DEPARTMENT OF STATE REVENUE

01-20211015.LOF

Letter of Findings: 01-20211015
Individual Indiana Income Tax
For the Years 2016 and 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 This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register.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

After reviewing Shareholder's protest of an additional income tax assessment, the Department disagreed that Indiana Manufacturer/Retailer met its burden of establishing that Manufacturer/Retailer provided the specific, contemporaneous documentation sufficient to establish that its Shareholder was entitled to additional flow-through qualifying research expense credits attributable to the Manufacturer/Retailer's development and manufacture of consumer electronic products.

ISSUE

I. Indiana Individual Income Tax - Qualified Research Expense Projects and Supporting 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 U.S. 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); *Indiana Dep't of State Rev. v. Caterpillar, Inc*., 15 N.E.3d 579 (Ind. 2014); *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); *Tell City Boatworks, Inc. v. Indiana Dep't of State Revenue*, 162 N.E.3d 603 (Ind. Tax Ct. 2020); I.R.C. § 41; Treas. Reg. 1.41-2; Treas. Reg. § 1.41-4; Treas. Reg. § 1.174-2; Treas. Reg. § 1.6001-1; *Audit Techniques Guide: Credit for Increasing Research Activities (i.e. Research Tax Credit) IRC § 41* - Substantiation and Recordkeeping, https://www.irs.gov/businesses/audit-techniques-guide-credit-for-increasing-research-activities-ie-research-tax-credit-irc-ss-41-substantiation-and-recordkeeping.

STATEMENT OF FACTS

Taxpayer is an Indiana resident individual who is the sole shareholder of an Indiana S-Corporation ("Company"). The Company is in the business of developing, selling, and distributing electronic products intended for use in commercial, marine, and recreational vehicles. Those products include televisions, speakers, camera systems, antennas, and related accessories. The products are manufactured in China and are then shipped to the Company's Indiana business location. Company subsequently sells its products over the internet and other routine retail outlets.

The Indiana Department of Revenue ("Department") conducted an audit review of Company's fiscal year 2014-, 2015-, and 2016-income tax returns and business records. The audit found various "areas of noncompliance." Specifically, according to the report ("Audit Report"), the audit questioned a portion of Company's claim to research expense credits ("RECs").

Company claimed Indiana 2015, 2016, and 2017 RECs. Company explained that the RECs were based on the findings and guidance contained within a REC study prepared by a third-party consultant ("Consultant"). The RECs were attributable to the wage expenses of Company's President, director of operations, engineers, sales personnel, and various other Company employees and officers. In addition, Company also claimed RECs for costs attributable to supplies, vendor contracts, and third-party suppliers. As explained in the Audit Report, "The [Company's] research and development activities are performed internally by [Company's] employees or outsourced to contractors or its suppliers to supplement [Company's] capabilities and capacity."

Specifically, Company originally calculated that it spent approximately $8.2 million dollars in expenses during

2014, 2015, and 2016 which related to the development of Company's electronic products. Based on these expenses, Company claimed approximately $560,000 in Indiana tax RECs.

After reviewing the REC study and the claimed credits, the Department concluded that Company failed to establish that all the originally claimed development and manufacturing activities constituted "qualified research" and that Company failed to establish that all the originally claimed labor costs - on which the credits were largely based - directly related to the claimed qualifying activities. In reviewing the claimed expenses, the Department concluded that Company failed to create, maintain, or provide "contemporaneous records" documenting all the originally claimed labor expenses. Instead, the audit found that a portion of the labor expenses were "self-reported expenses" attributable to Company's employees and leadership estimates.

The audit also found that Company failed to establish that it was entitled to all the RECs attributable to the cost of supplies consumed during Company's research activities and that Company was not entitled to claim RECs based on "contract research."

The Department's audit's decision, disallowing a portion of the originally claimed credits, did not result in the assessment of additional income tax for Company because Company was organized as an S-Corporation. As the Audit Report explains, the "[Company's] income and credits are passed through to the [Taxpayer] shareholder on Schedule K-1 . . . ."

As a result of Company's audit and the denial of a portion of the originally claimed RECs, Taxpayer (100 percent shareholder) was assessed additional individual income tax. As explained in the Audit Report, "[Company] underwent an Indiana audit for 2016 and 2017. This audit is limited to the pass through of the [T]axpayer's distributive share of the audit adjustments as explained . . . ."

Taxpayer - and by extension Company - disagreed with the assessments and submitted a protest to that effect. An administrative hearing was conducted during which Taxpayer's representative explained the basis for the protest.

This Letter of Findings results and, depending on context, refers to "Company" as the business incurring the expenses and "Taxpayer" who was assessed the additional tax and is the sole shareholder.

