

Letters of Findings: 01-20200425 and 01-20200436
Indiana Individual Income Tax
For the Years 2016 and 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 This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register.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 these Letters of Findings.

HOLDING

Indiana Shareholders failed to provide documentation establishing that their construction company performed qualified research. Therefore, Shareholders were not entitled to the flow-through Indiana qualified research expense credits.

ISSUES

I. Tax Administration - Statute of Limitations.

Authority: IC § 6-3-4-3; IC § 6-8.1-5-1; IC § 6-8.1-5-2; IC § 6-8.1-6-1; IC § 6-8.1-6-2; *Indiana Dep't. of State Revenue v. Rent-A-Center East, Inc.*, 963 N.E.2d 463 (Ind. 2011); *Lafayette Square Amoco, Inc. v. Indiana Dep't. of State Revenue*, 867 N.E.2d 289 (Ind. Tax Ct. 2007); Income Tax Information Bulletin 18 (August 2014).

Taxpayers protest the imposition of Indiana individual income tax for the 2016 tax year, claiming that the assessment was outside of the statute of limitations.

II. Indiana Individual Income Tax - Qualified Research Expense Credits.

Authority: IC § 6-3-1-3.5; IC § 6-3.1-4-1; IC § 6-3.1-4-2; IC § 6-8.1-5-1; IC § 6-8.1-5-4; *New Colonial Ice Co. v. Helvering*, 292 US 435 (1934); *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); *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; IRC § 6001; Treas. Reg. § 1.41-4; Treas. Reg. § 1.6001-1; Letter of Findings 01-20171187, 01-20171188, 01-20171189, 01-20171190 (May 2, 2018); Letter of Findings 01-20170279, 01-20170288 (October 6, 2017); *Audit Techniques Guide: Credit for Increasing Research Activities (i.e. Research Tax Credit) IRC § 41 - Substantiation and Recordkeeping*.

Taxpayers protest the imposition of Indiana individual income tax for the 2016 and 2017 tax years, arguing that their general contractor business conducted qualifying experimental research activities, adequately documented the wage and contract expenses related to those projects, and are therefore entitled to claim the benefit of flow-through tax credits associated with the business's qualifying research activities.

STATEMENT OF FACTS

Taxpayers are individuals located in Indiana who are shareholders in an Indiana general contractor S-Corporation (the "Company"), which employs project managers, estimators, project superintendents, and craftsmen. The Company plans, designs, builds, and develops/leases various types of commercial spaces. Company's income and losses pass through to its shareholders, who in turn report the income and losses on their individual income tax returns.

The Indiana Department of Revenue ("Department") conducted an audit review of the Company's Indiana tax returns for periods ending October 31, 2016, and October 31, 2017. As a result of this audit, Indiana research expense credits ("RECs") claimed by the Company were disallowed. Because the Company was organized as an S-Corporation, these adjustments passed through to the Taxpayers, resulting in an increase in their individual income tax liabilities for tax years 2016 and 2017. The Department issued proposed assessments to Taxpayers

Taxpayers disagreed with the assessments and submitted protests to that effect. An administrative hearing was conducted during which Taxpayers' representatives explained the basis for the protest. These Letters of Findings result. Additional facts will be provided below, as necessary.

I. Tax Administration - Statute of Limitations.

DISCUSSION

Taxpayers argue that the proposed assessments occurred more than three years after the start date for statute of limitations purposes. Therefore, Taxpayers argue, the proposed assessments were issued after the statute of limitations passed and are therefore unenforceable.

As a threshold issue, all tax assessments are *prima facie* evidence that the Department's claim for 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. 2011); *Lafayette Square Amoco, Inc. v. Indiana Dep't. of State Revenue*, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007). Consequently, the taxpayer is required to provide documentation explaining and supporting its challenge that the Department's position is wrong.

Individual income tax returns are typically due on the fifteenth day of the fourth month following the end of the tax year. IC § 6-3-4-3. However, when a taxpayer timely files a Form IT-9 extension request or the Internal Revenue Service allows a taxpayer to extend the deadline on their federal tax returns, the Department automatically extends the deadline for filing Indiana income tax returns for the same period as the federal extension, plus 30 days. IC § 6-8.1-6-1; Income Tax Information Bulletin 18 (August 2014) 20140827 Ind. Reg. 045140324NRA.

