DEPARTMENT OF STATE REVENUE

01-20200285.SLOF

Supplemental Letter of Findings: 01-20200285
Individual Income Tax
For Tax Years 2016, 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 This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register.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 reduced research expense credits for S-Corporation which in turn reduced the available credits for individual shareholders on their joint individual income tax return. The Department disagreed with shareholders that they met their burden to provide sufficient documentation supporting the additional credits; therefore, the protest is denied.

ISSUE

I. Individual Income Tax - Research Expense Credit 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; *Stinson Estate v. United States*, 214 F.3d 846 (7th Cir. 2000); *Indiana Dept. of State Revenue, Sales Tax Division v. RCA Corp.*, 310 N.E.2d 96 (Ind. Ct. App. 1974); *Conklin v. Town of Cambridge City*, 58 Ind. 130 (Ind. 1877); Treas. Reg. § 1.6001-1(a); Treas. Reg. § 1.41-4(d); Indiana Research Expense Credit Handbook, https://www.in.gov/dor/files/reference/rec-handbook.pdf.

Taxpayers protest the denial of a claimed credit.

STATEMENT OF FACTS

Taxpayers are a married couple, filing jointly. Both husband and wife are shareholders in an S-Corporation (hereinafter "Company"). The Indiana Department of Revenue ("Department") audited Company and determined that a portion of the Company's claimed research expenses were not permitted and redetermined the research expense credit. Because Company is an S-Corporation, the credits "flowed through" to individual shareholders and were reported on Taxpayers' individual income tax returns.

The adjustment to the Company's research expense credit resulted in a proposed tax assessment against Taxpayers. Prior to the audit, Company calculated its own research expense credits. After the audit, Taxpayers protested the assessment and hired a consulting firm ("Consultant") to prepare a "research and expense study." An administrative hearing was scheduled, and Consultant, acting as the Power of Attorney, failed to appear. Consultant requested a rehearing, and the Department granted the request. A rehearing was held where Consultant provided additional information and documentation. This Supplemental Letter of Findings results. Additional facts will be provided as necessary.

I. Individual Income Tax - Research Expense Credit and Documentation.

DISCUSSION

The issue is whether Taxpayers provided sufficient documentation for qualifying research expenses related to higher-level employees' wages.

During the years 2016, 2017, and 2018, Company claimed just over $5,000,000 for Qualifying Research Expenses ("QREs") entitling it to approximately $260,000 in Research Expense Credits ("RECs") during that time frame. Because the credits flow through to the shareholders of an S-Corporation, Taxpayers claimed approximately $36,000 in RECs on their individual joint tax returns during the same three-year period.

The Department conducted an audit of Company and made multiple adjustments related to QREs and RECs.

Taxpayers agreed with most of the audit's findings. The only issue under protest is the disallowance of higher-level employees' wages as research expense credits. Specifically, the audit found that Company used estimated percentages to calculate the amount of time each employee was involved in research projects. For the majority of employees, Company provided job reports to support the estimated percentages and labor reports which detailed the time each employee worked on a specific project. However, Company also used estimated percentages for other employees such as the Company President, Vice President of Sales, Construction Manager(s), Estimator(s), and Project Manager(s), but did not provide documentation for these employees. Company's Power of Attorney (which was not the current Consultant) stated the estimated time and salary percentages for these employees were based on interviews with the Company's President. Despite two requests from the Department to provide more specific information, Company failed to do so during the audit review.

As a result of the adjustments from the Company audit, the Department reduced the available RECs of Company to approximately $178,000 for the three-year period. In turn, the RECs available to Taxpayers for the same time frame were reduced to approximately $24,500. Because of the reduction in RECs, individual income tax assessments were issued for tax years 2016, 2017, and 2018. Taxpayers protest those assessments.

As a threshold issue, a notice of proposed assessment is prima facia evidence that the department's claim for unpaid tax is valid. IC § 6-8.1-5-1(c). It is the taxpayer's burden to prove the proposed assessment is wrong. *Id*.

A taxpayer that incurs Indiana qualified 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 research expense credits. 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 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).

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.

The Internal Revenue Code provisions that deal with deductions, exemptions, and exclusions are a matter of "legislative grace" and are to be narrowly construed. *Stinson Estate v. United States*, 214 F.3d 846, 848 (7th Cir. 2000). Where an exemption 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 Dept. of State Revenue, Sales Tax Division v. RCA Corp*., 310 N.E.2d 96, 100-01 (Ind. Ct. App. 1974) (quoting *Conklin v. Town of Cambridge City*, 58 Ind. 130, 133 (Ind. 1877)).

