

**Letter of Findings Number: 10-0171**  
**Adjusted Gross Income Tax**  
**For the Years Ending April 30, 2006, April 30, 2007, and April 30, 2008**

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**ISSUES**

**I. Research Expense Credit—Qualifying Wages.**

**Authority:** IC § 6-3.1-4-1; I.R.C. § 41.

Taxpayer protests the recomputation of wages for three employees in determining its research expense credit.

**II. Research Expense Credit—Qualifying Supplies.**

**Authority:** IC § 6-3.1-4-1; I.R.C. § 41.

Taxpayer protests the disallowance of expenses listed as "supplies" for research expense credit purposes.

**STATEMENT OF FACTS**

Taxpayer is a corporation doing business in Indiana. Taxpayer filed a corporate income tax return claiming a research expense credit for three tax years. The Indiana Department of Revenue ("Department") audited Taxpayer and, based on its audit, determined that Taxpayer's reported wages attributable to research activities was inflated. In addition, the Department's audit determined that supplies purportedly used in research activities were not in fact used in research activities. As a result of these two adjustments, the Department issued a proposed assessment of additional tax. Taxpayer protested the proposed assessment, the Department conducted an administrative hearing, and this Letter of Findings results.

**I. Research Expense Credit—Qualifying Wages.**

**DISCUSSION**

Taxpayer protests the redetermination of three employees' wages attributable to research activities.

Under IC § 6-3.1-4-1 et seq., a credit is permitted for increasing Indiana research activities. The basis for determining the credit is whether an item is a "qualified research expense" under I.R.C. § 41(b). I.R.C. § 41(b)(2)(A)(i) provides that wages paid for "qualified services" constitute "qualified research expenses." Under I.R.C. § 41(b)(2)(B), the term "qualified services" refers to services either "engaging in qualified research" or "engaging in the direct supervision or direct support of research activities which constitute qualified research." The issue is whether the three employees in question—all of whom worked in various managerial capacities—earned the wages claimed by Taxpayer for qualified services.

Taxpayer provided information regarding the employees' time during each calendar year. For instance, if an employee reported five percent of his time engaged in a particular research project that lasted three months, Taxpayer would attribute five percent of the employee's time for the entire year as working on that project and attribute five percent of the employee's wages for that year as a "qualified research expense." However, the Department's audit applied the five percent as if it was five percent of the time over the three-month period rather than the entire year. Thus, the Department determined that 1.25 percent (five percent multiplied by one-fourth of a year) of the employee's time was spent on the research project and attributed 1.25 percent of the employee's wages as a "qualified research expense."

Taxpayer explained its methodology at the administrative hearing and explained its issues with the Department's methodology. Based on the information presented with regard to the employees' time attribution, Taxpayer has provided sufficient information to conclude that the attribution of time provided in Exhibit C of its protest is proper, even though this may differ from the attribution of time in its originally-filed returns.

**FINDING**

Taxpayer's protest is sustained.

**II. Research Expense Credit—Qualifying Supplies.**

**DISCUSSION**

**A. "BT Scrap Expense"**

Taxpayer protests the exclusion of its expenses listed as "supplies" as a "qualified research expense." In particular, the Department stated that the items produced with the supplies were sold and thus did not qualify as qualified research expenses. Taxpayer asserted that the items listed as "scrap sales" were in fact the sales of scrapped prototypes. The prototypes were used for research purposes. According to Taxpayer, the purchases of the underlying supplies used to produce the prototype were "qualified research expenses." The issue is whether Taxpayer's supply purchases constituted "qualified research expenses" within the meaning of IC § 6-3.1-4-1 and I.R.C. § 41.

I.R.C. § 41(b)(2)(A)(ii) states that "any amount paid or incurred for supplies used in the conduct of qualified

research" is a "qualified research expense." I.R.C. § 41(b)(2)(C) defines "supplies" as "any tangible personal property other than (i) land or improvements to land, and (ii) property of a character subject to the allowance for depreciation." "Qualified research" is generally defined by I.R.C. § 41(d) to include expenses incurred in experimenting for new technology or improving existing products; it does not include expenses for products for ultimate resale.

Taxpayer provided information substantiating its revenues from the sale of scrap items constituted twenty-five percent of the amount listed as its supply expense. The selling of the supplies occurred only after the prototypes for which the supplies were used for research purposes. Further, the selling of the supplies was not the result of any new marketable product produced by the supplies but rather the sale of scrap materials. Thus, Taxpayer has provided sufficient information to substantiate its contention that the supplies were not purchased for ultimate manufacture and resale; instead, the ultimate sale was incidental to their underlying use as prototypes. Taxpayer has further substantiated that the supplies in question were used for qualified research; thus, Taxpayer's protest of this portion of the expense is sustained.

**B. "Lab Supplies"**

Taxpayer further protested the disallowance of expenses related to "lab supplies." Taxpayer has provided sufficient information to substantiate these expenses constituted "qualified research expenses" within the meaning of IC § 6-3.1-4-1 and I.R.C. § 41.

**FINDING**

Taxpayer's protest is sustained.

**CONCLUSION**

Taxpayer's protest is sustained on all issues.

*Posted: 11/24/2010 by Legislative Services Agency*  
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