



# Indiana Research Expense Credit

**Updated as of February 2023**



**Indiana Department of Revenue**

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## INTRODUCTION

The State of Indiana offers two tax incentives targeted at encouraging investments in research and development. Taxpayers may receive a credit against their Indiana state income tax liability calculated as a percentage of qualified research expenses incurred in Indiana. The Indiana credit is established under IC 6-3.1-4. A Qualified Research Expense (QRE) is defined by Section 41(b) of the Internal Revenue Code (IRC). For taxable years before 2016 please check prior versions of IC 6-3.1-4. The other incentive is a 100 percent sales tax exemption for qualified research and development equipment and property purchased for use in Indiana. This exemption can be found at IC 6-2.5-5-40.

This publication explains what is “qualified research,” who is eligible to claim the credit, how to claim the research credits for income tax purposes, how to claim the sales and use tax exemption, and what records must be kept to document the qualified research activities being conducted in Indiana.

### Research Expense Credit

Research Credit for Increasing Research: A taxpayer may be eligible for a credit on qualified research expenses incurred in Indiana. The potential value of the credit is equal to the taxpayer’s qualified research expense for the taxable year, minus the base period amount up to \$1 million, multiplied by 15 percent. A credit percentage of up to 10 percent is applied to any excess of Indiana qualified research expense over a base period amount greater than \$1 million. An alternative method can also be used and is discussed on page 8.

Detailed information on claiming the research expense credit is available in Part III.

### Sales and Use Tax Exemption

There is a 100 percent sales tax exemption for qualified research and development equipment and property purchased for use in Indiana. Taxpayers may file a timely claim for refund for sales tax paid on such a retail transaction should they not purchase it exempt from sales tax at the time of the actual transaction.

Detailed information on claiming the sales and use tax exemption is available in Part VI.

## WHAT IS QUALIFIED RESEARCH FOR THE INCOME TAX CREDIT?

“Qualified research” is defined by reference to section 41(d)(1) of the Internal Revenue Code (IRC), including the applicable regulations under Treas. Reg. § 1.41-4. Indiana follows the Internal Revenue Code and related regulations for purposes of determining what is and what is not “qualified research.”

Under IRC [§41\(d\)\(1\)](#), “qualified research” means research:

- With respect to which expenditures may be treated as expenses under IRC [§174](#);
- Which is undertaken for the purpose of discovering information which is:
  - Technological in nature;
  - The application of which is intended to be useful in the development of a new or improved business component of the taxpayer; and

- Substantially all of the activities of which constitutes elements of a process of experimentation relating to a new or improved function, performance, reliability, or quality.
- Is not an activity described in IRC [§41\(d\)\(4\)](#).

A claimant must establish the research activity being conducted meets all of these requirements. The requirements must be met for each business component that is the subject of the research activity. In the case of funded research, the requirements must be applied to each business component of the person funding the research.

### **Expenses under IRC § 174 Test:**

A research and experimentation expenditure is treated as an expense under IRC [§174](#) only to the extent the expenditure is reasonable under the circumstances. Expenditures for land and depreciable property are not allowed under IRC [§174](#), although depreciation and depletion allowances with respect to property used by the taxpayer in connection with research or experimentation may be allowed under IRC [§174](#).

**Note:** Although some expenditures may be allowed as research expenses under IRC [§174](#), the expenses may not meet all of the additional requirements under IRC [§41](#) to be qualified research expenses. Refer to the regulations under IRC [§174](#) for further explanation on specific expense disallowances.

“Research or experimental expenditures” means expenditures incurred in connection with taxpayer’s trade or business, which represent research and development costs in the experimental or laboratory sense and generally includes all such costs incident to the development or improvement of a product and the costs of obtaining a patent. 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 product.

Whether expenditures qualify as research or experimental expenditures depends on the nature of the activity to which the expenditures relate, not the nature of the product or improvement being developed or the level of technological advancement the product or improvement represents. “Product” includes any pilot model, process, formula, invention, technique, patent, or similar property, and includes products to be used by the taxpayer in its trade or business as well as products to be held for sale, lease, or license.

“Research or experimental expenditures” do not include expenditures for:

- Ordinary testing or inspection of materials for quality control
- Efficiency surveys
- Management studies
- Consumer surveys
- Advertising or promotions

- Acquisition of another’s patent, model, production, or process
- Research in connection with literary, historical, or similar projects
- Research related to style, taste, cosmetic, or seasonal design factors is research not relating to a new or improved function, performance, reliability, or quality.

