DEPARTMENT OF STATE REVENUE

02-20191301.LOF

Letter of Findings: 02-20191301
Corporate Income Tax
For the Years 2015 and 2016

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 This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register.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 Indiana Recreational Vehicle Manufacturer that its sales of vehicles in eleven other jurisdictions should not have been "thrown back" to Indiana. The Indiana Manufacturer's fulfillment of warranty obligations simply by means of payments to third-party, out-of-state dealers did not exceed the "mere solicitation standard. The Department did not agree that Manufacturer met its burden of establishing that it was entitled to claim Indiana's research expense income tax credits.

ISSUES

I. Corporate Income Tax - Throw-back Sales.

Authority: 15 U.S.C. § 381(a); 15 U.S.C. § 381(c); IC § 6-3-2-1(b); IC § 6-3-2-2(a); IC § 6-3-2-2(n); IC § 6-8.1-5-1(c); *Tyler Pipe Industries, Inc. v. Washington State Dept. of Revenue*, 483 U.S. 232 (1987); *Dept. of State Revenue v. Caterpillar, Inc.*, 15 N.E.3d 579 (Ind. 2014); *Wendt LLP v. Indiana Dep't of state Revenue*, 977 N.E.2d 480 (Ind. Tax Ct. 2012); *Indiana Dep't of State Revenue v. Rent-A-Center East, Inc.*, 963 N.E.2d 463 (Ind. 2012); *Scopelite v. Indiana Dep't of Local Gov't Fin.*, 939 N.E.2d 1138 (Ind. Tax Ct. 2010); *Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue*, 867 N.E.2d 289 (Ind. Tax Ct. 2007); *Sherwin-Williams Co. v. Indiana Dep't. of State Revenue*, 673 N.E.2d 849 (Ind. Tax Ct. 1996); 45 IAC 3.1-1-38; 45 IAC 3.1-1-38(4); 45 IAC 3.1-1-53; 45 IAC 3.1-1-64; Black's Law Dictionary (11th ed. 2019).

Taxpayer argues that money it received from sales of its vehicles to customers in eleven other states and jurisdictions should not have been "thrown back" to Indiana on the ground that Taxpayer was subject to income tax in those eleven jurisdictions.

II. Corporate Income Tax - Documenting Research and Expense Credits.

Authority: IC § 6-3.1-4-1; IC § 6-8.1-5-4; IC § 6-8.1-5-4(a); IC § 6-8.1-5-1(c); Treas. Reg. § 1.41-4(d); *IDOPCP, Inc. v. Comm'r*, 503 U.S. 79 (1992); *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); *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); *Audit Techniques Guide: Credit for Increasing Research Activities* (2020).

Taxpayer maintains that the Department erred is disallowing labor and supply research expense credits (RECs) on the ground that it conducted qualifying research activities and incurred the research labor and supply costs during the years at issue.

STATEMENT OF FACTS

Taxpayer is an Indiana company in the business of constructing and selling recreational vehicles and fifth-wheel trailers. Taxpayer fabricates, assembles, paints, and performs a final "finish" on each of the vehicles produced at its Indiana facilities.

Taxpayer is organized as an LLC and elected to file as a partnership with the income "flowing through" to the partners.

The Indiana Department of Revenue ("Department") conducted an audit review of Taxpayer's income tax returns

and business records. The audit found that Taxpayer had not included in its apportionment factor numerator sales made to customers in eleven other states and jurisdictions including Canada. The audit concluded that Taxpayer's activities in those eleven jurisdictions did not subject Taxpayer to an income tax in those locations. Therefore, for the year 2015, the audit "threw back" these out-of-state sales to Indiana. That audit decision resulted in an assessment of additional Indiana income tax.

The audit also found fault with Taxpayer's claim to research and expense credits attributable to labor and supply expenses incurred during 2015 and 2016. The audit disallowed the expense credits on the ground that Taxpayer was unable to document the extent to which its employees engaged in any qualifying research activities. The Department disallowed the credits in their entirety. That decision also resulted in an additional assessment of Indiana income tax.