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

DISCUSSION

The Department disallowed some RECs claimed by Company, a pass-through S corporation, resulting in the proposed assessments against Company's sole shareholder, Taxpayer. The audit concluded that the Company's claimed research activities did not all meet the definitions of "qualified research." The audit also concluded that Company was unable to substantiate the amount of time during which Company's employees and upper management were purportedly engaged in activities which met the definition of "qualified research."

It bears repeating at the outset that the audit did not disallow all the credits originally claimed because the audit agreed that Company conducted qualified research. Instead, it denied a portion of RECs for projects which the Department found did not constitute qualified research and also denied RECs which Company was unable to fully document.

The issues are whether Taxpayer can establish that Company conducted all the qualifying research activities originally claimed and whether Taxpayer can quantify the extent to which Company conducted those qualifying activities.

A. Department's Audit Examination.

The Audit Report summarized Company's process of developing and readying for production new products. Company first determines whether the product is "technologically feasible and a commercial opportunity . . . ." If so, Company prepares a "New Product Proposal" and arranges for a staff meeting to discuss the proposal. After considering the project's potential, technological hurdles, whether the new product is similar to existing products, and setting out initial specifications and concept drawings, Company decides whether to proceed with the proposal.

Once the proposal is approved, Company decides on the appearance, features, specifications, technical data,

materials, costs, and then calculates a timeline for developing the product. The Audit Report notes that some of these steps are undertaken by one of Company's overseas suppliers. Once Company has taken these steps, it undertakes the development of "prototypes" which are intended for testing of the proposed product.

Company's prototypes are produced by Company's overseas suppliers. As an example, the audit indicates that, in one particular instance, it verified the overseas supplier prepared *six* prototypes although in other instances, the audit indicated "sometimes *fewer* units are required . . . ." (*Emphasis added*).

Thereafter, these prototypes undergo a battery of tests. These tests constitute "the last stage of the project before [Company] releases the product for commercial production by the overseas supplier".

1. Qualifying Research Projects.

During the years 2014, 2015, and 2016, Company claimed approximately $8.2 million dollars in qualifying research expenses ("QREs") entitling it to approximately $560,000 in RECs. The "qualifying expenses" stemmed from wage expenses, contract costs, and supply expenses. The audit agreed that Company was entitled to a portion (approximately 50 percent) of the originally claimed RECs.

The Department's audit concluded that a portion of 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].

In summary, I.R.C. § 41(d) imposes a 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 undertake a "process of experimentation" during substantially all the research. I.R.C. § 41(d)(1)(C).

In applying those standards, the Department noted that - for purposes of this particular audit - the regulations found at Treasury Decision 8930 (TID 8930), defining "qualified research," were relevant in evaluating Company's activities during fiscal years 2015 and 2016 while the regulations found at Treasury Decision 9104 were relevant in evaluating Company's activities during fiscal year 2017.

For simplicity's sake, this Letter of Findings will refer to the TD 8930 regulations as the "Discovery" standard and the TD 9104 regulation as the "Uncertainty" standard.

2. Cost of Supplies Adjustment.

Company claimed that costs of "engineering supplies, prototypes, engineering samples, pilot production supplies, and engineering software and maintenance" were consumed in Company's qualifying research activities.

The audit noted that Company had claimed "the cost of entire production runs of certain products under development as qualified research supplies . . ." as qualifying expenses. Company believed it was entitled to claim all these supply expenses. Company believed so on the grounds "these large quantities were purchased because its overseas suppliers often have a minimum order quantity." However, the audit also noted that Company's engineering personnel explained "that only 6, or sometimes fewer of the units in these production runs were necessary to conduct the [Company's] battery of tests before the product is released for commercial production by the overseas supplier."

In addressing the issue related to prototype expenses, the audit cited to Treas. Reg. 1.174-2(a)(4) for guidance:

(a) In general

(4) Pilot model defined. For purposes of this section, the term pilot model means any representation or model of a product that is produced to evaluate and resolve uncertainty concerning the product during the development of the product.

The audit limited qualifying production protype expenses to the number of units "necessary to conduct the [Company's] battery of tests . . . ." In Company's case, that number was six because "only 6 of the units of each production run were used in the performance of qualified services by the [Company]." In addition, the audit disallowed pre-production units supplied to the customer for the customer's own testing and evaluation. As authority for doing so, the audit cited to Treas. Reg. 1.41-2 for the premise that "qualified research expenses are only those expenses that are either in-house or contract research expenses." Units supplied for the overseas customer's own evaluation were neither "in-house" nor "contract research expenses."

