DEPARTMENT OF STATE REVENUE

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Letter of Findings: 01-20200433; 01-20200434; 01-20200435
Individual Income Tax
For the Years 2014 through 2017

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 This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register.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 rejected Indiana Machining and Milling Company's argument that it was entitled to claim research expense credits; Machining and Milling Company's reliance on employee interviews, estimates, and statistical sampling did not clearly establish it was entitled to the credits.

ISSUE

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

Authority: IC § 6-3.1-4-1; IC § 6-8.1-5-1; IC § 6-8.1-5-4; *IDOPCP, Inc. v. Comm'r*, 503 U.S. 79 (1992); *New Colonial Ice Co. v. Helvering*, 292 US. 435 (1934); *United States v. McFerrin*, 570 F.3d 672 (5th Cir. 2009); *Stinson Estate v. United States*, 214 F.3d 846 (7th Cir. 2000); *Conklin v. Town of Cambridge City*, 58 Ind. 130 (1877); *Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue*, 867 N.E.2d 289 (Ind. Tax Ct. 2007); *Indiana Dep't. of State Revenue, Sales Tax Division v. RCA Corp.*, 310 N.E.2d 96 (Ind. Ct. App. 1974); I.R.C. § 41(d); Treas. Reg. § 1.174-2; Treas. Reg. § 1.41-4; Treas. Reg. § 1.6001-1(a).

Taxpayer argues that it conducted qualified, experimental research activities, that it can adequately document the wage expenses related to those projects, and that it is therefore entitled to claim the benefit of credits associated with the qualifying activities.

STATEMENT OF FACTS

Taxpayers are individual shareholders/owners of an Indiana company which specializes in precision, computer-controlled milling, and machining. The company's customers include the U.S. military, firearm manufacturers, and aerospace industries.

For simplicity's sake, this Letter of Findings will hereinafter designate the Indiana company as "Taxpayer" because Indiana company is an S corporation which originally claimed the now disputed credits. Any business income - or tax liability - was "passed through" to the individual shareholders. It is those "pass-through" tax credits that are here in dispute.

Taxpayer originally filed 2014, 2015, and 2016 corporate income tax returns claiming no Indiana tax credits. However, along with their 2017 return Taxpayer amended the earlier returns to claim the credits.

In 2018, Taxpayer engaged a consulting firm ("Consultant") to review its 2014, 2015, 2016, and 2017 business activities and prepare a "research and expense study." In a research credit study report issued in 2018, the Consultant concluded that Taxpayer conducted qualified research activities entitling it to claim Indiana labor, supply, and service research expense tax credits which in turn passed on to the shareholders and reduced their own income tax liability.

The shareholders reported and claimed the "flow-through" credits on their individual income tax returns. Taxpayer claimed that it incurred approximately $2,000,000 in qualified research expenses entitling it to claim approximately $100,000 in research and expense credits for the years 2014 through 2017.

The Indiana Department of Revenue ("Department") thereafter conducted an income tax audit of Taxpayer. The

Department's audit reviewed Taxpayer's tax returns, business records, and manufacturing records. The audit resulted in a decision denying Taxpayer's originally claimed research credits along with the credits which had "flowed through" and been claimed on the shareholders' individual income tax returns. On the ground that they were not entitled to the flow-through credits, the Department assessed the individual shareholders additional individual income tax because Taxpayer had not established it was entitled to claim the original credits.

Taxpayer disagreed with the Department's decision disallowing the credits and the shareholders' assessments. Taxpayer 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. Individual Adjusted Gross Income Tax - Qualified Research Expense Projects and Documentation.

DISCUSSION

The Department issued the proposed assessments because it concluded that Taxpayer's activities did not meet the definition of "qualified research." The audit also concluded that Taxpayer was unable to verify the amount of time during which Taxpayer's employees were purportedly engaged in activities which met the definition of "qualified research." As a result of the credit denial, the Department issued the shareholders proposed assessments of additional income tax.

The issues are whether Taxpayer conducted qualifying research activities and whether it can document the extent to which Taxpayer conducted those qualifying activities.

A. Department's Audit Examination.

1. Qualifying Research Projects.

During the years 2014 through 2017, Taxpayer claimed approximately $2,000,000 in qualifying research expenses ("QREs") entitling it to approximately $100,000 in Indiana Research Expense Tax Credits ("RECs"). The "qualifying expenses" stemmed entirely from wage expenses.

