**DEPARTMENT OF STATE REVENUE**

02-20130676.LOF

**Letter of Findings: 02-20130676**
**Corporate Income Tax**
**For the Years 2009, 2010, 2011, and 2012**

**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 This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register.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 this Letter of Findings.

## HOLDING

Food product developer and manufacturer's research activities, related to the development of new food products and improvement of existing food products, constituted qualified research expenses. Improvements to food textures, smells, or flavors could relate to functional aspects of a business component.

## ISSUES

### I. Corporate Income Tax - Research and Development Credit.

**Authority**: IC § 6-3-1-3.5(b); IC § 6-3.1-4-1; IC § 6-3.1-4-2(a); IC § 6-3.1-4-4; IC § 6-8.1-5-1(c); IC § 6-8.1-5-4(a); I.R.C. § 41; I.R.C. § 41(d)(1) (2001); I.R.C. § 6001; I.R.C. § 6110(k)(3); Conklin v. Town of Cambridge City, 58 Ind. 130 (1877); Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289 (Ind. Tax Ct. 2007); Indiana Dep't. of State Revenue, Sales Tax Division v. RCA Corp., 310 N.E.2d 96 (Ind. Ct. App. 1974); United States v. McFerrin, 570 F.3d 672 (5th Cir. 2009); Stinson Estate v. United States, 214 F.3d 846 (7th Cir. 2000); Treas. Reg. § 1.41-4(c)(3); Treas. Reg. § 1.41-4(c)(4); Treas. Reg. § 1.41-4(a)(5)(ii); Treas. Reg. § 1-6001-1; Treas. Reg. § 1.174-2(a)(1); I.R.S. TAM 9522001, 1994 WL 805206 (June 2, 1995); Techniques Guide: Credit for Increasing Research Activities (i.e. Research Tax Credit) IRC § 41 - Substantiation and Recordkeeping.

Taxpayer argues that the Department erred in denying it research expense credits claimed on Taxpayer's original Indiana income tax returns.

### II. Tax Administration - Ten-Percent Negligence Penalty.

**Authority**: IC § 6-8.1-5-1(c); IC § 6-8.1-10-2.1(a)(2); IC § 6-8.1-10-2.1(a)(3); IC § 6-8.1-10-2.1(d); 45 IAC 15-11-2(b); 45 IAC 15-11-2(c).

Taxpayer asks that the Department exercise its discretion to abate a ten-percent negligence penalty.

## STATEMENT OF FACTS

Taxpayer is an out-of-state company which develops and manufactures flavors, fragrances, and colors used in foods, pharmaceuticals, cosmetics, personal care products, and in the printing and imaging business. Taxpayer has an Indiana business location.

The Indiana Department of Revenue ("Department") conducted an audit review of Taxpayer's business records and tax returns. The audit resulted in an assessment of additional corporate income tax for the years 2009, 2010, and 2011. Subsequently, the Department adjusted Taxpayer's 2012 income tax return in accordance with the audit. That adjustment also resulted in an assessment of additional tax.

Taxpayer disagreed with both the audit assessment and the subsequent 2012 assessment and submitted a protest to that effect. An administrative hearing was conducted during which Taxpayer's representatives explained the basis for the protest. This Letter of Findings results.

### I. Corporate Income Tax - Research and Development Credit.

## DISCUSSION

The issue is whether Taxpayer has provided sufficient legal and factual information to establish that it is entitled to the research expense credits ("REC") claimed on its original Indiana income tax returns.

**A. Burden of Proof**.

Tax assessments are prima facie evidence that the Department's assessment of tax is presumed correct; the 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).

In order to obtain the benefit of the RECs at issue, Taxpayer is required to maintain and produce records sufficient to verify those credits. Indiana mandates that every person subject to a listed Indiana tax keep books and records, including all source documents "so that the [D]epartment can determine the amount, if any, of the person's liability for that tax by reviewing those books and records." IC § 6-8.1-5-4(a).

