DEPARTMENT OF STATE REVENUE

01-20160479.SLOF

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 This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register.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

HOLDING

Again upon rehearing, the Department found that Indiana Beverage Manufacturer failed to establish that it was entitled to all the Research and Expense credits claimed on its original tax returns; the documents provided did not contain the specific, contemporaneous, detailed information necessary to verify the claims; the Department disagreed with Indiana Beverage Manufacturer that the audit's findings were hasty, ill-informed, inconsistent, or imposed a documentation and verification standard nowhere found in either federal or Indiana law.

ISSUE

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(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); *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(d)(1) (2001); I.R.C. § 6001; Treas. Reg. § 1.174-2(a)(1); 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 and that the Department's Letter of Findings failed to give sufficient weight to the documentation provided.

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 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) for Indiana income tax purposes. 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 returns.

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. A Letter of Findings was issued April 2017 sustaining Taxpayer in part and denying Taxpayer in part. Taxpayer disagreed with the results

and requested a rehearing on the matter. A rehearing was conducted and this Supplemental Letter of Findings results.

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

DISCUSSION

The issue is whether Taxpayer has now 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 Supplemental Letter of Findings and, for simplicity's sake, "Taxpayer" refers to either the shareholder or the shareholder's business.

Taxpayer argues that the April 2017 Letter of Findings mischaracterized the events which took place during the original audit. Taxpayer refers to those portions of the Letter of Findings which - on their face - found that Taxpayer failed to provide the Department's audit the documents requested during the course of that audit. In particular, Taxpayer objects to statements in the April 2017 Letter of Findings such as:

> 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."
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> 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.
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> [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 Letter of Findings cites to numerous instances in which the Department sought "detailed information" and to instances in which the audit report found that Taxpayer failed to supply "specific information" or that the information provided was "sporadic," incomplete, insufficient, or irrelevant.

Taxpayer states that the Department's audit failed to consider the numerous documents provided (2,413 according to Taxpayer), failed to respond to Taxpayer's offer to "meet with the auditor in person," and that the audit's decisions were hasty and ill-informed.

Taxpayer also argues that the audit's decisions were simply based on job titles held by "upper management" employees and that the Letter of Findings compounded this error by failing to allow credits for employees with similar or identical titles. In other words, the Department's audit may have allowed credits for labor costs incurred by one titled employee and then failed to allow credit for labor costs incurred by another employee with an identical title. As explained by Taxpayer:

> [T]he Examiner was inconsistent on this matter. Certain employees were allowed in full which other employees, sharing the same job title, were disallowed in full.

Specifically, Taxpayer states that its chief executive officer, quality supervisor, plant process engineer, packaging director, design engineer, chief legal counsel, and vice-president of operations all engaged in qualified research activities for which Taxpayer should be allowed a research credit.

Finally, Taxpayer argues that the Department is imposing a documentation and verification standard which is far more rigorous than that permitted under law. Taxpayer states that it should be permitted to claim credits based upon time and material estimates and that it should "be provided reasonable flexibility in the matter in which they substantiate their research credits."

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).

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 expense (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 the outset, it is important to point out issues on which Taxpayer, the audit, and the Department have always agreed. There has never been and disagreement on the Department's part that Taxpayer engages in qualified research, that it likely incurs substantial costs in conducting that research, and that it is entitled to claim credits based on the expenses incurred during those qualified activities. What has been - and remains - is the question of documenting those activities and expenses with any degree of certainty. However, it is 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 that for tax by reviewing those books and records." IC § 6-8.1-5-4(a) (*Emphasis added*).

In addition, the Department does not disagree that a taxpayer is entitled to base its REC claim on "estimates." However, the Department has consistently held that those estimates must have some grounding in contemporaneous, verifiable, and "sufficiently usable" documentation. As pointed out in the audit report, the April Letter of Findings, and admitted to by Taxpayer, that "[Taxpayer] failed to keep contemporaneous documentation as required by I.R.C. § 41(d)." Taxpayer itself further admits 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."

The IRS's Audit Technique Guide, 2005 WL 405783 (June 2005), provides 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. (***Emphasis in Original***).

It is not enough to establish that its employees engaged in research activities. Taxpayer rightly points out that its owner and chief executive officer had his name listed on a patent design and that owner was to some degree likely associated with the development of the patented item. However, what Taxpayer has failed to establish with any degree of certainty whatsoever the amount of time and expenses associated with the research activities associated with the development of that patent. In this respect, Taxpayer has created an "inexactitude is of [its] own making," *Cohan v. Commissioner of Internal Revenue*, 39 F.2d 540 (2d Cir. 1930), and the Department will not interpose its own secondary judgment to correct for that inexactitude.

The Department has no reason to depart from the guidance set out by the court in *Eustace*, when it held that 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).

The Department does not agree that the audit findings were hasty or ill-informed or that the April 2017 Letter of Findings interposed a standard of proof not found in law. Nor does the Department agree that Taxpayer has provided specific, detailed, and verifiable documentation in any way sufficient to further adjust the original assessment.

FINDING

Taxpayer's protest is respectfully denied.

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