The Department's audit rejected Company's arguments that the excess production units were qualified research supplies because - although not *tested* by Company - they were "inspected by the [Company]." The audit found this position untenable under Treas. Reg. 1.174-2(a)(6) because "ordinary testing or inspection of materials or products for quality control does not constitute a process of experimentation." As explained in the Audit Report, "[O]rdinary testing and inspection for quality control [are] specifically excluded activity that is not allowable as a qualified research expense."

The audit concluded that the cost of six of the units produced during each of Company's production runs qualified as a QRE and disallowed the remaining amounts originally claimed by Company.

3. Wage and Labor Expense Adjustments.

Company originally claimed wage expenses attributable to - in part - Company's "president, director of operations, managers, engineers, sales personnel, and other employees." The Department adjusted and disallowed the wage expenses of Company's "President, Vice President of Operations ("VP"), and various sales personnel . . . ." The audit did so on the grounds that Company "could not substantiate that the claimed wages of these employees qualified as research expenses or could not substantiate the amount of wages claimed to the extent claimed by the taxpayer." The audit did not adjust any of the engineer wage expenses claimed by Company.

In other words, the audit disallowed these particular employee and officer wage expenses because the audit could not substantiate, and the audit could not verify, that these employees and officers were engaged in qualifying research activities or - if they indeed did so engage - could not substantiate the amount of time spent on those qualifying activities.

The audit arrived at this conclusion because the Company failed to provide "contemporaneous records . . . to document the research projects or the time devoted to those research projects" by the Company's President, VP, or its sales personnel.

Specifically, the audit found that Company failed to meet the documentation and substantiation standard required under Treas. Reg. § 1.41-4(d) (T.D. 8930) (the "Discovery Standard"). This regulation sets out the record keeping and documentation requirement for expenses related to RECs:

> 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 also cited to Treas. Reg. § 1.41-4(d) (T.D. 9104) (the "Uncertainty Standard") and the current governing regulation which states:

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

As cited in Treas. Reg. § 1.41-4(d), Treas. Reg. § 1.6001-1(a) 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. (**Emphasis added**).

In considering both the "Discovery" and "Uncertainty" standards, the audit cited to the preamble to the Treas. Reg. 1.41 (TD 9104) which provides the following guidance:

> As noted above, the 2001 proposed regulations do not contain a specific recordkeeping requirement beyond the requirements set out in section 6001 and the regulations thereunder. No change regarding recordkeeping is being made in these final regulations.

According to the audit, the 9104-preamble supported its position that the federal recordkeeping requirement remained unchanged even as the 8930 regulations gave way to the 9104 regulatory standards.

Regardless of 8903 or 9104, the Department's audit also relied on Indiana's own statutory provision which provides at 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 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.

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

As a result, the Department disallowed certain wage expenses attributable to Company's President, VP, and sales personnel. The audit did so because Company had originally based its claim to these expenses on after-the-fact "estimates" which the audit determined were insufficient to establish that these personnel performed the activities called for in the Federal Audit Guidelines and Treas. Reg. § 1.6001-1(a). As such, the estimates were insufficient to establish the "extent" of the QREs.

> Wages paid to an employee constitute in-house research expenses only to the extent the wages were paid or incurred for "qualified services" performed by the employee. *Audit Techniques Guide: Credit for Increasing Research Activities (i.e. Research Tax Credit) IRC § 41* - Substantiation and Recordkeeping, https://www.irs.gov/businesses/audit-techniques-guide-credit-for-increasing-research-activities-ie-research-tax-credit-irc-ss-41-substantiation-and-recordkeeping (last visited March 24, 2022).

Under I.R.C. § 41(b)(2)(B), "qualified services" consist of the following:

1. Engaging in qualified research,
2. Directly supervising qualified research,
3. Directly supporting qualified research.

Treas. Reg. 1.41-2(c) defines "engaging in qualified research" as follows:

> The term "engaging in qualified research" means the actual conduct of qualified research as in the case of conducting laboratory experiments.

As such, QREs necessarily consist of substantiated wage expenses associated with a claimant's employees who directly perform verifiable, qualified research or who substantiate their direct supporting qualified research.

4. Process of Experimentation.

As required under Treas. Reg. 1.41-2(c), to qualify for the credit, employees must be "engaging in qualified research" which subsumes the "process of experimentation" standard. As further explained in Treas. Reg. 41(d)(1)(c) to qualify as qualified research "substantially all of the activities . . . constitute elements of a process of experimentation . . . ."

