

Letter of Findings Number: 01-20100672
Individual Income Tax
For the Years 2006-2008

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ISSUE

I. Individual Income Tax – Research Expense Credit.

Authority: IC § 6-3.1-4-1; I.R.C. § 41; Treas. Reg. § 1.41-2; Treas. Reg. § 1.41-4; T.G. Missouri Corp. v. Comm'r, 133 T.C. 278 (2009)

Taxpayer protests the assessment of individual income tax.

STATEMENT OF FACTS

Taxpayer is a shareholder in an S corporation. The S corporation owned a subsidiary (Business) which operated in Indiana. The Indiana Department of Revenue ("Department") audited Business. Business had claimed an increase in research activities for 2006 through 2008, which resulted in a research expense credit. However, the Department determined that a portion of Business' claimed research expenses were not permitted and redetermined the research expense credit. Taxpayer claimed the credit as an S corporation shareholder. The resulting disallowance of the credit resulted in a proposed tax assessment against Taxpayer. Taxpayer protested the assessment, the Department conducted an administrative hearing, and this Letter of Findings results. Further information will be supplied as necessary.

I. Individual Income Tax – Research Expense Credit.

DISCUSSION

Taxpayer protests the disallowance of the credit for increasing research expenses.

Under IC § 6-3.1-4-1 et seq., taxpayers are permitted a credit for increasing research expenses. IC § 6-3.1-4-4 provides that federal law is "applicable to the interpretation and administration by the department of the credit provided by this chapter." Further, the key definitions relevant to the determination of the credit—"base amount" and "qualified research expense"—are determined by reference to I.R.C. § 41.

I.R.C. § 41(d) provides:

(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 (3).

Such term does not include any activity described in paragraph (4).

(2) Tests to be applied separately to each business component.--For purposes of this subsection--

(A) In general.--Paragraph (1) shall be applied separately with respect to each business component of the taxpayer.

(B) Business component defined.--The term "business component" means any product, process, computer software, technique, formula, or invention which is to be--

(i) held for sale, lease, or license, or

(ii) used by the taxpayer in a trade or business of the taxpayer.

(C) Special rule for production processes.--Any plant process, machinery, or technique for commercial production of a business component shall be treated as a separate business component (and not as part of the business component being produced).

(3) Purposes for which research may qualify for credit.--For purposes of paragraph (1)(C)--

(A) In general.--Research shall be treated as conducted for a purpose described in this paragraph if it relates to--

(i) a new or improved function,

(ii) performance, or

(iii) reliability or quality.

(B) Certain purposes not qualified.--Research shall in no event be treated as conducted for a purpose described in this paragraph if it relates to style, taste, cosmetic, or seasonal design factors.

(4) Activities for which credit not allowed.--The term "qualified research" shall not include any of the

following:

- (A) Research after commercial production.--Any research conducted after the beginning of commercial production of the business component.
- (B) Adaptation of existing business components.--Any research related to the adaptation of an existing business component to a particular customer's requirement or need.
- (C) Duplication of existing business component.--Any research related to the reproduction of an existing business component (in whole or in part) from a physical examination of the business component itself or from plans, blueprints, detailed specifications, or publicly available information with respect to such business component.
- (D) Surveys, studies, etc.--Any--
 - (i) efficiency survey,
 - (ii) activity relating to management function or technique,
 - (iii) market research, testing, or development (including advertising or promotions),
 - (iv) routine data collection, or
 - (v) routine or ordinary testing or inspection for quality control.
- (E) Computer software.--Except to the extent provided in regulations, any research with respect to computer software which is developed by (or for the benefit of) the taxpayer primarily for internal use by the taxpayer, other than for use in--
 - (i) an activity which constitutes qualified research (determined with regard to this subparagraph), or
 - (ii) a production process with respect to which the requirements of paragraph (1) are met.
- (F) Foreign research.--Any research conducted outside the United States, the Commonwealth of Puerto Rico, or any possession of the United States.
- (G) Social sciences, etc.--Any research in the social sciences, arts, or humanities.
- (H) Funded research.--Any research to the extent funded by any grant, contract, or otherwise by another person (or governmental entity).

Several issues are disputed by Taxpayer.

A. Continuous Improvement Jobs

Taxpayer protests the disallowance of research expenses related to so-called "continuous improvement jobs." Business divides its operations into two categories--"new opportunity jobs" and "continuous improvement jobs." A "new opportunity job" is a new project, either for a new client or a current client. A "continuous improvement job" is an existing project that requires a change in a tool or process to meet a customer's needs.

For continuous improvement jobs, the Department allowed a portion of the expenses for 2006 but disallowed all expenses for 2007 and 2008. The issue is whether the expenses related to "continuous improvement jobs" constituted qualified research expenses.

