DEPARTMENT OF STATE REVENUE

01-20191394.LOF
01-20191412.LOF

Letter of Findings: 01-20191394; 01-20191412
Individual Indiana 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 This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register.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 Shareholders that they met their burden of establishing that their businesses conducted qualifying research activities sufficient to generate income tax credits which flowed through to the Shareholders; the Department found that the businesses failed to establish that they undertook a process of qualifying experimentation which led to the discovery of technological innovations; the Department also concluded the Shareholders failed to provide specific, contemporaneous documentation of the businesses' qualifying labor expenses.

ISSUE

I. Indiana Individual Income Tax - Qualified Research Expense Projects and Documentation.

Authority: IC § 6-3-1-3.5(b); IC § 6-3.1-4-1; IC § 6-3.1-4-2(a); IC § 6-8.1-5-1(c); IC § 6-8.1-5-4; IC § 6-8.1-5-4(a); *IDOPCP, Inc. v. Comm'r*, 503 U.S. 79 (1992); *New Colonial Ice Co. v. Helvering*, 292 US. 435 (1934); *Trinity Industries, Inc. v. U.S.*, 757 F.3d 400 (5th Cir. 2014); *United States v. McFerrin*, 570 F.3d 672 (5th Cir. 2009); *Stinson Estate v. United States*, 214 F.3d 846 (7th Cir. 2000); *Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue*, 867 N.E.2d 289 (Ind. Tax Ct. 2007); *Indiana Dep't. of State Revenue, Sales Tax Division v. RCA Corp.*, 310 N.E.2d 96 (Ind. Ct. App. 1974); *Union Carbide Corp. and Subsidiaries, v. C.I.R.*, 97 T.C.M. 1207 (2009); I.R.C. § 41(d); I.R.C. § 41(d)(1)(A); I.R.C. § 41(d)(1)(B)(i); I.R.C. § 41(d)(1)(B)(ii); I.R.C. § 41(d)(1)(C); I.R.C. § 41(d)(2); I.R.C. § 41(d)(4); Treas. Reg. § 1.41-4(a)(3)(i); Treas. Reg. § 1.41-4(a)(3)(ii); Treas. Reg. § 1.41-4(a)(5); Treas. Reg. § 1.41-4(d); Treas. Reg. § 1.6001-1; Letter of Findings 01-20171187, 01-20171188, 01-20171189, 01-20171190 (May 2, 2018); Letter of Findings 01-20170279, 01-20170288 (October 6, 2017); 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 12, 2016); *Audit Techniques Guide: Credit for Increasing Research Activities (i.e. Research Tax Credit) IRC § 41 - Substantiation and Recordkeeping.*

Taxpayers argue that their companies conducted qualified, experimental research activities, that they can adequately document the wage expenses related to those projects, and that they are therefore entitled to claim the benefit of the flow-through credits associated with their companies' qualifying research activities.

STATEMENT OF FACTS

Taxpayers are individual shareholders/owners of three Indiana companies which are in the business of fabricating various products. The companies produce medical devices, medical implants, plastic injection molds, and metal platforms. The plastic injection molds are used by the companies' customers for producing automobile parts and various metal components.

The companies employ water-jet, plasma, and laser technology in producing the medical devices and injection molds. The companies' production of medical devices, injection molds, and platforms includes metal cutting, bending, welding, assembly, and 3D printing.

The Indiana Department of Revenue ("Department") conducted an audit review of the three companies' 2015 and 2016 corporate Indiana tax returns. The Department considered the three companies as the Taxpayers' "controlled group." The investigation was limited to a review of Indiana Research Expense Credits ("RECs") claimed by and apportioned among the three companies and which then "flowed through" to Taxpayers.

The companies claimed the RECs based on the results of a third-party's REC study. The Department concluded that the companies failed to establish that their companies' development and manufacturing activities constituted "qualified research" and the companies failed to establish that the labor expenses - on which the credits were based - directly related to the claimed qualifying activities. In reviewing the labor expenses, the Department concluded that the companies' "time tracking" records did not represent the actual amount of time spent by company employees on qualified research and could not be used to factually support the Qualified Research Expenses ("QREs").

The Department's audit disallowed the companies' claimed credits. The audit found that "[n]o credits [were] available for pass-thru to the shareholders for [2015 and 2016]. The credit disallowance resulted in an assessment to the shareholder/owners of additional Indiana income tax. Those shareholder/owners (here "Taxpayers") disagreed with the Department's assessments and submitted a protest to that effect. An administrative hearing was conducted during which Taxpayers' representative explained the basis for the protest. This Letter of Findings results.