That "process of experimentation" is defined at Treas. Reg. 1.41-4(a)(5) (TD 9104) which provides:

> For purposes of section 41(d) and this section, a process of experimentation is a process designed to evaluate one or more alternatives to achieve a result where the capability or the method of achieving that result, or the appropriate design of that result, is uncertain as of the beginning of the taxpayer's research activities. **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 a 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. A taxpayer may undertake a process of experimentation if there is no uncertainty concerning the taxpayer's capability or method of achieving the desired result so long as the appropriate design of the desired result is uncertain as of the beginning of the taxpayer's research activities. Uncertainty concerning the development or improvement of the business component (e.g., its appropriate design) does not establish that all activities undertaken to achieve that new or improved business component constitute a process of experimentation. (**Emphasis added**).

As to the "Uncertainty" requirement referred to in Treas. Reg. 1.41-4(a)(5), the preamble to Treas. Reg. 1.41-4 (TD 9104) explains in part:

> [T]he mere existence of uncertainty regarding the development or improvement of a business component does not indicate that all of a taxpayer's activities undertaken to achieve that new or improved business component constitute a process of experimentation . . . .

a. Company President.

Considering these standards and requirements, the Department's audit disagreed that Company established that 60 percent of its President's activities constituted qualified, experimental research. The Audit Report acknowledged the President's expertise, background, and experience. However, the report found that the "documentation provided by [Company] was not sufficient to establish that [President] was engaged in performing qualified services to the extent claimed by [Company]." The audit found that the "documentation" consisted of "estimates" which were not supported by contemporaneous time logs or other such evidence. Although Company's President actively participated in Company's new product verification and validation meetings, there was little indication that Company's President engaged in experimental activities as "in the case of conducting laboratory experiments." Instead, the audit agreed that Company's President engaged in the "direct supervision" of qualified research leading to the Company's development of new products but to a lesser degree than originally claimed. Instead of the 60 percent claim determined by Company, the audit was able to confirm that between 2.5 to 3.9 percent of Company's President's wages qualified for the credit.

As to Company's President, the audit concluded:

> No other direct involvement in, or direct support of, a process of experimentation using the physical sciences that would be considered as qualified research services could be documented or substantiated by the audit.

b. Company's Vice President of Operations.

Company originally claimed 60 percent of its VP's wages as qualifying expenses. The Audit Report notes that the VP was "responsible for obtaining manufactured component parts and finished goods from the [Company's] overseas suppliers."

In reviewing the available information, the audit found that documentation provided, such as emails "did not document or substantiate any role in qualified research activities by [VP]." In addition, the audit found that there was nothing to support the contention that VP "provide[d] any direct supervision of a process of experimentation" or that VP himself acted to "support a process of experimentation using the physical sciences."

c. Company's Sales Personnel.

Company had originally claimed a portion of its sales personnel wages as qualifying research expenses. The Department's audit disagreed with the entirety of that claim.

> No contemporaneous records were provided to document the research projects, or the time devoted to those research projects by sales personnel.
>
> . . . .
>
> None of the documentation provided by [Company] substantiated any involvement by sales personnel in the direct participation in, supervision of, or direct support of any process of experimentation using the physical sciences that would be necessary for their activities to be considered as qualified services for the Indiana Research Expense Tax Credit.

5. Audit Conclusion.

The Department's various conclusions resulted in an adjustment to the REC amounts originally claimed by Company. Company had originally claimed 2015, 2016, and 2017 RECs of approximately $560,000. The audit disallowed approximately $255,000 of that amount but agreed with Company that it was entitled to approximately $305,000 of the originally claimed RECs.

B. Taxpayer and Company's Summary Response and Criticisms.

Taxpayer and Company disagree entirely with the analysis contained in the Audit Report and with the report's conclusion. Taxpayer argues that Company is entitled to the full amount of RECs originally claimed. According to Taxpayer, the Department's audit personnel are at fault. As explained by Taxpayer, the Department personnel:

> [H]ave either not read, not understood, or completely ignored the documentation provided and explanations/clarifications presented in our responses.
>
> . . . .
>
> It is inconceivable that, in the more than 400 documents provided through the course of this audit, none were found to corroborate [President's and VP's] engagement, at a deep level, in qualified research activities.

Further, Taxpayer asserts that the audit examination "ended very prematurely" and that the audit personnel "had no interest in understanding the qualified activities at [Company] as well as the documentation provided and how [the Documentation] support[s] the research activities included in the [original] Credit calculation."

In addition to its opinion of the audit personnel's lack of competence and/or inattention, Taxpayer finds fault with the contents of the Audit Report. According to Taxpayer:

> The Audit Summary Report (ASR) is so full of inaccurate statements and misinterpretation of the Law and Regulations as to make a traditional response impractical.

