DEPARTMENT OF STATE REVENUE

02-20140244.LOF

Letter of Findings: 02-20140244
Corporate Income Tax
For the Years 2008, 2009, and 2010

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 This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register.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

Indiana recreational vehicle manufacturer was required to source income from the sales of its vehicles to Indiana; the dealers acquiring the vehicles accepted delivery in Indiana and Indiana was not an "ultimate destination state." The manufacturer failed to establish that Department's calculation of the manufacturer's research expense credit attributable to wages paid its upper-level management was wrong. Manufacturer also failed to establish that that income attributable to its out-of-state activities should not be thrown back to Indiana.

ISSUES

I. Corporate Income Tax - Sourcing Vehicle Sales.

Authority: IC § 6-3-2-2(e); IC § 6-8.1-5-1(c); Indiana Dep't of State Revenue v. Rent-A-Center East, Inc., 963 N.E.2d 463 (Ind. 2012); Wendt LLP v. Indiana Dep't of State Revenue, 977 N.E.2d 480 (Ind. Tax Ct. 2012); Dept. of Revenue v. Miller Brewing Co., 975 N.E.2d 800 (Ind. 2012); Scopelite v. Indiana Dep't of Local Gov't Fin., 939 N.E.2d 1138 (Ind. Tax Ct. 2010); Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289 (Ind. Tax Ct. 2007).

Taxpayer argues that its sales of vehicles to out-of-state retail dealers should be sourced to the ultimate customers' destination states.

II. Corporate Income Tax - Throw-back Sales.

Authority: 15 U.S.C. § 381(a); 15 U.S.C. § 381(c); IC § 6-3-2-2(a); IC § 6-3-2-2(n); IC § 6-3-2-2(n)(2); IC § 6-8.1-5-1(c); Sherwin-Williams Co. v. Indiana Dep't. of State Revenue, 673 N.E.2d 849 (Ind. Tax Ct. 1996); 45 IAC 3.1-1-38; 45 IAC 3.1-1-53; 45 IAC 3.1-1-64.

Taxpayer maintains that it was subject to income tax in several foreign states and that sales of its vehicles to customers in those states should not be "thrown back" to Indiana.

III. Corporate Income Tax - Research Expense Credits.

Authority: IC § 6-3-1-3.5(b); IC § 6-3-2-1(b); IC § 6-3.1-4-1; IC § 6-3.1-4-2; IC § 6-3.1-4-4; IC § 6-8.1-5-1(c); IC § 6-8.1-5-4; I.R.C. § 41(b); I.R.C. § 41(b)(2)(D); I.R.C. § 41(d); Treas. Reg. § 1.41-2(c)(2); Treas. Reg. § 1.41-2(d)(1); Treas. Reg. § 1.41-2; Treas. Reg. § 1.41-2(c)(1), (2), (3); Treas. Reg. § 1.41-2(c)(2); Treas. Reg. § 1.41-2(c)(3); United States v. McFerrin, 570 F.3d 672 (5th Cir. 2009); Stinson Estate v. United States, 214 F.3d 846 (7th Cir. 2000); 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);Techniques Guide: Credit for Increasing Research Activities (i.e. Research Tax Credit) IRC § 41 - Substantiation and Recordkeeping.

Taxpayer maintains that it has provided sufficient information to justify its claim to certain research expense credits attributable to wages paid to its upper level management employees.

IV. Administration - Underpayment Penalty.

Authority: IC § 6-3-4-4.1(d); IC § 6-8.1-10-2.1(b); IC § 6-8.1-10-2.1(d); 45 IAC 15-11-2(c).

Taxpayer asks the Department to exercise its authority to abate a ten-percent underpayment penalty.

STATEMENT OF FACTS

Taxpayer is a company in the business of manufacturing and selling recreational vehicles. Taxpayer filed a combined Indiana income tax return which included certain of its various subsidiaries.

The Indiana Department of Revenue ("Department") conducted an audit review of Taxpayer's business records and corporate income tax returns. The audit resulted in the assessment of additional income tax. Taxpayer disagreed with the 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 - Sourcing Vehicle Sales.

DISCUSSION

The issue is whether Taxpayer is required to include in the numerator of its sales factor money received from the sale of recreational vehicles in which out-of-state dealers accepted delivery of the vehicles at one of Taxpayer's Indiana locations.