I. Indiana Individual Income Tax - Qualified Research Expense Projects and Documentation.

DISCUSSION

The issue is whether Taxpayers have established that their companies conducted qualifying research activities and whether the companies can document the extent to which the companies conducted those qualifying activities.

A. Department's Audit Examination.

1. Qualifying Research Projects.

During the years 2015 and 2016 Taxpayers' companies claimed approximately $2.4 million dollars in QREs entitling them to approximately $350,000 in RECs. The "qualifying expenses" stemmed entirely from the three companies' labor costs.

The Department's audit concluded that the companies' activities did not "overcome the 4-part test" required under I.R.C. § 41(d) which defines "qualified research" as research:

1. With respect to which expenditures may be treated as expenses under section 174[;]
2. Which is undertaken for the purposes of *discovering information* and 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 [qualifying purpose].

(*Emphasis added*).

I.R.C. § 41(d) sets out this four-pronged test for verifying qualified research activities. First, the research must have qualified as a business deduction under I.R.C. § 174. I.R.C. 41(d)(1)(A). Second, the research must be undertaken to discover information "which is technological in nature." I.R.C. § 41(d)(1)(B)(i). Third, the taxpayer must intend to use the information to develop a new or improved business component. I.R.C. § 41(d)(1)(B)(ii). Finally, the taxpayer must pursue a "process of experimentation" during substantially all of the research. I.R.C. § 41(d)(1)(C).

(a) Section 174 Business Deductions.

The Department found that the wage expenses claimed as QREs were directly related to jobs being completed at Taxpayers' businesses and that the company had deducted these costs as "ordinary and necessary business expenses under IRC section 162." According to the audit report, the businesses were simply adapting existing commercial components to meet the businesses' customer specifications. As such, the audit found that these "ordinary expenses" were specifically excluded by I.R.C. § 41(d)(4) and could not be claimed as RECs.

(b) Discovering Technological Information.

As to the second of the four tests, the Department's audit did not agree that Taxpayers' business activities led to the discovery of information or technology which expanded upon and added to the common knowledge of other similar manufacturers. As authority for its position, the Department cited to Treas. Reg. § 1.41-4(a)(3)(i) of the 2001 Final Regulations which 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*).

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

The audit cited to Treas. Reg. § 1.41-4(a)(3)(ii) (T.D. 8930) for the definition of "common knowledge." The regulation provides:

> 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.

The audit found that the businesses had failed to establish that the projects met this technological test. As explained in the audit report:

> There was insufficient documentation to conclude that the [businesses] had a methodical plan involving a series of trials to test a hypothesis, analyze the data, refine the hypothesis and retest the hypothesis so that it constitutes experimentation in the scientific sense . . . . Furthermore, the documentation did not establish that the work performed was conceptually new and not normal industry practices.

(c) New or Improved Business Component.

As to the third of the four tests, the audit stated that each QRE expense must be expended "in the development of a new or improved business component of the taxpayer." As explained in the audit report, "The purpose of the qualifying research activity or project must be to create [a] new business component or improve existing functionality, performance, reliability, or quality of a business component."

The audit found that Taxpayers' businesses incurred its labor expenses in building products for their customers and not in developing the concept of a product or the underlying components. The audit further noted that the businesses failed to establish that its labor expenses stemmed from the creation of a plan for work that was "conceptually new."

The audit concluded that the businesses did not provide evidence that its expenses were related to the development of individual "components" and that the businesses had ignored one of the fundamental tenants of qualified research; qualifying research stems from activities tied to distinct *components*.

Therefore, even if the businesses' research related to individual components, the components could not be tied to activities "'actually' performed by each employee on each project." Given the audit's analysis, the Department found that the businesses failed to verify "the amount of expenditures that qualify per business component . . . ."

In addition, the audit found that Taxpayers failed to adequately "tie" the labor expenses to any of its qualifying projects. Instead when questioned about this requirement, the audit found that the businesses' were only able to cite to the consulting firm's "research and expense study." The audit criticized this singular reliance because "[t]here was no detail as how [the study's] estimates were arrived or documents to support it." As to the third test, the audit concluded that it was "impossible for the [D]epartment to verify that the required [four part] tests have been satisfied on a component by component basis."

(d) Undertaking a Process of Experimentation.

