

**Letter of Findings: 01-20160479
Individual Income Tax
For the Years 2012 and 2013**

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 This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register.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

The Department concluded that Indiana Beverage Manufacturer failed to establish that it was entitled to all the Research and Expense credits claimed on its original tax returns; although Beverage Manufacturer produced numerous documents intended to substantiate its Research and Development activities, the documents either did not contain the specific, contemporaneous, detailed information necessary to verify the claims or, when contemporaneous, Beverage Manufacturer's "estimations" did not have factual support for every underlying assumption.

ISSUES

I. Adjusted Gross Income - Research Expense Credits for Wages / Supplies / and Contractor Costs.

Authority: IC § 6-3.1; 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; IC § 6-8.1-5-1(c); IC § 6-8.1-5-4; IC § 6-8.1-5-4(a); IC § 6-8.1-5-4(c); *United States v. McFerrin*, 570 F.3d 672 (5th Cir. 2009); *Stinson Estate v. United States*, 214 F.3d 846 (7th Cir. 2000); *Cohan v. Commissioner of Internal Revenue*, 39 F.2d 540 (2d Cir. 1930); *Eustace v. C.I.R.*, T.C. Memo 2001-66 (U.S. Tax Ct. 2001); *Fudim v. Comm'r, T.C.M.* 1994-235 (U.S. Tax Ct. 1994); *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); I.R.C. 41(b)(2)(B); I.R.C. § 41(d); I.R.C. § 41(d)(1) (2001); I.R.C. § 6001; Treas. Reg. § 1.174-2(a)(1); Treas. Reg. § 1.41-2(c); Treas. Reg. § 1.41-4(d); Treas. Reg. § 1-6001-1; Audit Techniques Guide: Credit for Increasing Research Activities (i.e. Research Tax Credit) IRC § 41 - Substantiation and Recordkeeping.

Taxpayer argues that the Department's audit improperly disallowed Research Expense Credits attributable to wages paid to certain of its employees, credits for supply costs, and credits for expenses incurred by contractors and contractor employees.

STATEMENT OF FACTS

Taxpayer is an individual who is the sole shareholder of an Indiana business. The business elected to file as a Subchapter S corporation; as a result, its income flowed through to the shareholder. The Indiana Department of Revenue ("Department") conducted an audit review of the Taxpayer's business records and tax returns.

Taxpayer's business develops and manufactures a variety of flavor enhancers and low calorie sweeteners. Taxpayer also develops the consumer packaging for those same products.

The Indiana Department of Revenue ("Department") reviewed Taxpayer's income tax returns for the years 2012 and 2013.

The audit focused on the business's Research Expense Credits (RECs) claimed during the two-year audit period (2012 and 2013). That audit took approximately one year to conclude. The audit reduced the RECs originally claimed on the business's tax returns. That adjustment reduced the amount of credits available to Taxpayer. The Department therefore reduced the previously claimed credits on the Taxpayer's individual income tax return.

Taxpayer disagreed with the adjustment 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. Adjusted Gross Income - Research Expense Credits for Wages / Supplies / and Contractor Costs.

DISCUSSION

The issue is whether Taxpayer has provided sufficient documentation to support its claim that it was entitled to claim RECs for wages paid to certain of its employees, RECs attributable to supply costs, and RECs attributable to contractors and contractor employees. In this Letter of Findings and, for simplicity's sake, "Taxpayer" refers to either the shareholder or the shareholder's business.

This Letter of Findings outlines: (1) the Department's audit process; (2) the audit's adjustments to RECs attributable to wages paid to Taxpayer's employees; (3) Taxpayer's response to those first adjustments; (4) a statement of the law and Taxpayer's burden of proof; (5) the Department's adjustments to contractor RECs; (6) the Department's adjustment to RECs attributable to supply expenses; and (7) the Department's conclusion.

