DEPARTMENT OF STATE REVENUE

02-20160528.LOF

Letter of Findings: 02-20160528
Corporate Income Tax
For the Years 2009 through 2014

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 This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register.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 disagreed with Engineering Firm that it was entitled to rely on the "Uncertainty Test" in evaluating whether Engineering Firm was entitled to claim research and expense credits; Engineering Firm failed to establish that it was entitled to credits for wage expenses attributable to the provision of mechanical and electrical engineering services.

ISSUES

I. Adjusted Gross Income Tax - Research Expense Credits Regulations.

Authority: IC § 6-3-1-3.5; IC § 6-3.1-4-1; IC § 6-3.1-4-2; IC § 6-3.1-4-4; IC § 6-8.1-5-1; IC § 6-8.1-5-4; *Indiana Dep't of State Rev. v. Caterpillar, Inc.*, 15 N.E.3d 579 (Ind. 2014); *New Colonial Ice Co. v. Helvering*, 292 US. 435 (1934); *United States v. McFerrin*, 570 F.3d 672 (5th Cir. 2009); *Stinson Estate v. United States*, 214 F.3d 846 (7th Cir. 2000); *United Stationers, Inc. v. U.S.*, 163 F.3d 440 (7th Cir. 1998); *Norwest Corp. & Subsidiaries v. Comm. of Internal Revenue*, 110 T.C. 454 (1998); *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); Treas. Reg. 1.41-4(a)(3)(i) (T.D. 8930); Treas. Reg. § 1.41-4(d); Internal Revenue Service *Comments on Research Credit Regulations*, 2001-10 I.R.B. 784; 69 F.R. 22-01; 66 F.R. 280-01; 66 F.R. 66362-01; Letter of Findings 01-20160696; 01-20160697; 01-20160698; 01-20160700; 01-20160701; 01-20160702; 01-20160703 (June 27, 2017); Letter of Findings 01-20150385 (December 6, 2016); Letter of Findings 02-20130676 (January 16, 2015).

Taxpayer argues that the Department erred in denying research and expense credits claimed by the company on the ground that the Department imposed a "discovery" test not found in Indiana law.

II. Adjusted Gross Income Tax - Qualified Research Expenses - Documentation.

Authority: IC § 6-3.1-4-1; IC § 6-3.1-4-4; IC § 6-8.1-5-1; IC § 6-8.1-5-4; *United States v. McFerrin*, 570 F.3d 672 (5th Cir. 2009); *Stinson Estate v. United States*, 214 F.3d 846 (7th Cir. 2000); *Conklin v. Town of Cambridge City*, 58 Ind. 130 (1877); *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); I.R.C. § 6001; Treas. Reg. 1.41-4(a) (T.D. 8930); Treas. Reg. 1.41-4(d); Treas. Reg. 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 erred in disallowing research expense credits attributable to wages associated with specific projects engaged in by the company.

STATEMENT OF FACTS

Taxpayer is an Indiana company in the business of providing mechanical and electrical engineering services to its customers. Taxpayer's services include the development of engineering designs and processes, including projects undertaken to determine whether customers' new manufacturing processes could produce commercially-viable products on a mass production scale.

The Indiana Department of Revenue ("Department") conducted an audit review of Taxpayer's amended corporate income tax returns in which Taxpayer claimed Indiana Research Expense Credits ("RECs"). The Department had

previously issued refunds based upon the amended returns claiming the RECs for tax years 2009 through 2014 ("Tax Years at Issue").

The Department's audit review resulted in the denial of the claimed RECs and issuance of proposed assessments for the erroneous refunds. Taxpayer disagreed with the decision denying the RECs 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. Additional facts will be addressed below as necessary.

I. Adjusted Gross Income Tax - Research Expense Credits Regulations.

DISCUSSION

The issue is whether the Department erred in denying Taxpayer's credits for increasing research expenses. The Department determined that Taxpayer mistakenly relied on regulations published in Treasury Decision 9104 ("T.D. 9104," 69 F.R. 22-01, 2004 WL 18938) in calculating its Indiana research expense credits. The Department found that T.D. 9104 was not in effect until after the Indiana legislature adopted the research expense provisions provided at IC § 6-3.1-4-4. Thus, for the Tax Years at Issue, the initial question is whether Indiana's version of the Research Expense Credit impose the T.D. 8930 "Discovery Test" or the less restrictive T.D. 9104 "Uncertainty Test."