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:

> 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 Deduction.

The audit found that Taxpayer's expenditures did not meet the first test - verifying qualified research and experimental expenditures - based on the definition set out in Treas. Reg. § 1.174-2 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 audit found that Taxpayer "did not track any research and development expenses and the auditor was unable to verify the amount claimed on the returns . . . ." In addition, the audit found that Taxpayer had categorized these

same expenses as either wages or cost of labor under I.R.C. § 174 on its corresponding federal returns.

The audit concluded that the expenses "were directly charged to the jobs being completed by the taxpayer as ordinary and necessary business expenses under section 162 . . . ."

> Since the taxpayer did not track or report these expenses as research and development expense and [because] the auditors were unable to verify the amount claimed on the returns for the research credit based upon the limited and incomplete information the taxpayer provided, the amount of expenses that qualify under the Section 174 test could not be determined.

(b) 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 milling and machining companies. 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 also cited to Treas. Reg. 1.41-4(a)(3) (T.D. 9104) and rejected Taxpayer's contention that it was conducting qualified research necessary to resolve "uncertainties." As stated in the audit report:

> Based on Treas. Reg. 1.41-4(a)(3), the taxpayer must be discovering information to eliminate uncertainty and that uncertainty exists only if the information available to the taxpayer does not establish the capability or method for developing or improving the business component or the appropriate design of the business component. . . . Even though the taxpayer may not know every detail of the final design . . . both the customer and taxpayer [have] the education/experience to prepare the appropriate design based on the customer's requirements.

The audit noted that Taxpayer had been in the business of machining and milling metal parts for over 50 years and "has several long-time employees with education and experience in the design and programming of the CNC [Computer Numerical Control] machines."

The audit concluded that the claimed expenses did not qualify for the credits because Taxpayer was "not discovering information that is technological in nature" but was simply conducting a reasonable and well-trodden investigatory process of an existing level of information familiar to its long-time employees. As to the second test, the audit concluded that "taxpayer is not discovering information that is technological in nature."

> [T]axpayer is conducting a reasonable investigation of the existing level of information on customer requirements, blueprints, type of metal, tempering, and which metal holder to use on the machines.

. . . .

> Even though the taxpayer may not know every detail of the final design when the taxpayer first signs the contracts with the customer, both the customer and the taxpayer know that taxpayer has the education/experience to prepare the appropriate design based on the customer's requirements when they enter into the contract. Military, firearms, and aeronautics companies are not going to do business with companies that do not have the required skill experience and know-how to execute their contracts. These are all high-risk industries with a high liability factor with no room for errors.

As noted in the audit report, "[D]uring the plant tour the taxpayer told the auditors that they would not take a job that they did not know they could do."

(c) New or Improved Business Component.

As to the third of the four tests, the audit report explained that every QRE expense claimant must "tie the qualified research expenses it is claiming for the credit to the relevant business component." The audit found that Taxpayer failed to adequately "tie" the labor expenses to any of its projects.

Under the Business Component Test, the taxpayer must intend that the information to be discovered during its research will be useful in the development of a new or improved business component of the taxpayer. I.R.C. § 41(d)(1)(B)(ii). A "business component" is a product that the taxpayer either holds for sale, lease, or license or uses in its trade or business. I.R.C. § 41(d)(2)(B). For purposes of this test, the taxpayer must identify the business components for which it claims qualified research activities.

When questioned about the "component" standard, the audit found that Taxpayer was able to cite to the consulting firm's "research and expense study," but the audit criticized this singular reliance because the study itself "could not tie any of the employees' activities or the majority of the time to a specific project (business component)." According to the audit report, "The [Consultant] estimated the time spent by the majority of the employees doing research based on interviews conducted with the Vice President of Manufacturing and the Vice President of Marketing and Sales."

As to the third test, the audit concluded that because it was unable to "tie" any particular component to the activities of any specific employee, "[T]he taxpayer's activities fail the third test [because] the information must be intended to develop a new or improved business component."

(d) Undertaking a Process of Experimentation.

