DEPARTMENT OF STATE REVENUE

02-20191226.LOF

Letter of Findings Number: 02-20191226
Adjusted Gross Income Tax
For Tax Years 2015 and 2016

NOTICE: IC § 6-8.1-3-3.5 and IC § 4-22-7-7 requires 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 This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register.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

Company failed to provide source documentation to substantiate its claimed research and expense credits.

ISSUE

I. Adjusted Gross Income Tax–Research Expense Credits.

Authority: IC § 6-3-1-3.5; IC § 6-3-2-1; IC § 6-3.1-4-1; IC § 6-3.1-4-4; IC § 6-8.1-5-1; IC § 6-8.1-5-4; *Dep't of State Revenue v. Caterpillar, Inc.*, 15 N.E.3d 579 (Ind. 2014); *Indiana Dep't of Revenue v. Miller Brewing Co.*, 975 N.E.2d 800 (Ind. 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); *Wendt LLP v. Indiana Dep't of State Revenue*, 977 N.E.2d 480 (Ind. Tax Ct. 2012); *Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue*, 867 N.E.2d 289 (Ind. Tax Ct. 2007); *IDOPCP, Inc. v. Comm'r*, 503 U.S. 79 (1992); *Indiana Dep't of State Revenue, Sales Tax Division v. RCA Corp.*, 310 N.E.2d 96 (Ind. Ct. App. 1974); *Conklin v. Town of Cambridge City*, 58 Ind. 130 (1877); *United States vs. McFerrin*, 570 F.3d 672 (5th Cir. 2009); *Cohan v. Commissioner,* 39 F.2d 540 (2d Cir. 1930); *Shami v. Comm'r*, 741 F.3d 560 (5th Cir. 2014); *Williams v. United States*, 245 F.2d, 559, 560 (5th Cir. 1957); *Vanicek v. Commissioner*, 85 T.C. 731 (1985); *Fudim v. Commissioner*, T.C.M. 1994-235; *Suder v. Commissioner,* T.C. Memo 2014-201, 2014 WL 4920724 (U.S. Tax Ct. 2014); Treas. Reg. § 1.41-2 (2001); Treas. Reg. § 1-41-4; IRS *Audit Technique Guide*, 2005 WL 405783 (June 2005).

Taxpayer protests the disallowance of claimed research expense credits.

STATEMENT OF FACTS

Taxpayer is a manufacturer of electronics, systems integration and other capabilities in the areas of communication and intelligence systems with several locations throughout Indiana and the United States. In 2019 the Indiana Department of Revenue ("Department") conducted an audit of Taxpayer's books and records. As a result of the audit, the Department made adjustments to Taxpayer's 2015 and 2016 Indiana income tax returns. These adjustments resulted in proposed assessments for the referenced tax years. Taxpayer disagreed with these adjustments and filed a timely protest. An administrative hearing ("Hearing") was conducted during which Taxpayer explained the basis for the protest. This Letter of Findings results. Additional facts will be provided as necessary.

I. Adjusted Gross Income Tax–Research Expense Credits.

DISCUSSION

The Department conducted an audit of Taxpayer's books and records for tax years 2015 and 2016. The Department's audit denied the claimed research and expense credit ("REC") for the tax years at issue. Taxpayer filed a timely protest stating that it contended it properly claimed the RECs and sufficient documentation was provided to support its "reasonable method used to allocate its Indiana [REC]." However, the audit report states, "The research expenses are not directly tracked or recorded into cost center accounts. Instead, the taxpayer explained how the Qualified Research Expenses (QRE's) were discussed during an audit interview process and taxpayer provided the following methodologies which included tax year 2017. The 2017 method was discussed in the interviews because this is the current and future method of estimating the QRE's." Thus, this decision shall determine whether Taxpayer provided sufficient documentation and methodology for calculating QRE's.