As a matter of law, 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). Thus, a taxpayer is required to provide documentation explaining and supporting his or her challenge that the Department's position is wrong. Poorly developed and non-cogent arguments are subject to waiver. Scopelite v. Indiana Dep't of Local Gov't Fin., 939 N.E.2d 1138, 1145 (Ind. Tax Ct. 2010); Wendt LLP v. Indiana Dep't of State Revenue, 977 N.E.2d 480, 486 n.9 (Ind. Tax Ct. 2012).

A. Audit Results.

The audit found that Taxpayer failed to include in the sales factor numerator certain dealer sales. The audit made an adjustment to include those sales. As authority for its decision, the audit cited to IC § 6-3-2-2(e) which states in relevant part:

> The sales factor is a fraction, the numerator of which is the total sales of the taxpayer in this state during the taxable year, and the denominator of which is the total sales of the taxpayer everywhere during the taxable year. Sales include receipts from intangible property and receipts from the sale or exchange of intangible property. However, with respect to a foreign corporation, the denominator does not include sales made in a place that is outside the United States. Receipts from intangible personal property are derived from sources within Indiana if the receipts from the intangible personal property are attributable to Indiana under section 2.2 of this chapter. Regardless of the f.o.b. point or other conditions of the sale, sales of tangible personal property are in this state if:
>
> (1) the property is delivered or shipped to a purchaser that is within Indiana, other than the United States government[.] (Emphasis added).

The audit report summarized stating, "A sale 'of tangible personal property' is deemed to have taken place in Indiana 'if the property is delivered or shipped to a purchaser that is within Indiana other than the United States government.' This is true 'regardless of other conditions of the sales.'"

The audit report found that "Taxpayer has not included in the numerator of the sales factor, sales of vehicles picked up in Indiana by a [recreational vehicle] dealer (or employee thereof) whose physical location is in another state. In such scenario, the unit is 'delivered directly to the purchaser (dealer), not a third party agent, within Indiana and should be included in the numerator of the sales factor for apportionment." (Emphasis in original).

B. Taxpayer's Response.

Taxpayer disagreed with the audit contending that Indiana is an "ultimate destination" state, and that any sales to out-of-state dealers should be sourced to the "ultimate destination of the unit." The audit disagreed with the

Taxpayer's position stating that the recreational vehicles were "delivered" directly to the dealer/purchaser when the vehicle was picked up by the dealer at Taxpayer's Indiana manufacturing facility. "Any subsequent transfer to a locations outside of Indiana occurs after the sale has been completed."

In Taxpayer's written protest, Taxpayer argues that the dealer sales should be sourced to the dealers' out-of-state location because the dealers sold the vehicles to their own customers in those states. Taxpayer explains:

> The out-of-state dealers immediately took the vehicles out-of-state, and titled them out-of-state. In spite of numerous court holdings, a legislative mandate, and the Department's own arguments and policy that Indiana is a destination-rule state, the audit included in [Taxpayer's] Indiana sales factor numerator sales of vehicles to out-of-state dealers, picked up in Indiana, transported out-of-state, and destined for out-of-state dealer lots.
>
> For purposes of the destination rule, the destination state is equivalent to the state that provides the market for the sale of the goods; namely the state in which the ultimate purchase is located . . . . Under the destination rule, it is immaterial whether sales of the goods to an out-of-state customer are shipped from the seller's state by a third party carrier or the buyer picks up the goods in the state of the seller, the state that produces the market for the final sale remains the same. (Emphasis added).

C. Hearing Analysis.

Under Taxpayer's interpretation of IC § 6-3-2-2(e), even if an out-of-state recreational vehicle dealer purchased a vehicle in Indiana and takes delivery of that vehicle in Indiana, the sales should not be included in the numerator of Taxpayer's sales factor because the ultimate customer buys the vehicle at the dealer's out-of-state location.

While there is nothing in the statute to support Taxpayer's interpretation, Taxpayer cites to Dept. of Revenue v. Miller Brewing Co., 975 N.E.2d 800 (Ind. 2012) in support of its proposition that Indiana is an "ultimate destination" state. In that case, a Wisconsin company sought a refund of adjusted gross income and supplemental net tax which it paid on money earned from the sale of beer to Indiana distributors. Id. at 801.

