DEPARTMENT OF STATE REVENUE

02-20200332.LOF

Letter of Findings: 02-20200332
Corporate Income Tax
For the Fiscal Years 2011 through 2014

NOTICE: IC § 6-8.1-3-3.5 and IC § 4-22-7-7 require the publication of this document in the Indiana Register. This document provides the general public with information about the Department's official position concerning a specific set of facts and issues. This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register. The "Holding" section of this document is provided for the convenience of the reader and is not part of the analysis contained in this Letter of Findings.

HOLDING

Indiana Engineering Company failed to document that its activities in developing and producing molds, machine castings, and heat-treating processes constituted qualified research justifying Engineering Company's original claim to research expense tax credits; the Department rejected Engineering Company's reliance on employee interviews, projections, estimates, and statistical sampling.

ISSUE

I. Adjusted Gross Income Tax - Qualified Research Expense Projects.

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(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); *Union Carbine Corp. and Subsidiaries v. C.I.R.* 97 T.C.M. (CCH) (Tax Ct. 2009); *Conklin v. Town of Cambridge City*, 58 Ind. 130 (1877); *Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue*, 867 N.E.2d 289 (Ind. Tax Ct. 2007); *Indiana Dep't. of State Revenue, Sales Tax Division v. RCA Corp.*, 310 N.E.2d 96 (Ind. Ct. App. 1974); I.R.C. § 41(d); Treas. Reg. § 1.174-2(a); Treas. Reg. 1.41-2(d); Treas. Reg. § 1.41-4; Letter of Findings, 01-20181626; 01-20181627; 01-20181628 (August 26, 2020); Letter of Findings 01-20200017; 01-20200018; 01-20200019; 01-20200020; 01-20200021; 01-20200022; 01-20200023; 01-20200024; 01-20200025 (July 23, 2020); 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).

Taxpayer argues that the Department erred in disallowing research expense credits attributable to specific projects engaged in by the company.

STATEMENT OF FACTS

Taxpayer is an Indiana manufacturing company in the business of developing casting and milling processes, machine tooling, aluminum castings used in mold-making, and heat-treating processes for aluminum products. The company supplies its products to a variety of industries, including automotive, marine, industrial, and military.

The Indiana Department of Revenue ("Department") conducted an audit review of Taxpayer's corporate income tax returns. The audit noted that Taxpayer claimed approximately $521,000 in Indiana Research Expense Credits ("RECs") for fiscal years 2011, 2012, 2013, and 2014.

The Department's audit review resulted in the denial of the claimed RECs. Taxpayer disagreed with the decision denying the RECs and submitted a protest to that effect. An administrative hearing was conducted during which Taxpayer's representatives explained the basis for the protest. This Letter of Findings results.

I. Adjusted Gross Income Tax - Qualified Research Expense Projects.

DISCUSSION

The issue is whether Taxpayer has established that its design and engineering activities constitute "qualified research" entitling it to the originally claimed RECs.

A. Department's Audit Examination.

During the years 2011, 2012, 2013, and 2014, Taxpayer reported approximately $7,640,000 in qualifying research expenses ("QREs") and claimed approximately $521,000 in Indiana RECs for the four years at issue. The audit reviewed the basis for claiming the expenses to determine whether Taxpayer incurred the wage, supply, and contract expenses and whether it was entitled to the resulting Indiana RECs. These credits were originally calculated by an independent third-party consulting company ["Consultant] which completed an REC study for Taxpayer.

The audit report's explanation of adjustments notes Taxpayer's basis for claiming the credits:

> The [T]axpayer has claimed wages, cost of materials and contract expenses as QREs. The qualifying wage for each employee was calculated based on interviews with the [T]axpayer to determine an estimate of what percentage of time was spent performing qualifying activities.

The Department reviewed the Consultant's study which formed the basis for the claimed expenses and credits.

> The study began with an attempt to identify the possible research projects. The method used to identify the possible research projects began with a listing of all projects undertaken by the company. Due to the large number of projects, [Consultant] used a statistical sampling methodology that the study is in accordance with IRS revenue procedure [] to identify qualifying activity. The report states that this sampling methodology resulted in a random sample of various projects for further review to find qualified projects. The study states that key personnel were interviewed to determine which activities and projects qualified as research in accordance with IRC § 41.

