DEPARTMENT OF STATE REVENUE

02-20140634.LOF

Letter of Findings Number: 02-20140634
Adjusted Gross Income Tax
For Tax Years 2011, 2012, and 2013

NOTICE: IC § 6-8.1-3-3.5 and IC § 4-22-7-7 requires 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 This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register.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

Manufacturer was properly denied research tax credits for wages paid to employees because it could not provide proper documentation to show the time employees spent conducting qualifying research.

ISSUE

I. Adjusted Gross Income Tax–Research Credits.

Authority: IC § 6-8.1-5-1; I.R.C. § 41; Treas. Reg. § 1.41-2; IC § 6-3-2-1; IC § 6-3-1-3.5; IC § 6-3.1-4-1; IC § 6-3.1-4-4; Indiana Dep't of State Revenue v. Rent-A-Center East, Inc., 963 N.E.2d 463 (Ind. 2012); Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289 (Ind. Tax Ct. 2007); IDOPCP, Inc. v. Comm'r, 503 U.S. 79 (1992); 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); Cohan v. Comm'r, 39 F.2d 540 (2d Cir. 1930); Union Carbide Corp. and Subsidiaries v. Comm'r, T.C. Memo 2009-50 (U.S. Tax Ct. 2009); Shami v. Comms., 741 F.3d 560 (5th Cir. 2014); IRS, Audit Technique Guide: Credit for Increasing Research Activities, www.irs.gov/pub/irs-utl/rc2005atg2irsgovrepublished1_2008.pdf (last visited May, 6 2015).

Taxpayer protests the disallowance of claimed research credits.

STATEMENT OF FACTS

Taxpayer is a company incorporated in Indiana and conducts business in Indiana. Taxpayer manufactures, reconditions, and sells hydraulic pump products in and outside of Indiana. In 2006, Taxpayer employed a consulting firm ("Consultant 1") to conduct a Research and Development Tax Credit Study ("2006 Study") determining whether they were eligible to claim certain Indiana research tax credits. Taxpayer employed another consulting firm ("Consultant 2") for a second opinion in the year 2014; Consultants 2 confirmed Consultants 1 based on the 2006 Study and interviews of employees conducted in 2014. Consultants 1 based their study on several quantitative and qualitative information. Quantitative information included, general ledger information for the 2002-2006 tax years, W-2 information, federal and state tax returns (including research credit work papers for each year), and company policies regarding holidays, vacation, sick leave, and training. Qualitative information included, product lists for the 2002-2006 tax years, organization of divisions and functional areas, employee list with job description, product requirement documentation, product summary and review documents, test plans, programming notes, status meeting notes, documents that indicated challenges relating to development and research awards, industry recognitions, press releases, etc. Based on the 2006 Study and advice from Consultants 2, Taxpayer subsequently claimed research tax credits based on a percentage of employee wage expenses on its 2011, 2012, and 2013 Indiana income tax returns. Taxpayer's research credit amounts were claimed based upon employee wage expenses only and no other costs were claimed.

In 2014, the Indiana Department of Revenue ("Department") conducted an audit for those years. During the audit, the Department determined that Taxpayer failed to provide substantial contemporaneous documentation to show that the employees conducted "qualified research" thus denying Taxpayer's claim for the Indiana research expense tax credit.

Taxpayer protests the Department's disallowance of the Indiana research credit. An administrative hearing was conducted during which Taxpayer representatives explained the basis for the protest. This Letter of Findings results. Additional facts will be provided as necessary.

I. Adjusted Gross Income Tax–Research Credits.

DISCUSSION

As a threshold issue, it is the taxpayer's responsibility to establish that the existing tax assessment is incorrect. As stated in IC § 6-8.1-5-1(c), "The notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." Indiana Dep't of State Revenue v. Rent-A-Center East, Inc., 963 N.E.2d 463, 466 (Ind. 2012); Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007).