During the course of the court's review, the court considered the sales in dispute; out-of-state sales to Indiana distributors that were delivered to the Indiana distributors via third-party common carriers. The court determined that sales of beer that were shipped to Indiana distributors, rather than picked-up by the distributors themselves at out-of-state locations, were Indiana sales. The court was not concerned with the location of the ultimate customer that would purchase the beer for personal consumption. Instead, the court's focus was the location of the sale between the taxpayer and the taxpayer's customer–not the ultimate customer.

However, Taxpayer attempts to expand the court's holding and assert that the court held that Indiana follows the "ultimate destination" rule, which sources the sales of tangible personal property to the ultimate destination of the property, not the destination of the initial sale. A plain reading of the decision demonstrates that this is not what the court held. The court stopped short of holding that the Miller's sales were attributable to the location where the beer was ultimately purchased for consumption. Instead, the sales were sourced to the destination of the initial sale between Miller and the distributors, which was Indiana when the distributors did not travel out-of-state to purchase the beer.

Based on the Miller decision, the destination of the sales in this matter was Indiana, as Taxpayer sold the recreational vehicles to out-of-state vendors that were picked up by the vendors in Indiana. Where the vendors ultimately took the vehicles and where the vehicles were ultimately sold to the final customer are not relevant for purposes of determining the Taxpayer's tax liability. Unlike Miller in which the distributors remained in Indiana and did not travel out of state to pick-up the property, the vendors in this matter came to Indiana and purchased the property here. Thus the destination of the sales is Indiana.

Indiana is a "destination" and not an "ultimate destination" state and Taxpayer's analysis to the contrary is incorrect. Taxpayer has not met its burden under IC § 6-8.1-5-1(c) of establishing that the audit assessment was wrong.

FINDING

Taxpayer's protest is respectfully denied.

II. Corporate Income Tax - Throw-back Sales.

DISCUSSION

The issue is whether or not Taxpayer's sales of recreational vehicles to customers located in Hawaii, Kentucky, Maine, New Hampshire, Arkansas, West Virginia, and certain foreign countries should be "thrown back" to Indiana on the ground that Taxpayer is subject to either an income tax or a franchise tax measured by income in those out-of-state jurisdictions. Further, the burden of proving the assessments wrong remains with the Taxpayer.

A. Audit Results.

The Department's audit found that "Taxpayer made sales from Indiana locations to customers in foreign states in which [T]axpayer had not established that it was subject to an income or franchise tax (measured by income) in . . . Hawaii, Kentucky, Maine, New Hampshire, and foreign countries in all three years of the audit period." In addition, the audit also found that Taxpayer failed to establish that sales to customers in Arkansas and West Virginia - for the fiscal year ending July 31, 2010 - should not be thrown back to Indiana.

According to the audit report:

> In all of the listed states, Taxpayer was also unable to demonstrate it had payroll or property in the state. The absence of both factors in a state in most instances results in nexus not being established . . . . Taxpayer has not filed or paid any income tax or franchise tax in the states listed, or provided other evidentiary documentation to conclude sales to the states listed should not be thrown back to Indiana. Each of the listed states has a corporate income and/or franchise tax.

B. Taxpayer's Response.

Taxpayer disagrees stating that it "had sufficient nexus to be subject to an income or franchise tax in the states listed in the audit . . . ."

Taxpayer asserts that it "was subject to an income or franchise tax in Hawaii, Kentucky, Maine, and New Hampshire for all three audit years in question and [Taxpayer] was subject to income or franchise tax in Arkansas and West Virginia for the fiscal year ending July 31, 2010."

Taxpayer explains that its "subsidiaries made sales and had warranty repair obligations through third party dealers in the listed states during all three of the audit years. These third party warranty repair obligations created nexus between [Taxpayer's] subsidiaries and the listed states and exceeded the 'mere solicitation' threshold of P.L. 86-272." Taxpayer argues that "[w]hether or not [Taxpayer] filed or paid income tax in the listed states is immaterial to the determination of whether or not [Taxpayer] was subject to tax in those states."

Taxpayer further explains that it "filed a unitary combined Indiana income tax returns with its subsidiaries during the audit years." In addition, Taxpayer argues that the sales should not be thrown back "because Indiana follows the 'Finnigan' rule for unitary combined returns" and cites to Tax Policy Directive 6 (June 1992) as authority for that conclusion.