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

> 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 also cited to Treas. Reg. 1.41-4(a)(5)(a) (T.D. 9104) which provides in part:

> A process of experimentation must fundamentally rely on the principles of the physical or biological sciences, engineering, or computer science and involves the identification of uncertainty concerning the development or improvement of a business component, the identification of one or more alternatives intended to eliminate that uncertainty, and the identification and the conduct of a process of evaluating the alternatives (through, for example, modeling, simulation, or systematic trial and error methodology). A process of experimentation must be an evaluative process and generally should be capable of evaluating more than one alternative.

The audit found that Taxpayer failed to meet the "experimentation" standard under either the "discovery" or "uncertainty" tests. As stated in the audit report, "[T]axpayer's capability and method for developing or improving the business component are very certain." Rather, "[T]axpayer has been in the business for many years and has several employees with education/experience to do the job." The audit report further explained:

> Even though the [T]axpayer may not know every detail of the final design when it signs the contracts with the customer, both the customer and the [T]axpayer know that the [T]axpayer has the education/experience to prepare the appropriate design based on the customer's requirements and the environment where the product is to be placed/installed.

The audit concluded that under Treas. Reg. § 1.41-4(a)(5) (T.D. 8930), Taxpayer 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 are 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." The audit concluded that Taxpayer also failed to meet this less restrictive uncertainty test. The audit report stated:

> [U]ncertainty concerning the development or improvement of the business component . . . does not establish that all activities undertaken to achieve that new or improved business component constitute a process of experimentation. [M]erely demonstrating that uncertainty has been eliminated . . . is insufficient to satisfy the process of experimentation requirement.

In other words, even under Treas. Reg. § 1.41-4(a)(5) (T.D. 9104), any "uncertainty" at the outset of a Taxpayer project was insufficient to meet the experimentation standard. In doing so, the audit cited to the preamble of Treas. Reg. 1.41-4 (T.D. 9104) which provides that "merely demonstrating that uncertainty has been eliminated (e.g., the achievement of the appropriate design of a business component when such a design was uncertain as of the beginning of a taxpayer's activities) is insufficient to satisfy the process of experimentation requirement."

2. Documenting and Substantiating the Credit.

Even assuming that Taxpayer established that it was engaged in qualifying research activities, the Department's audit found that Taxpayer failed to adequately document the time and labor expenses which formed the basis for the claimed research credits. Most relevant, the audit found that Taxpayer failed to meet the documentation and substantiation standard under Treas. Reg. § 1.41-4(d) (T.D. 9104). The regulation sets out record keeping and documentation requirement for expenses related to the research credit:

> A taxpayer claiming a credit under section 41 must retain records in sufficient usable form and detail to substantiate that the expenditures are eligible for the credit. For the rules governing record retention, see section 1.6001-1.

The audit also cited to Treas. Reg. § 1.41-4(d) which 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.

In turn, Treas. Reg. § 1.6001-1(a) - referred to above - 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.

The audit report also pointed out 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 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 either of these standards, the audit concluded that "[T]axpayer has not provided . . . contemporaneous documentation . . . to support the employee research participating percentages that it used to calculate the qualified research expenses (QREs)."

B. Taxpayer's Response.

1. Qualifying Research Projects.

Taxpayer disagrees with the Department's conclusion that it does not engage in qualifying research activities. Instead, it is Taxpayer's contention that its "business components were all unique and required independent analysis to develop the appropriate design of same." In support of this contention, Taxpayer cites to numerous projects which it undertook during the relevant period. For example, Taxpayer points to the development of a "stand-alone depression stop" for one its customers.

> This required [Taxpayer] to design parts and fabricate fixtures according to the client's unique dimensional specifications. From the outset of this project [Taxpayer] encountered several uncertainties stemming from an appropriate design for an assembly that fit each of [the] unique fixtures according to specified dimensions. This uncertainty at the outset, then led to other uncertainties related to welding throughout the design and development phases of this project. . . . Taxpayer utilized trial and error to determine the tooling and machinery required to fabricate each fixture to test how each component could be fitted into each hole.

Taxpayer also points to a project which required it to "produce a belt bracket for the [a customer] . . . made from 4101 alloy steel."