Taxpayer's Consultant interviewed Taxpayer's controller, engineer, and vice president to determine the number of employees performing qualified services. The study indicated that its conclusions were prepared after reviewing "contemporaneous project documentation."

> [Consultant] identified qualified expenses through interviews. [W]ages for qualified services [were] calculated by multiplying the wages paid to the employee by the ratio of the time conducting qualified research activities over the time spent conducing all services for the [T]axpayer. The studies state that the [T]axpayer did not utilize a time tracking system to capture the costs of their employee wages.

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

> (A) with respect to which expenditures may be treated as specified research or experimental expenditures under section 174,
> (B) which is undertaken for the purpose of *discovering information* [also known as the Discovery Test];
> (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 [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).

1. Section 174 Business Deductions.

The Department's audit review considered whether the Taxpayer's met each of the four-part tests set out in I.R.C. § 41. In considering first the "business deduction" test, the Department's audit report cited to Treas. Reg. § 1.174-2(a) which states in part:

> Expenditures represent research and development costs in the experimental or laboratory sense if they are

> for activities intended to discover information that would eliminate uncertainty concerning the development or improvement of a product. Uncertainty exists if the information available to the taxpayer does not establish the capability or method for developing or improving the product or the appropriate design of the products.

The Department rejected Taxpayer's argument that it met the "business deduction" test as follows:

> [Taxpayer's] functions are the result of the application of common, commercially available proven and accepted manufacturing principles of the adaptive variations of the same through the use of the employees' experience and accumulated work site expertise. To the extent the [T]axpayer is doing simply what is required to be done in the normal practice of this industry, these costs are ordinary and necessary business expenses . . . . [Taxpayer must establish that it] has developed a new or improved method of fabrication, machining and 3D prototyping such that a process of experimentation is required to eliminate any uncertainties inherent in that new or improved method.

2. Discovering Technological Information.

As to the second of the four tests, the Department's audit did not agree that Taxpayer's 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 noted that Taxpayer has been in business for many years and has several long-time employees with education and experience in the manufacturing industry. The initial contract and production processes are not always a guarantee that the [T]axpayer will have a workable component and there is an element of risk. The [T]axpayer has uncertainty in the initial design methods being implemented. Based on the review, the [T]axpayer *is discovering information that is technological in nature*. The [T]axpayer is conducting a reasonable investigation of an unknown level of information that includes tool methods, design methods and improvements to production. These activities may not provide a workable outcome; therefore additional research and technical information may be needed which would be beyond the common knowledge of the skilled professional. (*Emphasis added*).

The Department's audit concluded that Taxpayer *met* the second, "discovering information," prong of the four-part test.

3. New or Improved Business Component.

As to the third of the four tests, the audit explained that every QRE expense claimant must "use the information in the development of a new or improved business component of the taxpayer." According to the audit report:

> The purpose of the activity or project must be to create new or improve existing functionality, performance, reliability, or quality of a business component. A business component is defined as any product, process, technique, invention, formula, or computer software that the taxpayer intends to hold for sale, lease, license, or actual use in the taxpayer's trade or business.

The audit pointed out "[T]axpayer considers the whole design/application of each project to the business component which is in connection with the [T]axpayer's trade or business." In other words, "[A]ctivities contributing to the development of a new or improved products are to be considered in isolation from those activities that may be on-going at the same time aimed at developing a new or improved manufacturing process, or the creation of a new or improved manufacturing tool."

Taxpayer's analysis was faulted because, by failing to undertake a separate analysis of activities related to processes, products, and components, Taxpayer ignored "one of the fundamental tenets of the definition of Qualified Research . . . ." By failing to perform that analysis, Taxpayer "made it impossible for the [D]epartment to verify that the required tests have been satisfied on a component by component basis."

The Consultant's study "did not list the time spent on projects, did not list any of the activities performed by each employee on each product, did not list activities direct, indirect or otherwise [] required by Treas. § 1.41-2, nor did it list a wage allocation for each employee . . ." Although, Taxpayer provided employee job record cards and information on project duties of a number of its engineers, "[T]axpayer did not utilize a project accounting system and could not supply each employee's research wages by research project for all other research expenses outside of the job record cards." As a result, "[T]axpayer could not substantiate the qualified research expenses to the relevant business, as required by the Treasury Regulations." This conclusion resulted in a partial denial of unsupported wages expenses under the third test.