> Under Finnigan, sales made by a member of the unitary group to a destination in another state in which that member was not taxable should not be "thrown back" to Indiana unless no member of the unitary group was taxable in the other state. The Indiana property, payroll and sales of all corporations within a unitary group will be taken into account in apportioning unitary business income to Indiana. This includes property, payroll, and sales attributable to entities that are not subject to Indiana taxation under 15 USC Section 381 (P.L. 86-272). The total business income apportioned to Indiana will then be assigned among the individual corporations taxable in Indiana. Each taxable corporation is assigned a share of the business income according to its relative share (it's percentage share without considering the nontaxable members' share) of the unitary groups' Indiana property, payroll and sales factors. Id.

C. Hearing Analysis.

In order to make a determination regarding this issue, it is necessary to provide a brief summary of several relevant points of law.

i. Adjusted Gross Income.

"Indiana imposes a tax on every corporation's adjusted gross income derived from sources within Indiana. [IC §

6-3-2-1(b)]. In cases where a corporation derives business income from sources both within and without Indiana, the 'adjusted gross income derived from sources within the state of Indiana' is determined by an apportionment formula." Sherwin-Williams Co. v. Indiana Dep't. of State Revenue, 673 N.E.2d 849, 851 (Ind. Tax Ct. 1996).

IC § 6-3-2-2(a) in pertinent part, states that Indiana taxpayers are subject to this state's income tax on money earned from doing business within this state:

> (a) With regard to corporations and nonresident persons, "adjusted gross income derived from sources within Indiana", for the purposes of this article, shall mean and include:
> (1) income from real or tangible personal property located in this state;
> (2) income from doing business in this state;
> (3) income from a trade or profession conducted in this state;
> (4) compensation for labor or services rendered within this state; and
> (5) income from stocks, bonds, notes, bank deposits, patents, copyrights, secret processes and formulas, good will, trademarks, trade brands, franchises, and other intangible personal property if the receipt from the intangible is attributable to Indiana under section 2.2 of this chapter.

However, IC § 6-3-2-2(n) provides that a taxpayer's income is not subject to this state's income tax if that income is attributable to conducting business in another state in which it is subject to that foreign state's own tax regime.

> (n) For purposes of allocation and apportionment of income under this article, a taxpayer is taxable in another state if:
> (1) in that state the taxpayer is subject to a net income tax, a franchise tax measured by net income, a franchise tax for the privilege of doing business, or a corporate stock tax; or
> (2) that state has jurisdiction to subject the taxpayer to a net income tax regardless of whether, in fact, the state does or does not.

45 IAC 3.1-1-38 illustrates the "doing business" in a foreign state principle.

> Doing Business. For apportionment purposes, a taxpayer is "doing business" in a state if it operates a business enterprise or activity in such state including, but not limited to:
> (1) Maintenance of an office or other place of business in the state
> (2) Maintenance of an inventory of merchandise or material for sale distribution, or manufacture, or consigned goods
> (3) Sale or distribution of merchandise to customers in the state directly from company-owned or operated vehicles where title to the goods passes at the time of sale or distribution
> (4) Rendering services to customers in the state
> (5) Ownership, rental or operation of a business or of property (real or personal) in the state
> (6) Acceptance of orders in the state
> (7) Any other act in such state which exceeds the mere solicitation of orders so as to give the state nexus under P.L. 86-272 to tax its net income.

45 IAC 3.1-1-64, in relevant part, further explains under what conditions a taxpayer is conducting business in another state:

> "Taxable in Another State" Defined. A corporation is "taxable in another state" under the Act when such state has jurisdiction to subject it to a net income tax. This test applies if the taxpayer's business activities are sufficient to give the state jurisdiction to impose a net income tax under the Constitution and statutes of the United States. Jurisdiction to tax is not present where the state is prohibited from imposing the tax by reason of the provision of Public Law 86-272, 15 U.S.C.A. §381-385.

ii. The Throwback Rule and Public Law 86-272.