IC § 6-3.1-4-4 provides that "'Research expense tax credit' means a credit provided under this chapter against any tax otherwise due and payable under IC 6-3." Similar to deductions, exemptions, and exclusions, tax credits - such as RECs - "are matters of legislative grace." Stinson Estate v. United States, 214 F.3d 846, 848 (7th Cir. 2000). The taxpayer who claims a tax credit is required to retain records necessary to substantiate a claimed credit. Where such a credit 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 Dep't. of State Revenue, Sales Tax Division v. RCA Corp., 310 N.E.2d 96, 100-01 (Ind. Ct. App. 1974) (citing Conklin v. Town of Cambridge City, 58 Ind. 130, 133 (1877)). Citing Stinson Estate, the circuit court in United States v. McFerrin summarized that "[t]ax credits are a matter of legislative grace, are only allowed as clearly provided for by statute, and are narrowly construed." United States v. McFerrin, 570 F.3d 672, 675 (5th Cir. 2009).

**B. Research and Expense Credits**.

For income tax purposes, Indiana follows the federal tax scheme with certain modifications. IC § 6-3-1-3.5(b). Indiana also provides tax credits outlined in IC § 6-3.1 which a taxpayer may claim to reduce its taxable income. 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 credit. In part, the statute provides:

> "Indiana qualified research expense" means qualified research expense that is incurred for research conducted in Indiana.
> "Qualified research expense" means qualified research (as defined in Section 41(b) of the Internal Revenue Code as in effect on January 1, 2001).

I.R.C. § 41(d)(1) (2001) provides:

> 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[.]

Treas. Reg. § 1.174-2(a)(1) describes research and development costs "in the experimental or laboratory sense" and that "[t]he term generally includes all such costs incident to the development or improvement of a product."

**C. Audit Analysis**.

The Department's audit reviewed Taxpayer's claim that it was entitled to claim research expense credits. The extent of those claimed credits is explained in the audit report:

> During the period under audit, [Taxpayer] incurred expenses to conduct a significant volume of projects which they claim to be qualified research for purposes of the [Research Expense Credit]. On average, [Taxpayer] has conducted over 4,100 research projects during each tax year under audit. This equates to over 12,300 research projects that began during the three years under audit. On average, [Taxpayer] starts slightly more than 11 new research projects each day in a given tax year. The expense of conducting these projects is incurred in house.

In reviewing Taxpayer's claim, the audit report cites to Indiana law and the Internal Revenue Code ("IRC") as the audit's authority.

> The research credit was enacted to provide an incentive to taxpayers to conduct product development research activities and certain basic research. In general, the definition of "qualified research" for purposes of the credit is the same as the term research or experimental activities that would qualify to be expensed under Section 174 of the IRC. IRC Section 41 however limits the scope of the credit to technological advances in products & processes and limits the definition of the term "qualified research" by establishing additional qualifying requirements and excluding several activities. (Emphasis in original).

In preparing to review REC Taxpayer's claims, the audit report notes that, "At its most fundamental level, the first step in calculating the REC is determining if the research activities occurring constitute qualified research for the REC."

In response to the audit's request for information, the "[t]axpayer supplied a computer file containing descriptions of the research projects for which it claimed the Indiana REC." The audit report states that the file produced "contain[ed] approximately 45,000 research project descriptions that were conducted over the years 2001 through 2011."

The Department reviewed Taxpayer's research project descriptions and determined that the projects fell into three general categories. According to the audit report, "After reviewing the three categories, the audit has concluded that none of the projects for which the Indiana REC was claimed involved qualified research." As described in the audit report, the three general categories follow:

> The category represented by Hispanic flavor conversion to natural fails to meet the definition of qualified research under Internal Revenue Regulation 1.41-4(c)(3). Many of [T]axpayer's research projects consist of merely adapting an existing business component to a particular customer's requirement or need. Adaption of an existing business component does not constitute qualified research for purposes of the REC.
>
> The category represented by the flavor batter coating demo fails to meet the definition of qualified research under Internal Regulation 1.41-4(c)(4). Research projects that reproduce an existing business component by examination of the business component itself do not constitute qualified research. [T]axpayer's project description states "applications worked on several flavored coating[s] for which we formulated a list of flavored batter coatings about 2 years ago" and "[t]hese flavors work in batter coating systems so please use them to start." [T]axpayer's statements demonstrate the project involves nothing more than duplication of an existing business component previously developed.
>
> The category represented by revise flavors for S cereal fails to meet the definition of qualified research under Internal Revenue Regulation 1.41-4(a)(5)(ii). [T]axpayer's project description states "make cream taste apparent before you taste the mixed berry." [T]axpayer's statement demonstrates the project concerns the taste and style of the product. Projects concerning taste and style do not constitute qualified research for purpose of the REC. (Emphasis added).

