved business component* of the taxpayer; and
> 4. [S]ubstantially all of the activities which constitute elements of a process of experimentation for a [qualified purpose.]

(*Emphasis added*).

At the outset, the Department's audit found that Taxpayer had erroneously based its claim to the credits on the application of "TD 9104 in calculating its Indiana research expense credit on its Indiana income tax returns." According to the audit report:

> The regulations that the [T]axpayer has asserted that it has relied on to calculate its credits were not promulgated and in effect until well over eleven months after the statutorily prescribed income in IC [§] 6-3.1-4-4.

The Department's audit then reviewed Taxpayer's REC Study. Taxpayer's study consultant stated that Taxpayer engaged in 216 projects which required Taxpayer to conduct qualifying research. The consultant "sampled" the 216 projects and prepared a "random sample of thirty projects." As the basis for the credits eventually claimed, the consultant then selected five projects which, according to the consultant, required qualifying "process improvements."

In turn, the Department's audit reviewed project details for three of the five projects. The Department reviewed Taxpayer research projects intended to (1) develop a "sweet nouveau wine," (2) develop a "sweet traditional port wine," and (3) improve Taxpayer's "pruning techniques to increase crop production."

The Department's audit then sought additional wage expense information from Taxpayer's consultant. The audit sought: (1) "detailed records of the wage expenses for each claimed project"; (2) "a breakdown of wages by employee by project"; and (3) "contemporaneous documentation to support the hours claimed." The Department also sought employee interview information on which the consultant's wage expense calculations were originally based. However, Taxpayer was unable to provide any details of the original employee interviews except for the consultant's "internal notes taken during a wage allocation interview [phone] call."

The audit also requested additional documentation to support the claimed cost of supplies consumed in

conducting the qualified research. The Department sought "supply invoices," "invoice numbers," and "vendor names." In addition, the Department asked Taxpayer to identify the research project associated with each particular supply expense. Taxpayer responded by identifying "fertilizer and chemical purchases" associated with the wine formulation and pruning research. Taxpayer claimed that *all* fertilizer and chemical purchases were used *exclusively* for research purposes a claim the audit found both "unlikely" and "unrealistic."

In addition to reviewing Taxpayer's documentation, the Department's audit representatives toured Taxpayer's facility accompanied by Taxpayer's own representatives and representatives of the consulting company which prepared the REC study. These various representatives toured Taxpayer's vineyard and distillery, obtaining firsthand knowledge pertaining to Taxpayer's activities.

The Department's audit disallowed the credits for reasons detailed in the audit report:

> After taking the tour, working with multiple representatives from [consultant] and making numerous requests for additional contemporaneous documentation to support the statements that were made in the [REC Study], the auditor did not receive any documentation that could support the claims made in the [REC Study] . . . . [T]he auditors were [] unable to substantiate the [T]axpayer's qualification for the credit in general. The auditors were unable to verify that the activities of the [T]axpayer would qualify as qualified research expenses . . . .

The audit concluded that Taxpayer failed to establish that it qualified for the credits because Taxpayer's cited activities did not meet the four-part test set out in I.R.C. § 41(d).

(a) Research Expenditures.

The audit found that Taxpayer's expenditures did not meet the first test - verifying qualified research and experimental expenditures - based on the definition set out in Treas. Reg. § 1.174-2. The audit found that Taxpayer "did not track any research and development expenses and the auditor was unable to verify the amount claimed on the returns . . . ."

(b) Discovering Technological Information.

The audit found that Taxpayer failed the second test as set out in Treas. Reg. § 1.41-4(a)(3) which requires that research "must be undertaken for the purpose of discovering information that is technological in nature." As explained in Treas. Reg. § 1.41-4(a)(3)(i), "[R]esearch 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 . . . ."

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 this case, the audit found that Taxpayer's wine formulation, spirit formulation, and pruning activities did not meet the second test because "[w]ith seven generations of the [owner's] family working in the business, the [T]axpayer has the education and experience in wine production." The audit concluded that Taxpayer's owners have "made wine for many years [and] already knew what was required to make the wine." According to the audit report:

> None of the information provided for the three selected projects established that the research exceeded expanded or refined the common knowledge of skilled professionals in the wine making business.