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 addition, when an agency is charged with enforcing a statute, the jurisprudence defers to the agency's reasonable interpretation of that statute "over an equally reasonable interpretation by another party." *Indiana Dep't of State Rev. v. Caterpillar, Inc.*, 15 N.E.3d 579, 583 (Ind. 2014).

The Department maintains the applicable regulations are found in Treasury Decision 8930 ("T.D. 8930") 66 F.R. 280-01, 2001 WL 34028585. According to the Department, T.D. 8930 imposes a "discovery requirement." According to Taxpayer, the Internal Revenue Service ("I.R.S.") eliminated the "discovery requirement" and that Taxpayer was entitled to rely on the less restrictive "elimination of uncertainty" test found in T.D. 9104.

During the years 2009, 2010, 2011, 2012, 2013 and 2014 Taxpayer claimed approximately $9,300,000 in qualifying research expenses ("QREs") entitling it to approximately $700,000 in Indiana Research Expense Tax Credits. The audit reviewed the basis for claiming the expenses to determine whether Taxpayer incurred the $9,300,000 in wage expenses and whether it was entitled to the resulting $700,000 in credits. The audit report concluded that the Federal regulations contained in T.D. 8930 were applicable to the Tax Years at Issue and contains a detailed explanation of Internal Revenue Code Section 41(d). The audit report states, "Within this Treasury Decision [8930] there is language that defines discovery. It states that, 'the research must be undertaken to obtain knowledge that exceeds, expands, or refines the common knowledge of skilled professionals in a particular field of science or engineering.'" *Audit Report: Explanation of Adjustments*, at 26. The auditor thus applied T.D. 8930 in its analysis of Taxpayer's claimed RECs.

Taxpayer argues that the auditor's disallowance of REC based upon T.D. 8930 was erroneous as a matter of law, asserting that the regulations found in T.D. 8930 were merely proposed regulations as of January 1, 2001, the date referenced in IC § 6-3.1-4-4. Taxpayer argues that the final regulations issued on January 2, 2004, per T.D. 9104, should be the applicable regulations because the regulations in T.D. 8930 were "effectively suspended immediately after their adoption." *Memorandum in Support of Protest of [Taxpayer]*, at 5-6. Taxpayer maintains that it was only required to show the elimination of uncertainty, not the discovery of information that is technological in nature.

IC § 6-3.1-4-1 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 the 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). *See also New Colonial Ice Co. v. Helvering*, 292 US. 435, 440 (1934) ("Whether and to what extent deductions shall be allowed depends upon legislative grace; and only as there is clear provision therefor[e] can any particular deduction be allowed.")

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).

For income tax purposes, Indiana follows the federal tax scheme with certain modifications. IC § 6-3-1-3.5(b). Indiana 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).

The issue is which regulations were in effect at the time the Indiana legislature promulgated IC § 6-3.1-4-4: T.D. 8930 (eff. Jan. 3, 2001); or T.D. 9104 (eff. Jan. 2, 2004).

The Department maintains that T.D. 8930 was in effect for the years at issue. If so, the regulations impose a "Discovery Test" in which qualified research must be "undertaken for the purposes of *discovering information* which is technological in nature." (*Emphasis added*). Taxpayer maintains that T.D. 9104 should be the applicable regulations. If so, these regulations incorporate a less restrictive "uncertainty" test in which qualified research is intended to eliminate uncertainty concerning the development or improvement of a business component.

The issue in this section is whether the Department should apply the "Discovery Test" for years 2009 through 2014 versus the "Uncertainty Test" based on the wording found in IC § 6-3.1-4-4. The Department denied Taxpayer's protest based on Taxpayer's failure to document that it met each part of the four-part test. However, during the audit and the protest process Taxpayer protested the Department's application of the Discovery Test as set forth in Treas. Reg. 1.41-4(a)(3)(i) (2001).

Taxpayer challenges the validity of the IC § 6-3.1-4-4 reference to the 2001 federal regulations. This reference to the 2001 I.R.C. and regulations was added by P.L. 192-2002, § 89 in 2002, which was the first time that IC § 6-3.1-4-4 referenced a specific date. The Department has historically applied the 2001 final regulations, published under T.D. 8930 (the "2001 Final Regulations"). The 2001 Final Regulations define qualified research and development under I.R.C. § 41 to include a discovery requirement. However, these regulations were not promulgated until January 3, 2001, not January 1, 2001 (the date referred in the statute), and no portion of the regulation was made retroactive.