Specifically, Consultant - who represented Taxpayer in preparing its protest - states that it "has been POA on over 100 Research Credit audits" but, in this case, the Department's personnel "lack[ed] the understanding of basic engineering concepts (such as the Engineering Design Process) and how to interpret the Law and Regulations."

In arriving at their conclusions and in preparing the Audit Report, Taxpayer concludes that the "auditors lose any credibility required to make determinations of the validity and accuracy of Research Tax Credit claims." Specifically, Taxpayer argues that the auditors failed to "seriously consider the [president and vice president's] testimonies if they even read them at all." According to Taxpayer, these shortcomings and inaccuracies make it challenging for Taxpayer to respond to what is an inherently flawed Audit Report.

1. Wage Expenses - the Specifics.

Taxpayer maintains that the Department erred in disallowing wage expenses associated with Company's President, VP, and sales personnel. In particular, Taxpayer challenges the Department's stance that, in order to qualify wage expenses, Company's leadership and sales personnel must be "directly involved" in the research. According to Taxpayer, under Treas. Reg. 1.41-(2)(c) wage expenses qualify for RECs when those wages are attributable to "engaging in qualified research," "direct supervision" of such research, or "direct support" of the research. As Taxpayer explains:

> Treas. Reg. 1.41-(2)(c) supports that qualified research activities, while clearly defined through the Four-Part

> Test, take place with the supervision and support of personnel, who in the conduct of their qualified supervision or support, may not, by themselves, meet all four parts of the Four-Part Test. [T]hat is exactly the intent of the legislature.

a. Company President.

Specifically, Taxpayer argues that the Company's President, VP, and sales personnel directly engage in the following supportive, qualifying activities.

- Setting parameters and requirements for new or improved products or processes;
- New or improved Product or Process Conceptualization;
- Theoretical Product Evaluation;
- Prototype Testing and Evaluation;
- Pilot Production Runs.

Taxpayer points out that the Company's President is a "degreed engineer," a former nuclear power electrical technician, and spent 3.5 years attending a technical school.

In the case of the QREs here at issue, Taxpayer explains that Company's President directly engages in the following:

- Technical discussions with engineering staff and customers' suggesting design solutions and providing technical support;
- Product Verification Meetings;
- Approval of New Product Proposals;
- Design Validation Meetings.

b. Company Vice President.

Taxpayer argues that Company's VP "is heavily engaged in [Company's] product development. Taxpayer indicates that VP spends time "participating in new product development," developing "new manufacturing or improvements to manufacturing," and the "direct supervision of qualified research."

Taxpayer explains that Company's VP conducts the following qualified research activities:

- Product design direction, design reviews, prototype testing and both the formal and informal meetings that occur throughout the design process;
- Product Verification Meetings;
- Approval of Engineering Change Orders;
- Design Validation Meetings.

Taxpayer indicates that its Consultant provided the Department's auditors with "response after response" and "numerous examples of supporting documentation which documented both Company's President and VP's qualifying research activities." However, Taxpayer states that "[t]he INDOR auditors once again simply ignored" this documentation.

c. Sales Personnel.

Taxpayer maintains that Company's sales personnel "engage in direct conduct of qualified research and direct support of qualified research during the development of new products." As explained by Taxpayer:

> The Sales Engineers are tasked with the initial phase of product development including New Product Proposal (NPP), NPP Review, Product Feasibility, Product Definition, and Project Approval, as well as supporting Engineering during the last phases of product development, including Validation.

Taxpayer maintains that these sales personnel undertake qualifying research because:

> [Sales personnel] make extensive use of their own technical, educational, and professional backgrounds to mitigate and resolve risks related to the design and development of a new product, particularly during the initial phases of product development.

Specifically, Taxpayer explains that Company's customers do not purchase "off-the-shelf, previously developed product[s]" but seek a product which incorporates each customer's "feature requests and application[s]." In other words, its salespersons do not simply hawk consumer grade electronic products but are actively and directly

involved in qualified research leading to the development of new and improved products.

Taxpayer points to specific qualifying activities performed by Company's sales personnel when addressing customer concerns. For example, the sales personnel address issues such as:

- Bluetooth connectivity on audio product[s];
- Time delays on rear and side body sensor technology;
- Sensor mapping;
- Display selection (monitors, stereo displays, televisions).

2. Documentation Requirements.

Taxpayer argues that the Department has imposed "non-existent documentation requirements" as a "means to disqualify qualified research activities at [Company]." As explained by Taxpayer:

> "Contemporaneous documentation of time allotted to qualified research activities" is simply not a requirement to quantify time spent in qualified research activities . . . . [S]uch a requirement would automatically disqualify taxpayers who do not employ time tracking from claiming the tax credit.