Taxpayer protested the audit assessment arguing that Indiana should not "throwback" Taxpayer's sales to out-of-state customers in these eleven jurisdictions. Taxpayer also argued that it was entitled to claim the Indiana research and expense credits. Taxpayer submitted a protest to that effect. An administrative hearing was conducted during which Taxpayer's representative explained the basis for the protest. This Letter of Findings results.

I. Corporate Income Tax - Throw-back Sales.

DISCUSSION

The issue is whether Taxpayer has provided the information necessary for it to establish that it was subject to income tax in Florida, Alaska, Connecticut, Delaware, Oklahoma, Virginia, West Virginia, Nevada, South Dakota, Wyoming, and Canada. As a result, Taxpayer maintains that income from the sale of its vehicles in those eleven jurisdictions should not have been "thrown back" to Indiana.

A. Audit Results.

The Department's audit concluded that Taxpayer was subject to Indiana income tax on sales to customers in ten other states and Canada because Taxpayer was "*not* subject to income tax in the state of the purchaser[s]." The Department's audit report stated that Taxpayer's activities in those states did not exceed the "mere solicitation" standard. The Department noted that Taxpayer's reliance on warranty repairs - performed by third-party, out-of-state dealers - did not bring Taxpayer within the ambit of the various jurisdictions' income tax. As explained in the audit report:

> [Taxpayer] does not own nor operate these repair facilities in the other states . . . and thus does not have any physical nexus to these states. These are dealers independent of [Taxpayer] and are not part of the company and as such, the dealer's activities are not an extension of [Taxpayer]. The dealers are performing warranty repairs which entails sending [Taxpayer] a repair estimate, receiving authorization to go ahead with the repair, making the repairs and then billing [Taxpayer] for the repair changes. In these instances, under warranty means [Taxpayer] has an obligation to its customers and will pay the repair facility the cost to repair the defective good. The [out-of-state] dealer is billing [Taxpayer] for the repair, but this is a sale from the dealer performing the repair to [Taxpayer].

The Department also rejected Taxpayer's assertion that employment of its "goodwill" in the eleven jurisdictions subjected Taxpayer to those jurisdictions' income tax. According to the audit report Taxpayer defined "goodwill" as "the value of the parts given to customers for repairs made after the warranty period of the recreation vehicles has expired." The Department disagreed finding that costs associated with the extension of "goodwill" were "not gross receipts derived from sales" and should not have been included in the numerator nor the denominator . . . ."

Finally, the audit rejected Taxpayer's argument that it subjected itself to the eleven jurisdictions' income tax because it paid its own "traveling repairman" to perform customer warranty work within the eleven jurisdictions. The Department rejected that argument because Taxpayer "was not able to provide the relevant source documents, such as travel logs, expense reports, invoices, for these activities to substantiate the traveling repairman's activities."

B. Taxpayer's Response.

Taxpayer maintains that sales income received from out-of-state customers should not have been "thrown back" to Indiana because it is subject to income tax in ten other states and Canada, and because it was obligated to

perform warranty repairs in those jurisdictions.

As explained by Taxpayer, "Under IC § 6-3-2-2(n) Taxpayer is taxable in the states at issue because they have 'jurisdiction to subject the taxpayer to a net income tax regardless of whether, in fact, the state does or does not.'"

Taxpayer cites to the Multistate Tax Commission's *Nexus Program Bulletin* 95-1 (December 20, 2015) in support of its position that the third-party warranty repairs create taxable nexus in the jurisdictions in which the repairs are performed. In the case of a computer manufacturer, the Bulletin states:

> The provision of warranty repair service in the customer's state is precisely the kind of presence that squarely supports the finding of substantial nexus. The provision of in-state repair services by a direct marketing computer company as part of the company's standard warranty or as an option that can be separately purchased and as an advertised part of the company's sales contributes significantly to the company's ability to establish and maintain its market for computer hardware sales in the State.

Taxpayer also cites to the Department's Letter of Findings 02-20130506 (September 24, 2015), 20151125-Ind. Reg.-045150400NRA (LOF), in support of its position that warranty work performed on behalf of Taxpayer by third-parties subjects Taxpayer to income tax in the eleven jurisdictions. In that 2015 protest, the Department found that an affiliate's activities within Indiana subjected that affiliate to *Indiana's* income tax. The Department noted that the affiliate performed warranty work by means of third-party vendors, licensed intellectual property to Indiana customers, and maintained an inventory - or took title - to merchandise in Indiana. The LOF concluded that "Taken together, those activities go beyond de minimis non-solicitation activities and so give [affiliate] nexus with Indiana . . . ." However, the 2015 LOF also found that "[e]ach the three primary activities listed by the Department in its audit report independently gives Fourth nexus with Indiana."