(c) New or Improved Business Component.

The audit found that Taxpayer failed to meet the third, "business component," test. According to the audit report, "A business component is defined as 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." According to the audit report, Taxpayer's particular wine formulation and pruning activity was not "tied" to any particular Taxpayer business component because Taxpayer "has not provided contemporaneous information to tie the

projects/business components to the claimed wage and supply expenses." According to the audit report, Taxpayer failed to meet the Treas. Reg. 1.41-4(d) "contemporaneous record" requirement.

> 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.

(d) Undertaking a Process of Experimentation.

The audit found that Taxpayer failed to meet the fourth, "process of experimentation," test as defined under Treas. Reg. § 1.41-4(a)(5). The regulation 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 found that Taxpayer's activities missed the experimentation benchmark because "uncertainty" was "clearly not present" and because Taxpayer was unable "to provide contemporaneous documentation supporting the wages or supplies by business component/project . . . ."

Anticipating Taxpayer's objection as to which regulatory regime was relevant in determining Taxpayer's qualification for the credit, the audit report found that under either regulatory regime, Taxpayer's wine development and pruning activities did not rise to the level of "qualified research." Whether under Treasury Decision 8930 (T.D. 8930, 66 F.R. 280-01), 2001 WL 34028585 (eff. Jan. 3, 2001) incorporating the "discovery test" or under Treasury Decision 9104 (T.D. 9104, 69 F.R. 22-01, 2004 WL 18938) (eff. Jan. 2, 2004) incorporating the less rigorous "uncertainty test," the audit concluded that Taxpayer had not established it was undertaking a "process of experimentation" qualifying it for the credits.

In support of the proposition that Taxpayer would have failed to meet the "process of experimentation" standard under the TD 9104 uncertainty standard, the audit cited to Treas. Reg. 1.41-4 (T.D. 9104) which provides in small part:

> Uncertainty concerning the development or improvement of the business component (e.g. its appropriate design) does not establish that all activities undertaken to achieve that new or improved business component constitute a process of experimentation.

The audit report notes that "[T]axpayer was specifically asked to provide documentation as to: 'what the steps were in their process of experimentation' 'what [were] the alternatives for each project;' and 'what process was used to evaluate the alternatives?'" In response, the audit report states that "[T]axpayer did not provide this information and [instead] provided mere statements as to its activities."

The audit concluded that Taxpayer failed to meet its "burden of demonstrating that its research activities . . . satisfy the process of experimentation requirement." *Id.*

2. Wage and Supply Expense Documentation.

The Department's audit concluded that Taxpayer did not prepare and retain contemporaneous records necessary to substantiate Taxpayer's argument that it was entitled to credits based on wages paid to Taxpayer's employees or the cost of supplies consumed in formulating Taxpayer's wine, spirits, or improving its pruning activities. The audit report stated that Taxpayer claimed credits based upon the consultant's after-the-fact employee interviews.

> The [REC Study] completed by [consulting company] states the employee qualified research participating percentages were estimated based on manager interviews.

The audit rejected the consultant's and Taxpayer's reliance on employee interviews and reliance on "estimates."

> [The] use of estimations of employee qualified research participation percentages on post activities management interviews is in conflict with [Treas. Reg. § 1.41-4(d) (TD 8930)].

Treas. Reg. § 1.41-4(d) (TD 8930) sets out the record keeping and documentation requirements for expenses

related to the research credit.

> 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*).

On their face, the audit found that employee interviews revisiting activities which took place months or years prior were not a reliable substitute for documentation prepared "before or during the early stages of the research project[s] . . . ."

As to Taxpayer's record keeping responsibility under Indiana law, the audit cited to this state's statutory record keeping requirement at IC § 6-8.1-5-4(a) which provides:

> 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.
>
> In addition, the audit report also referred to Chapter 7 of *Audit Techniques Guide: Credit for Increasing Research Activities (i.e. Research Tax Credit) IRC § 41 - Substantiation and Recordkeeping*, http://www.irs.gov/Businesses/Audit-Techniques-Guide:-Credit-for-Increasing-Research-Activities-(i.e.-Research-Tax-Credit)-IRC-§ 41 (last visited January 2, 2015).