**i. Taxpayer's REC Records.**

The audit report sets out concerns relating to the sufficiency of Taxpayer's research expense records and Taxpayer's response to audit's requests for those records. The report explains:

> The auditor prepared an Information Document Request ("IDR") requesting the [T]axpayer to provide a description of each research project conducted during the tax years 2000 through 2011 for which the Indiana REC was claimed. Initially, the [T]axpayer verbally responded to the IDR indicating that no such documentation existed . . . . [T]axpayer verbally responded that it was not an issue since "all of their research activity constitutes qualified research" for purposes of the REC.

Subsequently, Taxpayer provided certain documents on which the audit eventually reached its conclusions.

> After initially refusing to provide a copy, the [T]axpayer provided a Microsoft Excel file containing descriptions of the research projects for which it claimed the Indiana REC. The file contains approximately 45,000 research project descriptions that were conducted over the tax years 2001 through 2011.

The audit reviewed Taxpayer's project descriptions contained in its information and proceeded as follows:

> The audit included a complete review of the research project descriptions to determine if the activities conducted constituted qualified research for purposes of the Indiana REC. After reviewing the project descriptions, the projects were . . . classified into three categories.

Taxpayer objects to the audit's qualitative review of its records and the audit's premise that the records were insufficient. Taxpayer concludes that the audit's review was superficial and incomplete. Taxpayer asserts that "[t]he auditor did not make a reasonable and adequate effort to understand [Taxpayer's] research activities, which took place in Indiana." As explained by Taxpayer, "The auditor did not ask any questions or provide any comments on these projects, and made no reference to them in [the audit] Summary." Taxpayer further objects, "Instead of reviewing those files, or even a substantial number of them, and invest the time and effort to understand the nature of those research projects, the auditor picked **three** files, and claimed that three out of 45,000 was 'a representative sample.'" **(Emphasis in original**).

Taxpayer's view of the sufficiency of its records and the audit's view of those identical records are completely at odds. However, this Letter of Findings makes no findings as to adequacy of Taxpayer's records except to note that it is the Taxpayer's statutory obligation to maintain and produce to the Department records sufficient to verify the credits which it claims pursuant to IC § 6-3.1-4-1 and IC § 6-8.1-5-4. This is especially true in the case of the RECs for which the I.R.C. imposes stringent and detailed parameters and which - if Taxpayer seeks to obtain the benefit of those credits - Taxpayer is required to meet. I.R.C. § 6001; Treas. Reg. § 1-6001-1.

As to the information necessary to verify REC credits, in this regards the IRS's Audit Technique Guide provides useful guidance stating in relevant part:

> 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 is 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 - Substantiation and Recordkeeping, http://www.irs.gov/Businesses/Audit-Techniques-Guide:-Credit-for-Increasing-Research-Activities-(i.e.-Research-Tax-Credit)-IRC-§ 41 (last visited January 2, 2015) (Emphasis added).

In Taxpayer's case, the IRS guidance bears repeating: "[A] taxpayer must retain records in sufficiently usable form and detail to substantiate that the expenditures claimed are eligible for the credit." In situations in which precise detail is lacking and in which the Taxpayer "estimates" the amount of the credits, "[T]axpayer must have factual support for every assumption underlying their estimates to meet their burden of proof."

**ii. Audit Conclusion**.

The audit cited to Treas. Reg. § 1.41-4(c)(3) as authority for concluding that "[m]any of [T]axpayer's research projects consist of merely adapting an existing business component to a particular customer's requirement or need." The cited regulation provides:

> Activities relating to adapting an existing business component to a particular customer's requirement or need are not qualified research. This exclusion does not apply merely because a business component is intended for a specific customer.

The audit cited to Treas. Reg. § 1.41-4(c)(4) in concluding that "[r]esearch projects that reproduce an existing business component by examination of the business component itself do not constitute qualified research." The regulation provides:

> Activities relating to reproducing 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 about the business component are not qualified research. This exclusion does not apply merely because the taxpayer examines an existing business component in the course of developing its own business component.