> From the start of the project, Taxpayer encountered several uncertainties, including its capability to produce the part and the method to machine the metal to hard material to achieve specifications. To overcome these technical uncertainties, [Taxpayer] evaluated different machines to use to create the bracket. As the piece contained several holes and angles that complicated the machining process, Taxpayer selected a five-axis CNC milling machine. [Taxpayer] also evaluated several different setups and positions to mill the bracket. After completing the process and producing the belt bracket, [Taxpayer] submitted the piece to the DOD [Department of Defense] for inspection. [Taxpayer] relied on the principles of engineering and material science to resolve the uncertainties. For example, Taxpayer relied on the principles of engineering when they determined that a 5-axis machine was necessary to machine the belt bracket.

As a third example of a milling project that required the expenditure of qualified research expenses, Taxpayer points to a project that required it to develop the manufacturing process for an "aviation aerospace project."

> Taxpayer set out to develop the appropriate process of fabricating this piece to meet requirements. At the outset and throughout the duration of the project, [Taxpayer] encountered technological uncertainties. These include, but were not limited to . . . . [t]he appropriate method of manufacturing the part to the corrected dimensions; the appropriate design of the machining tolerances; and the appropriate material to meet requirements. To overcome the aforementioned uncertainties, [Taxpayer] undertook a process of experimentation to iteratively design the [] aviation part. Specifically, Taxpayer conducted a systematic trial and error process to design, engineer, and fabricate the unique part to meet functional and performance specifications.

Taxpayer concludes that it engages in an "interative" process of "trial and error" during the development and implementation of each of its projects which satisfies each of the four distinct tests set out in I.R.C. § 41(d)(1). Taxpayer summarizes as follows:

> Taxpayer's development activities relied on principles of engineering and physics in the design and development of customer fixtures and parts while developing or improving manufacturing processes . . . . Taxpayer utilized physics in [the] design of experiments to conduct hardness and temperature tests to determine durability . . . . Taxpayer relied on principles of mechanical engineering to ensure the final designed product met project requirements.

In effect, Taxpayer finds it unnecessary to tie its expenses to any particular business component because it regards its entire design and manufacturing process, from inception to execution, as the requisite component.

The Department finds it unnecessary to evaluate whether Taxpayer's projects meet each of the I.R.C. § 41(d)(1) four distinct tests concluding that, in this regard, the audit report stands on its own and because the disputed credit issues are resolved by addressing the documentation issue. Without minimizing Taxpayer's obvious experience, sophistication, and history and without conceding Taxpayer's arguments as to whether these projects constitute "qualified research," this Letter of Findings addresses the documentation issue.

2. Wage Expense Documentation.

At the core of Taxpayer's argument, Taxpayer concludes that "Indiana law does not require taxpayers to substantiate with written documentation." Nonetheless, Taxpayer argues that it has provided over four hundred pages of supporting documentation including project summary reports, financial documents, design drawings, "travelers," and contracts sufficient to supports its claims to the credits. Taxpayer explains:

> Taxpayer hosted a site visit at their facilities for the Examiner. In that site visit Taxpayer demonstrated to the Examiner the breadth of additional documentation it maintains for each project and duration of each project by navigating through its file folders and email correspondence . . . . [Taxpayer] highlighted its engineering, manufacturing, and quality departments, and walked the Examiner through the iterative and technically demanding process by which Taxpayer develops each [of] its business components.

Specifically, Taxpayer cites to IC § 6-8.1-5-1(b) which provides:

> **If the department reasonably believes that a person has not reported the proper amount of tax due,** the department shall make a proposed assessment of the amount of the unpaid tax **on the basis of the best information available. (Taxpayer's Emphasis).**

Taxpayer believes that the four hundred pages of documents provided constitute the "best information available" and that the Department is not only entitled but is required to rely on that information. As explained by Taxpayer, "Indiana does not require substantiation by documentation [and] that documentation is not necessary to prove a taxpayer engaged in a particular activity in the tax years at issue."

C. Burden of Proof and Analysis.

1. Proving that Taxpayer is Entitled to the Credit.

Tax assessments are *prima facie* evidence that the Department's assessment of tax is presumed correct; the taxpayer bears the burden of proving that the assessment is incorrect. IC § 6-8.1-5-1(c); *Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue*, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007).

IC § 6-3.1-4-1 provides that, "'Research expense tax credit' means a credit provided under this chapter against any tax otherwise due and payable under IC 6-3." Similar to deductions, exemptions, and exclusions, tax credits - such as RECs - "are matters of legislative grace." *Stinson Estate v. United States*, 214 F.3d 846, 848 (7th Cir. 2000).