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 Department concluded that even if Taxpayer had conducted qualifying research activities, Taxpayer had not prepared, maintained, retained, or presented records necessary to substantiate the wine development, distilled spirit development, and pruning research activities before or at the early stages of the experimentation.

B. Taxpayer's Response.

1. Qualifying Research Projects.

Taxpayer disagrees with the Department's conclusion that it does not engage in qualifying research activities. Taxpayer explains that it undertook to design new and improved wine, whiskey, and brandy, winemaking techniques, and process improvements "to increase the quality, efficiency, and functionality of all processes and products associated with [Taxpayer]." As an example, Taxpayer states that it undertook research projects to improve its wine's "flavor profile and mouth-feel." Taxpayer outlines its research projects:

• Determining the optimal field conditions and equipment configurations to develop new or improved wine varietals;
• Identifying and treating vineyard physical, chemical, and biological soil characteristics for specified grape cultivation;
• Determining the optimal method to produce new or improved wine products;
• Determining the appropriate equipment and machinery necessary to develop new functionalities for the manufacturing processes including bottling;
• Identifying the required improvements to existing and new manufacturing machinery for increased performance and capabilities;
• Determining the optimal process flow for the new or improved manufacturing processes, such as sequencing;
• Identifying the quality assurance method necessary to evaluate new, improved, and current wine products

and manufacturing processes; and
• Establishing the optimal ratio of ingredients for each wine formulation to achieve the specified flavor and texture characteristics.

Taxpayer concludes that it faced numerous uncertainties in addressing these specific questions. According to Taxpayer, "When the proper legal standards are applied to the facts relating to this inquiry, it leads to only one natural conclusion - that Taxpayer did have the requisite uncertainties."

Taxpayer explains that its activities were "technological in nature" because their experimentation relied "on the principles of agriculture and general engineering, biology, and chemistry . . . ." Taxpayer purportedly relied on these various technological principles in determining "baseline soil assessments and soil remediation" to develop solutions to soil "physical, chemical, or biological hazards," and developing new and improved bottling equipment and bottling techniques.

Taxpayer states that its research activities were directed toward developing a "[n]ew or improved business component." Taxpayer explains that these "business components" consist of improved wine, whiskey, and brandy.

Finally, Taxpayer states that its research activities rested upon a "[p]rocess of experimentation." According to Taxpayer, it experimented on "small blocks of experimental grapes" and "larger blocks of experimental vineyards." Taxpayer states that in doing so, it "evaluated vineyard characteristics to ensure that the vines could provide the necessary grapes to achieve the desired wine product."

Taxpayer explains in its own words:

> To develop the vines, during the first nine-week phase the growing vines were established on each respective trellis, to develop stronger vine trunks to increase winter survivability. Throughout the growing season, vineyard workers and winemaking personnel monitored the vines and maintained proper cropping zones. The Taxpayer made harvest decisions based on the type of grape and varietal of wine product. Additionally Taxpayer harvested the grapes and then analyzed for quality utilizing an array of chemical analysis, taste tests, and crush tests to ensure optimal wine quality.

Taxpayer states that it has met each and every one of the four criteria set out in I.R.C. § 41(d). Taxpayer concludes that its expenses were related to its business, that it faced numerous uncertainties, that its research was technological in nature, and that its activities resulted in the development of new or improved "components" such as wine, whiskey, and brandy.

2. Wage Expense Documentation.

Taxpayer disagrees with the Department's conclusion that Taxpayer failed to adequately document its employees' research activities and disagrees with the Department's audit finding that Taxpayer "has not provided records to substantiate qualification for the [REC] or to substantiate the amount of the [REC]."

According to Taxpayer, the only applicable REC record keeping requirement is found at Treas. Reg. § 1.41-4(d) which provides in small part:

> 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.