45 IAC 3.1-1-53 illustrates the "throw back" principle:

> When Sales of Tangible Personal Property Are in This State. Gross receipts from the sales of tangible personal property (except sales to the United States Government--See Regulation 6-3-2-2(e)(050) [45 IAC 3.1-1-54] are in this state: (a) if the property is delivered or shipped to a purchaser within this state regardless of the F.O.B. point or other conditions of sales; or (b) if the property is shipped from an office, store, factory, or other place of storage in this state, and the taxpayer is not taxable in the state of the purchaser. See Regulation 6-3-2-2(n)(010) [45 IAC 3.1-1-64].

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(5) If the taxpayer is not taxable in the state of the purchaser, the sale is attributed to this state if the property is shipped from an office, store, warehouse, factory, or other place of storage in this state. Such sale is termed a "Throwback" sale. Example: The taxpayer has its head office and factory in State A. It maintains a branch office and inventory in Indiana. Taxpayer's only activity in State B is the solicitation of orders by a resident salesman. All orders by the State B salesman are sent to the branch office in Indiana for approval and are filled by shipment from the inventory in Indiana. Since the taxpayer is immune under P.L.86-272 from tax in State B, all sales of merchandise to purchasers in State B are attributed to Indiana, the state from which the merchandise was shipped. (Emphasis added).

The issue then becomes whether Taxpayer's activities brought itself within the purview of the Hawaii, Kentucky, Maine, New Hampshire, Arkansas, West Virginia, and foreign countries' income tax regime. 15 U.S.C. § 381(a) (Public Law 86-272) establishes the minimum standards under which Indiana or any foreign state may permissibly impose tax. In relevant part, the law provides as follows:

No State, or political subdivision thereof, shall have power to impose, for any taxable year ending after September 14, 1959, a net income tax on the income derived within such State by any person from interstate commerce if the only business activities within such State by or on behalf of such person during such taxable year are either, or both, of the following:

(1) the solicitation of orders by such person, or his representative, in such State for sales of tangible personal property, which orders are sent outside the State for approval or rejection, and, if approved, are filled by shipment or delivery from a point outside the State; and
(2) the solicitation of orders by such person, or his representative, in such State in the name of or for the benefit of a prospective customer of such person, if orders by such customer to such person to enable such customer to fill orders resulting from such solicitation are orders described in paragraph (1).

15 U.S.C. § 381(c) explains under what conditions a company is not conducting business in another state.

For purposes of subsection (a) of this section, a person shall not be considered to have engaged in business activities within a State during any taxable year merely by reason of sales in such State, or the solicitation of orders for sales in such State, of tangible personal property on behalf of such person by one or more independent contractors, or by reason of the maintenance, of an office in such State by one or more independent contractors whose activities on behalf of such person in such State consist solely of making sales, or soliciting orders for sales, of tangible personal property. (Emphasis added).

In summary, Public Law 86-272 prohibits states from imposing a net income tax on a foreign taxpayer if the foreign taxpayer's only business activity within that state is the solicitation of sales. A state may not impose an income tax on income derived from business activities within that state unless those activities exceed the "mere solicitation" of sales.

iii. Analysis of the Law Applied to the Facts.

Based on the law summarized above, in every transaction, at least one state has the authority to impose an income or franchise tax on income derived from the sale of tangible personal property. A state may impose tax on a taxpayer only when the taxpayer's activity within the state exceeds "solicitation."

At the outset, and as explained in Part I above, Taxpayer sold its recreational vehicles to out-of-state third-party dealers. However, these sales are "in this state" because the dealers either took possession of the vehicles in Indiana or the dealers arranged for a third-party to take possession of the vehicles in this state.

Since the vehicle sales are "in this state," Taxpayer's argument necessarily hinges on whether fulfilling Taxpayer's warranty obligation to out-of-state dealers and their customers gave Taxpayer sufficient contact with those customers' and dealers' home states such that those states "had jurisdiction to impose a net income tax under the Constitution and statutes of the United States." 45 IAC 3.1-1-64.

In Taxpayer's case, the warranty repairs were performed by its third-party dealers. The warranties apparently obligated Taxpayer to compensate the dealers for these warranty expenses because - in whole or in part - Taxpayer "stands behind" those warranties. However, the Department questions whether the dealer reimbursements necessarily give the state in which the reimbursements were directed "jurisdiction to subject

[Taxpayer] to a net income tax." IC § 6-3-2-2(n)(2). Indeed, since the warranty transactions represent Taxpayer expenditures, it is unclear what net income would be subject to each foreign state's own net income tax.

