DEPARTMENT OF STATE REVENUE

02-20200272.LOF

Letter of Findings: 02-20200272
Income Tax
for the Years 2015 and 2016

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 This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register.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

HOLDING

Indiana Business failed to demonstrate that it was entitled to additional Indiana Research Expense Credits.

ISSUE

I. Corporate Income Tax - Burden of Proof.

Authority: I.R.C. § 41; IC § 6-3-2-1; IC § 6-3-1-3.5; IC § 6-3.1-4-1; IC § 6-3.1-4-4; IC § 6-8.1-5-1; IC § 6-8.1-5-4; *Indiana Dep't of State Revenue v. Rent-A-Center East, Inc.*, 963 N.E.2d 463 (Ind. 2012); *Dep't of State Revenue v. Caterpillar, Inc.*, 15 N.E.3d 579 (Ind. 2014); *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); *Suder v. Comm'r,* T.C. Memo. 2014-201 (T.C. 2014); *United States v. McFerrin*, 570 F.3d 672 (5th Cir. 2009); *Stinson Estate v. United States*, 214 F.3d 846 (7th Cir. 2000); *Indiana Dep't. of State Revenue, Sales Tax Division v. RCA Corp.*, 310 N.E.2d 96 (Ind. Ct. App. 1974); *Research, Inc. v. United States*, 1995 WL 560140 (D. Minn. 1995); Treas. Reg. § 1.41-4; Treas. Reg. § 1.41-9; Treas. Reg. § 1.6001-1; IRS, *Audit Technique Guide*, 2005 WL 4057831 (June 2005).

Indiana company argued that it was entitled to additional Indiana research expense credits, which in turn reduced its 2015 and 2016 tax liabilities.

STATEMENT OF FACTS

Taxpayer is an Indiana manufacturer. Taxpayer files Indiana corporate income tax returns reporting its Indiana income tax due. On its 2015 and 2016 returns, Taxpayer claimed Indiana Research Expense Credits ("RECs") based on a study prepared by an out-of-state consulting firm.

In 2019, The Indiana Department of Revenue ("Department") audited Taxpayer's business records and tax returns for the tax years 2015 and 2016 ("Tax Years at Issue"). Pursuant to the audit, the Department disallowed a portion of Taxpayer's RECs.

Taxpayer protested. An administrative hearing was conducted during which Taxpayer's representatives explained the basis for the protest. This Letter of Findings results. Further facts will be provided, as necessary.

I. Corporate Income Tax - Burden of Proof.

DISCUSSION

Pursuant to the audit, the Department disallowed a portion of Taxpayer's claimed RECs for the Tax Years at Issue. Taxpayer disagreed, claiming that it was entitled to not only the portion allowed by the audit, but also to additional RECs it had claimed but which were disallowed by the audit. The issue is whether Taxpayer provided sufficient documents to substantiate that it was entitled to additional RECs.

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). 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).

Indiana follows the federal tax system 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. One of the tax credits available for the Tax Years at Issue under Indiana tax law is the RECs under IC § 6-3.1-4-1 *et seq*. IC § 6-3.1-4-4 (2015) states:

> 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. *See also* IC § 6-3.1-4-4 (2016).

I.R.C. § 41(d)(1) defines "qualified research" as:

> (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--
> (i) which is technological in nature, and
> (ii) the application of which is intended to be useful in the development of a new or improved business component of the taxpayer, and
> (C) substantially all of the activities of which constitute elements of a process of experimentation for a purpose described in paragraph (3).
>
> Such term does not include any activity described in paragraph (4).

In other words, under I.R.C. § 41(d)(1), "qualified research" is research that meets the above distinct tests and cannot be activities outlined under I.R.C. § 41(d)(4)(A) through (H). Each of the above tests must be applied separately first at the level of the discrete business component. If a business component as a whole fails, one of the tests, the "shrinking-back rule" could be applied pursuant to Treas. Reg. § 1.41-4(b)(2). Only when the above requirements are satisfied, may expenses such as in-house research expenses and contract research expenses be considered as qualified research expenses. I.R.C. § 41(b)(2) and (3).