The taxpayer who claims the tax credit is required to retain records necessary to substantiate a claimed credit. 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.")

2. Taxpayer's REC Study, the Documentation Underlying that Study, and the Basis for the Study's Conclusions.

The Consultant's study relied on a sampling of hundreds of Taxpayer's projects. In the face of the large number of Taxpayer's projects, the Consultant employed a "sampling methodology" prepared by a degreed statistician who selected 24 projects which were "independently analyzed through a review of contemporaneous documentation, in connection with employee interviews, to identify the qualified R&D activity undertaken in each project." To that end, the Consultant interviewed employees and also members of its executive team including the Vice President of Marketing, the Vice President of Marketing and Sales, and the President. Wage allocations were determined on

a "project based" analysis. To determine which employees worked on which project, the study relied on the executive-level interviews. Based on those interviews, the Consultant attributed a percentage of each individual employee's qualified activities compared to that particular employee's total wages. In instances in an employee's research activities passed the 80 percent threshold, the claimed qualifying wages were changed to 100 percent based on the "substantially all rule." *See* I.R.C. § 41(d)(1)(C), -3(A).

As noted above, the audit found this methodology deficient. As explained in the resulting audit report:

> The documentation provided failed to demonstrate nexus between the wages and the projects claimed. The [T]axpayer cannot link specific employees to projects or to the parts of the projects on which they are claiming research activities. The only record of time tracking was for the Vice President of Sales and one quoter/estimator. They only track the quoter/estimator on one project and the Vice President of sales on eleven projects occurring in 2011 through 2019. . . . There was no record kept for any of the other employees.

In addition, the audit noted that qualifying wages included costs attributed to paid employee leave time.

3. Analysis and Conclusions.

Setting aside issues related to whether Taxpayer was engaged in qualified research, 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 it 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 $2,000,000 million to research and develop methodologies necessary to satisfy their customers' requirements.

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 added).*

Treas. Reg. § 1.41-4(d) (T.D. 9104) restates the record keeping requirements as follows:

> Recordkeeping for the research credit. 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 *(Emphasis added).*

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 may substantiate and claim the credits "when taxpayers have no documentation of expenses at all." The Department finds that the argument grossly oversimplifies the relevant regulatory requirement and statutory requirements. Instead, it is Taxpayer's statutory obligation to prepare, keep, retain, 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) and Treas. Reg. § 1.41-4(d) (TD 9104). Under either version, the regulation requires that "any 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." Treas. Reg. 6002-1.

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" and "retained" "before or during the early stages of the research project."

The Department rejects Taxpayer's argument that the issue is governed by the "best available information" language found in IC § 6-8.1-5-1(b) because the premise turns the statute on its head. In cases in which the Department audits or reviews a taxpayer's return, the Department is *required* to issue an assessment. If the taxpayer's documentation is either insufficient or non-existent, the Department is entitled to rely on whatever information it can gather provided that it is the "best" information obtainable. In instances in which a taxpayer is claiming a credit, that taxpayer is required to document that credit by evidence which is with the exact letter of law. *RCA Corp.*, 310 N.E.2d at 100-01.

In this case, Taxpayer asks that the Department broadly interpret the REC record keeping requirements to encompass - as explained in the audit report - estimated wage allocations for employees who dedicated their time to develop support or supervise the development of new and improved designs and manufacturing methods. 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 clearly substantiate the amounts of 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. Even if the Department were to agree - and it did not - that Taxpayer 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.

The Department concludes that Taxpayer has not met the record keeping requirements set out in Treas. Reg. § 1.41-4(d) (TD 8930), Treas. Reg. § 1.41-4(d) (TD 9104), Treas. Reg. 6001-1, and IC § 6-8.1-5-4(a).

The Department is unable to agree that Taxpayer presented documentation of qualifying activities which clearly and plainly established that it was entitled to the $100,000 in credits originally claimed. The Department is also unable to agree that Taxpayer meet its burden under IC § 6-8.1-5-1(c) of establishing that the assessments were "wrong" and its claim to income tax credits was established with "sufficient evidence" which was "clearly within the exact letter of the law." *RCA Corp*., 310 N.E.2d at 100-01.

FINDING

Taxpayer's protest is respectfully denied.

February 26, 2021

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