Instead of contemporaneous documentation, Taxpayer argues that "taxpayers are allowed to estimate the time spent in qualified research activities." (Taxpayer's emphasis). Also Taxpayer argues that the audit missed the mark in considering Taxpayer's and its representative's QREs, "The auditors decided to pick and choose when to use this inaccurate requirement . . . .[and that] INDOR understands that time quantification is not a real requirement to support qualified research because time quantification was not required by the INDOR's auditors to verify the qualified research percentages associated with nearly every other employee at [Company]."

Taxpayer points out that it presented the Department's auditors with "written affidavits, provided under the penalty of perjury . . ." entirely sufficient to verify the RECs originally claimed. However, Taxpayer doubts that "the auditors seriously considered [employee's] testimony if they even read [the affidavits] at all."

3. Misrepresentation of Company's Business Model.

Taxpayer argues that the Department's auditors misrepresented the nature of Company's business as that of a "retailer and distributor." According to Taxpayer, characterizing Company's business as a retailer and distributor "is inaccurate and only further contributes to [Consultant] questioning the competency of the INDOR auditors." Rather than a simple misunderstanding, over-simplification, or misinterpretation, Taxpayer believes the Department's characterization was "an insult and an unnecessary byproduct of an examination that has proven to be flawed at the most basic levels."

4. Exclusion of Qualified Research Supplies.

Taxpayer disagrees with the Department's decision disallowing a portion of the cost of "pilot production units" as QREs. In its conclusion, the Department found that not all the production units qualified for the claimed credit. As detailed in the Audit Report, "[O]nly 6 of the units were actually produced for the purpose of evaluating and resolving uncertainty."

C. Burden of Proof and Analysis.

1. Proving that Taxpayer is Entitled to the Credit.

The issue in question here was established at the start of this document. Did Taxpayer meet its burden of establishing that it was entitled to the full amount of credits originally claimed (approximately $560,000) and that the Department's assessment of additional tax was wrong because Company is entitled to an additional ≈ $255,000 in RECs?

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). Moreover, when considering Taxpayer's argument, the Department bears in mind that "when [courts] examine a statute that an agency is 'charged with enforcing . . . [courts] defer to the agency's reasonable interpretation of [the] statute even over an equally reasonable interpretation by another party.'" *Dept. of State Revenue v. Caterpillar, Inc.*, 15 N.E.3d 579, 583 (Ind. 2014). Thus, interpretations of Indiana tax law contained within the audit and this Letter of Findings

are entitled to deference.

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)).

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." Like 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).

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 therefore can any particular deduction be allowed.")

D. Analysis and Conclusion.

1. Engaging in Qualifying Research Activities.

It is not necessary here to determine whether Company was engaged in activities which met the I.R.C.§ 41(d) four-part test. In all respects, the Department agrees that Company does engage in such activities and that Company is fully entitled to claim Indiana RECs associated with qualifying Indiana projects. Taxpayer has provided substantial and detailed documents clearly establishing that Company engages in leading-edge research which meets both the statutory and regulatory requirements and that this research leads to the design and production of state-of-the-art consumer electronics.

Nonetheless, the court in *Tell City Boatworks, Inc. v. Indiana Dep't of State Revenue*, specifically explains:

> For purposes of the Indiana Credit, the term "qualified research expense" has the same meaning as that defined under Section 41(b) of the Internal Revenue Code **except that the qualified expense must be incurred for research conducted in Indiana** . . . .

Tell City Boatworks, Inc. v. Indiana Dep't of State Revenue, 162 N.E.3d 603, 612 (Ind. Tax Ct. 2020) (**Emphasis added**).

The Department's audit agreed that Company established that it engaged in qualifying research activities. However, Department's audit found that Company failed to adequately quantify and document the time and labor, contract, and supply expenses which formed the basis for all the originally 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), Treas. Reg. § 1.41-4(d) (TD 8930), Treas. Reg. § 1.6001-1(a), and IC § 6-8.1-5-4(a). The Audit Report summarized the statutory and regulatory standards under which it evaluated Company's efforts to verify the labor expenses stating 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."

2. Documentation Standards.

Company performs qualifying research activities. Where the Department, Taxpayer, and Company part ways is on the question of documentation. Taxpayer disagrees with the audit's finding that Company failed to adequately document its employees' specific activities and wages attributable to those projects. Taxpayer does not claim that Company utilized a system of time quantification in order to accurately quantify the research expenses. Instead, Taxpayer maintains that as a question of fact and law:

> [T]ime quantification is not a real requirement to support qualified research because time quantification was not required by the INDOR's auditors to verify the qualified research percentages . . . .