The in-house research expenses may include "supplies," which "means any tangible property other than (i) land or improvements to land, and (ii) property of a character subject to the allowance for depreciation." I.R.C. § 41(b)(2)(C). As to "contract research expenses," I.R.C. § 41(b)(3)(A) explains that it "means 65 percent of any amount paid or incurred by the taxpayer to any person (other than an employee of the taxpayer) for qualified research."

I.R.C. § 41(c)(5)(A) further states "Notwithstanding whether the period for filing a claim for credit or refund has expired for any taxable year taken into account in determining the fixed-base percentage, the qualified research expenses taken into account in computing such percentage shall be determined on a basis consistent with the determination of qualified research expenses for the credit year." *See also* Treas. Reg. § 1.41-9(c)(2).

In order to obtain the benefit of the credit, both federal and Indiana law require that taxpayers 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." *Suder v. Comm'r,* T.C. Memo. 2014-201, *12 (T.C. 2014). 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). "Tax 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) (citing *Stinson Estate v. United States*, 214 F.3d 846 (7th Cir. 2000)).

Under IC § 6-8.1-5-4(a), "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. *See also* Treas. Reg. § 1.41-4(d) (2016).

The IRS's *Audit Technique Guide*, 2005 WL 4057831 (June 2005) further provides guidance in relation to the information necessary to verify research expense credits. The Guide, in relevant part, states:

> **6. THE CONSISTENCY REQUIREMENT**
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> Section 41(c)(5)(A) provides that the QREs and gross receipts taken into account in computing the fixed base percentage must be determined on a basis which is consistent with the determination of qualified research expenses for the credit year, regardless of whether the period for filing a claim for credit or refund has expired for any taxable year that is taken into account in determining the fixed base percentage. To satisfy this consistency requirement, the taxpayer must show consistency between the QREs in the credit year and its QREs during the base years, as well as consistency between gross receipts in the base years and the prior four years' average. Thus, ***if an expense is not qualified in the current credit year, it must be removed from the base year expenses, without regard to the law in effect during the base years.***
>
> The consistency rule is designed to ensure that there is an accurate determination of the relative increase in qualified research expenses over the amount "typically" spent by the taxpayer relative to its gross receipts. The increase will be accurately measured only if the taxpayer includes the same type of expenses in the credit computation for both the base years and the credit year. This rule would apply, for example, where the taxpayer has failed to include a particular type of expense in both the base years and credit year computations, thus distorting the true increase in qualified research expenses.
>
> If a taxpayer claims a certain type of expense is a QRE in the credit year that it never previously treated as a QRE, it must adjust its fixed base percentage to reflect similar expenses that were paid or incurred during the base years. The research credit is an incremental credit and, thus, the taxpayer must prove that there has been an increase qualified research expenses relative to the base period. It is imperative that taxpayer establish its base year expenses. ***Taxpayers may not rely upon extrapolation of recent years' data as their support for the fixed-base percentage computation***. Thus, ***base year records should be analyzed to determine the proper amount of expenses. Since you are examining an open credit year, which requires consideration of the earlier years, the statute of limitations for the earlier years is not controlling***.
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> . . .
>
> **7. SUBSTANTIATION AND RECORD KEEPING**
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> Under the final regulations, ***a taxpayer must retain records in sufficiently usable form and detail to substantiate that the expenditures claimed are eligible for the credit****. See* I.R.C. § 6001; Treas. Reg. § 1.6001-1. The taxpayer must clearly establish full compliance with all of the relevant statutory and regulatory requirements. Failure to maintain records in accordance with these rules is a basis for disallowing the credit.
>
> The 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.
>
> 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.***

> 2005 WL, at *23-24. *Audit Techniques Guide: Credit for Increasing Research Activities (i.e. Research Tax Credit) IRC § 41 - Substantiation and Recordkeeping*, available at https://www.irs.gov/businesses/audit-techniques-guide-credit-for-increasing-research-activities-ie-research-tax-credit-irc-ss (last visited June 27, 2022) (**Emphasis in original**) (***Emphasis added***).