A. Department's Audit Examination.

The audit took approximately one year to complete. During that year, the audit repeatedly and - in many cases - unsuccessfully sought records and documentation that was thought necessary to verify the claimed RECs. As explained in the audit report, the audit "focused on examining the records presented during the [audit] investigation to verify the RECs that were claimed by the taxpayer for these periods."

In January 2015, the audit report stated that the Department was waiting for research and development (R&D) information that had been requested six months prior. As explained in its final report, the audit had requested information related to:

- Base amount and fixed percentage calculations;
- A list and description of all projects and how these [constituted] qualified projects;
- A list of the expenses for supplies and contract research;
- Wage information including names, titles and percentages of time spent [on research activities].

Taxpayer responded with a R&D study prepared for the two years prior to the years under audit review. Taxpayer explained that the 2012 and 2013 R&D study (the years under review) was "not yet available" but that it would be ready by "early February" 2015.

The 2012 and 2013 R&D study was not provided by the time first indicated by Taxpayer. The audit subsequently resubmitted several requests for the 2012 and 2013 R&D study in February 2015. However, when the study was eventually received, the audit report stated that the study contained "none of the information" requested.

In March 2015, the Department again requested "detailed information" that the audit regarded as necessary to complete the R&D review and to determine the correct amount of RECs to which Taxpayer was entitled. As explained in the audit report, the documentation requested included:

- The project numbers;
- Site location;
- Project status;
- Project name;
- Project Description;
- Breakdowns of wages and supplies for each qualified project.

Taxpayer again failed to respond to the request for this specific information. However, after further requests, discussions, and negotiations with Taxpayer and its representative, "It was agreed that documentation would be provided on May 11," 2015.

On May 11, 2015, the Department's representative was presented with a copy of the R&D report along with a "[four] page explanation." However, the audit found that neither the report nor the explanation contained the specific information (project status, project name, wages and supplies) originally requested.

Later that same month, the Department again requested information thought necessary to verify the R&D credits. As explained in the audit report, the Department "simplified" its original request seeking to obtain the following:

- General ledger line items for supplies and contract research;
- A breakdown of all Research and Development projects (include[ing] the project detail for each);
- Wage allocation.

Taxpayer's representative eventually responded stating that "there was no real tracking system in place used for the calculation of the percentages of wages." However, Taxpayer's representative did assure the Department that it "would eventually provide ledger details for projects, including supplies and contractor expenses."

As of June 2015, the information requested by the Department's audit had not yet been received. The Department's examiner again "requested that the [Taxpayer's representative] provide additional detailed information including "how wages were calculated and the invoices for both supplies and contractor expenses."

Taxpayer responded with "invoices for contractor expenses" and a "Nexus table" purportedly "documenting the employees who worked on qualified research projects and which project."

In September 2015, the Department "sent [Taxpayer] a [preliminary calculation of the proposed] reductions to the Research Expense Credits and a work paper showing the new calculations per audit." The Department offered to review with Taxpayer any new information that might become available but that this "new information" would be needed by the "middle of October." Taxpayer's representative was advised that if the additional information was not "new," that "the audit would be completed as it stood at that time" (September). In effect, the September audit findings and adjustments to the claimed RECs would remain unchanged.

Specifically, the audit requested additional "support for what the upper level management positions specifically did on the qualified research projects." Taxpayer responded in November 2015 but the Department regarded the information supplied as "minimal" and that "[n]o additional information about contractor expenses, wage calculations, or supplies was provided."

At the end of November 2015, after failing to receive any of the additional information requested from Taxpayer's representative, the final proposed adjustments were sent to Taxpayer's representative. Included with the emailed submission were "all work papers relating to the adjustments."

B. Audit Adjustments / Wages.

The audit made adjustments to the RECs claimed by Taxpayer on the ground that "wages and expenses in the calculation of the credit . . . do not qualify under IRS regulations or for which the taxpayer was unable to substantiate the research expenses claimed."