Additionally, "tax credits are a matter of legislative grace, and taxpayers bear the burden of proving they are entitled to claim tax credits." IDOPCP, Inc. v. Comm'r, 503 U.S. 79, 84 (1992). The taxpayer who claims a tax credit against any tax 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). In addition, the 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." 570 F.3d 672, 675 (5th Cir. 2009).

A. Audit Results.

The audit reviewed all documentation provided by Taxpayer, including the 2006 Study. The auditor requested additional documentation supporting the 2006 Study. In response, Taxpayer provided a list of new parts along with production costs and the selling price of those parts. The audit report concluded that: 1) "The taxpayer did not provide any supporting documentation on those projects that would distinguish experimental costs from actual production costs, or reversing engineering projects from those that develop new part.. . ." and 2) "[T]he taxpayer failed to provide any supporting record that would tie the claimed employee wages to qualified activities on any specific project." When the auditor requested to see specific information that would demonstrate these things, Taxpayer responded that "such records were not kept and they were not required to keep such detailed records in order to claim the research credit."

B. Taxpayer's Response.

Taxpayer protests that the Department incorrectly disallowed the research credits for the years at issue. Taxpayer argues that the estimated percentages of employee wages based upon the 2006 Study and employee interviews are an acceptable basis for calculating its research credit. Taxpayer refers to some authorities which it believes support this position. Taxpayer maintained that "[they] are not required to substantiate by adequate records or by sufficient evidence corroborating [their] own statement of the amount of such expenses" pursuant to Cohan v. Comm'r, 39 F.2d 540 (2d Cir. 1930); referring to Fudim v Comm'r, T.C. Memo. 1994-235 (U.S. Tax Ct. 1994), United States v. McFerrin, 570 F.3d 672 (5th Cir. 2009), and Union Carbide Corp. v. Comm'r, T.C. Memo 2009-50 (2009 WL 605161) (U.S. Tax Ct. 2009).

Taxpayer also stated in its protest that the direct calculation method of determining qualifying research hours is not required under the Internal Revenue Service ("IRS") Audit Techniques Guide: Credit for Increasing Research Activities ("Guide") published in June 2005. Taxpayer quotes from page 29 of the Guide:

> 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 activates as defined in section 41(d). And second, the failure to maintain proper system to capture relevant information cannot be an "inexactitude 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.

Taxpayer argues that these authorities support its position and that the Department must allow estimations as adequate support for Taxpayer's qualifying research credit calculations.

C. Hearing Analysis.

For income tax purposes, Indiana follows the federal tax scheme with certain modifications. IC § 6-3-2-1(b); IC §

6-3-1-3.5(b). Indiana also provides certain tax credits which a taxpayer may claim to reduce its tax liability. See generally, IC § 6-3.1 and IC § 6-3.5. One of the tax credits is the "Indiana qualified research expense tax credit" under IC § 6-3.1-4-1, in relevant part, states:

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

IC § 6-3.1-4-4 provides:

> The provisions **of Section 41 of the Internal Revenue Code as in effect on January 1, 2001, and the regulations promulgated in respect to those provisions and in effect on January 1, 2001, are applicable to the interpretation and administration** by the department of the credit provided by this chapter, including the allocation and pass through of the credit to various taxpayers and the transitional rules for determination of the base period.
> (**Emphasis added**).

"Qualified research" is defined in I.R.C. § 41(d), as follows:

> (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.

I.R.C. § 41(b) also provides that:

> **Qualified research expenses**.--For purposes of this section--
> (1) Qualified research expenses.--The term "qualified research expenses" **means the sum of the following amounts which are paid or incurred by the taxpayer during the taxable year in carrying on any trade or business of the taxpayer**--
> (A) **in-house research expenses**, and
> (B) contract research expenses.
> (2) **In-house research expenses**.--
> (A) In general.--The term "in-house research expenses" means--
> (i) **any wages paid or incurred to an employee for qualified services performed by such employee,**

(ii) any amount paid or incurred for supplies used in the conduct of qualified research, and
(iii) under regulations prescribed by the Secretary, any amount paid or incurred to another person for the right to use computers in the conduct of qualified research.
Clause (iii) shall not apply to any amount to the extent that the taxpayer (or any person with whom the taxpayer must aggregate expenditures under subsection (f)(1)) receives or accrues any amount from any other person for the right to use substantially identical personal property. (**Emphasis added**).