## Discovering Technological Information Test

Research is undertaken for the purpose of discovering information if it is intended to eliminate uncertainty concerning the development or improvement of a business component. Uncertainty exists 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.

In order to satisfy the “technological in nature” requirement for qualified research, the process of experimentation used to discover information must fundamentally rely on principles of the physical or biological sciences, engineering, or computer science. A taxpayer may employ existing technologies and may rely on existing principles of the physical or biological sciences, engineering, or computer science to satisfy this requirement. A determination that research is undertaken for the purpose of discovering information that is technological in nature does not require the taxpayer to seek information that exceeds, expands or refines the common knowledge of skilled professionals in the particular field of science or engineering in which the taxpayer is performing the research. In addition, a determination that research is undertaken for the purpose of discovering information that is technological in nature does not require that the taxpayer succeed in developing a new or improved business component.

The issuance of a patent by the Patent and Trademark Office under [35 U.S.C. § 51](#) (other than a patent for design issued under the provisions of [35 U.S.C. § 171](#)) is conclusive evidence that a taxpayer has discovered information that is technological in nature that is intended to eliminate uncertainty concerning the development or improvement of a business component. This is known as the “patent safe-harbor”. However, the issuance of such a patent is not a precondition for credit availability.

**Note:** The issuance of a patent is not conclusive evidence of qualified research, as the taxpayer still has to meet all the other activity requirements of IRC [§41\(d\)](#). Also, the securing of a patent usually occurs after the actual research occurs.

## Business Component Test

“Business component” of a taxpayer means any product, process, computer software, technique, formula, or invention which is to be held for sale, lease, or license or used by the taxpayer in a trade or business of the taxpayer. Any plant process, machinery, or technique for commercial production of a business component is treated as a separate business component and not as part of the business component being produced.

**Note:** Taxpayers often group all research activity in one broad category and do not identify the specific

business component to which the research activity relates. A taxpayer must be able to relate the research activity it is claiming for the credit to the relevant business component to show entitlement for the credit. Substantially all of the taxpayer's activities for each business component must be qualified research activities in order for any of the expenses related to the business component to be qualified research expenses. See Section D below for more information on the "substantially all" test that is applied to each business component.

## Process of Experimentation Test

Qualified research is research in which substantially all of the activities for a particular business component constitute elements of a process of experimentation.

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 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 exists 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. The mere demonstration that uncertainty concerning the development or improvement of the business component (e.g. its appropriate design) exists does not establish that all activities undertaken to achieve that new or improved business component constituted a process of experimentation.

So, in addition to requiring the research be undertaken for the purpose of discovering information is technological in nature, the taxpayer must:

- Identify the uncertainty regarding the development or improvement of a business component that is the object of the taxpayer's research activities,
- Identify one or more alternatives intended to eliminate that uncertainty, and
- Identify and conduct a process of evaluating the alternatives.

The key difference regarding "uncertainty" in IRC [§§41](#) and [174](#) is that, under [IRC §41](#), uncertainty must relate to a qualified purpose, and must be resolved through a three-element process of experimentation, fundamentally relying on the principles of the hard sciences, engineering, or computer science.

**Note:** Merely demonstrating uncertainty existed and has been eliminated is insufficient to satisfy the "process of experimentation test."

In order for activities to constitute qualified research, 80 percent or more (substantially all) of the taxpayer's research activities for each business component, measured on a cost or other consistently applied reasonable basis (and without regard to Treas. Reg. [§1.41-2\(d\)\(2\)](#)), must constitute elements of a process of experimentation for a qualified purpose. If this substantially all requirement is met for the business component, then the balance of the research activities of the business component may qualify, if the remaining balance meets the requirements of IRC [§ 41\(d\)\(1\)\(A\)](#) (with respect to which expenditures may be treated as expenses under §174), as long as they are not activities excluded under IRC [§41\(d\)\(4\)](#).

The requirements of IRC [§41\(d\)](#) are to be applied first at the level of the discrete business component, i.e., the product, process, computer software, technique, formula, or invention to be held for sale, lease, or license, or used by the taxpayer in its trade or business. If the requirements for credit eligibility are met at that business component level, then some, or all, of the taxpayer's research activities are eligible for the credit. If all aspects of such requirements are not met at the business component level, the test applies at the most significant subset of elements of the product, process, computer software, technique, formula, or invention to be held for sale, lease, or license. This "shrinking back" is to continue until either a subset of elements of the business component that satisfies the requirements is reached, or the most basic element of the business component is reached and such element fails to satisfy the test.