As a basis for arriving at its conclusions, the audit cited to I.R.C. § 41(d) which defines the term "qualified research" as research:

1. [w]ith respect to which expenditures may be treated as an expense under section 174[;]
2. [w]hich is undertaken for the purposes of discovering information which is technological in nature (also known as the discovery test)[;]
3. [t]he application of which is intended to be useful in the development of a new or improved business component of the taxpayer; and
4. [s]ubstantially all of the activities which constitutes elements of a process of experimentation for a qualified purpose.

The audit report explained that "[t]o be considered qualified research, the taxpayer must establish the expenses claimed meet ALL elements of the four part test."

The audit report took note of what it regarded as the lack of substantive documentation and cited to Treas. Reg. § 1.41-4(d) and I.R.C. § 6001 as the requisite standard for substantiating the claimed RECs.

A taxpayer claiming a credit under section 41 must retain records in sufficiently usable form and detail to substantiate that the expenditures claimed are eligible for the credit. For the rules governing record retention. See § I.R.C. 1.6001; Treas. Reg. § 1.41-4(d).

[E]very person liable for any tax imposed by this title, or for the collection thereof, shall keep such records, render such statements, make such returns, and comply with such rules and regulations as the Secretary may from time to time prescribe. I.R.C. § 6001.

The audit report acknowledged that Taxpayer was indeed engaged "in some qualifying research activities" but found that:

In calculating wages for qualified research activities, the taxpayer applied an estimated percentage to employees' wages to determine the amount qualifying for the credit. The taxpayer was unable to supply the auditor with supporting documentation which would substantiate the percentages claimed.

According to the audit report Taxpayer admitted that it "did not utilize a contemporaneous time tracking system to capture qualified research expenditures and [Taxpayer's] records do not allow it to compute qualified research expenses on a project-by-project basis."

In calculating the R&D activities performed by its personnel and in the apparent absence of contemporaneous documentation, Taxpayer resorted to conducting "technical interviews" with a number of its employees "to determine the qualified activities performed." According to Taxpayer:

Based upon the technical interviews and review of contemporaneous documentation, Taxpayer was able to estimate the percentage of time each employee engaged in qualified research activities. Thus the wage percentage is an estimate, not a calculation.

The audit requested access to these "technical interviews" and "contemporaneous documentation" relied upon by Taxpayer. However, the audit report stated that:

[T]he interview records were never supplied even after multiple requests for this documentation were made. Rather, the representatives supplied what they referred to as a "nexus" table. The "nexus" table identified the jobs/projects in which each employee worked on during the audit period. The "nexus" table failed to identify the activities performed by the employee on the project or provide any information on the amount of time spent on each job.

The audit recognized that Taxpayer was engaged in R&D activities and was entitled to a limited number of RECs. However, after considering the quality, detail, and specificity of the selective documentation Taxpayer chose to provide, the audit made adjustments to the RECs attributable to employee wages. The audit found:

- Two employees were not included in Taxpayer's "nexus" table and their wages were disallowed.
- The audit disallowed "wages for upper level management or employees engaged in administrative functions such as sales personnel." The audit did so on the ground that "[b]y nature of the employee's title, these employees would generally not be engage[d] directly in research and development activities or be 'first line' managers to those engaged directly in research." As an example the audit questioned whether the business's CEO would spend 52 percent of his time conducting "qualifying research activities."

As noted, the audit did not disallow all R&D labor expenses claimed by Taxpayer. The audit did accept "reasonable percentages" for employees "whose job descriptions by nature would indicate they are engaged in qualifying activities." The audit accepted "percentages for engineers, quality control, department managers and blenders." The audit accepted these percentages "as being reasonable and representative of qualifying activities based upon the information available to the auditor."

The audit concluded that Taxpayer was engaged in qualified research but found that "[Taxpayer] failed to keep contemporaneous documentation as required by I.R.C. § 41(d)." As noted at the outset of this Letter of Findings, the audit "made several requests for documentation to be provided to verify qualified research expenses" but the information was provided "sporadically" and in most instances the "information was not complete."