Treas. Reg. § 1.41-2 further illustrates "qualified research expenses," in relevant part, that "a research expense must relate to a particular trade or business done by the taxpayer at the time the expense is paid or incurred in order to be a qualified research expense"; thus, "expenses [. . .] incurred in connection with a trade or business within the meaning of section 174(a) are not necessarily paid or incurred in carrying on a trade or business for purposes of section 41." Furthermore, the regulation explains how to calculate the percentage used for employees who engaged in both qualified and non-qualified research activities.

> In the absence of another method of allocation that the taxpayer can demonstrate to be more appropriate, the amount of in-house research expense shall be determined by multiplying the total amount of wages paid to or incurred for the employee during the taxable year by the ratio of the **total time actually spent by the employee in the performance of qualified services** for the taxpayer to the total time spent by the employee in the performance of all services for the taxpayer during the taxable year. (**Emphasis added**).
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> Treas. Reg. § 1.41-2(d)(1).

Thus, if a taxpayer wishes to exempt certain "wages paid to or incurred for an employee" under the "qualified research expense tax credit," the taxpayer must show that these wages constitute in-house research expenses; i.e., the wages were earned when the employee was performing qualified activities within a qualified research project. Treas. Reg. § 1.14-2 Moreover, to claim the Indiana qualified research expense tax credit on wages incurred, the taxpayer must demonstrate that its activities meet the statutory/regulatory requirements of "qualified research," as defined in I.R.C. 41(d), and that the "qualified research" activities were conducted in Indiana in carrying on a trade or business of the taxpayer. Id.

Furthermore, "[w]ages paid to or incurred for an employee constitute in-house research expenses only to the extent the wages were paid or incurred for qualified services performed by the employee." Treas. Reg. § 1.41-2(d)(1). "If an employee has performed both qualified services and nonqualified services, only the amount of wages allocated to the performance of qualified services constitutes an in-house research expense." Id. Thus, only when a taxpayer demonstrates that the wages paid or incurred to employees for qualified services performed by its employees for Indianan qualified research, is the taxpayer entitled to the Indiana qualified research expense tax credit.

Taxpayer cited to the IRS Audit Technique Guide to show that the IRS will allow the use of estimates when contemporaneous records are not available; the phrasing "will allow" does not imply that the IRS auditor must accept estimates. Additionally, the IRS has discretion to allow such estimates, and provides that two conditions must be met; one of which the failure to maintain or keep the contemporaneous records must not be an "inexactitude of their own making." IRS Audit Technique Guide: Credit for Increasing Research Activities, 29. "Failure to maintain records in accordance with these rules is a basis for disallowing the credit." Id. The Guide goes on to list helpful information to understand the appropriate amounts of resources that were allocated to qualifying research and development. In addition, as to employee testimony, the Guide merely states that "oral testimony by individuals with personal knowledge of the issues **may be** helpful in **evaluating and/or supplementing a taxpayer's contemporaneous documentation**. Id. (**Emphasis added**).

Taxpayer referred to McFerrin, which states in relevant part:

> The government next argues that even if qualified research occurred, McFerrin failed to provide adequate documentation to substantiate the costs associated with that research. But this goes against the longstanding rule of Cohan v. Commissioner that if a qualified expense occurred, the court should estimate the allowable tax credit. 39 F.2d at 544. If McFerrin can show activities that were "qualified research," then the court should estimate the expenses associated with those activities. The district court need not credit McFerrin's reconstruction of expenses from years after the fact. See Eustace v. Comm'r, 81 T.C.M. (CCH) 1370, *5 (2001). But the court should look to testimony and other evidence, including the institutional knowledge of employees, in determining a fair estimate. 570 F.3d at 679.