See IRC Regulation [§1.41-4\(a\)\(8\)](#) for examples illustrating the application of the "process of experimentation" test.

## Activities that are Not Qualified Research

Activities described under IRC [§41\(d\)\(4\)](#) do not constitute "qualified research," and include:

- Research conducted after beginning of commercial production of the business component.
- Research related to the adaptation of an existing business component to a particular customer's requirement or need.
- Research related to the reproduction of an existing business component (in whole or in part) from a physical examination of the business component itself or from plans, blueprints, detailed specifications, or publicly available information about the business component is not qualified research. This exclusion does not apply merely because the taxpayer examines an existing business component in the course of developing its own business component.
- Any efficiency survey; activity related to management function or technique; market research testing, or development (including advertising and promotions); routine data collection; or routine or ordinary testing or inspection for quality control.
- Research related to the development of computer software for internal use by the taxpayer (exceptions apply).
- Research conducted outside the United States, the Commonwealth of Puerto Rico, or any possession of the United States.

**Note:** Indiana law further requires the research to actually be conducted in Indiana to be eligible for the research credits.

- Research related to social sciences, arts, or humanities.
- Research to the extent funded by any grant, contract, or otherwise by another person or government entity.

See Treas. Reg. [§1.41-4\(c\)](#) for additional information relating to activities that are not qualified research.

## RESEARCH EXPENSE CREDIT

### Purpose of the Credit

The Indiana research expense credit provides an incentive for increasing qualified research activities that are conducted in Indiana.

### What Credit is Available?

A taxpayer may be eligible for a credit on qualified research expenses incurred in Indiana. The potential value of the credit is equal to the taxpayer's qualified research expense for the taxable year, minus the base period amount up to \$1 million, multiplied by 15 percent. A credit percentage of up to 10 percent is applied to any excess of qualified research expenses over a base period amount greater than \$1 million.

Additionally, for the aerospace industry, as well as for Indiana qualified research expenses, an alternative method of calculating the credit is available. At the taxpayer's election, the amount of the taxpayer's research expense tax credit is equal to ten percent of the part of the taxpayer's Indiana qualified research expense for the taxable year that exceeds 50 percent of the taxpayer's average Indiana qualified research expense for the three taxable years preceding the taxable year for which the credit is being determined. However, if the taxpayer (other than aerospace industry taxpayers) did not have Indiana qualified research expenses in any one of the three taxable years preceding the taxable year for which the credit is being determined, the amount of the research expense tax credit is equal to five percent of the taxpayer's Indiana qualified research expense for the taxable year. Credits awarded pursuant to the relevant statutory provisions may be carried forward for up to 10 taxable years.

### **Who is Eligible to Compute and Claim the Credit?**

Corporations and pass through entities (S corporations, partnerships, LLCs and LLPs), trusts and estates can claim the credit against their own liabilities. However, beneficiaries of estates or trusts are NOT eligible except Grantor Trusts.

### **Qualified Research Expenses**

**Qualified research expenses** are defined under IRC [§41\(b\)](#), and must be incurred in an activity meeting the definition of "qualified research" as explained in Part II. Further, the qualified research expenses must be incurred in qualified research activities being conducted in Indiana.

Under IRC [§41\(b\)](#), "**qualified research expenses**" include:

- In-house research expenses
- Contract research expenses

Indiana does follow the following provisions of IRC [§ 41](#) for purposes of computing the Indiana research expense credit:

- Section 41(f)(1), which provides special rules for the aggregation of expenditures for a controlled group of taxpayers filing a federal consolidated return
- Section 41(f)(2), which provides for special allocations in the case of trusts and partnerships
- Section 41(f)(5), relating to the definition of a controlled group of corporations
- Section 41(f)(6), regarding an energy research consortium
- The changes to IRC § 41 under [§ 1351 of P.L. 109-58](#), as it pertains to certain collaborative energy research consortia.

In addition, **qualified research expenses** under IRC [§41\(b\)](#) are further modified for Indiana purposes by including only expenses for qualified research conducted in Indiana.

**Qualified research expenses** are equal to the sum of **in-house research expenses** and **contract research expenses** for research conducted in Indiana. Additionally, the research expenditures must relate to a particular business being carried on by the taxpayer.