Treas. Reg. § 1.41-4(c)(2) provides:

Research after commercial production--(i) In general. Activities conducted after the beginning of commercial production of a business component are not qualified research. Activities are conducted after the beginning of commercial production of a business component if such activities are conducted after the component is developed to the point where it is ready for commercial sale or use, or meets the basic functional and economic requirements of the taxpayer for the component's sale or use.

(ii) Certain additional activities related to the business component. The following activities are deemed to occur after the beginning of commercial production of a business component--

- (A) Preproduction planning for a finished business component;
- (B) Tooling-up for production;
- (C) Trial production runs;
- (D) Trouble shooting involving detecting faults in production equipment or processes;
- (E) Accumulating data relating to production processes; and
- (F) Debugging flaws in a business component.

(iii) Activities related to production process or technique. In cases involving development of both a product and a manufacturing or other commercial production process for the product, the exclusion described in section 41(d)(4)(A) and paragraphs (c)(2)(i) and (ii) of this section applies separately for the activities relating to the development of the product and the activities relating to the development of the process. **For example, even after a product meets the taxpayer's basic functional and economic requirements, activities relating to the development of the manufacturing process still may constitute qualified research, provided that the development of the process itself separately satisfies the requirements of section 41(d) and this section, and the activities are conducted before the process meets the taxpayer's basic functional and economic requirements or is ready for commercial use. (Emphasis added.)**

Business asserts that it may alter or seek to improve its processes for existing jobs as circumstances require. The Department's audit asserts that the costs related to "continuous improvement jobs" are deemed to occur "after the beginning of commercial production of a business component."

Business has not affirmatively established that its "continuous improvement jobs" meet the definition of

"qualified research expenses" within the meaning of I.R.C. § 41. Nevertheless, even if the commercial production of a business component has begun, activities relating to the process nevertheless can qualify as qualified research, provided that the activities in question independently qualify under I.R.C. § 41. The exact activities allowable or disallowable are subject to further audit.

B. New Opportunity Jobs

Taxpayer protests the disallowance of research expenses for certain wages related to "new opportunity jobs." Treas. Reg. § 1.41-2(c) provides:

Qualified services--(1) Engaging in qualified research. The term "engaging in qualified research" as used in section 41(b)(2)(B) means the actual conduct of qualified research (as in the case of a scientist conducting laboratory experiments).

(2) Direct supervision. The term "direct supervision" as used in section 41(b)(2)(B) means the immediate supervision (first-line management) of qualified research (as in the case of a research scientist who directly supervises laboratory experiments, but who may not actually perform experiments). "Direct supervision" does not include supervision by a higher-level manager to whom first-line managers report, even if that manager is a qualified research scientist.

(3) Direct support. The term "direct support" as used in section 41(b)(2)(B) means services in the direct support of either--

(i) Persons engaging in actual conduct of qualified research, or

(ii) Persons who are directly supervising persons engaging in the actual conduct of qualified research. For example, direct support of research includes the services of a secretary for typing reports describing laboratory results derived from qualified research, of a laboratory worker for cleaning equipment used in qualified research, of a clerk for compiling research data, and of a machinist for machining a part of an experimental model used in qualified research. Direct support of research activities does not include general administrative services, or other services only indirectly of benefit to research activities. For example, services of payroll personnel in preparing salary checks of laboratory scientists, of an accountant for accounting for research expenses, of a janitor for general cleaning of a research laboratory, or of officers engaged in supervising financial or personnel matters do not qualify as direct support of research. This is true whether general administrative personnel are part of the research department or in a separate department. Direct support does not include supervision. Supervisory services constitute "qualified services" only to the extent provided in paragraph (c)(2) of this section.

The issue for each category of expenses is whether the activities associated with the category constitute "qualified services."

1. Time Spent with Customers-New Product Feasibility Meetings

Business' employee surveys list this as "Developing process hypotheses and analyzing research data with customers for manufacturability of new products (including what impact product design has on the process)."

The federal test for whether services qualify as qualified research expenses provides that the person must be engaged in the actual conduct of qualified research. While the development of hypotheses and analysis of research data falls within the ambit of "qualified research," Business has not established that its activities in this category meet the requirement of being the "actual conduct of qualified research." Therefore, Business is denied with regard to this category of services.

2. Time Spent with Customers-Brainstorming Production Processes

Business' employee surveys describe this category as "Additional meeting and phone calls with customers to discuss various process alternatives that are in the experimental stage."

With regard to this category of time, Business has not established that these activities are the "actual conduct of qualified research" similar to a scientist in a lab--the baseline for federal credit qualification and therefore state credit qualification. Thus, Business' protest is denied for services attributed to this category.

3. Time Spent with Customers-Relaying Results of Production

Business' employee surveys describe this category as "Communication w/customers to discuss results of experimental/prototype production runs (analyzing data and drawing conclusions)."

With regard to this category of time, data analysis--the determination of whether an experiment works--is part of the process of experimentation. While Business has not affirmatively established that the labor performed in this category constituted "qualified services," Business has established that expenses listed in this category could be considered qualified research expenses. Thus, the claimed credit based on expenses in this category is sustained subject to further verification.