Taxpayer believes that the "sufficiently usable form and detail" provision should be "broadly read." Taxpayer concludes that the Department "is barred from demanding specific documents, and disallowing [credit] due to their lack of production, including . . . where the auditor demands documents of 'time actually spent' on qualified research activity." Taxpayer asserts that "taxpayers may capture their research costs using an appropriate method that relates to their system of maintaining, so long as the results are auditable." Taxpayer asserts that the laws of Indiana "forbid examiners for basing an adjustment on a purported failure to produce documentation in any examination" and that "documentation is not necessary to prove a taxpayer engaged in a particular activity in the tax year(s) at issue."

Taxpayer asserts that it has far exceeded the "documentation" standard on which it bases the claimed credits. Taxpayer explains that it supplied documentation of its "wage and supply allocation" and the documented results of "in person interviews." To that end, Taxpayer provided summaries of its discussions with Taxpayer's "cellar

managers," "cellar reporting and research" personnel, "executive farm managers," "farm crew," "fertilizer management," "spray management," "orchard workers," "production manager[s]," "wine club managers," "tasting room associates," and its "graphic designer." Taxpayer states that it determined the specific amount of qualified research activities, determined a fixed percentage of the time eligible personnel were engaged in qualifying activities, and then - in order to avoid uncertainty - applied a percentage of supply costs such as "equipment, materials, and components utilized during product development and testing." As a result, Taxpayer calculated that it spent $1,580,580 in "qualifying research expenses."

C. Burden of Proof, Analysis, and Conclusion.

1. Proving that Taxpayer is Entitled to the Credit.

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).

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 Taxpayer's argument that neither TD 8930 nor TD 9104 were the governing regulatory scheme relevant to the years at issue. Taxpayer's argument is that only an ambiguous, pre-regulatory REC standard governs Taxpayer's protest. 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 01-20180753 (June 15, 2018) 20180829 Ind. Reg. 045180334NRA,Letter of Findings 01-20171187; 01-20171188; 01-20171189; 01-20171190 (May 1, 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 6, 2016), 20170222 Ind. Reg. 045170090NRA; Letter of Findings 02-20130676 (January 16, 2015), 20150325 Ind. Reg. 045150065NRA; Letter of Findings 02-20140326 (October 30, 2015), 20151230 Ind. Reg. 045150436NRA; Letter of Findings 01-20110213 (October 4, 2011), 20111228 Ind. Reg. 045110749NRA.

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).

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**). "Qualified research" is defined in the Internal Revenue Code ("I.R.C.") under section 41(d) I.R.C. subsection 41(d) defines qualified research in pertinent part as follows:

> (d) Qualified research defined.-For purposes of this section-
> (1) In general.-The term "qualified research" means research-
> (A) with respect to which expenditures may be treated as expenses under section 174,
> (B) which is undertaken for the purpose 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 purpose described in paragraph . . .

I.R.C. § 41(d)(1).

This provision 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 Id.* § 41(d)(1)(A). Second, the research must be undertaken to "discover information which is technological in nature." *Id.* § 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 undertake a "process of experimentation" during substantially all of the research. *Id.* § 41(d)(1)(C).

4. Analysis and Conclusions.

In order for its argument to prevail, Taxpayer's activities must meet the four-part test under I.R.C. § 41(d) including the requirement that Taxpayer's activities were undertaken for the "purposes of discovering information" and must eventually yield a "new or improved business component" each of which derives from a process of experimentation.

As explained by Taxpayer, its "business components" consist of wine, distilled liquor, and improved pruning techniques. These particular components have a lengthy historical footprint. People have been using grapes to produce wine for approximately 4,500 years, *Wine Production*, https://www.britannica.com/topic/wine (last visited March 28, 2019), commercially producing brandy since "the 15th century, *Brandy*, https://www.britannica.com/topic/brandy (last visited March 28, 2019), while pruning and cultivating grapes has a history "nearly as long as civilization," *Grape*, https://www.britannica.com/plant/grape (last visited March 28, 2019). Although the Department ignores neither Taxpayer's diligence nor experience in attempting to produce an improved consumer product.