Based upon the information provided and the audit's review of the claimed expenses, the audit made adjustments to the claimed expenses. As stated in the audit report, "Adjustments were made to the expenses claimed based on the lack of records provided in the investigation or because the expenses do not qualify for the reasons stated in [the audit] report."

C. Taxpayer's Response to REC Wage Adjustments.

Taxpayer argues as follows:

[T]he Department has misinterpreted and misapplied the law and current regulations applicable to the Research Development Credit, and therefore has inappropriately disallowed the research credit[s] claimed.

Taxpayer states that, pursuant to its administrative protest, it has now provided "over 2,400 pages of documentation to substantiate its credit claim."

Taxpayer disputes the audit's contention that information provided during the year-long audit was incomplete or inadequate. Instead, Taxpayer states that it "timely responded to all requests for information" submitted by the Department's audit and has "demonstrated thorough project documentation" which clearly establishes how the Taxpayer's "methodology for computing the qualified research expenditures is accurate, reliable, and consistent."

Taxpayer disagrees with the audit's disallowance of credits claimed for R&D functions purportedly undertaken by certain of its employees. The Department's audit denied the credit for over 50 percent of the wages paid to 37 of its upper-level/management employees including - but not limited to - its: (1) accountants; (2) controller; (3) vice-president of finance; (4) chief executive officer; (5) attorneys; (6) chief operating officer; (7) sales personnel; (8) chief financial officer; (9) information technology officer; (10) logistics director; (11) president; (12) procurement directors; (13) sales planning managers; and (14) director of marketing.

Taxpayer claims that the audit was not justified in disallowing these wage expenses because the "activities conducted by employees should have been evaluated to determine qualification for the credit."

D. Statement of Law and Burden of Proof.

In order to establish that it is entitled to the sought-after R&D credits, Taxpayer is required to meet its burden of proving that it is entitled to those credits.

1. 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, both Indiana and federal law require that a taxpayer maintain and produce contemporaneous records sufficient to verify those credits. See Treas. Reg. § 1.41-4(d). Moreover, 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).

2. Indiana Research 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, this statute - in effect for the taxable years in question - 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 R&D 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."

At this point, it is useful to point out that Taxpayer's view of the sufficiency of its records and the audit's view of those identical records are completely at odds. It is also important to note that this Letter of Findings makes no findings as to the simple veracity of Taxpayer's records except to point out that it is Taxpayer's statutory obligation to maintain and produce to the Department relevant and complete records sufficient to verify - and not merely suggest - the amount of 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 federal statutes and regulations (and the Department) impose 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 RECs, in this regards the IRS's Audit Technique Guide, 2005 WL 405783 (June 2005), 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 [] 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. 2005 WL405783, at *24. 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](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 audit 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." Id. In situations in which precise detail is lacking and in which a 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." Id.

3. RECs for Wages Paid Management Personnel.

Taxpayer concludes that wages paid to its upper-level management personnel qualify for the credit.

I.R.C. § 41(b)(2)(B) lists three types of employee's services that qualify for R&D: 1) engaging in qualified research; 2) directly supervising qualified research; or 3) directly supporting qualified research. Treas. Reg. § 1.41-2(c) provides

(1) Engaging in qualified research. The term "engaging in qualified research" as used in section 41(b)(2)(B)

means the actual conduct of qualified research.

(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, who may not actually perform experiments). "Direct supervision" does not include supervision by 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-

- a. Persons engaging in actual conduct of qualified research, or
- b. Persons who are directly supervising persons in the actual conduct of qualified research

Treas. Reg. § 1.41-4(d)(1) (2001) states that for taxpayer to receive the research and development tax credit, a taxpayer must:

Prepare[] documentation before or during the early stages of the research project, that describes the principal questions to be answered and the information the taxpayer seeks to obtain to satisfy the requirements of paragraph (a)(3) of this section and retains that documentation on paper or electronically in the manner prescribed in applicable regulations, revenue rulings, revenue procedures, or other appropriate guidance until such time as taxes may no longer be assessed [] for any year in which the taxpayer claims to have qualified research expenditures in connection with the research project; and (2) satisfies section 6001 and the regulations thereunder.