Taxpayer admits that it did not file income tax returns in the states under consideration. The Department agrees that that Taxpayer's failure to file returns or pay income tax in those states is not necessarily dispositive. However, the Department does not agree that the failure to file or pay is insignificant. Ultimately, the Department does not agree that Taxpayer's warranty obligation to its out-of-state dealers and their customers exceeds the Public Law 86-272 "mere solicitation" standard.

On the question of throw-back sales, the Department does not agree that Taxpayer has met the IC § 6-8.1-5-1(c) standard of establishing that the audit assessment was "wrong."

FINDING

Taxpayer's protest is respectfully denied.

III. Corporate Income Tax - Research Expense Credits.

DISCUSSION

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

Further, similar to deductions, exemptions, and exclusions, tax credits "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 Stinson Estate, 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." United States v. McFerrin, 570 F.3d 672, 675 (5th Cir. 2009).

A. Audit Results.

The Department's audit stated that it "does not disagree that the [T]axpayer [is] engaged in research activities during the audit period; however the [T]axpayer has not provided adequate documentation to support the percentages claimed as required by IRC Section 41."

Further the audit report noted that "[t]he auditor has accepted many of the percentages claimed for employees such as engineers whom by virtue of job description would typically engage in research type activities." In addition, "The [T]axpayer and auditor came to an agreement on more reasonable percentages for some upper level personnel who would typically not engage directly in research activities."

However, the auditor and Taxpayer were not able to agree on certain other adjustments made to Taxpayer's REC. "Adjustments proposed are for upper level personnel in the operations, sales, and purchase departments who generally would not engage directly in research and development activities on a day to day basis." The audit adjusted the research time claimed by one of Taxpayer's subsidiaries on behalf of its president and its vice president of operations. In addition, the audit adjusted the research time claimed by certain "other upper level employees." According to the audit report:

> The audit requested documentation to establish these employees engage in qualifying activities and estimates of time involved in each activity. The [T]axpayer provided a list of projects and the activities performed for many of the employees, but the [T]axpayer did not provide estimates of the time spent on these activities.

The audit did not disallow the claimed RECs. In those cases where the audit determined that the documentation was insufficient, "The audit has agreed to allow 11[percent] for those employees in which the documentation provided was not sufficient to determine a more reasonable percentage."

The audit report summarized its position as follows:

> In conclusion, the adjustments proposed are reasonable given the lack of usable records provided. The audit has attempted to adjust the claimed wages for the upper level management positions that would be typically heavily involved in research activities to more accurately represent the amount of research performed.

B. Taxpayer's Response.

In submitting its protest, Taxpayer argues that the 11 percent adjustment was "unsupported" and "arbitrary." Taxpayer states that it "adequately supported its qualified research expenses with sufficiently usable and detailed documentation to support the percentages claimed for its REC with documentation as required by Internal Revenue Code § 41 and supporting regulations . . . ."

Taxpayer explains the method it employed to calculate the amount of credit originally claimed:

> In order to identify research credit eligible activities, [Taxpayer evaluated each employee's activities on an individual basis using reports from technical personnel, daily activity logs, project notes, project summaries, reports to management and other related documentation. The activities were then recorded in a time allocation sheet containing 23 categories of activities in order to arrive at each employee's final "qualifying percentage."

Taxpayer concludes:

> The records provided by [Taxpayer] to support its percentages complied with federal standards, and Indiana law does not require any additional specific records above what [Taxpayer] provided. The audit does not indicate any basis for the audit conclusion that [T]axpayer's records were insufficient . . . . [Taxpayer's] documentation of research credit eligible activities and its methodology in determining each employee's qualifying percentage is more than sufficient to meet the substantiation and documentation requirements under I.R.C. § 41 and Indiana law.

C. Hearing Analysis.

In order to make a determination regarding this issue, it is necessary to provide a brief summary of several relevant points of law.

i. The Qualified Research Expense Credit.

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). "If the [D]epartment reasonably believes that a person has not reported the proper amount of tax due, the [D]epartment shall make a proposed assessment of the amount of the unpaid tax on the basis of the best information available to the [D]epartment." IC § 6-8.1-5-1(a).