However, Taxpayer can point to nothing specifically it has done to discover information and develop a "new or improved business component" beyond the common knowledge of other vintners and grape producers. Rather Taxpayer's activities are better categorized as attempts to apply long standing techniques of producing grapes, wine, and distilled liquors. Essentially, Taxpayer has not established that it fundamentally expanded upon the "common knowledge" using variations of long-standing techniques, or expanded the "existing level of information in [Taxpayer's] field of science or engineering." Treas. Reg. § 1.41-4(a)(3)(ii).

Taxpayer states that it carefully monitors its products' processing, barrel selection, flavor, maceration (softening) time, fermentation time, yeast content, filtration time, product stabilization, and sweetness level. These activities reflect a knowledgeable and detailed process of "trial and error" aimed improving or differentiating its products. Taxpayer's process - even if it did lead to the "discovery" of a new product - does not represent "a methodical plan involving a series of trials to test a hypothesis, analyze the data, refine the hypothesis, and retest the hypothesis

so that it constitutes experimentation in the scientific sense." *Trinity Industries, Inc. v. U.S.*, 757 F.3d 400, 414 (5th Cir. 2014). As explained by that court, the "process of experimentation" requirement is not met by means of "a method of simple trial and error to validate that a process or product change meets the taxpayer's needs." *Id.* (See also *Union Carbine Corp. and Subsidiaries v. C.I.R.* 97 T.C.M. (CCH) 1207 (Tax Ct. 2009) explaining "It is not sufficient that the taxpayer use a method of simple trial and error to validate that a process or product change meets the taxpayer's needs.")

The Department is unable to agree that Taxpayer has met it statutory burden under IC § 6-8.1-5-1(c) of establishing that the Taxpayer's activities to improve upon its business components constitute "qualified research" activities under either the "Discovery Test" or the "Uncertainty Test." Simply demonstrating that "uncertainty" in achieving a particular result has been eliminated and that a particular result has been achieved, is insufficient to satisfy the "process of experimentation" requirement. The Department is unable to agree that Taxpayer has established that Taxpayer's efforts to produce a "sweet nouveau wine," develop a "sweet traditional port wine," or improve Taxpayer's "pruning techniques to increase crop production" resulted in the discovery of a new product which became part of the body of common knowledge of other skilled vintners.

Setting aside issues related to whether the company was engaged in qualified research, Taxpayer disagrees with the audit's finding that Taxpayer failed to adequately document the company's employees' specific activities and wages attributable to those projects. Taxpayer admitted that the company did not maintain a system of project accounting in order to quantify the company's research expenses accurately but instead relied on belated phone interviews and estimates to substantiate the amount of qualified research activities the company incurred. While the Department recognizes Taxpayer's efforts to estimate the qualifying wages of its employees, the Department rejects Taxpayer's argument that the Department is precluded from demanding specific, contemporaneous documentation and that "documentation is not necessary to prove taxpayer engaged in a particular activity in the tax year(s) at issue." Instead, the Department finds the law on this issue clear.

Treas. Reg. § 1.41-4(d) (T.D. 8930) sets out the record keeping and documentation requirement for expenses related to the research credit:

> 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*).

Indiana provides its own record keeping requirements.

> 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. IC § 6-8.1-5-4(a).

The Department rejects Taxpayer's argument that it is sufficient to merely produce documentation in a "sufficiently usable form" because the argument grossly oversimplifies the regulatory requirement. Of course, any documentation must be "usable" but it also must be "prepared before or during the early stages of the research project." Treas. Reg. § 1.41-4(d) (TD 8930). The documentation must be *both* "usable" and "contemporaneous."

It is Taxpayer's statutory obligation to maintain and produce to the Department contemporaneous 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 Taxpayer. "[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.

In this case, Taxpayer asks that the Department broadly interpret the REC record keeping requirements to encompass - as stated in the audit report - "mere statements as to its activities" when there is no evidence that Taxpayer's efforts to simply monitor and control the quality of its products constitutes the "process of experimentation" called for the in REC provisions.

FINDING

Taxpayer's protest is respectfully denied.

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