T.D. 8930, published in the Federal Register on January 3, 2001, contains final regulations relating to the computation of the research expense tax credit under section 41(c) and the definition of "qualified research" under section 41(d). "These regulations reflect changes to section 41 made by the Tax Reform Act of 1986 (the 1986 Act), the Revenue Reconciliation Act of 1989, the Small Business Job Protection Act of 1996, the Taxpayer Relief Act of 1997, the Tax and Trade Relief Extension Act of 1998 (the 1998 Act) and the Tax Relief Extension Act of 1999 (the 1999 Act)." T.D. 8930, 66 F.R. 280-01, 2001 WL 34028585. The 2001 Final Regulations set forth the discovery requirement for defining qualified research under I.R.C. § 41(d). Section 1.41-4(a)(3)(i) of the 2001 Final Regulations states:

> For purposes of section 41(d) and this section, research is undertaken for the purpose of discovering information only if it is undertaken to obtain knowledge that exceeds, expands, or refines the common knowledge of skilled professionals in a particular field of science or engineering.

T.D. 8930, 66 F.R. 280-01 at 290.

T.D. 8930 notes criticism by commentators to the proposed regulations (published in 1998) that this definition

imposes a "discovery requirement" that was not mandated by I.R.C. § 41(d); however, the IRS and the Treasury Department elected to retain the Discovery Test because they "continue[d] to believe that section 41 conditions credit eligibility on an attempt to discover information that goes beyond the common knowledge of skilled professionals in the particular field of science or engineering" and that the legislative history of the Tax Reform Act of 1986 (the "1986 Act") supported such a definition. T.D. 8930, 66 F.R. 280-01. T.D. 8930 further explains that the 1986 Act narrowed the definition of the term "qualified research," and cites to legislative history explaining that "Congress was concerned that taxpayers had applied the original definition of qualified research 'too broadly,'" and under the 1986 Act research must be undertaken "*to discover information* that is technological in nature . . . ." *Id.* at 282. (quoting H.R. Conf. Rep. No. 99-841, at II 71 n.3 (1986)).

T.D. 8930 additionally notes that the discovery requirement is consistent with the legislative intent of the 1999 Act. The legislative history of the 1999 Act states "[e]mploying existing technologies in a particular field or relying on existing principles of engineering or science is qualified research, if such activities are otherwise undertaken *for purposes of discovering information* and satisfy the other requirements under section 41." *Id.* at 283. (quoting H.R. Conf. Rep. No. 106-478, at 332) (*emphasis in original*). T.D. 8930 states:

> By referring separately to a requirement that the research be undertaken for purposes of discovering information, this legislative history again confirmed that the phrase "discovering information" is a separate substantive requirement and not merely a phrase used to link the term *research* with the types of information required as the subject of the research.

Id.

T.D. 8930 also refers to case law applying the Discovery Test subsequent to the 1986 Act and prior to promulgation of the 1998 Proposed Regulations and the 2001 Final Regulations. In *United Stationers, Inc. v. U.S.*, 163 F.3d 440 (7th Cir. 1998), the Seventh Circuit relied upon the plain language of § 41(d)(1)(B)(i) and the legislative history of the 1986 Act in determining that the taxpayer had not engaged in "qualified research" because it did not develop research programs for the purpose of discovering information. The Court stated, "Congress clearly intended . . . that qualifying research pass a high threshold of innovation and be of broad effect." *Id.* at 444; *see also Norwest Corp. & Subsidiaries v. Comm. Of Internal Revenue*, 110 T.C. 454, 489 (1998) (relying upon "ordinary meaning of the language used in the statute . . . as well as the legislative history surrounding the promulgation of the [Tax Reform Act of] 1986[.]").

Thus, T.D. 8930 clearly reflects the fact that the Treasury Department and the IRS considered the criticisms of the Discovery Test, yet chose to retain the requirement "[i]n light of the case law and the legislative history[.]" T.D. 8930. The 2001 Final Regulations did not spontaneously implement the Discovery Test, but instead rely upon legislative, statutory, and case law guidance evidencing that Congress intended to implement such a test with the enactment of the 1986 Act, and reiterated this position in the 1999 Act. Because the interpretation of the 1986 Act and the 1999 Act by the IRS and courts, the "Discovery Test" was meant to be applied based on the statutory interpretation alone. Thus, Indiana's adoption of the "Discovery Test" is consistent with IRS and the Seventh Circuit interpretation of I.R.C. §41.