Taxpayer states that this case supports its position that the Department must allow estimations as adequate

support for Taxpayer's research credit calculations. The Department disagrees.

First, the Department notes that the McFerrin decision was issued by the Fifth Circuit Court of Appeals, while Indiana is located in the Seventh Circuit. The McFerrin opinion is therefore not binding on Indiana. Next, the McFerrin opinion states that, if the taxpayer in that case could show activities that were "qualified research," then the court should estimate the expenses associated with those activities. Next, the opinion explained that the court should look to testimony and other evidence including the institutional knowledge of employees in determining a fair estimate of research credits.

The Department notes that the 2006 Study and employee interviews, offers no other documentation that affirms the percentages estimated were for time spent conducting qualifying research. Taxpayer's documentation neither identifies qualified projects nor employees time spent on those projects. Additionally, there is no "testimony," since no one was under oath or penalties of perjury. The Department is not convinced that it is required to accept as fact the unsupported estimations of a single person's wages engaged in general qualifying research.

Taxpayer also referred generally to Union Carbide Corp. and Subsidiaries v. Comm'r, T.C. Memo 2009-50. In that case, taxpayer suggested that and the court allowed expert witnesses to provided that ("Qualified Research Expense") QREs were incurred by Union Carbide Corp ("UCC") in connection with the claimed projects $23,356,600 for 1994 and $32,114,800 for 1995. Id. at 42. The Department disagrees with Taxpayer's assertion. The Department refers to relevant portion of the opinion which provides:

> The research credits claimed on petitioner's original returns and allowed by respondent included the wages of UCC's R & D scientists and engineers at its technical centers. Petitioner now seeks to treat as additional QREs amounts paid to operators at Taft and Star for the Amoco anticoking and UCAT-J projects, respectively.
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> For the Amoco anticoking project, petitioner treated as wage QREs the wages paid to Mr. Hyde, Mr. Tregre, and Mr. Gorenflo according to the number of hours each spent working on the project. Mr. Hyde and Mr. Tregre both credibly testified that they spent a combined total of 50 hours working on the Amoco anticoking project. We find that the services that Mr. Hyde and Mr. Tregre provided in connection with the Amoco anticoking project, including planning the tests, participating in the pretreatments, and sending the data to the technical center to be analyzed, constitute qualified services. **While respondent argues that petitioner has not substantiated its claimed QREs, we find that the testimonies of Mr. Hyde, Mr. Tregre, and Ms. Hinojosa were credible and sufficiently substantiated the wages paid to these employees. We find that petitioner has satisfied its burden and may treat as wage QREs $835 and $210 for 1994 and 1995, respectively. However, Mr. Gorenflo did not testify as to how much time, if any, he spent on the Amoco anticoking project. Accordingly, petitioner has not satisfied its burden of proving that Mr. Gorenflo spent 2 hours engaged in qualified research with respect to the Amoco anticoking project in 1994 and may not claim his wages as QREs.**
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> Id at *115. (**Emphasis added**).

As the Union Carbide court explained, the employees themselves testified as to the actual hours they worked on projects which qualified for the research credit. Id. In the instant case, the interviews provided by Consultants 2 merely lists employees wages and an estimated percentage for each of the employees' wages. It offered no list of qualified research projects or activities. It offered no breakdown of how many hours were spent on qualifying projects or activities and how many hours were spent on non-qualifying projects or activities, or any other information for the basis of the estimate for the employee.

The Department notes another Fifth Circuit case that distinguishes and clarifies the Fifth Circuit's intent behind the McFerrin rule. In Shami v. Comms., 741 F.3d 560 (5th Cir. 2014), the Fifth Circuit held that the Tax Court properly determined that the use of estimates was not permissible. Id. at 569. While the Fifth Circuit is only persuasive authority the Department believes it refutes Taxpayer's reliance on other Fifth Circuit cases.