In addition to the warranty repairs, Taxpayer also states that it regularly sends representatives into other states to perform on-site repairs the local dealer is unwilling or unable to perform. Taxpayer states its Indiana representatives travel to other jurisdictions in order to "[p]erform repairs at Rallys held across the country" "and to deliver replacement vehicles to individual owners and pick up damaged vehicles." In addition, Taxpayer explains:

> [T]he taxpayer had a traveling person who traveled to various states for rallies and performed repairs while at the rally and assisted dealers with repairs which the dealer could not sufficiently handle on its own as well as picking up damaged vehicles.

Taxpayer concludes that the third-party warranty repairs and the activities conducted by its representatives renders Taxpayer subject to income tax in the ten states and Canada.

C. Burden of Proof.

As a threshold issue, it is the Taxpayer's responsibility to establish that the assessment of additional tax is incorrect. As stated in IC § 6-8.1-5-1(c), "The notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." *Indiana Dep't of State Revenue v. Rent-A-Center East, Inc.*, 963 N.E.2d 463, 466 (Ind. 2012); *Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue*, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007). Thus, a taxpayer is required to provide documentation explaining and supporting his or her challenge that the Department's position is wrong. Poorly developed and non-cogent arguments are subject to waiver. *Scopelite v. Indiana Dep't of Local Gov't Fin.*, 939 N.E.2d 1138, 1145 (Ind. Tax Ct. 2010); *Wendt LLP v. Indiana Dep't of state Revenue*, 977 N.E.2d 480, 486, fn. 9 (Ind. Tax Ct. 2012).

In considering Taxpayer's argument, the Department points out that "when [courts] examine a statute that an agency is 'charged with enforcing . . . [courts] defer to the agency's reasonable interpretation of [the] statute even over an equally reasonable interpretation by another party.'" *Dept. of State Revenue v. Caterpillar, Inc.*, 15 N.E.3d 579, 583 (Ind. 2014). Thus, interpretations of Indiana tax law contained within this decision are entitled to deference.

D. Hearing Analysis.

In order to make a determination regarding this issue, it is necessary to provide a brief summary of several relevant points of law including issues of law which were in effect during 2015 which is the only year subject to the throwback provision.

i. Adjusted Gross Income.

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

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

> With regard to corporations and nonresident persons, "adjusted gross income derived from sources within Indiana", for the purposes of this article, shall mean and include:
> (1) income from real or tangible personal property located in this state;
> (2) income from doing business in this state;
> (3) income from a trade or profession conducted in this state;
> (4) compensation for labor or services rendered within this state; and
> (5) income from stocks, bonds, notes, bank deposits, patents, copyrights, secret processes and formulas, good will, trademarks, trade brands, franchises, and other intangible personal property to the extent that the income is apportioned to Indiana under this section or if the income is allocated to Indiana or considered to be derived from sources within Indiana under this section. (*effective July 1, 2013 to December 31, 2015*).

However, IC § 6-3-2-2(n) (amended January 1, 2017 deleting the throwback requirement) provides that a taxpayer's income is not subject to this state's income tax if that income is attributable to conducting business in another state in which it is subject to that foreign state's own tax regime.

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

(*Emphasis added*).