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 oversimplifies the relevant regulatory requirement and statutory requirements. Instead, it is a claimant'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 Company seeks to obtain the benefit of those credits - Company is required to meet. Under either Treas. Reg. § 1.41-4(d) (TD 8930) or Treas. Reg. § 1.41-4(d) (TD 9104), 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. 6001-1. The common thread through all the requirements is that a claimant must "keep," "retain," "maintain," "permanent" documentation prepared "before or during the early stages of the research project."

Indiana case law speaks in general to 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." There is little support for Taxpayer's argument that reliable records may be generated after-the-fact, created, or recreated. There is no support for Taxpayer's stance that "time quantification is not a real requirement to support qualified research . . . ."

3. Interpreting and Applying the Documentation Standards.

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 administrative "summary judgment" in which the Department overturns the audit's finding that Company 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 Company used to calculate the qualified research expenses. Even if the Department were to agree - and it did not - that all claimed activities were associated with qualifying projects, 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.

4. Taxpayer's Supplementary Documentation.

Taxpayer has gone to some lengths in supplying additional, detailed documentation during the course of the administrative appeal. Taxpayer supplied lists, emails, employee reports, time tracking reports, travel logs, engineering time allocation, employee questionnaires, and the like. However, the Department finds that the majority of this additional documentation falls short of what is required to meet Taxpayer's evidentiary burden. The documentation was reviewed during the course of the original audit, or the documentation is not pertinent to the adjustments made during that audit.

For example, Taxpayer provided "tech services time tracking" information. However, the information is irrelevant because the audit did not disallow any of the credits attributable to technical services. To the contrary, the audit allowed Company to claim the benefit of these particular credits.

Taxpayer provided copies of Company employees' international travel logs. Notwithstanding, the travel logs do nothing to support Taxpayer's argument that these expenses were attributable to Indiana qualifying research activities. See *Tell City Boatworks, Inc.*, 162 N.E.3d at 612. Even if the expenses were somehow attributable to Indiana activities, Taxpayer does not explain why or how these travel costs were necessarily expended "for the purposes of discovering information . . . which is technological in nature" and "useful in the development of a new or improved business component . . . ." I.R.C. § 41(d). Of course, travel expenses may be legitimately incurred and entirely necessary, but that does mean such expenses are qualifying research expenses.

Taxpayer provided an analysis of Company's engineering time allocation and costs. Again, this analysis is

irrelevant because none of the credits attributable to engineering wages were denied during the audit.

Taxpayer provided additional copies of employee time allocation questionnaires and a summary of those questionnaires. However, these questionnaires were reviewed during the course of the audit. The audit concluded that these documents consisted of estimated and self-reported information by employees who thought that they were - or may have been - involved in qualifying research. Specifically, the estimated and self-reported questionnaires alone without contemporaneous and verifiable supporting documents regarding the employees or management's direct supervision or direct support connecting to particular qualified research activities are insufficient to substantiate the wage expenses for the purposes of claiming the Indiana RECs.

Taxpayer provided a summary of the President's activities on the grounds that the President was heavily involved in conducting qualifying research. Again, this summary breakdown is an estimate unsupported by contemporaneous time, scheduling, and attendance records. The summary consists of information previously considered by the Department' audit personnel. A secondary review of President's calendar establishes that the President spent the bulk of his time in non-research meetings, attending trade shows, attending conferences, and engaged in international travel. Taxpayer's estimate that its President spent 60 percent of his time conducting experimental research is simply not supported by this additional documentation.

Taxpayer supplied documentation intended to establish Company's vice-president of operations ("VP") spent time in conducting qualifying research. The documentation is a breakdown of its VP's time spent on research projects. Again, this information consists solely of estimates; the information was previously reviewed during the course of the audit examination which concluded that there was little to support Taxpayer's contention that the VP was involved in qualified research or that he was directly supervising or supporting qualified activities. Instead, the documentation - including emails - tends to support the conclusion that the VP was largely involved in non-qualifying procurement and purchasing activity.

Likewise, the Department finds little support for Taxpayer's contention that its sales personnel were engaged in qualified research activities. The audit reviewed numerous training materials intended for use by Company's sales personnel. The documentation was provided to support Company's assertion that its sales personnel were sufficiently knowledgeable to both conduct qualified research and - in fact - did engage in such research. Company's training materials introduced sales personnel to basic electronic principles and explain the specifications, capabilities, and functionality of Company's electronic products. That is all very well and good, but the training materials were directed to the sales personnel with little to indicate that the sales personnel thereafter engaged in activities "for the purposes of discovering information . . . which is technological in nature" and "useful in the development of a new or improved business component . . . ." I.R.C. § 41(d).