IC § 6-8.1-5-2(a) provides a limitation on the Department's assessment authority as follows:

[T]he department may not issue a proposed assessment under section 1 of this chapter more than three (3) years after the latest of the date the return is filed, or . . . [t]he due date of the return.

In this case, Taxpayers correctly requested an extension of their 2016 individual income tax filing deadline. However, April 15, 2017 was a Saturday, meaning that Taxpayers initial return deadline was April 17, 2017. See IC § 6-8.1-6-2 ("If any due date falls on a Saturday . . . the act that must be performed by that date is timely if performed by the next succeeding day that is not a . . . Sunday.") Because of this, Taxpayers extended filing deadline was November 17, 2017, and the Department's proposed assessments were allowable no later than November 17, 2020. The proposed assessments in this case state an issue date of August 20, 2020 and thus are within the three-year statute of limitations. Taxpayers failed to meet their burden of proof under IC § 6-8.1-5-1.

FINDING

Taxpayers are respectfully denied.

II. Indiana Individual Income Tax - Qualified Research Expense Credits.

DISCUSSION

The issue is whether Taxpayers have established that their general contractor business conducted qualifying research activities and whether the business can document the extent to which it conducted those qualifying activities and, as a result, are entitled to credits originally claimed.

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). 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). Also, "all statutes are presumptively constitutional." *Indiana Dep't of State Rev. v. Caterpillar, Inc.*, 15 N.E.3d 579, 587 (Ind. 2014). When an agency is charged with enforcing a statute, the jurisprudence defers to the agency's reasonable interpretation of that statute "over an equally reasonable interpretation by another party." *Caterpillar, Inc.*, 15 N.E.3d at 583.

A. The Research Expense Credit's Regulatory Regime.

As a preliminary matter, both the Department's audit report and the Taxpayers' protest reference Treasury Decisions ("T.D.") 8930 and 9104, which offer two different analyses for the test to determine "qualified research expenses" used to calculate research expense credits. T.D. 8930 imposes a "Discovery Test" in which qualified research must be "undertaken for the purposes of *discovering information* which is technological in nature." (*Emphasis added*). T.D. 9104 imposes a less-restrictive "Uncertainty Test" under which qualified research is intended to *eliminate uncertainty* concerning the development or improvement of a business component.

The Department has repeatedly explained its position on the application of these different test components in detail. See, e.g., Letter of Findings 01-20171187, 01-20171188, 01-20171189, 01-20171190 (May 2, 2018), 20180725 Ind. Reg. 045180286NRA; Letter of Findings 01-20170279, 01-20170288 (October 6, 2017), 20180131 Ind. Reg. 045180014NRA. In this case, the Taxpayers did not challenge the applicability of these analyses to the tax years in question. Therefore, further analysis of these regimes is not germane to the resolution of this case.

B. Indiana's Research 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. Similar to deductions, exemptions, and exclusions, tax credits "are matters of legislative grace." *Stinson Estate v. United States*, 214 F.3d 846, 848 (7th Cir. 2000); 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.").

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 qualified research expenses by incorporating portions of the Internal Revenue Code.

IRC § 41(d) 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 definition sets out the four-pronged test for verifying qualified research activities. First, the research must have qualified as a business deduction under IRC § 174. IRC § 41(d)(1)(A). Second, the research must be undertaken to discover information "which is technological in nature." IRC § 41(d)(1)(B)(i). Third, the taxpayer must intend to use the information to develop a new or improved business component. IRC § 41(d)(1)(B)(ii). Finally, the taxpayer must pursue a "process of experimentation" during substantially all of the research. IRC § 41(d)(1)(C). All four components of this test must be satisfied to receive research expense tax credits.

Both Indiana and federal law expound on the documentation required to satisfy the four components of this test. Indiana's more general record keeping requirement, found at IC § 6-8.1-5-4(a), requires taxpayers to maintain all records and source documents necessary for the Department to determine a taxpayer's liability. Treas. Reg. § 1.41-4(d) explains that a taxpayer claiming RECs must "retain records in sufficiently usable form and detail to substantiate that the expenditures claimed are eligible for the credit." This regulation, in turn, cites Treas. Reg. § 1.6001-1(a), which provides that:

Any person required to file a return of information with respect to income shall keep such permanent books of accounts or records, including inventories, as are sufficient to establish the amount of gross income, deductions, credits, or other matters required to be shown in any return of such tax or information.