Finally as to the fourth test, the audit relied on Treas. Reg. § 1.41-4(a)(5) (T.D. 8930) which states:

> A process of experimentation is a process to evaluate more than one alternative designed to achieve a result

> where the capability or method of achieving that result is uncertain at the outset. A process of experimentation does not include the evaluation of alternatives to establish the appropriate design of a business component, if the capability and method for developing or improving the business component are not uncertain.

The audit concluded that under Treas. Reg. § 1.41-4(a)(5) (T.D. 8930), the businesses failed to meet the requirement that a claimant engage in a process of "experimentation" because "the [T]axpayer's capability and method for developing or improving the business component is certain [and] the [T]axpayer's evaluation of an alternative to establish the appropriate design is not a process of experimentation."

The audit took an additional step by evaluating the experimentation standard under the Treas. Reg. § 1.41-4(a)(5) (T.D. 9104) less restrictive "uncertainty test." Although not applicable for the years at issue, the audit concluded that Taxpayers' businesses also failed to meet this less restrictive uncertainty test. The audit report stated:

> The taxpayer failed to establish that the projects met the process of experimentation test under the current regulation, TD 9104. There was insufficient documentation to conclude that the taxpayer had a methodical plan involving a series of trials to test a hypothesis, analyze the data, refine the hypothesis and retest the hypothesis so that it constitutes experimentation in the scientific sense.

In other words, even under Treas. Reg. § 1.41-4(a)(5) (T.D. 9104), addressing and resolving any "uncertainty" at the outset of a Taxpayer project was insufficient to meet the experimentation standard.

2. Documenting and Substantiating the RECs.

Even assuming that Taxpayers' businesses could establish that they were engaged in qualifying research activities, the Department's audit found that the businesses failed to adequately document the wage and labor expenses which formed the primary basis for the claimed RECs. Specifically, the audit found that the businesses failed to meet the documentation and substantiation standard under Treas. Reg. § 1.41-4(d) (T.D. 8930). This regulation sets out the record keeping and documentation requirement for expenses related to the REC:

> 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*).

The Department's audit also considered Treas. Reg. § 1.41-4(d) (TD 9104), the current governing regulation, which states:

> 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 section 1.6001-1.

In turn, Treas. Reg. § 1.6001-1 provides:

> Any person required to file a return of information with respect to income shall keep such permanent books of accounts or records, including inventories, as are sufficient to establish the amount of gross income, deductions, credits, or other matters required to be shown in any return of such tax or information.

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.

The audit report also pointed to Indiana's own general record keeping requirement.

> 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. IC § 6-8.1-5-4(a).

The Department's audit concluded that under either Treas. Reg. § 1.41-4(d) (TD 9104) or Treas. Reg. § 1.41-4(d) (T.D. 8930), Taxpayers' businesses were unable to provide the requisite contemporaneous records establishing that they were entitled to claim the credits. Further, the businesses failed to meet Indiana's own general record keeping requirement, IC § 6-8.1-5-4(a), that they "keep books and records . . ." sufficient to determine the amount of tax owed by the businesses.

B. Taxpayer's Response.

1. Qualifying Research Projects and the Four-Part I.R.C. § 41(d) Test.

Taxpayers disagree with the Department's conclusion that their companies do not engage in qualifying research activities. Taxpayers explain that their businesses employ a team of talented and experienced engineers, fabricators, and quality assurance personnel and that these businesses specialize in the manufacture of sophisticated medical devices, medical implants, plastic injection molds, and metal platforms.

For example, Taxpayers point out that their medical division "specializes in producing complex medical instruments, assemblies, and orthopedic implants - such as bone screws and bone plates." According to Taxpayers, "[E]very step of the [medical device] process must be planned to assure these medical devices are manufactured to satisfy the strictest requirements and tightest tolerances." Taxpayers state that the manufacturing of medical devices begins with only an "initial hypothesis" and that the finished parts "often incorporate very complex geometry that must be made from forged metal." Taxpayers state that its medical device production facility "contain[s] many of the most advanced manufacturing devices available so [the facility] can continue to sharpen the cutting edge of its industry and push the limit on what can be manufactured."

Taxpayers also point out to their injection mold facility which - according to Taxpayers - "utilizes some of the most advanced technology in the industry to maintain a competitive advantage and provide cutting edge production capabilities to its clients." More specifically, Taxpayers indicate that their metal molds incorporate cooling hubs and channels which facilitate cooling of each plastic part produced. As Taxpayers explain, without these cooling hubs and channels, "the plastic would not have hardened and could not be removed from the mold without compromising the [finished] part." Since each manufacturer produces thousands of part, without the cooling hubs and channels the manufacturer's production process would be slowed and the cost to manufacture each part increased.