The Department's audit did not wholly discount Taxpayer's R&D claims based on wages paid to Taxpayer's employees. Despite the notable lack of documentation, the Department "accepted the qualified research expenses for [engineers, quality control, department managers and blenders] as being reasonable and representative of qualifying activities based upon the information available to the auditor."

Taxpayer has provided thousands of pages of documents and a lengthy narrative purporting to establish that the Department erred in disallowing all wage expenses claimed by Taxpayer. Although Taxpayer has provided substantial amounts of information and lengthy narrative, what is still lacking is the contemporaneous documentation detailing the research activities of these 37 employees. As explained by the United States Tax Court, taxpayers are not entitled to claim RECs when the "petitioners' reconstruction of qualifying expenses was unreliable, inaccurate, incomplete, and wholly insufficient to establish what various workers did and whether such expenses qualify for the research credit." *Eustace v. C.I.R.*, T.C. Memo 2001-66 (U.S. Tax Ct. 2001), *aff'd*, 312 F.3d 905 (7th Cir. 2002).

It is entirely possible that these upper level/management employees did conduct research and it is entirely possible that Taxpayer is entitled to some portion of the contested RECs it claimed. However a detailed examination of the records should have been conducted at the audit stage and Taxpayer's failure to provide those records made that examination impossible. It is basic, fundamental Indiana law that, "Every person subject to a listed tax must keep books and records so that the department can determine the amount, if any, of the person's liability for tax by reviewing those books and records." IC § 6-8.1-5-4(a) (Emphasis added). In addition, IC § 6-8.1-5-4(c) provides that, "A person must allow inspection of the books and records and returns by the department or its authorized agents at all reasonable times." (Emphasis added). The audit report is replete with repeated requests for documents which the Taxpayer either did not possess or chose not to provide. Taxpayer now asks the Department to second-guess the results of that on-site audit which began in February 2015 and was not completed until February 2016. The Department must decline Taxpayer's invitation to do so despite the flood of documents supplied during the protest because those documents do not constitute the detailed, contemporaneous documentation which would have established that such persons as its controller, vice-president of finance, chief executive officer, attorneys, chief operating officer, sales personnel, chief financial officer engaged in R&D activities. Even more significantly, Taxpayer's voluminous documents do not establish how many hours these key personnel engaged in R&D activities. Did Taxpayer's vice-president of finance spend an hour every day researching artificial flavors? Did Taxpayer's finance officer spend 25 hours a week researching Taxpayer's flavor enhancers? Did Taxpayer's sales personnel investigate the blending of various components in order determine the taste and flavor of Taxpayer's experimental food products? Although Taxpayer has produced many pages of information, what it still lacks is the specific documentation - clearly required under law - which answers these fundamental, routine questions.

Taxpayer cites to *Cohan v. Commissioner of Internal Revenue*, 39 F.2d 540 (2d Cir. 1930) and *Fudim v. Comm'r, T.C.M.* 1994-235 (1994) for the proposition - as explained by Taxpayer - that "taxpayers [are] allowed to deduct their business expenses via any form of admissible evidence including 'self-serving statements' . . . [i]f records

[are] incomplete and documentary proof missing" Instead, "[T]he taxpayer need only show that he had incurred some amount of those expenses." According to Taxpayer, under the Cohan rule, a "taxpayer may estimate the amount of qualified research expenditures if there is some basis to support the estimates." The Department does not disagree with Taxpayer's proposition but points out that the Department's audit did agree with much of the Taxpayer's estimates and "did accept 'reasonable percentages for employees 'whose job descriptions by nature would indicate that they are engaged in qualifying activities.'"