### In-House Research Expenses

In-house research expenses are any of the following incurred in Indiana:

- Wages paid or incurred to an employee for **qualified services** performed by that employee
- Supplies that are used in the conduct of qualified research
- Amounts paid to or incurred to another person for the right to use computers in the conduct of qualified research

### *Wages*

Generally, wages paid to an employee constitute in-house research expenses only to the extent the wages are paid or incurred for **qualified services** performed by the employee. For this purpose, “wages” means wages as defined in IRC [§ 3401\(a\)](#). This includes all taxable wages as reported on Form W-2, including bonuses and stock option redemptions. It does not include amounts that are not subject to withholding, such as certain fringe benefits or non-taxed income, even if paid for research services performed by an employee.

Exception: “Wages” for employees within the meaning of IRC [§ 401\(c\)\(1\)](#) (self-employed individuals and owner-employees) includes the earned income, as defined in IRC [§ 401\(c\)\(2\)](#), of such employee.

There are three qualified services:

- Engaging in qualified research;
- Directly supervising qualified research; or
- Directly supporting qualified research.

Treasury Regulation [§ 1.41-2\(c\)](#) provides the following definitions of qualified services:

- The term **engaging in qualified research** means the actual conduct of qualified research, as in the case of a scientist conducting laboratory experiments.
- The term **direct supervision** means the immediate supervision (first-line management) of qualified research (as in the case of a research scientist who directly supervises laboratory experiments, but who may not actually perform experiments). Direct supervision does not include supervision by a higher-level manager to whom first-line managers report, even if that manager is a qualified research scientist
- The term **direct support** means services in the direct support of either persons engaging in the actual conduct of qualified research, or persons who are directly supervising persons engaging in the actual conduct of qualified research. Direct support of research includes, but not limited to, the services of a:
  - Secretary for typing reports describing laboratory results derived from qualified research
  - Laboratory worker for cleaning equipment used in qualified research
  - Clerk compiling research data for qualified research
  - Machinist for machining a part of an experimental model used in qualified research

Direct support of qualified research activities does not include general administrative services only indirectly of benefit to research activities, regardless of whether the personnel are assigned to the research department or some other department, such as:

- Payroll personnel preparing salary checks for laboratory scientists
- Accountants who account for research expenses
- Janitors who perform general cleaning of a research laboratory
- Officers who engage in supervising financial or personnel matters

Supervisory services constitute qualified services only to the extent the services are **direct supervision** as explained previously.

If an employee performs both qualified and nonqualified services, only the amount of wages allocated to the qualified services is allowed. Absent another method of allocation that the taxpayer can demonstrate to be more appropriate, the amount of allowable wages shall be determined by multiplying the total amount of wages by the ratio of the total time actually spent by the employee in performance of qualified services to the total time spent by the employee for all services for the year.

**Note:** It is important to keep records to support the actual time spent in performing qualified services by each employee for each business component. See Part V for more information on recordkeeping.

### *Supplies*

A taxpayer may claim the research credit for amounts paid or incurred for supplies used in the conduct of qualified research in Indiana. Supplies are considered used in the conduct of qualified research if they are used in the performance of qualified services by an employee of the taxpayer (or person acting in the capacity of an employee). In order to be a qualified research expense (QRE), a supply must be directly related to the performance of qualified services. Expenses for property used in general and administrative activities are not QREs. For the purposes of IRC [§ 41](#), supplies are non-depreciable tangible property acquired by the taxpayer that are used in the performance of qualified services.

Examples of costs that are not supply QREs are:

- land or improvements to land
- services
- depreciable property
- intangible property (e.g., software)
- indirect supplies
- overhead expenses
- licenses and fees
- rent expenses for equipment (except certain computers)
- travel, meals or entertainment
- telephone expenses of researchers
- relocation or moving expenses
- professional dues
- royalty or franchise expenses

### *Use of computers to conduct qualified research:*

- QREs may include amounts paid or incurred for the use of time sharing computers in the conduct of qualified research
- The computer must be owned and operated by someone other than the person computing the credit, located off that person's premises, and must not be that person's primary computer.
- Does not apply if the person computing the credit receives or accrues an amount from another person for the right to use substantially identical personal property.

## Contract Research Expenses

A contract research expense is 65 percent of any expense paid or incurred in carrying on a trade or business to any person (other than an employee of the taxpayer) for the performance on behalf of the taxpayer of qualified research in Indiana, or services performed in Indiana which, if performed by employees of the taxpayer, would constitute qualified services within the meaning of IRC [§41\(b\)\(2\)\(B\)](#). If any contract research expense is attributable to qualified research to be conducted after the close of the taxable year, it shall be treated as paid or incurred when the qualified research is conducted. Therefore, prepaid research expenditures are not eligible for the credit until the services are performed.