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

A. The Audit.

Referencing the applicable federal and Indiana law, the audit noted that Taxpayer in this instance "must show that it meets all the requirements (the four-part test) as described in IRC section 41(d)," which defines "qualified research" as research:

> 1. With respect to which expenditures may be treated as an expense under section 174.
> 2. Which is undertaken for the purpose of discovering information 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 [are] for a qualified purpose.

The Department's audit stated that Taxpayer claimed the RECs based on a study prepared by the consulting firm. The Department did not accept that study or the methodology - "Statistical Sample" - used by the consulting firm. The Department reviewed *all* of Taxpayer's research projects and information provided. Upon review, the audit categorized "which projects qualified [versus] those projects that did not qualify" based on verifiable information provided. The audit noted the following:

> [Taxpayer] was not able to provide contemporaneous documentation indicating all the projects [for the Tax Years at Issue] identified in Exhibits [] were qualifying for the credit, i.e. the documentation, if any, provided did not establish these projects met all elements of the [four-part] test discussed above. The hours determined to be qualifying from [Taxpayer's] project listing were compared with the total hours from the projects on [audit] listing to determine a qualifying percentage. . . .

The Department's audit "applied the percentage of hours it determined to be qualifying" and adjusted the wages and supply expenses claimed by Taxpayer.

The audit also noted that Taxpayer's documents revealed that Taxpayer incorrectly classified its contract expenses as supply expenses and "most of the services provided by these contracts were performed outside of Indiana and would not qualify [for] Indiana REC." The audit disallowed those expenses as well. Nonetheless, the audit determined that Taxpayer "does contract services with one Indiana company" and thus allowed 65 percent of the contract expenses with respect to the qualifying projects related to that Indiana company pursuant to I.R.C. § 41(b)(3)(A).

Finally, the audit noted that Taxpayer claimed the RECs under "Alternative Incremental Credit for Research Conducted in Indiana." Based on the above adjustments, the audit recalculated "the average of qualified research expenses for the three preceding tax years" in line 23 of Form IT-20REC for 2016.

B. Taxpayers' Response.

Taxpayer in this instance agreed with the audit's application of the four-part test. Nonetheless, Taxpayer argued that it was entitled to additional RECs for the Tax Years at Issue. Taxpayer claimed:

> Audit's assessment violates the 'Consistency Rule' in I.R.C § 41(c)(6) *[sic]* because it is predicated on determining QREs in the base years in a manner inconsistent with the credit years.

According to Taxpayer, the credit years were the Tax Years at Issue, 2015 and 2016. For 2015, the base years were 2012, 2013, and 2014. For 2016, the base years were 2013, 2014, and 2015. Taxpayer claimed that the audit violated the "Consistency Rule" by "approv[ing] all QREs" related to "the base years [] 2012-2014" for 2015 and adjusted some numbers under 2015 to recalculate "the base years [] 2013-2015" for 2016. Taxpayer also

argued that the audit's disallowance of Taxpayer's supply expenses attributable to Taxpayer's non-sampled projects was part of the violation of the "Consistency Rule" as well. Taxpayer further asserted the following:

> Audit's adjustment to [Taxpayer's] supply QREs is rooted, in part, in the Consistency Rule violation and, in part, to 1) misapplying the definition of "Indiana Qualified Research Expense in IC [§] 6-3.1-4-1, and 2) mischaracterizing contracts for the purchase of materials (i.e. supplies) as contract research expenses.