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 tax credits 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, which states in relevant part:

> 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 . . . .** (**Emphasis added**).

In order to claim the REC, a taxpayer must demonstrate it engaged in qualified research. "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**. . .

***

(B) **Qualified services**.--The term "qualified services" means services consisting of--
(i) **engaging in qualified research**, or
(ii) **engaging in the direct supervision or direct support of research activities which constitute qualified research**. . .[.](**Emphasis added**).

Treas. Reg. § 1.41-2 further illustrates "qualified research expenses," as here relevant:

(a) Trade or business requirement--(1) In general. An in-house research expense of the taxpayer or a contract research expense of the taxpayer is a qualified research expense **only if the expense is paid or incurred by the taxpayer in carrying on a trade or business of the taxpayer**. The phrase "**in carrying on a trade or business" has the same meaning for purposes of section 41(b)(1) as it has for purposes of section 162**. . .. **A research expense must relate to a particular trade or business being carried on by the taxpayer at the time the expense is paid or incurred in order to be a qualified research expense**.

***

(c) **Qualified services**–

***

(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**.

***

(d) **Wages paid for qualified services**--(1) In general. **Wages 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. 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. 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**).

ii. Analysis of the Law Applied to the Facts.

Based on the law summarized above, if a taxpayer wishes to exempt "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. In-house research expenses are earned when the employee was performing qualified activities within a qualified research project. However, to claim the Indiana qualified research expense tax credit on wages incurred, the taxpayer must first 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. Second, after meeting the statutory/regulatory requirements, the taxpayer may only include in-house research expenses and contract research expenses paid or incurred by the taxpayer when the taxpayer demonstrates that the research expenses were incurred in carrying on any qualified research activities in Indiana.

"In-house research expenses" include "wages paid or incurred to an employee for qualified services" performed in Indiana and amounts paid or incurred for "supplies used in the conduct of qualified research" in Indiana. Indiana adopts federal interpretations of "qualified services," which include (1) services rendered in performing qualified research; (2) direct supervision of qualified research activities; and/or (3) direct support of qualified research activities. IC § 6-3.1-4-4; Treas. Reg. § 1.41-2(c)(1), (2), (3).

"'Direct supervision' 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)." Treas. Reg. § 1.41-2(c)(2). "'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." Id. "'Direct support' of qualified research activities includes services in the direct support of '(i) [p]ersons engaging in actual conduct of qualified research,' or '(ii) [p]ersons who are directly supervising persons engaging in the actual conduct of qualified research.'" Treas. Reg. § 1.41-2(c)(3). Additionally, "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, and of a clerk for compiling research data, and of a machinist for machining a part of experimental model used in qualified research." Id. However, "[d]irect support of research activities does not include general administrative services, or other services, or other services only indirectly of benefit to research activities." 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 wages paid or incurred to employees for qualified services performed by its employees for Indiana qualified research, is the taxpayer entitled to the Indiana qualified research expense tax credit. When the taxpayer demonstrates that it conducts Indiana qualified research and its employees perform "qualified services" relating to that research, Indiana permits the taxpayer to calculate the REC using appropriate income ratios. The taxpayer may "[i]n the absence of another method of allocation that the taxpayer can demonstrate to be more appropriate," determine the claimed tax credit on wages "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." Id.

The Department's audit adjusted the amount of REC claimed by Taxpayer based on the credits attributable to Taxpayer's upper level management. The audit adjusted - but did not disallow - expenses attributable to Taxpayer's executive, upper level management, sales, and purchase departments on the ground that these "departments . . . generally would not engage directly in research and development activities on a day to day basis."

Taxpayer is correct to the extent that I.R.C. § 41(b)(2)(D) allows Taxpayer to claim a credit for wages attributable to in-house research and development expenses. However, the claimed expenditures are only eligible to the extent that the wages are paid to employees for qualified research. IC § 6-3.1-4-2. In the case of wage expenditures, the credit is permitted for engaging in qualified research, directly supervising research, or supporting qualified research. "Direct supervision" means "the immediate supervision (first-line management) of qualified research." Treas. Reg. § 1.41-2(c)(2). However, "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." Id.