4. Conclusion / Wage RECs.

As to the wages paid to its upper-level employees, Taxpayer has created an "inexactitude is of [its] own making," Cohan, 39 F.2d at 544, and the Department will not interpose its own judgment to correct for that inexactitude. Taxpayer has failed to provide "records in sufficiently usable form and detail to substantiate that the [wage] expenditures are eligible for the credit." See I.R.C. § 6001; Treas. Reg. § 1.41-4(d). Even estimates, such as that offered by Taxpayer, must be documented such that every underlying assumption is substantiated. As to the question of the R&D upper-level/management credits, Taxpayer has failed to meet its statutory burden of establishing that the audit's conclusion as to this issue was "wrong." IC § 6-8.1-5-1(c).

E. Audit Adjustments / Contractor Expenses.

The audit reviewed REC expenses attributable to hiring contractors to purportedly conduct qualified research activities. The audit found that: (1) some of the contract research was conducted outside Indiana; (2) much of the work was for store surveys, focus groups, and for software used by the business internally such as inventory tracking.

The audit disallowed expenses attributable to a contract vendor that provided shuttle services. In addition, the audit found that the invoices presented for this particular vendor "were much less than what was [originally] claimed."

The audit disallowed expenses attributable to a contract vendor who supplied staffing services. The contract between this vendor and Taxpayer indicated that the vendor would "provide labor for warehousing positions when needed" The audit disallowed these contract expenses because Taxpayer was unable to provide documentation establishing that these expenses were attributable to warehousing R&D projects.

Taxpayer challenges the audit's findings for six different contractors:

1. Brandgenuity: The audit denied R&D expenses related to Brandgenuity. Taxpayer states that the Brandgenuity contractor expenses were legitimate costs related to the development and design of packaging. In support of its argument, Taxpayer points to Bates No. 0106-0110 documents as supporting its contention that the money spent with Brandgenuity was for R&D purposes.

The documents on which Taxpayer relies consists of invoices for a "monthly retainer," "airfare," "car services," "rental cars," "creative and presentation expenses." There is nothing in the documentation which supports Taxpayer's contention that Brandgenuity was engaged in R&D in the development and design of Taxpayer's packaging.

2. Stress Engineering: The audit's findings on Stress Engineering were inconclusive. The auditor discussed Stress Engineering with Taxpayer's representatives and those representatives "agreed to send information" on the company. That promised information was not provided to the auditor. Taxpayer now explains that the Stress Engineering costs were related to the development and design of packaging materials. Taxpayer cites to Bates No. documents 0112-0113, 0353 and indicates that document 0353 specifically refers to "test and analysis."

The documents on which Taxpayer relies consist of invoices for "engineering services," "testing," "initial analysis," "car rental," "parking fees," and "hotel rental." Stress Engineering is a company located in Houston, Texas. There is nothing in the documentation which establishes that the "analysis" or "testing" occurred in Indiana as required under IC § 6-3.1-4-1 ("Indiana qualified research expense" means qualified research expense that is incurred for research conducted in Indiana.) (Emphasis added).

3. Silliker Inc.: The audit's findings on Silliker Inc. were inconclusive. The auditor discussed this vendor with Taxpayer's representatives and "agreed to send information" on the company. That promised information was not provided to the auditor. Taxpayer now explains that the Silliker expenses were related to "sensory

testing." In other words, did the food product produced by Taxpayer meet the required expectations? Taxpayer cites to Bates No. documents 0235-0132 as supporting the proposition that Silliker was performing contractual R&D on behalf of Taxpayer. A review of these documents does not allow for a conclusion that Silliker - a company located in Bentonville, Arkansas - conducted qualified research in Indiana as required under IC § 6-3.1-4-1.