Finally, Taxpayers point to their custom steel fabricating facility which produces metal workplace platforms. Taxpayers state that this facility produces custom designed steel platforms which conform to each customers' specific needs. According to Taxpayers, each metal platform requires an evaluation of the customer's requirements, location, and the machinery to which the platform is eventually fitted. Taxpayers' company must decide whether the platform is constructed of solid, square, or hollow steel. As described by Taxpayers, "Depending on these factors, [final] platform designs may incorporate varying geometries and grades of steel to achieve a design that would function as required." Determining the final platform design requires complex "modeling simulations and engineering calculation[s] . . . ."

2. Taxpayers Conclude their Businesses' Activities Met the Four-Part Test.

Taxpayers conclude that their companies are entitled to the RECs because they met all four prongs of the I.R.C. § 41(d) test.

Taxpayers explain that their companies face many uncertainties in manufacturing the medical devices, injection molds, and metal platforms. For example, Taxpayers state they face uncertainty in developing "[t]he appropriate design of tooling componentry necessary to be incorporated into the manufacturing process in order to yield the intended product.

Next, Taxpayers believe they met the second test because they discover information which is "technological in nature . . . ." Taxpayers state that their businesses rely on advanced "principles of engineering and physics in the design and development of custom tooling and fixtures."

Taxpayers claim that their businesses fulfill the third test because the businesses "developed new processes by which to manufacture medical devices and implants . . . manufacture plastic injection products . . . [and] custom steel products . . . ."

Finally, Taxpayers state that their businesses fulfill the fourth requirement because they engage in a process of experimentation intended to eliminate uncertainty and arrive at potential alternatives. Taxpayers conclude that the businesses engage in a "systematic process of experimentation to design and develop each of the medical and automotive tooling to meet stringent functional and performance requirements.

3. Which Regulatory Standard - "Discovery" or "Uncertainty"?

Taxpayers claim that the Department erred in relying on the TD 8930 "discovery" regulations when it should have applied the less strenuous TD 9104 "uncertainty" regulations. To that end, Taxpayers state that the Department has stipulated to that effect and that the Department of Revenue now agrees that the standards adopted in the January 1, 2016, statute were also adopted by the January 1, 2003, version of the statute. According to Taxpayers, the Department now agrees that the only relevant test is the TD 9104 "uncertainty" standard.

4. Wage Expense Documentation.

Taxpayers disagree with the Department's conclusion that Taxpayers failed to adequately document its businesses' employees' research activities and disagrees with the Department's audit finding that the businesses did not provide records necessary to substantiate their *qualification* for the RECs or substantiate the *amount* of the RECs.

According to Taxpayers, the only applicable REC record keeping requirement is found at Treas. Reg. § 1.41-4(d) which provides in small part:

> 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 § 1.6001-1.

Taxpayers argue that Treas. Reg. § 1.6001-1 "imposes a general recordkeeping requirement for every taxpayer to maintain accounting records that will enable the taxpayer to file a correct return of taxable income each year." According to Taxpayers, the regulation merely calls for records which are "sufficient to show whether nor not such a person is liable for tax under this title." In this instance, Taxpayers appear to misquote Treas. Reg. § 1.6001-1 which provides in small part:

> [A]ny person required to file a return of information with respect to income, shall keep such permanent books of account or records, including inventories, as are sufficient to establish the amount of gross income, deductions, credits, or other matters required to be shown by such person in any return of such tax or information.

According to Taxpayers, Treas. Reg. § 1.6001-1 "does not impose a specific documentary evidence requirement" and that "Indiana law does not require taxpayers to substantiate [the claimed credits] with written documentation."

C. Burden of Proof, Analysis, and Conclusion.

1. Proving that Taxpayers are Entitled to the Credit.

Tax assessments are *prima facie* evidence that the Department's assessment of tax is presumed correct; in every assessment case, each 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).

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.")

Therefore, REC claimants must establish that any Department assessment was "incorrect," that their REC claim is supported by contemporaneous documentation, and that the substance of the claim falls with the "exact letter of the law" within the "clear provision[s]" of the law.

2. The Research Expense Credit's Indiana Regulatory Regime.

At the outset, the Department rejects Taxpayers' argument that TD 8930 was the governing regulatory scheme relevant to the years at issue. According to Taxpayers, "Taxpayer[s] qualified for the Credit in the amount as claimed and, if [the businesses'] were analyzed under the proper standards, [they] would have been found entitled to that Credit." Taxpayers believe that the Department's audit misapplied the regulatory standard, "the proposed assessment is wrong."