4. 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 Department's audit agreed that, in part, Taxpayer engaged in a process of experimentation.

However, Taxpayer did not "utilize a project accounting system and could not support 'all' viable experimentation methods," the Department's audit could not substantiate that all of the Taxpayer's projects met the "process of experimentation" standard.

As a result, the audit imposed "a partial denial of unsupported expenses for the fourth test."

B. Documenting and Substantiating Taxpayer's Claim to the Credits.

As noted above, the Department agreed that Taxpayer was entitled to claim the credit but not the entire amount originally claimed. The audit reduced the originally claimed credits "to the total of the records supplied which included the job records for engineers (time tracking cards) and material expenses." The audit concluded that the time tracking cards "support[ed] time utilized by the engineers per sample project and supported a portion of the qualifying expenses."

The audit reduced the amount of QREs originally claimed. "The audit concluded that "25 out of 35 [projects] were qualified research and percentages were applied to both the labor and the material based on the limited information supplied."

The audit concluded that "[r]egardless of the approved QREs per audit, the adjusted expenses were still under the base percentage calculation and therefore are being denied." In other words, Taxpayer's approved QREs were not enough to meet "increasing research expenses" threshold.

This result is largely attributable to the Taxpayer's purported inability to document a portion of the originally claimed QREs.

The audit found that Taxpayer failed to meet the documentation and substantiation standard under Treas. Reg. § 1.41-4(d) (T.D. 8930). The regulation 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*).

The audit report also pointed out to Indiana's own 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 audit report summarized the standard under which it evaluated Taxpayer's efforts to verify the labor expenses stating that "[t]he common theme in all of the legal authorities . . . is that the [T]axpayer must keep records to substantiate the amounts reported on its returns" and Taxpayer "must have contemporaneous documentation that was prepared before or in the early stages of the research project that describes the principal questions to be answered and the information the [T]axpayer seeks to obtain."

Under any of these standards, the audit found that "[T]axpayer has not provided this contemporaneous documentation . . . to support the employee research participating percentages that it used to calculate the qualified research expenses." As stated in the audit report's conclusion, "Overall the [T]axpayer did not utilize a project accounting system that provided sufficient detail that could be used to determine the appropriate REC on a per project basis.

C. Taxpayer's Response to the Audit Results.

1. Documentation Standard.

Taxpayer argues that the Department erred in requiring the documentation it did. According to Taxpayer, "[T]he Department is barred from demanding specific documents, and disallowing due to their lack of production including [] where the audit demands documents of 'time actually spent' on qualified research activity." According to Taxpayer "tracking eligible expenditures may necessitate taxpayers preparing and keeping records unlikely to be prepared or kept for other business purposes."

Taxpayer objects to the audit's disallowance of the additional credits on the ground Taxpayer "lacked a project accounting system that provided sufficient detail that could be used to determine the appropriate REC on a per project basis."

Instead, according to Taxpayer, "the relevant case law allows Taxpayer to make reasonable, good faith estimates in order to supplement existing documentation from the relevant tax years." Taxpayer concludes that given a "reasonable basis" for its claim, "[T]he use of estimates . . . is an acceptable method of determining QREs for [Taxpayer's] employee wages."

Taxpayer further explains that "there is no legal requirement to tie expenses to projects, nor is there a specific type of record that must be maintained." Instead - according to Taxpayer - "the legislative history and the relevant case law allows the Taxpayer to make reasonable, good faith estimates in order to supplement existing documentation from the relevant tax years."

Taxpayer concludes that "the use of estimates grounded on a reasonable basis is an acceptable method of determining QREs for [Taxpayer's] employee wages."

2. The Credit's Regulatory Regime.

Taxpayer objects to the audit's reliance on the "Discovery" test, found at Treas. Reg. § 1.41-4(a)(3)(i) (TD 8903), on the ground that the rule was abolished and that Taxpayer was entitled to rely on the less restrictive test found at Treas. Reg. § 1.41-4(a)(3) (TD 9104). Treas. Reg. § 1.41-4(a)(3)(i) (TD 8903)'s discovery, test provides in part as follows:

> 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*).

D. Burden of Proof, Analysis, and Conclusion.

1. Proving that Taxpayer Is Entitled to the Credits.

Taxpayer has the burden of establishing that the audit assessments were wrong.

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 tax 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.