As a threshold issue, it is a taxpayer's responsibility to establish that the existing tax assessment 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 n.9 (Ind. Tax Ct. 2012).

"[W]hen [courts] examine a statute that an agency is 'charged with enforcing . . . [courts] defer to an agency's reasonable interpretation of [the] statute even over an equally reasonable interpretation by another party.'" *Dep't of State Revenue v. Caterpillar, Inc.*, 15 N.E.3d 579, 583 (Ind. 2014). Therefore, when the statute is plain and unambiguous there is no need to delve into the legislative history of the statute.

> Our settled procedure of statutory construction begins with a determination as to whether the legislature has spoken clearly and unambiguously on the point in question. If so, our task is relatively simple: we need not "delve into legislative intent" but must give effect to "the plain and ordinary meaning of the language." *Indiana Dep't of Revenue v. Miller Brewing Co.*, 975 N.E.2d 800,803 (Ind. 2012).
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> (Internal citation omitted).

Indiana follows the federal tax scheme with certain modifications. IC § 6-3-2-1(b); IC § 6-3-1-3.5(b). Indiana also provides certain tax credits which a taxpayer may claim to reduce its tax liability. See generally, IC § 6-3.1 and IC § 6-3.5. One of the tax credits available under Indiana tax law is the REC under IC § 6-3.1-4-1 *et seq.* The 2003 statute, which was effective until December 31, 2015, and is relevant to the tax years at issue (the "2003 Indiana Statute"), provides:

> The provisions of Section 41 of the Internal Revenue Code as in effect on January 1, 2001, and the regulations promulgated in respect to those provisions and in effect on January 1, 2001, are applicable to the interpretation and administration by the department of the credit provided by this chapter, including the allocation and pass through of the credit to various taxpayers and the transitional rules for determination of the base period. IC §6-3.1-4-4.

Treas. Reg. § 1.41-2(d) (2001) states:

> (1) Wages paid to or incurred for an employee constitute in-house research expenses only to the extent the wages were paid or incurred for qualified services performed by the employee. If an employee has performed both qualified services and nonqualified services, only the amount of wages allocated to the performance of qualified services constitutes an in-house research expense. In the absence of another method of allocation that the taxpayer can demonstrate to be more appropriate, the amount of in-house research expense shall be determined by multiplying the total amount of wages paid to or incurred for the employee during the taxable year by the ratio of the total time actually spent by the employee in the performance of qualified services for the taxpayer to the total time spent by the employee in the performance of all services for the taxpayer during the taxable year.
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> (2) "Substantially all." Notwithstanding paragraph (d)(1) of this section, if substantially all of the services performed by an employee for the taxpayer during the taxable year consist of services meeting the requirements of section 41(b)(2)(B) (i) or (ii), then the term "qualified services" means all of the services performed by the employee for the taxpayer during the taxable year. Services meeting the requirements of section 41(b)(2)(B) (i) or (ii) constitute substantially all of the services performed by the employee during a taxable year only if the wages allocated (on the basis used for purposes of paragraph (d)(1) of this section) to services meeting the requirements of section 41(b)(2)(B) (i) or (ii) constitute at least 80 percent of the wages paid to or incurred by the taxpayer for the employee during the taxable year.

In order to obtain the benefit of the credit, both Indiana and federal law require that a taxpayer maintain and produce *contemporaneous* records sufficient to verify those credits. "Tax credits are a matter of legislative grace, and taxpayers bear the burden of proving they are entitled to claim tax credits." *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." *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).