In response to taxpayer concerns regarding T.D. 8930, on March 5, 2001, the Treasury Department and the IRS published Notice 2001-19 announcing that the Treasury Department and the IRS would review T.D. 8930 and reconsider comments previously submitted in connection with the finalization of T.D. 8930. *Comments on Research Credit Regulations*, 2001-10 I.R.B. 784, 2001 WL 84197. Notice 2001-19 also provided that, upon completion of the review, the Treasury Department and the IRS would announce changes in the regulations in the form of proposed regulations. These proposed regulations were published in the Federal Register on December 26, 2001 (the "2001 Proposed Federal Regulations"). 66 F.R. 66362-01, 2001 WL 1640763. The resulting 2001 Proposed Federal Regulations departed from the "Discovery Test" and instead implemented the "Uncertainty Test":

> Uncertainty, for purposes of this requirement, exists if the information available to the taxpayer does not establish the capability or method of developing or improving the business component, or the appropriate design of the business component.

F.R. 66362-01 at 66363-64.

The final regulations, which replaced the "Discovery Test" with the current "Uncertainty Test" for defining qualified research under § 41(d), were promulgated on January 2, 2004 (the "2004 Final Regulations"). 69 F.R. 22-01, 2004 WL 18938.

The Indiana Legislature would presumably have been aware that the IRS and the Treasury Department were reviewing the 2001 Final Regulations shortly after their promulgation, by means of Notice 2001-19 published on March 5, 2001, and that there were concerns about the application of the Discovery Test. However, the Indiana Legislature, in 2002–after the 2001 Proposed Regulations eliminating the "Discovery Test" had already been published in December 2001–consciously selected a date prior to these revised regulations. Had the Indiana Legislature intended to adopt the "Uncertainty Test" over the "Discovery Test" in the 2003 Indiana Statute, it could have either referred to a date after the promulgation of the 2001 Proposed Regulations, waited until after the final regulations were promulgated in 2004, or not referenced any date at all. The application of the discovery requirement was a reasonable interpretation of I.R.C. § 41(d) from the date the 1986 Act was enacted until the promulgation of the 2004 Final Regulations.

The Department has consistently applied the regulations found in T.D. 8930 and has rejected taxpayers' arguments that T.D. 9104 is applicable in tax years prior to 2016. The Department has staked out its position repeatedly and in detail. *See*, *e.g.*, Letter of Findings 01-20160696; 01-20160697; 01-20160698; 01-20160700; 01-20160701; 01-20160702; 01-20160703 (June 27, 2017), 20170830 Ind. Reg. 045170363NRA; Letter of Findings 01-20150385 (December 6, 2016), 20170222 Ind. Reg. 045170090NRA; Letter of Findings 02-20130676 (January 16, 2015), 20150325 Ind. Reg. 045150065NRA.

The audit was correct in relying on the "Discovery Test" in determining whether Taxpayer's activities qualified for the Indiana research and expense credits.

FINDING

Taxpayer's protest on the issue of the applicable regulations is respectfully denied.

II. Adjusted Gross Income Tax - Qualified Research Expenses - Documentation.

DISCUSSION

The issue is whether Taxpayer has adequately documented to what extent it may claim Indiana RECs on its mechanical and electrical engineering projects, and whether Taxpayer has adequately documented that it paid its employees approximately $9,300,000 to engage in qualified research expense activities. Taxpayer disagrees with the audit's finding that Taxpayer failed to adequately document its employees' specific activities related to those projects. The audit found that Taxpayer failed to sufficiently document the nature and extent of those employee activities.

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. with respect to which expenditures may be treated as an expense under section 174;
2. which is undertaken for the purposes of *discovering information* which is technological in nature (also known as the Discovery Test);
3. the application of which is intended to be useful in the development of a new or improved business component of the taxpayer; and
4. substantially all of the activities which constitute elements of a process of experimentation for a qualified purpose.