Treasury Regulation [§1.41-2\(e\)](#) provides a three-part test for determining if the payment is for the performance of qualified research where a third party performs the research for the taxpayer. An expense is considered paid or incurred for the performance of qualified research only to the extent that it is paid or incurred pursuant to an agreement that:

- is entered into prior to the performance of the qualified research,
- provides that research be performed on behalf of the taxpayer, and
- requires the taxpayer to bear the expense even if the research is not successful.

Qualified research is considered performed on behalf of the taxpayer if the taxpayer has a right to the research results. Qualified research can be performed on behalf of the taxpayer notwithstanding the fact that the taxpayer does not have exclusive rights to the results. Also, if the expense is paid or incurred pursuant to an agreement under which payment is contingent on the success of the research, then the expense is considered paid for the product or result, rather than the performance of research, and the payment is not a qualified contract research expense.

**Note:** Since the Indiana credit is only available for research activities conducted in Indiana, the taxpayer shall be responsible to retain documentation to demonstrate the research activities conducted by the hired contractor were performed in Indiana in order to claim the credit for these expenses.

## **Credit Computation**

The Indiana research expense credit is computed using the qualified research expenses incurred during the taxable year and, for the alternative simplified credit, the 3 prior taxable years. Special rules apply in the case of members of a consolidated group. See Part III sections D and G.

**Research Credit for Increasing Research:** To determine the credit, the first step is to determine the Indiana qualified research expenses for the current taxable year. For the second step, take the Indiana fixed-base percentage (computed in the manner set forth under IRC § 41(c)) multiplied by the average Indiana gross receipts of the taxpayer for the four previous years. However, the amount under the second step cannot be less than 50 percent of the Indiana QREs for the current taxable year. Finally, determine the difference between the Indiana qualified research expenses and the amount in computed in the second step (“the excess”). Thus, for 2018, the excess on which the credit is computed would be equal to the lesser of:

- Indiana QREs for 2018-(Indiana fixed-base percentage \* Average Indiana receipts for 2014-2018).
- Indiana QREs for 2018 x 50 percent.

If the excess is not greater than \$1,000,000, the credit is equal to 15% of the excess. If the excess is greater

than \$1,000,000, the credit is equal to 10% of the excess above \$1,000,000 plus \$150,000.

**Alternative simplified credit and special aerospace industry credit:** For the alternative simplified credit, a taxpayer is entitled to a credit equal to the Indiana qualified research expenses for the current year minus fifty percent of the average Indiana qualified research expenses for the three previous years. For taxpayers that do not qualify for the credit under IC 6-3.1-4-2.5 (related to the aerospace industry), if the taxpayer did not have Indiana qualified research expenses during any the three previous years, the credit is equal to five percent of the current year's Indiana qualified research expenses.

Short period adjustments: If a credit year is a short taxable year, then the base amount (fixed-base percentage times average gross receipts for the previous four years) must further be multiplied by the months in the short taxable year, then divided by twelve.

If one or more of the 4 prior years is a short taxable year, gross receipts for such short taxable year are multiplied by twelve and divided by the months in the short taxable year.

For the alternative simplified credit, if one or more of the 4 prior years is a short taxable year, then the QREs for the short taxable year(s) are deemed to be equal to the QREs actually paid or incurred in that year multiplied by 365 and divided by the number of days in that year.

Acquisitions and dispositions of portion of business: The computation of the credit may need to be adjusted. See Treas. Reg. 1.41-6 for further explanation.

## Claiming the Credit

Schedule IT-20REC must be used to calculate the credit for increased research activities conducted in Indiana. The credit is 15% of the increase in Indiana qualified research expenses paid or incurred in the taxable year over the taxpayer's base amount if it is \$1 million or less. The credit is 10% if the amount is in excess of \$1 million. "Indiana qualified research expense" means qualified research expense (as defined in Section 41(b) of the IRC) incurred for research conducted in Indiana. "Base amount" means base amount as defined in IRC Section 41(c), modified by considering only Indiana qualified research expenses and gross receipts attributable to Indiana in the calculation of both of the taxpayer's:

- (1) fixed base percentage;
- (2) average annual gross receipts.