Under IC § 6-8.1-5-4 "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. . . ." In addition, Treas. Reg. § 1-41-4(d)(1) (2001) states that for taxpayer to receive the research and development tax credit, a taxpayer must:

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

The IRS's *Audit Technique Guide*, 2005 WL 405783 (June 2005) provides useful guidance in relation to the information necessary to verify research expense credits. The Guide states:

> 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.
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> 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.
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> The courts will allow the use of an estimation method only where the taxpayer does not have contemporaneous records, and then only as long as the following two conditions are satisfied. First, the taxpayer must establish that it engaged in qualified research activities as defined in section 41(d). And second, the failure to maintain a proper system to capture relevant information cannot be an "inexactitude [] of their own making." ***Estimation methods are permitted only in cases where the sole issue is the exact amount paid or incurred in the qualified research activity. Accordingly, taxpayers must have factual support for every assumption underlying their estimates to meet their burden of proof***.
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> 2005 WL, at *24. *Audit Techniques Guide: Credit for Increasing Research Activities (i.e. Research Tax Credit) IRC § 41 - Substantiation and Recordkeeping*, http://www.irs.gov/Businesses/Audit-Techniques-Guide:-Credit-for-Increasing-Research-Activities-(i.e.-Research-Tax-Credit)-IRC-§ 41 (last visited January 17, 2018) (***Emphasis added***).

Thus, while estimation methods can be permissible when computing the amount of the REC, those estimates must be backed by documentation which verifies the amount of the expense. To reiterate the IRS' guidance, "taxpayers must have factual support for every assumption underlying their estimates to meet their burden of proof."

In this instance, the Department requested documentation such as an REC study, contemporaneous tracking system, and/or any other contemporaneous documentation to substantiate the amount of REC taken.

First, this decision will determine whether Taxpayer provided sufficient documentation to substantiate that its activities qualify for the REC and the amount of REC taken. In the audit report the Department noted that, "The [T]axpayer did not provide a completed study or contemporaneous documentation that tracks or explains qualifying research activities. . . . The [T]axpayer did not provide records to substantiate the qualification for the credit or to substantiate the amount of credit" as required by IC § 6-8.1-5-4(a), Treas. Reg. 1.41-4(d) (TD 9104), and Treas. Reg. 1.41-4(d) (TD 8930). During the protest process, Taxpayer was asked on three separate occasions to provide documentation that begins with an Indiana engineer employed by Taxpayer and tie that employee to projects, and explain those projects with supporting documentation as to why those projects qualify for REC. The Department requested that Taxpayer demonstrate to the Legal Division how at least one engineer ties to projects and how those projects qualify using source documentation. Taxpayer did respond to these

requests however the only documents provided were explanations of its methodology and an excel sheet with employee names, state, and project number(s) those employees worked on. Taxpayer did not provide explanation of those projects, documents supporting that these projects qualify for the REC, source documentation tying the employees to the projects, or anything that could tie the projects to Indiana. The information provided in no way showed that Taxpayer qualified for the REC, let alone substantiated the credit amount, regardless of methodology.

Second, since Taxpayer stated the one of the Department's biggest issues with its QREs was the methodology, this decision will now discuss methodology. The Department explained Taxpayer's methodology for calculating QREs in its audit report:

> Through tax year 2016, [Taxpayer] sourced federal QREs to the states using the Cost of Performance method as outlined in Sections 17 under the Uniform Division of Income for Tax Purposes Act. Once sourced, credits based on those QREs are then calculated based on the local research credit rules. . . .
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> Due to increased accounting systems functionally, [Taxpayer] was able to determine a better method of identifying federal QRE's with each state; the Engineering Payroll Method. This method entails taking as the numerator the total payroll paid to [Taxpayer's] engineers in the state, determined by where [Taxpayer] pays unemployment insurance for those employees, over a denominator of the total [Taxpayer] engineering payroll. The [T]axpayer used this method as a discussion point of how they are estimating their QRE's. The percentage derived from the above methods are then applied to the each of the claimed QREs for wages, supplies, and contractor expenses.

The audit report determined that the Department could not utilize Taxpayer's methodology because no source or supporting documentation was provided. During the protest process, the Department was amenable to reviewing employees and projects of Taxpayer's choosing; the Department merely requested the source documentation and project explanation. As stated above, only a methodology explanation, and list of employees was provided.