45 IAC 3.1-1-38 illustrates the "doing business" principle.

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

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

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

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

45 IAC 3.1-1-53 illustrates the "throwback" principle:

> When Sales of Tangible Personal Property Are in This State. Gross receipts from the sales of tangible personal property (except sales to the United States Government--See Regulation 6-3-2-2(e)(050) [45 IAC 3.1-1-54]) are in this state: (a) if the property is delivered or shipped to a purchaser within this state regardless of the F.O.B. point or other conditions of sales; or (b) if the property is shipped from an office, store, factory, or other place of storage in this state, and the taxpayer is not taxable in the state of the purchaser. See Regulation 6-3-2-2(n)(010) [45 IAC 3.1-1-64].
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> ***
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> Example:
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> > (5) If the taxpayer is not taxable in the state of the purchaser, the sale is attributed to this state if the property is shipped from an office, store, warehouse, factory, or other place of storage in this state. *Such sale is termed a "Throwback" sale.* Example: The taxpayer has its head office and factory in State A. It maintains a branch office and inventory in Indiana. Taxpayer's only activity in State B is the solicitation of orders by a resident salesman. All orders by the State B salesman are sent to the branch office in Indiana for approval and are filled by shipment from the inventory in Indiana. Since the taxpayer is immune under P.L.86-272 from tax in State B, all sales of merchandise to purchasers in State B are attributed to Indiana, the state from which the merchandise was shipped.

(*Emphasis added*).

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

> No State, or political subdivision thereof, shall have power to impose, for any taxable year ending after September 14, 1959, a net income tax on the income derived within such State by any person from interstate commerce if the only business activities within such State by or on behalf of such person during such taxable year are either, or both, of the following:
> > (1) the solicitation of orders by such person, or his representative, in such State for sales of tangible personal property, which orders are sent outside the State for approval or rejection, and, if approved, are filled by shipment or delivery from a point outside the State; and
> > (2) the solicitation of orders by such person, or his representative, in such State in the name of or for the benefit of a prospective customer of such person, if orders by such customer to such person to enable such customer to fill orders resulting from such solicitation are orders described in paragraph (1).

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

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

(*Emphasis added*).

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

iii. Analysis of the Law Applied to the Facts.

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

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

In Taxpayer's case, the warranty repairs were performed by third-party dealers. The warranties apparently obligated Taxpayer to compensate the dealers for these warranty expenses because - in whole or in part - Taxpayer "stands behind" those warranties.

Taxpayer admits that it did not file income tax returns in the jurisdictions under consideration. Nonetheless, the Department agrees that that Taxpayer's failure to file returns or pay income tax in those states is not necessarily dispositive. IC § 6-3-2-2(n).

However, the Department does not agree that Taxpayer has sufficiently documented the extent to which its own employee or employees conducted activities within the jurisdictions which would necessarily subject Taxpayer to those jurisdictions' own income tax. The Department must also disagree with Taxpayer's exercise of "good will" in the various jurisdictions dispositive because the argument is ambiguous at best. "Good will" is defined as "[a] business's reputation, patronage and other intangible assets that are considered when apprising the business . . . for purchase." Black's Law Dictionary 839 (11th ed. 2019). In this case, Taxpayer's reputation alone is an intangible impossible here to measure in the eleven jurisdictions and unlikely to meet the "beyond mere solicitation" standard.

Taxpayer's argument necessarily relies on the warranty repair and replacement activities conducted independently by third-parties hired by and paid for by Taxpayer. To that end, Taxpayer cites to the United States Supreme Court decision in *Tyler Pipe Industries, Inc. v. Washington State Dept. of Revenue*, 483 U.S. 232 (1987) when it stated:

> As a matter of law, the Washington Supreme Court concluded that this showing of a sufficient nexus could not be defeated by the argument that the taxpayer's representative was properly characterized as an independent contractor instead of as an agent. We agree with this analysis. In *Scripto, Inc. v. Carson*, 362 U.S. 207, 80 S.Ct. 619, 4 L.Ed.2d 660 (1960), Scripto, a Georgia corporation, had no office or regular employees in Florida, but it employed wholesalers or jobbers to solicit sales of its products in Florida. We held that Florida may require these solicitors to collect a use tax from Florida customers. Although the "salesmen" were not employees of Scripto, we determined that "such a fine distinction is without constitutional significance." *Id*., at 211, 80 S.Ct., at 621. This conclusion is consistent with our more recent cases. See *National Geographic Society v. California Equalization Board*, 430 U.S. 551, 556-558, 97 S.Ct. 1386, 1390-1391, 51 L.Ed.2d 631 (1977).
>
> As the Washington Supreme Court determined, "the crucial factor governing nexus is whether the activities performed in this state on behalf of the taxpayer are significantly associated with the taxpayer's ability to establish and maintain a market in this state for the sales." 105 Wash.2d, at 323, 715 P.2d, at 126. The court found this standard was satisfied because Tyler's "sales representatives perform any local activities necessary for maintenance of Tyler Pipe's market and protection of its interests...." *Id*., at 321, 715 P.2d, at 125. We agree that the activities of Tyler's sales representatives adequately support the State's jurisdiction to impose its wholesale tax on Tyler.
> *Id*. at 250-51.