Taxpayer maintained that the audit erred in excluding its non-sampled projects and reclassifying supply expenses as contract research expenses. According to Taxpayer,

> Audit's Consistency Rule error can be corrected by recalculating the REC with all of the base years' QREs (i.e. 2012, 2013, and 2014) determined in the same fashion as the 2015 and 2016 QREs. This simply requires that the base years' QREs consist only of QREs attributable to the 31 approved jobs that were incurred in those base years. As an example of the inconsistency in Audit's current calculation, the 2014 QREs used to calculate the assessment include QREs specifically attributable to many jobs that Audit denied in 2015.

Finally, Taxpayer argued that the Department's audit erred in reclassifying and disallowing expenses related to "Supplies purchased from vendors outside of Indiana, but used in Indiana research" and "Supplies re-characterized as contract research." To support its protest, Taxpayer offered one purchase order, four invoices, and an Excel file - which contained Employee Name, Job Title, 2012 R&D Hours, 2012 Total Hours, 2012 R&D Allocation, 2012 Gross Salaries, and 2012 QREs - summarized its R&D Qualifying Wages for 2012.

C. Analysis and Conclusion.

Upon review, however, Taxpayer's reliance on the Consistency Rule and its documents is misplaced. First, as mentioned earlier, the Department did not accept Taxpayer's study and the methodology used by the consulting firm. Rather, the Department requested that Taxpayer provide *all* of the verifiable supporting documents to substantiate the RECs Taxpayer claimed. When Taxpayer failed to provide the requested documents, the audit could not verify some projects and therefore disqualified those projects. As such, the audit disallowed some of Taxpayer's RECs under the Tax Years at Issue. The audit approach is clear and distinguishable. IC § 6-8.1-5-1(b); IC § 6-8.1-5-4(a).

Second, as mentioned earlier, "Tax credits are a matter of legislative grace, and taxpayers bear the burden of proving they are entitled to claim tax credits." *Suder*, T.C. Memo. 2014-201, *12; *see also Research, Inc. v. United States*, No. CIV. 3-94-385, 1995 WL 560140 (D. Minn. 1995) (determining that the taxpayer was denied the research credit because it could not quantify the base period research expenses attributable to its "special system projects"). Taxpayer here - seeking additional tax credits - challenged the audit's finding and was required to provide verifiable documents to demonstrate that its 2012, 2013, and 2014 expenses supported its RECs claim in connection with all of the projects in question. Taxpayer failed to do so. Since Taxpayer did not provide the requested documents to substantiate its claimed RECs, the audit was permitted to disqualify the projects claimed and adjust the RECs including the corresponding base years. IC § 6-8.1-5-1(b); IC § 6-8.1-5-4. Taxpayer thus was not entitled to additional RECs simply based on the "Consistency Rule" when it failed to provide the requested supporting documents.

In particular, Taxpayer's Excel file - R&D Qualifying Wages for 2012 - was not verifiable and thus could not be used to support its assertion that its non-sampled projects for the Tax Years at Issue qualified for the RECs or the audit erred in disqualifying non-sampled projects. Also, the purchase order and four invoices did not support Taxpayer's assertion that they were "supplies" of specific project or projects. Even if, for the sake of argument, assuming that the purchase order and invoices were recorded under specific qualified projects, Taxpayer's documentation showed that Taxpayer engaged with several out-of-state businesses to "design," "test" or provide "analysis," which did not meet the definition of "supplies" under I.R.C. § 41(b)(2)(C). As such, Taxpayer's documentation failed to substantiate its assertion that it purchased "Supplies [] from vendors outside of Indiana, but used in Indiana research." Since these vendors were out-of-state businesses, those expenses incurred did not qualify for Indiana RECs.

In short, given the totality of the circumstances, in the absence of other verifiable supporting documentation, the Department is not able to agree that Taxpayer met its burden of proof demonstrating that it was entitled to additional RECs and the Department's audit assessments were incorrect under IC § 6-8.1-5-1(c).

FINDING

Taxpayer's protest is respectfully denied.

July 18, 2022

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An html version of this document.