Treas. Reg. 1.41-4(a)(3)(i) (T.D. 8930) states:

> For purposes of section 41(d) and this section, research is undertaken for the purpose of *discovering information* only if it is undertaken to obtain knowledge that *exceeds, expands, or refines the common knowledge* of skilled professionals in a particular field of science or engineering. (*Emphasis added*).

This regulation then goes on to state "research is not undertaken for the purpose of discovering information merely because an expenditure may be treated as an expense under section 174." *Id.*

Treas. Reg. 1.41-4(a)(3)(ii) (T.D. 8930) defines common knowledge:

> Common knowledge of skilled professionals in a particular field of science or engineering means information that should be known to skilled professionals had they performed, before the research in question is

> undertaken, a reasonable investigation of the existing level of information in the particular field of science or engineering.

Treas. Reg. § 1.41-4(d) (T.D. 8930) provides:

> No credit shall be allowed under section 41 with regard to an expenditure relating to a research project unless the taxpayer–
>
> (1) Prepares 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 (except under section 6501(c)(1), (2), or (3)) 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 audit concluded that Taxpayer has not adequately documented that it was engaged in "qualified research" under T.D. 8930. The audit report states:

> No documentation has been provided to support research and development costs apart from direct job costs. Although the wages used to calculate the research expense credit for this taxpayer are seemingly tied to employees with direct technical knowledge, the taxpayer did not support that such wages were incurred to obtain knowledge that exceeds, expands or refines the common knowledge of skilled professionals within their industry. Moreover, the taxpayer has not provided documentation to prove that new business components were being developed. They were unable to tie specific qualified research expense activities to any new business component. Additionally, the activity claimed as experimentation was not verifiable since *sufficient documentation was not provided*.

Audit Report: Explanation of Adjustments, at 30 (*Emphasis added*).

The audit report further concluded that Taxpayer did not established the required nexus between the qualified activities and the individuals conducting the research. "The time allocation worksheets show identical percentages in each category for employees with the same job description. The department could not distinguish time spent on research activities from ordinary jobs." *Audit Report: Explanation of Adjustments*, at 27. The auditor reviewed ten projects from 2010. While Taxpayer claimed that all projects listed in 2010 contained some portion of qualified research, of the ten projects selected to be sampled by the auditor, taxpayer's representative stated that four of the ten projects did not have any time recorded by qualified individuals. Thus, the audit report concluded that Taxpayer did not provide sufficient documentation to establish that the projects claimed met all parts of the four-part test and that the wages claimed were tied to qualifying projects.

Taxpayer's argument overwhelmingly focuses on the interpretation of IC § 6-3.1-4-4 and the regulations applicable thereto, asserting that the auditor's misapplication of the regulations makes the audit determinations incorrect as a matter of law. Taxpayer makes the conclusory statement that it provided sufficient documentation to show that it qualified for the credit, relying upon the IRS's acceptance of Taxpayer's federal credits without adjustment. Taxpayer merely concludes that the auditor did not review or did not understand the documentation provided, stating "[i]t is not the responsibility of the taxpayer to train an auditor or the department on the code, regulations, or industry-specific terminology/documents/drawings/technology." *Taxpayer Supplemental Memorandum in Support of Protest*, at 6 (March 13, 2017).

IC § 6-3.1-4-1 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).

It is the Taxpayer's statutory obligation to maintain and produce to the Department records sufficient to verify the credits which it claims, pursuant to IC § 6-3.1-4-1 and IC § 6-8.1-5-4. This is especially true in the case of the RECs for which the I.R.C. imposes stringent and detailed parameters and which - if Taxpayer seeks to obtain the benefit of those credits - Taxpayer is required to meet. I.R.C. § 6001; Treas. Reg. § 1-6001-1.

As to the information necessary to verify REC credits, in this regard 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*, https://www.irs.gov/businesses/audit-techniques-guide-credit-for- increasing-research-activities-ie-research-tax-credit-irc-ss-41-substantiation-and-recordkeeping (last visited January 17, 2018) (*Emphasis added*).