4. Time Spent Designing the Production Process-Brainstorming Designs

Business' employee surveys describe this category as "Development of new concepts/ideas for tooling, jigs, fixtures, etc. and the development of initial concepts for production layouts (developing hypotheses)."

With regard to this category of time, Business has not established that these activities are the "actual conduct of qualified research" similar to a scientist in a lab--the baseline for federal credit qualification and therefore state credit qualification. Thus, Taxpayer's protest is denied for services attributed to this category.

5. Time Spent Designing the Production Process-Drawing Production Layouts

Business' employee surveys describe this category as "Sketches and CAD drawing for new die designs as well as production layouts and fixturing, including overall tooling and component inserts for the tooling (detailed development activities)."

With regard to drawing production layouts, the sketches and drawing of new die designs is part of the qualified research process; one of the crucial aspects of research is proper planning for the test itself. The activities are part of the preparation for the experiment and, in reality, are part of the experiment itself. Thus, Business has established that the services performed under this category constitute "qualified services" eligible for the Indiana research expense credit.

6. Time Spent Designing the Production Process-Meeting with Other Departments

Business' employee surveys describe this category as "Feasibility meetings, CI meetings, and other design meetings to discuss product development activities (developing hypotheses, designing experiments, analyzing data, drawing conclusions)."

The mere categorization of services into this category does not necessarily mean that the services qualify as "qualified services." However, based upon the time spent in the production process, Business may be eligible for some of the labor. For instance, if time was spent working on actual design of the experimental processes, these expenses are eligible for the credit. However, if the time spent was used to discuss the cost of a project, the related expenses are not eligible for the credit. The claimed credit based on expenses in this category is sustained subject to further verification.

7. Time Spent in Prototyping Production Processes-Machining New Dies

Business' employee surveys describe this category as "Machining details for new dies (prototypes for testing of hypothesis)"

With regard to machining details, the development of prototypes is part of the qualified research process; one of the crucial aspects of research is development of the materials for the test itself. The activities are part of the preparation for the experiment and, in reality, are part of the experiment itself. Thus, Business has established that the services performed under this category constitute "qualified services" eligible for the Indiana research expense credit.

8. Time Spent in Quality Control-Designing Quality Control Plans

Business' employee surveys describe this category as "Developing testing methods for new products and processes, including the development of gaging and measurement techniques (developing hypothesis and designing experiments)."

With regard to drawing production layouts, the sketches and drawing of new die designs is part of the qualified research process; one of the crucial aspects of research is proper planning for the test itself. The activities are part of the preparation for the experiment and, in reality, are part of the experiment itself. Thus, Business has established that the services performed under this category constitute "qualified services" eligible for the Indiana research expense credit.

C. Supplies

Business asserts that various purchases Business made from third parties qualified for as research expense credits. In particular, Business asserts that a recent federal Tax Court case, T.G. Missouri Corp. v. Comm'r, 133 T.C. 278 (2009), stands for the proposition that its costs paid to Business' vendors for certain products later transferred to Business' customers are permitted for purposes of the research expense credit. While Business asserted that the operations of the taxpayer in T.G. Missouri were similar to its operations, the Department asserted that the items either constitute "cost of goods sold" or items that are subject to depreciation and therefore not eligible for the research expense credit under I.R.C. § 41.

With regard to Business' claimed expenses, Business has not affirmatively established that any particular claimed "supplies" constituted qualified research expenses within the meaning of I.R.C. § 41. However, Business has established that it may be eligible for credit based on the particular supplies claimed based on the T.G. Missouri case. Thus, the claimed credit based on expenses in this category is sustained subject to further verification.

D. Base Period Computation

Business asserts that the auditor's adjustments to the base period costs were improper. With regard to the wage component of expenses claimed for the base period, Business has provided sufficient information to conclude that its claimed wages and salaries during audit were proper.

With regard to supplies claimed to be used in qualified research, Business has not affirmatively established that its claimed supply costs for the base period were eligible for the research expense credit. Nevertheless, Business has provided sufficient information that, to the extent supplies are otherwise allowable for during the current period, the supplies used during the base period should be permitted.

E. Items Subject to Audit Verification

In this Letter of Findings, several items have been sustained subject to audit verification. Business is asked to provide any documentation necessary to verify its claimed credit to the Department's auditor no more than thirty (30) days (or any other time agreed upon by Business and the Department) after the issuance of this Letter of Findings. A failure to provide the additional information within the designated time will result in denial of the

claimed credit based on the items still subject to audit verification.

FINDING

Taxpayer's protest is sustained on issues B(5), B(7), and B(8).

Taxpayer's protest is sustained subject to audit verification on issues A, B(3), B(6), C, and D.

Taxpayer's protest is denied on issues B(1), B(2), and B(4).

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