However, the Department points out that *Tyler Pipe* addressed nexus requirements arising from an assessment of Washington State's business and occupation tax on manufacturing. *Id.* at 234. The Department does not agree that the Court's analysis of the nexus issue in *Tyler Pipe* is directly comparable to issues raised by Taxpayer concerning Indiana's own adjusted gross income tax. In *Tyler Pipe*, the Court found that Washington State's tax scheme was unconstitutional because it discriminated against out-of-state manufacturers finding that "[the tax] places a tax burden upon manufacturers in Washington engaged in interstate commerce from which local manufacturers selling locally are exempt." *Id.* at 252.

In this instance, even if the relationship between Taxpayers and the third-party dealers was that of independent contractors, Taxpayer's agreement with the third-party dealers - to fulfill the warranties and to perform the warranty-related repairs on Taxpayer's behalf - does not go beyond the mere solicitation of orders. Taxpayer is simply spending money in those states to fulfill its obligations and the Department does not agree that spending money in foreign jurisdictions potentially subjects Taxpayer to those jurisdictions' income tax regime.

Ultimately, the Department does not agree that Taxpayer's expenditures in the eleven jurisdiction to fulfill its obligations to its out-of-state customers exceeds the Public Law 86-272 "mere solicitation" standard. As specified in 45 IAC 3.1-1-38(4), Taxpayer was not "doing business" within the jurisdictions" because it was merely spending money in those locations to fulfill its warranty obligations. Simply put, nothing that Taxpayer did subjected Taxpayer to the eleven jurisdiction's taxing authority.

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

FINDING

Taxpayer's protest is respectfully denied.

II. Corporate Income Tax - Documenting Research and Expense Credits.

DISCUSSION

The issue is whether Taxpayer has provided sufficient information to document the extent of it incurred labor and supply expenses specifically attributable to qualifying research activities.

A. Burden of Proof.

As in Part I above, Taxpayer bears the statutory responsibility of establishing that the denial of the credits and the consequent assessment of additional tax is wrong. As stated in IC § 6-8.1-5-1(c), "The notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid." *Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue*, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007).

B. Audit Results.

The Department's audit report indicated that Taxpayer claimed approximately $4.6 million dollars is qualifying labor and supply research expenses during the years at issue. The claimed qualifying expenses entitled Taxpayer to approximately $400,000 in credits. By claiming the credits, Taxpayer reduced its 2015 and 2016 Indiana income tax liability.

The audit report indicated that Taxpayer based its claim to the credits on Taxpayer's activities involved in the "conception, design, prototype build, evaluation, [and] final design" of Taxpayer's recreational vehicles and fifth wheel trailers. Taxpayer claimed qualifying labor expenses attributable to "the company president, general managers & product managers, plant managers & assistant plant managers, engineers, sales managers & product managers, manufacturing support manager, the Vice President of Service Operation, and purchasing department employees."

In arriving at the amount of labor expenses, Taxpayer provided the audit "an analysis of hours spent on qualifying activities during an average week." The analysis was based on interviews conducted with Taxpayer's subject matter experts. Taxpayer's experts estimated the expenses based on their "knowledge of the activities performed within [their] department." The experts "estimated the number of hours [which] were then used to calculate a qualifying percentage, which then determined the total amount of qualifying wages engaged in qualifying research."

As to the claimed labor expenses, the Department's audit report concluded that the Department was "unable to verify the [T]axpayer's calculations for hours and wages claimed in the calculation of the Research Expense Credit." The audit found that Taxpayer's interviews of an individual in each of Taxpayer's departments was insufficient to accurately verify the labor expenses claimed. The audit report indicates that the interviewee did not perform all the activities claimed and did not keep a log of the employees' qualifying activities as statutorily required.