The Department has addressed and repeatedly rejected this basic, foundational issue. The Department has time-after-time staked out its position in detail which need not be repeated here. *See* Letter of Findings 01-20171187, 01-20171188, 01-20171189, 01-20171190 (May 2, 2018), 20180725 Ind. Reg. 045180286NRA; Letter of Findings 01-20170279, 01-20170288 (October 6, 2017), 20180131 Ind. Reg. 045180014NRA; 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 12, 2016), 20170222 Ind. Reg. 045170090NRA.

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." Simply stated, the REC requires that the taxpayer undertake activities "for the purposes of *discovering information* which is technological in nature." I.R.C. § 41(d)(2) (*Emphasis added*).

In addition, the Department rejects Taxpayers' argument that the Department has agreed with Taxpayers' position. The Tax Court stipulation on which Taxpayers rely has nothing to do with the substance of the issues in dispute here or in Tax Court. The stipulation to which the Department agreed was simply a decision - made under at Department's behest - to streamline the litigation and in the interests of judicial economy. The distinction between TD 8930 and TD 9104 and the applicability of the regulations was simply not important to the particular cited case. The Department points out that, as a basic tenant of administrative law, the Department may only change its policies and interpretations through official publication in the Indiana Register and that under Ind. Tax Ct. Trial Rule 7(F)(6), such a stipulation "shall be binding and have effect only in the pending case and not for any other purpose, and cannot be used against any of the parties thereto in any other case or proceeding."

3. Indiana's Research and Expense Tax Credit.

For income tax purposes, Indiana follows the federal tax scheme with certain state-specific 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 (**as defined in Section 41(b) of the Internal Revenue Code as in effect on January 1, 2001**). (**Emphasis added**).

Further, "qualified research expense" under the 2003 Indiana Statute is "as defined in Section 41(b) of the Internal Revenue Code **as in effect on January 1, 2001**[.]" IC § 6-3.1-4-1 (2003) (**Emphasis added**). "Qualified research" is defined in the Internal Revenue Code ("I.R.C.") under section 41(d) I.R.C. subsection 41(d) defines qualified research in pertinent part as follows:

> (d) Qualified research defined.-For purposes of this section-
> (1) In general.-The term "qualified research" means research-
> (A) with respect to which expenditures may be treated as expenses under section 174,
> (B) which is undertaken for the purpose of discovering information-
> (i) which is technological in nature, and
> (ii) the application of which is intended to be useful in the development of a new or improved business component of the taxpayer, and
> (C) substantially all of the activities of which constitute elements of a process of experimentation for a purpose described in paragraph . . .

I.R.C. § 41(d)(1).

As pointed out above, the provision sets out the four-pronged test for determining whether a taxpayer conducted qualified research. First, the research must have qualified as a business deduction under § 174. *See Id.* § 41(d)(1)(A). Second, the research must be undertaken to "discover information which is technological in nature." *Id.* § 41(d)(1)(B)(i). Third, the taxpayer must intend to use the information to develop a new or improved business component. *Id.* § 41(d)(1)(B)(ii). Finally, the taxpayer must undertake a "process of experimentation" during substantially all of the research. *Id.* § 41(d)(1)(C).

4. Analysis and Conclusions.

In order for its argument to prevail, Taxpayer's activities must meet the four-part test under I.R.C. § 41(d) including the requirement that Taxpayer's activities were undertaken for the "purposes of discovering information" and must eventually yield a "new or improved business component" each of which derives from a process of experimentation.

As explained by Taxpayers, their businesses develop and produce medical instruments, medical implants, injection molds, and custom workplace platforms. In each case, Taxpayers emphasize the sophistication and precision involved in the development and production of these items. Taxpayers also make much of the fact that their production facilities utilize "cutting edge" water-jet, plasma, and laser technology. However, Taxpayers can point to nothing its businesses have done to discover and develop a "new or improved business component" incorporated into or necessary to the production of the businesses' products. Not minimizing in any degree the sophistication of the businesses' products, Taxpayers have pointed to nothing which advances upon or adds to the common knowledge of other similar lines of business. Moreover, Taxpayers have not established that its businesses fundamentally expanded upon the "common knowledge" using variations of long-standing techniques, or expanded the "existing level of information in [Taxpayer's] field of science or engineering." Treas. Reg. § 1.41-4(a)(3)(ii).