The Department's audit report noted that I.R.C. § 41(d) - outside of a few minor additions - is essentially the same as it was when it was promulgated in January 2001. However, the audit also noted that the regulations governing the definition of "qualified research" have changed although "[t]he only regulations that were promulgated and in effect at the time the statute was implemented were published in Treasury Decision 8930 (TD 8930). In effect, the Department adopted I.R.C. § 41(d) and the then applicable regulations. The audit report noted that TD 9104 "was promulgated and published as a proposed regulation in December 2001 and was published as a final regulation in December of 2003 with an effective date of January 2, 2004." As such, the regulation post-dated Indiana's adoption of IC § 6-3.1-4-4 with TD 8930 as "the only set of regulations that were promulgated and in effect on January 1, 2001." The audit concluded that Taxpayer was required to meet the "discovering information" and "common knowledge" criteria under TD 8930.

As a result, the Department rejects Taxpayer's argument that TD 8930 was not the governing regulatory scheme relevant to the years at issue. According to Taxpayer, it qualified for the RECs in the amount as claimed and, if its activities were analyzed under the proper standards, Taxpayer would have been found entitled to those credits. Taxpayer believes that because 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 01-20200017; 01-20200018; 01-20200019; 01-20200020; 01-20200021; 01-20200022; 01-20200023; 01-20200024; 01-20200025 (July 23, 2020), 20200930-IR-045200479NRA; 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") for the 2011 through 2014 years here at issue. 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*).

However, the audit also noted that even under TD 9104, Taxpayer's core argument failed because "[T]axpayer did not utilize a time tracking system to capture the cost of [Taxpayer's] employee wages" which is in direct conflict with Treas. Reg. 1.41-2(d) (TD 9104) which requires:

> [T]he 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 *actually spent* by the employee in the performance of qualified services for the for the taxpayer to the total time spent by the employee in the performance of all services for the taxpayer during the taxable year. (*Emphasis added*).

Taxpayer did not utilize time "actually spent" as the basis for calculating qualifying wages; instead, Taxpayer relied on employee interviews to reconstruct records it did not maintain or retain.

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 and sets out a 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 "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 Taxpayer, it is "a premier pattern and engineering firm that utilizes innovative technology to produce products for customers in a variety of different industries and maintain[s] an effective quality management system."

Taxpayer states that it "utilizes computer software to design and develop a variety of components . . . [and] produces a variety of pattern equipment through alternative casting and milling processes." In addition, Taxpayer "designs and develops high-quality aluminum casting for use in sand, semi-permanent, and permanent molds." Finally, Taxpayer states it "develops innovative heat-treating processes for aluminum products."

Taxpayer emphasizes the sophistication and precision involved in the development and production of these items. However, Taxpayer can point to nothing it does to discover and develop a "new or improved business component" incorporated into or necessary to the production of the business's products. Not minimizing in any degree the sophistication of the products, Taxpayer pointed to nothing which advances upon or adds to the common knowledge of other similar lines of business. Moreover, Taxpayer has not established that its business 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).

Taxpayer's development of machine milling and metal casting - even if it did lead to the "discovery" of new products - did 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.")

The Department is unable to agree that Taxpayer has met its statutory burden under IC § 6-8.1-5-1(c) of establishing that its activities to develop or improve its products constituted "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.

Setting aside issues related to whether Taxpayer was engaged in qualified research beyond that which the audit recognized, Taxpayer disagrees with the audit's finding that it failed to adequately document its employees' specific activities and wages attributable to those projects. Taxpayer does not argue that they maintained a system of project accounting in order to accurately quantify the research expenses. Instead, Taxpayer relies on employee surveys, job titles, wage statements, and project descriptions in concluding that the Taxpayer paid its employees approximately $7.64 million dollars to conduct experimentation on components eventually incorporated into or made part of the Taxpayer's products.

While the Department recognizes Taxpayer's apparent good-faith efforts to estimate the qualifying wages of their employees, the Department rejects Taxpayer's 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. As noted above, the regulation requires that a claimant must "[p]repare[] 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 . . . ." (*Emphasis*).

Again, as noted above, Indiana imposes its own record keeping requirement at IC § 6-8.1-5-4(a). The statute requires that each taxpayer "must keep books and records so that the department can determine the amount, if any, of the person's liability for that tax . . ." and requires that the taxpayer keep and maintain "all source documents necessary to determine the tax . . . ."