The Department's audit also disallowed the claimed supply expenses. The audit did so because the supply expenses were allocated to Taxpayer's "cost center" and not to individual qualify research expenses. In effect, the audit concluded that Taxpayer was unable to track supply expenses to any particular qualifying research project.

C. Taxpayer's Arguments.

Taxpayer asserts that its methodology and estimates were "sufficient to comply with IRC 41 requirements." Taxpayer explains that "[e]ight different individuals . . . provided detail regarding employee qualification detail for themselves and their direct reports" and that this information was "base[d on the individuals' first-hand experience and knowledge of their own personal activities as well as the direct reports for who they are [responsible] for overseeing on a daily basis."

Taxpayer disputes the audit's determination to not give credence to the "first-hand knowledge" provided and criticizes the audit's insistence on "time logs or entry detail which did not exist . . . ."

D. Legal and Factual Analysis.

The issue is whether Taxpayer has sufficiently documented the labor and supply expenses directly attributable to qualifying research projects. Has Taxpayer met its burden of establishing that the Department's proposed assessment was "wrong?" IC § 6-8.1-5-1(c).

i. Indiana Credits, Deductions, Exemptions, Exclusions.

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).

Every taxpayer who claims the tax credit is required to retain records necessary to substantiate a claimed credit. 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). (*See also* IC § 6-8.1-5-4(a) which requires that taxpayers *keep* records). 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 can any particular deduction be allowed.")

ii. Record Keeping Requirements.

Treas. Reg. § 1.41-4(d) (TD 8930) sets out the record keeping and documentation requirements for expenses related to the research credit.

> 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 regulations there under.

(*Emphasis added*).

In addition, the audit report also referred to Chapter 7 of *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 14, 2020).

> 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.

As to Taxpayer's general record keeping responsibility under Indiana law, IC § 6-8.1-5-4(a) provides:

> 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 that tax by reviewing those books and records. The records referred to in this subsection include all source documents necessary to determine the tax, including invoices, register tapes, receipts and canceled checks.

The Department concluded that even assuming Taxpayer conducted qualifying research activities, Taxpayer had not prepared, maintained, retained, or presented records necessary to substantiate that Taxpayer's claimed research expenses were specifically attributable to Taxpayer's "conception, design, prototype build, evaluation, [and] final design" of Taxpayer recreational vehicles and fifth wheel trailers.

The Department rejects Taxpayer's argument that it is sufficient to merely produce documentation based on interviews with and the recollection of its key personnel because the argument oversimplifies the federal and Indiana regulatory requirements. Of course, any documentation must be based on information provided by its personnel but it also must be "prepared before or during the early stages of the research project." Treas. Reg. § 1.41-4(d) (TD 8930). The documentation must be *both* "usable" and "contemporaneous."

It is Taxpayer's statutory obligation to maintain and produce to the Department contemporaneous 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. Treas. Reg. § 1.41-4(d) (TD 8930).

Indiana case law also speaks to the issue of the documentation required to establish one's entitlement to credits such as that sought by Taxpayer. "[A]n income tax deduction is a matter of legislative grace and that the burden of clearly showing the right to the claimed deduction is on the taxpayer." *IDOPCP, Inc. v. Comm'r*, 503 U.S. 79, 84 (1992). Moreover, 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**." *RCA Corp.*, 310 N.E.2d at 100-01. (**Emphasis added**). Thus, every taxpayer's claims against any tax must be supported by records necessary to substantiate the claimed credits and those records are required to be "kept" "before or during the early stages of the research project.

In this case, Taxpayer asks that the Department broadly interpret the REC record keeping requirements to encompass - as stated in the audit report - "estimates of the hours engaged in qualified research by the various employees within his department." The Department is unable to agree that Taxpayer has met its burden of establishing - by means of reliable, contemporaneous records - that its employees and executive staff were actively engaged in qualifying research activities to the extent claimed.

FINDING

Taxpayer's protest is respectfully denied.

SUMMARY

Taxpayer's fulfillment of its warranty responsibilities within jurisdictions outside Indiana by means of the engagement of third-party dealers is not sufficient to render Taxpayer subject to those jurisdictions' income tax. Taxpayer has not established it was entitled to the RECs originally claimed.

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