Taxpayers state their businesses exercise care, expertise, and diligence in producing finished products which specifically meet their customers' needs. Taxpayers conclude that these activities reflect a knowledgeable and detailed process of "trial and error" aimed at improving or differentiating its products. However, the businesses' processes - even if they did lead to the "discovery" of new products - do not necessarily represent "a methodical plan involving a series of trials to test a hypothesis, analyze the data, refine the hypothesis, and retest the hypothesis so that it constitutes experimentation in the scientific sense." *Trinity Industries, Inc. v. U.S.*, 757 F.3d 400, 414 (5th Cir. 2014). As explained by that court, the "process of experimentation" requirement is not met by means of "a method of simple trial and error to validate that a process or product change meets the taxpayer's needs." *Id.* (See also *Union Carbine Corp. and Subsidiaries v. C.I.R.* 97 T.C.M. (CCH) 1207 (Tax Ct. 2009) explaining "It is not sufficient that the taxpayer use a method of simple trial and error to validate that a process or product change meets the taxpayer's needs.")

Fundamentally, Taxpayers' analysis errs because they conflate concepts of difficulty, sophistication, and diligence into an amorphous difficulty/sophistication standard which they claim entitle them to the RECs.

The Department is unable to agree that Taxpayers have met their statutory burden under IC § 6-8.1-5-1(c) of establishing that the businesses' activities to develop or improve upon its businesses products constitute "qualified research" activities under either the "Discovery Test" or the "Uncertainty Test." Even under TD 9104, simply demonstrating that "uncertainty" exists in achieving a particular result has been eliminated and that a particular result has been achieved, is insufficient to satisfy the "process of experimentation" requirement. The Department is unable to agree that Taxpayers have established that the businesses' efforts to produce sophisticated medical devices or metal platforms resulted in the discovery of a new product which became part of the body of common knowledge of others skilled in the production of such products.

Setting aside issues related to whether Taxpayers' businesses were engaged in qualified research, Taxpayers disagree with the audit's finding that the businesses failed to adequately document the employees' specific activities and wages attributable to those projects. Taxpayers do not assert that their businesses maintained a system of project accounting in order to accurately quantify the businesses research expenses. Instead, Taxpayers rely on employee surveys, job titles, wage statements, and project descriptions in concluding that the businesses paid their employees approximately $2.4 million dollars to conduct experimentation on components eventually incorporated into or made part of the businesses' products. For example, Taxpayers assert that one of their "mill and lathe" operators "recommended improvements to optimize the design of new parts and tools." As a result, Taxpayers assert that 25 percent of this employee's time was spent in qualifying research activity. Taxpayers state that one of their sales persons "suggest[ed] alternate designs to achieve the project requirements for the specific application." Taxpayers conclude that this sales person spent 80 percent of his time in conducting qualifying research. The Department finds such assertions less than convincing and that the bare assertions certainly fall short of the record keeping requirements under federal or Indiana law.

While the Department recognizes Taxpayers' efforts to estimate the qualifying wages of their employees, the Department rejects Taxpayers' argument that the Department is precluded from demanding specific, contemporaneous documentation and that "documentation is not necessary to prove taxpayer engaged in a particular activity in the tax year(s) at issue." Instead, the Department finds the law on this issue clear.

Treas. Reg. § 1.41-4(d) (T.D. 8930) sets out the record keeping and documentation requirement 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*).

Indiana provides its own record keeping requirements.

> 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. IC § 6-8.1-5-4(a).

The Department rejects Taxpayers' argument that it is sufficient to verify its claim to the credit "based upon whatever alternate means may be available." The Department finds that the argument grossly oversimplifies the relevant regulatory requirement and statutory requirements. Instead, it is Taxpayers' statutory obligation to maintain and produce to the Department contemporaneous records sufficient to verify the credits which they claim 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 Taxpayers seek to obtain the benefit of those credits - Taxpayers are required to meet. Treas. Reg. § 1.41-4(d) (TD 8930).

Indiana case law speaks in general to the issue of the standard required to establish one's entitlement to credits such as that sought by Taxpayers. "[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 claim 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, Taxpayers asks that the Department broadly interpret the REC record keeping requirements to encompass - as stated in the audit report - "estimated qualified percentage allocations" when there is no evidence that the businesses' efforts to develop and then monitor and control the quality of its products constitutes a "process of experimentation" which led to technological innovations otherwise outside the knowledge of other skilled professionals.

FINDING

Taxpayers' protest is respectfully denied.

February 25, 2020

Posted: 04/29/2020 by Legislative Services Agency
An html version of this document.