The Department rejects Taxpayer's argument that it is sufficient to verify its claim to the credit by "the use of estimates grounded on a reasonable basis." The Department finds that the argument grossly oversimplifies the relevant regulatory requirement and statutory requirements. Instead, 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 speaks in general to the issue of the standard 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 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, Taxpayer asks that the Department broadly interpret the REC record keeping requirements to encompass - as stated in the audit report - "estimated qualified percentage allocations." What Taxpayer here seeks is a form of "summary judgment" in which the Department administratively overturns the audit's finding that the Taxpayer did not provide records to substantiate the amounts of the credits reported on its returns and did not provide contemporaneous documentation to support the employee research participation percentages that Taxpayer used to calculate the qualified research expenses. Although the audit and Department may intuitively

agree that Taxpayer very likely conducted qualifying research, the Department is unable to agree that there is sufficient quantifiable and verifiable information to allow the credits in the amount originally requested and as here protested.

In a Letter of Findings, 01-20181626; 01-20181627; 01-20181628 (August 26, 2020) recently issued, the Department found that a manufacturer of electric power modules and generator enclosures met its burden of establishing that it engaged in qualifying research activities in the development and construction of individual *components*. Moreover, the Department found that the petitioner was entitled to the credit because it had presented its employees' contemporaneously prepared timesheets delineating the extent to which research was conducted on individual components. As explained in the LOF sustaining the petitioner's argument:

> Taxpayer is being sustained because Taxpayer established that it was conducting a methodical, systematic, experimental process by which it developed individual business *components* and, in the process of doing so, expanded the common knowledge of information related to those components. (*Emphasis added*).

The petitioner was sustained because it provided "contemporaneous" documentation prepared at the "early stage of the research project" tracking the qualifying time each employee spent on each component project.

However, the Department was careful to point out why the petitioner in that case was not being sustained. In part, the August 2020 LOF stated:

> • Taxpayer is *not* being sustained, either in whole or in part, because it builds complicated and difficult to construct electrical devices;
> • Taxpayer is *not* being sustained, either in whole or in part, because it has finicky and difficult customers who demand products suited to their particular needs;
> • Taxpayer is *not* being sustained, either in whole or in part, because it faced "uncertainties" in the design and construction of its products;
> • Taxpayer is *not* being sustained, either in whole or in part, because its employees recalled incidents in which they engaged in qualifying activities and were able to tick off the boxes on a survey questionnaire;
> • Taxpayer is *not* being sustained, either in whole or in part, because it repeatedly "explored alternatives" in developing and building its customers' products;
> • Taxpayer is *not* being sustained, either in whole or in part, because it engaged in a simple "process of bare-bones 'trial and error.'"

(*Emphasis in original*).

On the question of documentation, the August LOF rejected the proposition that any taxpayer was entitled to claim RECs based on an "employee research and experimentation time allocation questionnaire."

> The Department finds that it is insufficient for a claimant to depend on documentation based solely on interviews with and the recollection of its key personnel, because the assertion oversimplifies the federal and Indiana regulatory requirements.

Further, the Department rejected the similar proposition that it would allow credits based on what the LOF labeled the "take our word for it" standard.

> [T]he Department is asked to allow credits on what is essentially a "take our word for it" (TOWFIT) standard, and although the Department does not question the good faith and veracity of claimants, it does find the TOWFIT standard on which a claimant may rely unworkable, unverifiable, and inconsistent with both the law and common sense. Simply put, Department finds that reliance on the TOWFIT standard is wholly at odds with the Indiana case law which requires that a taxpayer's claim to income tax credits must be established with "sufficient evidence" which is "clearly within the exact letter of the law." *RCA Corp.*, 310 N.E.2d at 100-01.

The audit agreed that Taxpayer conducted qualified research and spent good money to do so. Did Taxpayer narrowly define its additional activities which lead to the development of individual components which are themselves the results of a "methodical, systematic, experimental process" of experimentation? Did Taxpayer keep and retain contemporaneous documentation of those qualifying activities which clearly and plainly established that it was entitled to the $521,000 in credits originally claimed? As to the last two questions, the Department is unable to agree with Taxpayer that it did so and did so within the "exact letter of the law." *Id.*

FINDING

Taxpayer's protest is respectfully denied.

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