To further clarify these regulations, the IRS has created a document called *Audit Techniques Guide: Credit for Increasing Research Activities (i.e. Research Tax Credit) IRC § 41*. Specifically, Chapter 7 of this Guide notes that:

Substantiation and Record Keeping: 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 Service does not have to accept estimates of qualified research expenses if documentation exists to verify the actual amount of such expenses. As set forth above, taxpayers are required to keep records substantiating the amount of any reported, claimed, or affirmatively raised deductions or credits.

The courts will allow the use of an estimation method only where the taxpayer does not have contemporaneous records, and then only as long as the following two conditions are satisfied. First, the taxpayer must establish that it engaged in qualified research activities as defined in section 41(d). And second, the failure to maintain a proper system to capture relevant information cannot be an "inexactitude [] of their own making." Estimation methods are permitted only in cases where the sole issue is the exact amount paid or incurred in the qualified research activity. Accordingly, taxpayers must have factual support for every assumption underlying their estimates to meet their burden of proof.

Audit Techniques Guide: Credit for Increasing Research Activities (i.e. Research Tax Credit) IRC § 41 - Chapter 7 Substantiation and Recordkeeping, <https://www.irs.gov/businesses/audit-techniques-guide-credit-for-increasing-research-activities-ie-research-tax-credit-irc-ss-41-substantiation-and-recordkeeping> (last visited November 10, 2021).

C. Analysis and Conclusion.

The Department's audit found that the Company's activities failed to satisfy any of the four parts of the qualified research test under IRC § 41. The activities were found to be normal, everyday activities of a contractor in the performance of improving real estate that did not produce anything conceptually new. The Company's claimed expenses would have occurred whether or not research was completed because it was simply completing contracted designs, building, remodeling, and repairs as part of its normal course of business, which it had been doing for decades. Most importantly, the Department noted that the Taxpayers failed to keep sufficient documentation to support its claimed expenses, which is required to qualify for RECs.

In its protest and during the administrative hearing, Taxpayers argued that the Company's activities met all four of the IRC § 41 requirements. Taxpayers provided explanations for a sampling of their claimed projects, explaining generally how each of their projects involved the research of technological questions which required a process of experimentation to complete the project. That said, even if the Department agreed with the Taxpayers on all accounts, which it does not, the Department still could not grant the Taxpayers' request to reinstate the claimed RECs.

Taxpayers could not provide sufficient documentation to support their claims. Despite multiple requests, Taxpayers could not provide documents which allowed the Department to accurately determine the amount of claimed research activity expenses. Taxpayers relied on time sheets and interviews with the Company CEO, President, and a Project Manager to estimate the amount of credit to claim for each of their activities. But the relationship between these estimates and the specific research activities, such as individual experiments, trials, surveys, or data collection, was not provided. Moreover, the purposes of each of these activities and how they eliminate the Company's uncertainty was not clear. In short, the documents provided by the taxpayer were insufficient for the Department to confirm the amount of money spent on qualifying research activities. This inexactitude was of the Taxpayers' own making, as it failed to provide sufficient contemporaneous records for the Department to accurately audit the Company's activities. The use of time sheets and summaries of management meetings was insufficient to remedy the imprecision of the Company's records.

Although Taxpayers claim that entire project phases should qualify for research expense credits, Treas. Reg. § 1-41-4(b)(2) allows for "shrinking back" to a subset of the research components that do meet the four-part test. However, Taxpayers did not develop these components and subcomponents sufficiently for the Department to use the shrink back rule. For example, Taxpayers claimed that the entire schematic design phase of Company's projects was a business component, while explaining that this phase included "conceptual design and creating floor plans and layouts." The Department was unable to distinguish wages or contract research expenses that were used for conceptual designs as opposed to floor plans or floor layouts.

Without more precise documentation tying claimed expenses to specific business components or

sub-components, the Department is unable to accurately audit the Company's claimed expenses, and thus the Taxpayers' claimed tax credits. Because the Department was not provided with documents allowing it to analyze the specific value of claimed research expenses, the research expense credits are denied.

FINDING

Taxpayers' protest is respectfully denied.

SUMMARY

Taxpayers are denied on their statute of limitations argument because the assessments were timely. Taxpayers are denied on their request to reinstate research expense credits because the provided documentation was insufficient to demonstrate the value of these credits or if any qualified research did occur.

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