The Department's Indiana Research Expense Credit Handbook (Updated December 2021 and applicable to tax years beginning on or after January 1, 2016) provides additional guidance on recordkeeping as it relates to QREs and RECs. https://www.in.gov/dor/files/reference/rec-handbook.pdf (last visited Feb. 21, 2022). As noted in the handbook, "it is critical that sufficient contemporaneous documentation be identified, gathered, properly compiled, and retained" to substantiate an REC claim. *Id*. at 15-16. The Department routinely reviews records relating to research credits, and when credits are calculated based on "interviews, estimates, and data manipulation" that is not done contemporaneously with the research, there is often not the required connection between qualified research expenses and qualified research activities. *Id*. at 16. If a study relies on "surveys, interviews, and other input from internal personnel," there are often not enough details to show the connection between the qualified research expenses or activities by the assignment of a time percentage to the qualified research activity. *Id*.

An example provided in the Handbook discusses qualified wages calculated by multiplying a qualified percentage of an individual employee's wages or a department's total wages based on oral testimony from a manager's recollection. *Id*. at 17. The manager may have worked in the tax year at issue or may have worked in the same area for which he/she is providing an estimate. *Id*. Often, these types of representations may not be supported by corroborating records. *Id*. A taxpayer can provide items such as an organizational chart, names and work titles of employees, details as to job duties performed by each employee, the amount of time/wages included in the credit, timesheets, social security numbers, W2s, and a breakdown of wages claimed by an employee with the year and qualified project; however, even if a taxpayer provides all or a portion of these items, other documentation may still be required. *Id*.

In the instant protest, Company provided some documentation to the Department during the audit review. The auditor determined that Company used estimated percentages to calculate the amount of time each employee was involved in QREs. The documentation was sufficient to show certain employees' wages were qualified research expenses because Company provided related employee labor time by job reports which supported the estimated percentages. However, documentation related to higher-level employees did not include a job report because labor hours for these employees were not tracked. When asked to provide more specific information during the audit review related to labor hours for these employees, Company's Power of Attorney stated the estimated percentages were based on an interview with Company's President and declined to provide further documentation. As a result, the auditor disallowed all wages for the higher-level employees when calculating QREs and related RECs. Higher-level employees that were excluded from RECs were positions such as the Company President, Vice President of Sales, Construction Manager(s), Estimator(s), and Project Manager(s).

Taxpayers provided additional documentation during the protest which included employee information with employee title and an estimated percentage of QREs performed per year, job descriptions, a detailed explanation of how jobs by the Company are bid and worked on by various employees until completion, memoranda detailing communications and/or approvals with customers, and various contracts/blueprints/drawings for Company projects. Taxpayers argue that each higher-level employee with a specific job title was employed in the same capacity throughout the year which correlates to an equal percentage of QREs activity for each group of employees. For example, if an Estimator was assigned between one and ten projects, but only a few of those projects were active in terms of the Estimator's role in the project, then it would be likely that each Estimator worked the same number of projects, requiring approximately the same amount of time, throughout the year.

The Department does not dispute that some higher-level employees worked on some Company projects that qualified as QREs. However, the documents Taxpayers provided do not detail any specifics in terms of actual time the higher-level employees spent working on QRE projects. Taxpayers provide an estimated percentage of wages for each higher-level employee that they feel qualify as RECs, but the estimations are missing the calculations as to how Taxpayers arrived at the actual percentage. Neither Company nor Taxpayers provided this information despite being asked to do so several times by the Department. Company relied on an interview with the Company President - who is one of the Taxpayers associated with this protest - to provide the estimates given to the Department. Taxpayers are correct that estimates may be used in determining QREs and RECs, but the Department also requires more specific details and documentation. Taxpayers cannot relate a specific higher-level employee to specific time spent on a project. In essence, Taxpayers are unable to document how the estimates provided by Company President translate into a QRE and/or REC percentages as discussed in the Department's Indiana Research Expense Credit Handbook. This is the type of information needed by the Department in order to provide REC credit.

During an audit review, the majority of QREs and related RECs for Company were approved because supporting documentation was provided by Company and could relate employees to labor hours spent on qualifying projects. Despite several requests, Taxpayers failed to provide specific details showing how they arrived at the estimate percentages of qualifying wages related to higher-level employees. Therefore, Taxpayers did not meet the burden imposed under IC § 6-8.1-5-1(c) of proving the proposed assessment wrong.

FINDING

Taxpayers' protest is denied.

March 25, 2022

Posted: 05/25/2022 by Legislative Services Agency
An html version of this document.