Taxpayer claimed RECs on various percentages of wages it paid its upper level staff members including president, vice-present, engineers, quality assurance managers, plant managers, manufacturing managers, vice president of operations, general managers, maintenance managers, and vice-president of sales. The amount of time allocated to those personnel ranged from 15 percent to 75 percent. According to Taxpayer, it based its estimates on log books, status reports, project reports, engineering log books. However, Taxpayer has provided no contemporaneous documentation which link any of the employee's claimed hours to a specific qualified research and development project. Instead, as noted in the audit report, "Taxpayer has . . . suggested specific time tracking is not necessary in order to take credit and refers to the time surveys it originally provided." The Taxpayer's position is contrary to the relevant law.

Taxpayer's view of the sufficiency of its records and the audit's view of those identical records are at odds. However, the Department notes that it is 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. ("Every person subject to a listed tax must keep books and records so that the department can determine the amount, if any, of the persons liability for that tax . . . .") 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 documentation and 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 May 25, 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 when "the failure to maintain a proper system to capture relevant information [is not] an

"inexactitude of their making" 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."

In this instance, on the question of the RECs originally claimed by Taxpayer, the Department is unable to sustain Taxpayer's objection that the audit was unjustified in modifying the amounts claimed for the following reasons: (1) RECs are "a matter of legislative grade and only allowed as clearly provided for by statute and are narrowly construed. McFerrin, 570 F.3d at 675 (Emphasis added); (2) The Department agrees with the audit's assumption that "upper level management" are not typically "involved in research activities;" (3) The documentation supplied by Taxpayer does not unqualifiedly establish that its upper level management were directly involved in "qualified research" as that term is defined in I.R.C. § 41(d); (4) The documentation provided does not clearly establish that its upper level management were "engaged in the direct supervision or direct support of research activities as required under I.R.C. § 41(2)(B); (5) The documentation offered does establish that its upper level management were "directly supervising persons engaged in the actual conduct of qualified research" as required under Treas. Reg. § 1.41-2(c)(3) and not merely engaged in "general administrative services" which were "only indirectly of benefit to research activities;" and (6) Taxpayer places too much reliance on general estimates of the time its upper level management were directly involved in qualified research activities without providing the requisite "proof for every assumption underlying their estimates . . . ." Audit Techniques Guide: Credit for Increasing Research Activities. Finally, the Department notes that the audit did not make a wholesale denial of the RECs claimed but simply modified the amount of those credits to a degree not unreasonable or distinctly out of proportion to the amount originally claimed.

FINDING

Taxpayer's protest is respectfully denied.

IV. Administration - Underpayment Penalty.

DISCUSSION

The Department assessed a penalty on the ground that Taxpayer underpaid its corporate income tax for the years 2008, 2009, and 2010. Taxpayer maintains that the Department should exercise its discretion and abate the penalty because - according to Taxpayer - it "reasonably relied on Indiana statutes, regulations, and Department rulings in filing its Indiana corporate income tax returns."

The penalty which Taxpayer challenges is authorized under IC § 6-3-4-4.1(d);

> (d) The penalty prescribed by IC 6-8.1-10-2.1(b) shall be assessed by the department on corporations failing to make payments as required in subsection (c) or (f). However, no penalty shall be assessed as to any estimated payments of adjusted gross income tax which equal or exceed:
> (1) the annualized income installment calculated under subsection (c); or
> (2) twenty-five percent (25[percent]) of the final tax liability for the taxpayer's previous taxable year.
> In addition, the penalty as to any underpayment of tax on an estimated return shall only be assessed on the difference between the actual amount paid by the corporation on such estimated return and twenty-five percent (25[percent]) of the corporation's final adjusted gross income tax liability for such taxable year.

IC § 6-8.1-10-2.1(b) sets the amount of penalty as ten percent. However, IC § 6-8.1-10-2.1(d) provides:

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

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 . . . ."

In particular, Taxpayer argues that in filing its 2008, 2009, and 2010 returns it made a reasonable interpretation of Indiana statutes, the Department's regulations, and on other published guidance.

As discussed in Part I, II, and III above, the Department disagrees with Taxpayer's substantive arguments. However, there is sufficient information to conclude that Taxpayer "exercised ordinary business care and

prudence . . . ." and that the penalty should be abated.

FINDING

Taxpayer's protest is sustained.

SUMMARY

Taxpayer's protest of the underpayment penalty is sustained. In all other respects, Taxpayer's protests are respectfully denied.

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