Case law provides some guidance as to whether or not estimates of QREs are acceptable when claiming the REC. In the case of *Cohan v. Commissioner*, the Circuit Court of Appeals for the Second Circuit allowed taxpayer entertainment and travel expenses to be estimated even though taxpayer had kept no records of the expenses. The court reasoned that "Absolute certainty in such matters is usually impossible and is not necessary . . . It is not fatal that the result will inevitably be speculative." *Cohan v. Commissioner,* 39 F.2d 540, 544 (2d Cir. 1930). In explaining its decision, the court stated that "there was obviously some basis for [the] computation . . ." and asked the Board to "reconsider the evidence."

From the *Cohan* case came a "longstanding rule . . . that if a qualified expense occurred, the court should estimate the allowable tax credit." *McFerrin*.That rule has been qualified by several courts. As the United States Court of Appeals for the Eighth Circuit noted, "We believe that considerable discretion exists in the application of the Cohan rule, and that such rule should be applied only in cases where the taxpayer has clearly shown that he is entitled to some deduction and that uncertainty exists only as to the exact amount thereof." *Oates v. Commissioner of Internal Revenue*, 316 F.2d 56, 59 (8th Cir. 1963). The United States Court of Appeals for the Fifth Circuit, in finding that the record *did not* contain a reasonable basis upon which an estimate of taxpayer's allowable tax credit could be made, noted that even though the Tax Court "might have considerable latitude in making estimates of amounts probably spent," the *Cohan* rule "certainly does not require that such latitude be employed." *Shami v. Comm'r*, 741 F.3d 560, 569 (5th Cir. 2014) (citing *Williams v. United States*, 245 F.2d, 559, 560 (5th Cir. 1957). Further, "Our decision in *Williams* explicitly held that the Tax Court 'may not be compelled to estimate even though such an estimate, if made, might have been affirmed." *Id*. In other words, though a court *may* estimate allowable tax credits under *Cohan*, it is not *compelled* to do so.

If a court does apply the *Cohan* rule, "a reasonable basis must exist on which the Court can make an estimate." *Williams v. United States*, 245 F.2d, 559, 560 (5th Cir. 1957). As stated by the United States Tax Court, "While it is within the purview of this Court to estimate the amount of allowable deductions where there is evidence that deductible expenses were incurred, **we must have some basis on which an estimate may be made.**" *Vanicek v. Commissioner*, 85 T.C. 731 (1985) (**emphasis added**). "For the basic requirement is that there be sufficient evidence to satisfy the trier that at least the amount allowed in the estimate was in fact spent or incurred for the stated purpose." *Williams v. United States*, 245 F.2d 599 (5th Cir. 1957). In a 1994 United States Tax Court case, the court estimated time spent on research and development based on both taxpayer testimony and "other evidence in the record." *Fudim v. Commissioner*, T.C.M. 1994-235. A recent United States Tax Court case allowed a taxpayer to estimate its wage QREs, but only after several days of testimony by several witnesses taken under oath which was supported by "documentary evidence in the record." *Suder v. Commissioner,* T.C.

Memo 2014-201, 2014 WL 4920724 at *24 (U.S. Tax Ct. 2014). Therefore, estimates of QREs are acceptable, but only to the extent that they are supported by testimony and documentary evidence.

In this instance, the Department does not dismiss Taxpayer's methodology of calculating QRE's but rather cannot uphold it based on the lack of source documentation provided. As stated in *Vanicek* "we must have some basis on which an estimate may be made." Even after several requests and explanations of source documentation requested, Taxpayer still did not provide any substantive basis for its estimate or methodology. Thus, the Department cannot grant the credit. Taxpayer has failed to meet its burden under IC § 6-8.1-5-1(c) to show that the proposed assessments were wrong.

FINDINGS

Taxpayer's protest is denied.

April 28, 2020

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