4. Orion Group: The audit's findings on the "Orion Group" were inconclusive. The auditor discussed this vendor with Taxpayer's representative who "agreed to send information" on the company. That promised information was not provided to the auditor. Taxpayer explains that Orion Group was hired to develop computer software. Taxpayer states that the software was designed to aid in tracking ingredients used in its various R&D projects. Taxpayer cites to Bates No. documents 0143-0144 which consists of invoices issued by Orion Group.

A review of the documentation relied upon by Taxpayer indicates costs for a trip to Taxpayer's location, costs for travel, costs for "consulting and training regarding rocket fuel project," "fixed asset training," "gift cards," "shipping boxes," and various "gift materials." In this case, the Department agrees that the costs associated with Bates number document 0143 and 0144 appear to be related to research activities conducted within Indiana.

5. M&W Logistics: The audit disallowed expenses related to M&W Logistics. The audit report concluded that the M&W Logistics invoices provided "were much less than what was [originally] claimed." M&W Logistics invoices which were labeled "shuttle services" were disallowed. The audit also noted that some of services provided by M&W Logistics were performed in Denver. During the audit, Taxpayer failed to provide information on these out-of-state services. Taxpayer now explains that M&W Logistics was hired to conduct field testing of packaged food products. The food products were loaded onto M&W Logistics' vehicles, the vehicles transported the products from point-to-point, and the packaged goods were then examined to determine if the packages maintained their integrity. Simply stated, M&W was asked to determine if the bottled liquids leaked during transport. Taxpayer states that 74 of the road tests took place in Indiana. Taxpayer cites to Bates No. documents 0158-0225 which are M&W's invoices for these services.

The documents to which Taxpayer cites consist of a lengthy listing of invoices, "freight" expenses, "shuttle services," "road testing," "test run," and "LWE road test." The Department agrees that - to the limited extent that the documents are labeled "road test," Bates number documents 0158-0225 represent expenses related to qualified research expenses.

6. MS Inspections: Taxpayer originally claimed "qualified research expenses," however Taxpayer failed to provide detailed information on the services provided by this contractor. The contract with MS Inspections called for this vendor to "provide labor warehousing positions when needed, for specific mark ups" Although Taxpayer claimed R&D expenses attributable to this vendor, Taxpayer purportedly "estimated" the amount of actual expenses "but did not show these amounts were calculated." Taxpayer's "information . . . only showed the invoiced amounts and to what area [MS Inspections] were assigned." The audit noted that the areas to which MS Inspection's employees were assigned did not include the "research or bottle inspection areas." Taxpayer explains that MS Inspections is a company which loaded vehicles for the road testing conducted by M&W Logistics. In support of its argument that the MS Inspections incurred legitimate R&D expenses on behalf of Taxpayer, Taxpayer cites to pages 34 and 35 of its protest letter and to Bates No. documents 0373-0385.

The documents on which Taxpayer relies consist entirely of a lengthy list of "supplier invoices payments." There is nothing in the documents which establishes that Taxpayer incurred costs associated with MS Inspections were associated with qualified research activities conducted in this state.

F. Audit Adjustments / R&D Supplies.

The audit rejected RECs attributable to supply expenses claimed for two vendors because the vendors were not retail merchants selling supplies but "service providers that run tests on items for food safety and quality." In addition, one of the vendors was not located in Indiana and the audit "was unable to verify where the work was performed."

The audit reviewed REC supply expenses claimed for "samples" provided to contractors for "sensory evaluation." These samples were used to compare Taxpayer's own products with competitors' products. The audit found that only one of the contractors was located in Indiana and that the remaining contractors were located outside

Indiana. Based on the information available, the audit estimated ten-percent of the samples were utilized within Indiana and disallowed the remaining ninety-percent.

The audit reviewed R&D supply expenses claimed by two vendors: Silliker Inc. and Sherry Labs. The audit found that both Silliker Inc. and Sherry Labs were reimbursed not for supplies but for providing services. Both companies ran tests on food safety and quality. Additionally, the audit found that Silliker is not located Indiana and "any work completed would not be an Indiana qualified research activity." In the case of Sherry Labs, the audit noted that although Sherry does have an Indiana location, Taxpayer failed to provide "documentation pertaining to the amounts claimed . . ." and that the audit "was unable verify where the work was completed." The lack of information led to the audit denying all of the credits attributable to Sherry Labs.