The Department is unable to agree that the supplemental documentation clearly and plainly established that Company was entitled to the entirety of the $560,000 in credits originally claimed. The Department is also unable to agree that Taxpayer - even considering the supplementary document - has met the burden under IC § 6-8.1-5-1(c) of establishing that the adjustments were "wrong" and Company's 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.

5. The Audit's Findings and the Department's Original Analysis.

A review of the audit and the supporting documentation does make it clear that Taxpayer and the Department expressed different views on the nature and applicability of this particular tax credit and Company's claim to the credits. However, it is also clear that the Department did not disagree that Company was conducting qualified research activities. Moreover, there is nothing in the audit findings or the Audit Report's statements that in any way suggest that Taxpayer was claiming a tax advantage to which it knew it was not entitled. Instead, the Department disagreed with Taxpayer's claim that it was entitled to $560,000 in RECs. This bears repeating; this is about dollars and the amount of dollars Company is entitled to claim as a credit. Taxpayer and the Department's calculation differ - a result not entirely unknown and not necessarily unexpected in the arena of state and federal tax disputes.

Taxpayer aims specific criticisms at Department's personnel who prepared the Audit Report suggesting that they lacked the experience and background necessary to understand or fully appreciate Company's business operations. It further criticizes the Department's representatives as having "had no interest in understanding the qualified activities at [Company] as well as the documentation provided." The Department here finds no support for Taxpayer's contention that the audit was intended as "an insult and [was] an unnecessary byproduct of an examination that has proven to be flawed at the most basic levels." The Department disagrees that the audit was

intended as an insult because there is no such proof.

The Department also disagrees with Taxpayer's contention that the audit was "prematurely" closed denying Taxpayer and Company the opportunity to make its case. Company provided the first round of documentation in 2018 and the Department's *proposed* adjustments were reported to Company in April of 2019. Thereafter, Company was given two years to provide evidence supporting its REC claim. There is nothing in the record to establish that the Department's audit personnel failed to respond to, acknowledge, and review any of the documentation provided. Taxpayer provided the Department's audit with what can reasonably be considered a "flood" of information and documentation. However, much of these materials have little to do with the REC issues in question.

The Department found that Company failed to establish that that it was entitled to the entirety of its $560,000 original claim - a determination which cannot be found attributable to the supposed ill-will and incompetence of the audit examiners.

Taxpayer maintains that a claim to the credit can be based on estimates and its personnel's after-the fact-recollections. The Department maintains that a claim to a specific amount of credits must be based upon equally specific, measurable, contemporaneous documentation. The Department agrees that well-informed and **well-accepted** estimates may form the basis for a claim, but that there must be something at the core of that estimate against which the Department can reasonably be expected to measure, quantify, and verify.

Taxpayer argues that the Department is promulgating a "non-existent" documentation standard which only the most sophisticated, meticulous businesses could hope to achieve. Moreover, Taxpayer contends that this "non-existent" standard was imposed solely as a "means to disqualify [its] qualified research activities . . ." The Department must disagree on both counts. A review of the Audit Report or associated materials does not support Taxpayer's assertion that the Department's personnel approached the audit with the preconceived notion that the credits - or a large portion of the credits - should be disallowed without due consideration of the facts and the law.

It is not possible is to sustain Taxpayer's protest here because to do so would require the Department to accept the argument that "estimates" and employee affidavits are sufficient to satisfy the regulatory requirement that Company "*retain records in sufficiently usable form* and detail to substantiate that the expenditures claimed are eligible for the credit," Treas. Reg. § 1.6001-1(a), the statutory requirement that Company "keep books and records so that the department can determine the amount, if any, of the person's liability for that tax," IC § 6-8.1-5-4(a), and agree that estimates and affidavits constitute "sufficient evidence, which is clearly within the exact letter of the law." *RCA Corp*., 310 N.E.2d at 100-01.

The Department concludes that Taxpayer and Company have 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). In arriving at that conclusion, the Department does not suggest in any way that Taxpayer's arguments are incoherent, irrelevant, or groundless. However, the Department here is not prepared - nor is it justified - in granting a form of administrative "summary judgment" in favor of Taxpayer based wholly on the questions, uncertainties, and criticisms raised by his objections. The Department recognizes the complexities in such a REC analysis and that - in the absence of a rigorously enforced time accounting system - there is no perfect, exact answer on which everyone can agree. However, Taxpayer has not met its burden under IC § 6-8.1-5-1(c) of establishing that the pending assessment was incorrect.

FINDING

Taxpayer's protest is respectfully denied.

October 26, 2022

Posted: 06/07/2023 by Legislative Services Agency
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