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

During the protest, Taxpayer provided a description of one of the sample projects, as well as analysis of how the project meets the requirements of the four-part test. Again, Taxpayer focuses much of its analysis on its argument that the Department applied the wrong regulations. Even assuming that the individual sample project explained during the protest involved discovery of information of a technological nature, it does not follow that all of the sampled projects claimed by Taxpayer are qualifying projects, much less all of the claimed projects. As noted by the auditor, other projects reviewed included "relocat[ion] of a drinking fountain, boiler plant renovation, new maintenance building, heating and cooling system for [an] elementary school, install[ation of] new roof drains, install[ation of] utility piping for [a] packaging facility, install[ation] of a 'de gumming' system at [a] manufacturing facility . . . and repair of [a] shed roof[.]" *Audit Report: Explanation of Adjustments*, at. 27. In addition, the audit report notes that Taxpayer conceded that four of the ten projects sampled by the auditor did not have time recorded by the qualified individuals. Thus, while Taxpayer may have some qualifying projects, the Department is not prepared to conclude that all of the projects claimed by Taxpayer meet all parts of the four-part test and therefore have qualifying research expenses.

Despite the possibility that Taxpayer does have some qualifying research activity, the issue still remains as to whether Taxpayer has adequately documented the claimed wage expenses. Taxpayer provided a copy of its REC study, prepared by its tax consultant, in which it shows how it calculated qualifying wages. Taxpayer's tax consultant relied upon individual and group interviews to determine what percentage of time each employee spent on qualified research for each of its approximately 350 projects claimed. Taxpayer asks that the Department accept that its employees - including supervisors, senior project managers, and site project managers - engaged in research activities and that it can reliably document the amount of time these employees engaged in those activities. However, these estimates are not based upon documentation tying each employee's work to individual projects or even a reasonable basis for its estimates; rather, Taxpayer categorically estimates percentages of qualified work based simply upon the employee's job title. All senior project managers were estimated to have spent 80 percent of their time doing qualified research, and supervisors and site project managers were estimated

to have spent 35 percent and 45 percent of their time, respectively, on qualified research. In addition, these percentages are applied consistently for all Tax Years at Issue. These estimates presume that each employee spent the same percentage of time on each qualifying research project for all Tax Years at Issue. There is no additional documentation substantiating these estimates aside from estimates based on employee interviews, which took place several years after the Tax Years at Issue. As stated in the Audit Techniques Guide, "[t]axpayers must have factual support for every assumption underlying their estimates to meet their burden of proof." Self-serving statements from Taxpayer, without any other supporting documentation to form the basis of those estimates, are not sufficient factual support.

Furthermore, as quoted on page 11 of Taxpayer's credit study:

> Determinations as to whether an employee is (or is not) engaged in qualified services, *should not be based solely on job descriptions or titles*. *Credit eligibility is based solely upon what an employee actually does, or does not, do during a specific time period.* It is important to note the technical and educational qualification of a researcher, but this is not conclusive evidence that the individual engaged (or did not engage) in the performance of qualified services.

(quoting *IRS Market Segment Specialization Program Audit Techniques Guide, Credit for Increasing Research Activities (Research Credit) Code Sec. 41* (June 2005)) (*Emphasis added*). Thus, by Taxpayer's own acknowledgement, it is not permitted to rely upon job titles to determine qualifying activity. This is precisely what Taxpayer has done in calculating qualifying wages for purposes of determining its Indiana RECs.

Without the required usable and verifiable records during the Tax Years at Issue to establish the "nexus" for the QREs or more detailed information of employees' involvement in certain qualified activities that occurred in Indiana, the Department is not able to agree that Taxpayer was entitled to the claimed Indiana RECs for the Tax Years at Issue. Even assuming that Taxpayer did engage in some qualifying research projects, Taxpayer failed to maintain the contemporaneous records necessary to establish that its employees engaged in the claimed activities and - if those employees did engage in those activities - failed to definitively establish that they conducted research to the extent claimed. Taxpayer failed to prepare documentation "before or during the early stages of the research project" as required by Treas. Reg. 1.41-4(d). Thus, Taxpayer has failed to meet its burden under IC § 6-8.1-5-1(c) to show that the proposed assessment was wrong.

FINDING

Taxpayer's protest is respectfully denied because Taxpayer failed to adequately document to what extent it could claim Indiana RECs.

SUMMARY

The Department does not agree that Taxpayer was entitled to rely on the "Uncertainty Test" in evaluating whether it was entitled to claim the Indiana RECs, or that Taxpayer documented to what extent it could claim the Indiana RECs based on wages paid its employees. Taxpayer's protest of both Issue I and Issue II is respectfully denied.

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