The audit cited to Treas. Reg. § 1.41-4(a)(5)(ii) in reviewing a category of Taxpayer's research projects which addressed the issue of food flavors. According to the audit report, "[T]axpayer's statements demonstrate the project concerns the taste and style of the product."

> For purposes of section 41(d) and this section, a process of experimentation is undertaken for a qualified purpose if it relates to a new or improved function, performance, reliability or quality of the business component. Research will not be treated as conducted for a qualified purpose if it relates to style, taste, cosmetic, or seasonal design factors.

In order to justify its claim for the REC, Taxpayer provided various work papers during the audit. According to the audit report, "The workpapers identify total salary and wages, supplies, and 65 percent of contracted research expense incurred." The audit requested more specific information. "The [Department] provided to the [T]axpayer requested copies of all documentation necessary to determine the Indiana REC." In response "[T]axpayer provided a separate calculation of the expenses included in the REC calculation for tax years 2001 through 2011." The audit found the "separate calculation" inadequate:

> The calculation provided by [T]axpayer did not assign, allocate, or otherwise apportion the total salary, supplies, or contracted research expense to the individual research projects. Consistent with [T]axpayer's assertion that "all of their research activity constitute qualified research," presumably [Taxpayer] did not see [a] need to establish an accounting system[] to capture information necessary for research expense to be assigned at an individual project level. While the audit has independently concluded [T]axpayer's research activities do not meet the definition of qualified research, the lack of proper documentation also independently supports an audit adjustment.

Taxpayer objects to the audit's conclusion. Taxpayer argues that it is entitled to the benefit of the RECs claimed on its 2009, 2010, 2011, and 2012 Indiana income tax returns.

**D. Hearing Officer Analysis**.

The following analysis is based on the Hearing Officer's review of the audit materials, arguments and materials that Taxpayer submitted during the course of the administrative protest, the Taxpayer's presentation during the protest hearing, as well as the Hearing Officer's independent research and consideration of relevant legal materials.

**i. Prior Audit Results**.

In addition to challenging the scope and thoroughness of the audit's review of its records and of the sufficiency of those records, Taxpayer maintains that the audit's conclusion contradicts prior audits conducted by both the IRS and the Department. Taxpayer explains that "[t]he IRS audits [Taxpayer] on an annual basis, and those audits were focused on [Taxpayer's] QREs in the 1990s." Taxpayer explains that the IRS "extensively analyzed [Taxpayer's] QREs," that Taxpayer subsequently "reported QREs in a manner consistent with its resolution of those issues with the IRS," that the IRS "has not adjusted [Taxpayer's] QREs as reported for federal purposes," and that Taxpayer "has reported the same QREs for Indiana purposes to the extent of the research conducted in Indiana."

In addition, Taxpayer points to the results of an audit conducted by the Department in 2000 for the years 1996 through 1998. Taxpayer states that, "The Department recognized [Taxpayer's] entitlement to research expense credits, and made only small adjustments consistent with the IRS audits."

The Department does not agree that it is now necessarily bound by either the prior IRS audits or by the Department's own 2000 audit. The Department is, of course, required to apply the law consistently, predictably,

and entirely within the bounds of the law insofar as it interprets and applies the REC. However, there is insufficient information to conclude that the circumstances, issues, and documentation relevant to the prior IRS and the Department's 2000 audits are identical or necessarily pertinent to the issues in this Letter of Findings. There is insufficient information to conclude that the audit abrogated its obligation to apply the law in a manner consistent with either the previous IRS or the Department's 2000 audit.

**ii. Food Taste as Qualified Research.**

Taxpayer cites to a I.R.S. Technical Advice Memorandum ("TAM") as authority for its position that Taxpayer's research intended to modify and develop food products constitutes qualified research within the meaning of I.R.C. § 41. The TAM sets out the disputed issue as follows:

> Are Taxpayer's research activities related to the development of new food products and manufacturing techniques, and the improvement of existing food products and manufacturing techniques excluded from qualifying for the credit for increasing research activities because research relating to style, taste, cosmetic, or seasonal design factors is ineligible for the credit under § 41(d)(3)(B); I.R.S. TAM 9522001, 1994 WL 805206 (June 2, 1995).

