

Supplemental Letter of Findings Number: 01-20100211
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 et seq.; IC § 6-3.1-4-4; IC § 6-8.1-5-2; IC § 6-8.1-6-1; 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. Previously the Department conducted an administrative hearing and issued a Letter of Findings partially sustaining and partially denying Taxpayer's protest. Taxpayer requested a rehearing, which the Department granted, and this Supplemental 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 asserted that the costs related to "continuous improvement jobs" are deemed to occur

"after the beginning of commercial production of a business component."

For these activities, Business has provided sufficient information to conclude that the expenses related to "continuous improvement jobs," other than expenses specifically disallowed under federal law (e.g., depreciable expenses), are eligible for the research expense credit. Thus, any non-depreciable supply expenses in Business' accounts designated for "continuous improvement jobs" and wages related to "continuous improvement jobs" are permitted for purposes of determining the research expense credit.

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 definitively that all time and wages allocated to this category qualify for the expense. However, Business has established that a portion of the time attributed to this category qualifies for the credit and is sustained to that extent.

Business is requested to provide within 30 days of the issuance of this Letter of Findings a complete, well-organized record of any and all documents needed to clearly and definitively establish the amount of time and wages attributable to "qualified research" as described above. Based on the records provided, the Audit Division is requested to make whatever adjustments are warranted.

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 definitively 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. However, Business has established that some portion of the time was used for the development of hypotheses that subsequently became part of Business' research activities.

Business is requested to provide within 30 days of the issuance of this Letter of Findings a complete, well-organized record of any and all documents needed to clearly and definitively establish the amount of wages and salaries attributable to the "development of hypotheses" as described above. Based on the records provided, the Audit Division is requested to make whatever adjustments are warranted.

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. With regard to this category of expenses, Business has not provided a sufficient factual basis to rebut the assessment.

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. However, Business has established that some portion of the time was used for the development of hypotheses that subsequently became part of Business' research activities. Therefore, to the extent Business can establish its allocation of time to such development of hypotheses, the protest is sustained.

Business is requested to provide within 30 days of the issuance of this Letter of Findings a complete, well-organized record of any and all documents needed to clearly and definitively establish the amount of wages and salaries attributable to the "development of hypotheses" as described above. Based on the records provided, the Audit Division is requested to make whatever adjustments are warranted.

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.

Business is requested to provide within 30 days of the issuance of this Letter of Findings a complete, well-organized record of any and all documents needed to clearly and definitively establish the amount of wages and salaries attributable to the "actual design of experimental processes" as described above. Based on the records provided, the Audit Division is requested to make whatever adjustments are warranted.

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.

In addition, Taxpayer protests that expenses listed in its account 5040 were actually for supplies and not for "contract research expenses." One key legal distinction is that sixty-five percent of "contract research expenses" are allowable for determining the research expense credit under I.R.C. § 41(b)(3), whereas the full cost of supplies used in qualified research are deductible. A second key legal distinction is that the location where contract research activities occur—inside Indiana or outside Indiana—determines whether the contract research expense is allowable for Indiana purposes. However, for supplies, the location where the supplies are used determines whether the deduction is permitted.

In this protest, Business has established that its account designated for research supplies was in fact a supply account rather than a contract research account. Therefore, the protest is sustained on this subissue subject to verification that the expenses in this account did not represent items subject to depreciation. Business is asked to provide a list of the expenses in account 5040 with specific notation of whether the expenses represent depreciable expenses and/or whether the expenses were for activities performed outside Indiana.

Also, Business asserts that certain expenses were not permitted as supplies. For instance, Business sold an item (e.g., XXXX-A) to a customer and the expenses were permitted for that item; however, another item (XXXX-B) was produced but rejected, or item B represented other expenses related to item A. Business asserts that item B was in fact transferred to the customer and that item B's expenses were not subject to depreciation by Business. Business has provided sufficient information to conclude that item B was not subject to depreciation and that the expenses incurred in developing item B are at least partially allowable for research expense credit purposes.

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.

Business further asserts that the methodology used for "supplies" was inconsistent for the base period as opposed to the audit period. Business is correct in that the expenses should be consistently treated as located where the supplies were used. Taxpayer's protest is sustained subject to verification of how the supplies permitted for research expense credit purposes should be attributed.

For purposes of the supplies used during the base period, all supplies shall be presumed to be used in Indiana during the base period. Business is requested to provide within 30 days of the issuance of this Letter of Findings a complete, well-organized record of any and all documents needed to clearly and definitively establish the supplies purchased during the "base period" but used outside Indiana. Based on the records provided, the Audit Division is requested to make whatever adjustments are warranted.

E. Items Subject to Audit Verification

Certain items are sustained subject to audit verification. Taxpayer and the Department shall arrange to conduct a second supplemental audit after issuance of this Supplemental Letter of Findings.

F. Items raised at rehearing

Business raised several issues at rehearing. In particular, Business indicated that the Department made a mathematical error in determining "Account 5020 Allowed" for 2008. Business is correct on this issue.

Business also indicated that the auditor used the wrong amounts for Accounts 5020 and 5040 for 2006 and 2007. Business has provided sufficient information to conclude that the numbers listed in the audit were incorrect and should be adjusted in accordance with the amounts indicated by Taxpayer.

Finally, Business stated that, for certain shareholders, proposed assessments for 2006 may have been issued after the statutory deadline provided in IC § 6-8.1-5-2(a). Business has not provided specific information related to any proposed assessment to conclude that the proposed assessment was issued after the statutory deadline. Further, if an individual filed a federal extension, their 2006 return was due November 15, 2007 pursuant to IC § 6-8.1-6-1(c); the 2006 proposed assessments were issued in the spring of 2010, well within three years of the statutory deadline.

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(1), B(2), B(4), B(6), C, and D.

Taxpayer's protest is denied on issue B(3).

Taxpayer's protest is sustained in part and denied in part on issue (F).

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