Taxpayer argues that the cost of the supplies constituted legitimate R&D expenses. Taxpayer cites to Bates No. documents 0132-0235 as justifying supply expenses attributable to Silliker. Taxpayer states that 100 percent of the costs paid for these supplies are legitimate R&D expenses.

The documents on which Taxpayer relies (Bates No. 0132-0235) consist of "employee expenses reports," "car rental," "administrative fees," acknowledgement of a "recent donation," "Target gift cards," "Wal-Mart gift cards," "retail service[s]," and "samples of damaged product[s]." Despite the multiplicity of documents, Taxpayer has not established that these materials consisted of supply expenses associated with R&D activities conducted in this state. As noted at the outset, "qualified research" consists of activities undertaken for "purposes of discovering information which is technological in nature," "intended to be useful in the development of a new or improved business component of the taxpayer," and which "constitutes elements of a process of experimentation for a qualified purposes." I.R.C. § 41(d). Taxpayer invites the Department to conclude that these supply expenses represented in Bates No. documents 0132-0235 meet the four-part test set out in I.R.C. § 41(d); such a conclusion is not possible based on the documentation presented.

Taxpayer cites to Bates No. documents 0077-0081 as representing legitimate R&D supply expenses attributable to "Sherry."

The documentation on which Taxpayer relies consists of "Transaction values for ledger." The documentation is simply a lengthy list of expenses none of which conclusively - or even speculatively - establish that these expenses were associated with the payment of supplies consumed in R&D activities.

The audit reviewed RECs for supply expenses associated with a "Spray Dry Tower." Although Taxpayer's representatives explained how the materials were used, the audit report found that "[t]he representative did not present the auditors with any documentation supporting the amount of materials purchased for the Spray Dry Tower or how they were used in qualified research activities." The audit disallowed these supply expenses citing IC § 6-8.1-5-1, I.R.C. § 6001 and IC § 6-8.1-5-4.

Taxpayer now explains that the Spray Dry Tower is a blending device which combines various dry ingredients to produce one of Taxpayer's products. Taxpayer further explains that materials used in this device are legitimate R&D expenses because these materials were used to test the device before it went into day-to-day production. Taxpayer cites to Bates No. documents 1084-1085; 1092-1093; 1099-1100; 1102-1104; 1106; 1108; 1110; and 1117-1118 as supporting its contention that these particular supplies were consumed in the testing of the Spray Dry Tower. Taxpayer also cites to its protest documentation pages 23-25.

The documentation on which Taxpayer relies consists of a "revision history," "technical data sheets," and "packaging standards." Taxpayer may have incurred material expenses associated with the initial testing of this device. However, there is nothing in the documentation that establishes that Taxpayer incurred material expenses used to test the spray dry tower or - even if it did so - what was the cost of those start-up material?

G. Conclusions.

Taxpayer failed to take advantage of the opportunity to fully evaluate the R&D expenses during the most opportune period during which these complex and detailed issues could have been addressed. Instead, Taxpayer relied on a flood of documentation presented at the administrative review level. The Department finds that much of this documentation is either irrelevant, ambiguous, or inconclusive and - as Taxpayer admits - represents an "estimate" of its R&D expenses. Taxpayer has failed to establish "by sufficient evidence" that its R&D claims fall "within the exact letter of the law." RCA Corp., 310 N.E.2d, 101. With the exception of the contractor expenses noted in Part E above, Taxpayer's protest is denied.

FINDING

With the limited exceptions noted in Parts E(4) and (5), Taxpayer's protest is respectfully denied.

Posted: 06/28/2017 by Legislative Services Agency
An [html](#) version of this document.