The affected taxpayer in the TAM developed and manufactured food products and "engaged in various activities aimed at developing new food products and manufacturing techniques, and improving existing food products and manufacturing techniques." Id. The taxpayer "treated these activities as qualified research and claimed the credit for increasing research activities." Id. On federal audit review, the IRS "proposed to disallow some of the [t]axpayer's credit for increasing research activities on the theory that any research related to sensory taste does not qualify for the research credit under § 41(d)(3)(B)." Id. In reviewing this issue, the IRS concluded "that the term 'taste' as used in § 41(d)(3)(B) means individual or consumer preference not sensory taste" and that the "[t]axpayer's research activities in developing new food products and manufacturing techniques, and improving existing food products and manufacturing techniques may not be excluded from the definition of the term 'qualified research' under § 41(d)(3)(B)."

The TAM concluded as follows:

> In the case of food products, new product development and improvements to existing products may relate to texture, smell, and flavor. These characteristics affect taste in the sensory context. To the extent that a food product developer tries to develop products with a new or improved function, performance, or reliability or quality including new or improved textures, smells, or flavors, the research activities to develop the products may relate to functional aspects of a business component as required in § 41(d)(1) and (3)(A). Thus, the research activities conducted for purposes described in § 41(d)(3)(A) and otherwise satisfying the definition of "qualified research" in § 41(d)(1) would not be treated as conducted for an ineligible purpose under § 41(d)(3)(B).

Although I.R.C. § 6110(k)(3) provides that "a written determination may not be used or cited as precedent," the Department finds no reason to depart from the analysis as set out in TAM 9522001. To the limited extent that the audit concluded that research activities related to food taste, texture, smells or flavor are precluded pursuant to Treas. Reg. § 1.41-4(a)(5)(ii), Taxpayer's protest is sustained. To the extent that the Department verifies Taxpayer's research activities are related to the development of food taste, texture, smells, or flavor - and which meet the requirements of qualified research activities - the Audit Division will adjust the assessment.

**FINDING**

As set out in Part I above, Taxpayer's protest is sustained.

**II. Tax Administration - Ten-Percent Negligence Penalty.**

**DISCUSSION**

Taxpayer believes that imposition of the ten-percent negligence penalty is unwarranted.

IC § 6-8.1-10-2.1(a)(3) requires that a ten-percent penalty be imposed if the tax deficiency results from the taxpayer's negligence. IC § 6-8.1-10-2.1(a)(2) imposes a ten-percent penalty if the taxpayer "fails to pay the full amount of tax shown on the person's return on or before the due date for the return or payment."

IC § 6-8.1-10-2.1(d) provides as follows:

> If a person subject to the penalty imposed under this section can show that the failure to . . . pay the full amount of tax shown on the person's return . . . or pay the deficiency determined by the department was due to reasonable cause and not due to willful neglect, the department shall wave the penalty.

Departmental regulation 45 IAC 15-11-2(b) defines negligence as "the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer." Negligence is to "be determined on a case-by-case basis according to the facts and circumstances of each taxpayer." Id.

Departmental regulation 45 IAC 15-11-2(c) requires that in order to establish "reasonable cause," the taxpayer must demonstrate that it "exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed . . . ."

Under IC § 6-8.1-5-1(c), "The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." An assessment - including the negligence penalty - is presumptively valid.

The audit imposed the penalty in apparent response to either the perceived or actual difficulty in obtaining the records sought. As noted above, the Department is unwilling to agree that the audit misinterpreted the records or that the audit was unreasonable in making the record requests that it did. For purposes of this pending penalty, the Department is not prepared to exercise its discretion to abate the penalty. Taxpayer is a substantial and sophisticated business entity seeking the benefit of sizeable tax benefits and it has the responsibility and capacity to timely produce accurate, complete, and detailed records justifying its entitlement to those credits.

**FINDING**

Taxpayer's protest is respectfully denied.

**SUMMARY**

To the extent that the audit concluded that research activities related to food taste, texture, smells or flavor are precluded by correct application of federal and Indiana law, Taxpayer's protest is sustained. The Audit Division is requested to review Taxpayer's documentation and to make whatever adjustment to the assessment that is warranted. The Department does not agree to abate the ten-percent negligence penalty.

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