In Shami, the IRS denied the taxpayer's research credit; the Tax Court held that the taxpayer had not met its burden of proving that the claimed wages paid to employees were wages from conducting qualifying research. Id. at 568. The taxpayer argued that the Tax Court failed to properly allow the taxpayer's use of estimations on wages paid for qualifying research. Id. The Tax Court determined, and the Fifth Circuit affirmed, that the argument fails on merit. Id. In Shami, the Fifth Circuit stated that "the Cohen decision holds that if a taxpayer proves that he is entitled to a tax benefit but does not substantiate the amount of the tax benefit the court should make as close an approximating as it can, **bearing heavily if it chooses upon the taxpayer whose inexactitude is of his own**

making." Id. (**Emphasis added**). That Shami court further stated that, while in McFerrin, the court held the Cohen rule extends to §41 credit. Id. (citing, McFerrin, 570 F.3d at 675, 679), the Cohen rule is not implicated unless taxpayer proves that he is entitled to some tax benefit. Shami, at 568.

In Shami, the Fifth Circuit based its opinion on Williams v. United States. In Williams, the Fifth Circuit held that even though the Tax Court may have latitude in making estimates of amounts probably spent, the Cohen rule does not require that such latitude be employed. Shami, at 568, (citing Williams v. United States, 245 F.2d 559 (5th Cir. 1975)). Furthermore, in Williams, the Fifth Circuit held that "the Tax Court may not be compelled to estimate an amount of tax credit even though such an estimate if made might have been affirmed, [and] the basic requirement is that there be sufficient evidence to satisfy the trier that at least the amount allowed in the estimate was in fact spent or incurred for the stated purpose and until the trier has that assurance from the record relief to the taxpayer would be unguided largesse." Shami, at 569. "Neither Williams nor any other exception to the Cohen rule was before the court in McFerrin, and we do not read McFerrin to hold that Cohan is untempered by any exceptions." Id.

In the instant case, Taxpayer used estimations without any supporting documentation to show employees' time doing qualified research. The Department is not required to take as fact any estimates of employees' time based on interviews conducted by Consultants 2.

In summary, Taxpayer has not established that the estimates are a valid basis for arriving at the wage figures used in its research credit calculations. The IRS Audit Guide requires that the taxpayer maintain contemporaneous documentation. Only in the instances where contemporaneous documentation is not available, due to no fault of the taxpayer, will the IRS exercise its discretion as to whether the estimates are sufficient in allowing the qualifying research tax credit. Taxpayer's reliance on McFerrin is misplaced for several reasons, such as: 1) the case is from the Fifth Circuit, while Indiana is in the Seventh; 2) in addition the court in McFerrin, did not solely rely on testimonial evidence from employees to substantiate estimated percentages; and, 3) the court's instructions were to use the testimony along with other evidence in arriving at a fair estimate. There is no other evidence in the instant case.

Taxpayer's reliance on Union Carbide is misplaced for several reasons, such as: 1) Union Carbide offered testimony regarding wages while Taxpayer offers common statements of employees' estimations; 2) Union Carbide established its witnesses' expertise and qualifications for making estimations, along with the available supporting documentation which those witnesses used in arriving at their estimations; and, 3) some of Union Carbide's employees offered breakdowns of the hours they spent on qualifying projects and hours spent on non-qualifying projects. The court rejected Union Carbide's claim for credit regarding its employee that did not offer a breakdown of actual hours spent on qualifying and non-qualifying projects.

Furthermore, in Shami and Williams the Fifth Circuit determined that estimates are only sufficient when a taxpayer proves that: 1) the taxpayer is entitled to the tax benefit and 2) the taxpayer provides evidence other than employee statements to substantiate estimates. Thus based on the information above, Taxpayer has not met the burden of proving the proposed assessments wrong, as required by IC § 6-8.1-5-1(c).

FINDINGS

Taxpayer's protest is denied.

Posted: 07/29/2015 by Legislative Services Agency
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