For purposes of codes 01, 03, 04, or 05, use of these codes require **both**:

- Computation of a positive federal credit under either IRC Sections 41(a)(1) or 41(c)(4).
- The federal credit computation included all Indiana qualified research expenses claimed on this IT-20REC.

For purposes of the codes above, "computation of a positive federal credit" or similar language means a computation based on federal Form 6765 and supplied with the taxpayer's federal tax return for the year in which the federal tax return is filed. "Claiming the credit" or similar language means reporting the credit on the taxpayer's federal tax return. In the case of a pass-through entity such as an S corporation or partnership, "claiming the credit" means making the credit available for the shareholders or partners to use on their returns.

## Combined/Consolidated Groups

In the case of corporations that comprise a controlled group of corporations, the credit must be computed in aggregate for the entire group. Then, the credit is pro-rated among the members of the group. See Treas. Reg. §§1.41-6 and 1.41-6T for further illustrations of how the computation works in this situation. Note: If the taxpayer has different filing entities in its federal consolidated and Indiana consolidated groups, this calculation would need to be re-performed to include only those entities with Indiana research credits that are in the Indiana consolidated filing group.

## **Unused Credits**

The amount of credit not entirely offset against Indiana income taxes may be carried forward and credited against Indiana income taxes due for up to ten years. However, IC 6-3.1-4-3(b) provides that a current year credit must be used to offset that year's tax liability prior to any carryforward credit being applied. In other words, if a taxpayer has a credit carryforward from 2010 and a 2018 credit, the 2018 credit must be applied first before applying the 2010 credit.

For combined groups the research expense credit carry forward must be used first by the earning member up to the amount of their tax liability, and then by other members of the group up to the amount of their tax liability. (Note: It may only be applied within the statute of limitation to claim a refund.)

## **Additional Information**

Detailed information is available from the following sources:

- Form IT-20REC and Instructions
- Indiana Sales Tax Information Bulletin: #75

## **SALES AND USE TAX EXEMPTION FOR QUALIFIED RESEARCH IN INDIANA**

A sales and use tax exemption is available for purchases of certain property used exclusively and directly in qualified research. IC 6-2.5-5-40 provides a sales tax exemption for research and development property. In 2015, P.L. 242-2015 amended IC 6-2.5-5-40 to clarify that certain activities are not considered research and development activities and to clarify that certain activities are considered incidental to research and development activities.

The following definitions related to research and development property apply:

- "Research and development property" means tangible personal property that has not previously been used in Indiana for any purpose and is acquired by the purchaser for the purpose of research and development activities in Indiana.
- "Research and development activities" include design, refinement, and testing of prototypes of new or improved commercial products conducted before sales have begun for the purpose of determining facts, theories, or principles, or for the purpose of increasing scientific knowledge that may lead to new or

enhanced products. “Research and development activities” does not include:

- efficiency surveys;
- management studies;
- consumer surveys;
- economic surveys;
- advertising or promotions;
- research in connection with literary, historical, or similar projects;
- testing for purposes of quality control;
- marketing and sales research;
- product market testing, including product testing by product consumers or through consumer surveys for evaluation of consumer product performance or consumer product usability;
- the acquisition, investigation, or evaluation of another’s patent, model, process, or product for the purpose of investigating or evaluating the value of a potential investment; or
- the providing of sales services or any other service, whether technical or nontechnical in nature.

## Purchasing Exempt Items

The exemptions for research and development equipment and research and development property apply only to equipment or property purchased for the purpose of research and development activities. The exemption for research and development property applies regardless of whether the person who acquires the property is a manufacturer or seller of the new or existing products that are the subject of the research and development activities in Indiana.

Further, the rules applicable to the sales tax exemption for research and development property and the rules applicable to the credit for increasing research expenses under IC 6-3.1-4 are not identical. While some categories of expenses would qualify for both, the sales tax exemption and income tax credit have somewhat different provisions which may permit certain expense purchases to qualify for either the exemption or the credit but not both. With regard to the sales tax exemption, the only restrictions are that the property must not have been previously used in Indiana for any purpose and must have been acquired by the purchaser for the purpose of research and development activities. Thus, if an item is originally purchased for an unrelated purpose, such as inventory held for resale or machinery used for a different purpose, and is subsequently used in research and development activities, the subsequent use of the item in research and development activities is taxable.

**Note:** to qualify for the exemption, the property must be used directly in research and development activities. Office supplies, consumables, hand-powered tools, and repair parts are all examples of items that may be exempt from sales tax as research and development property only when directly used in research and development activities.

Office furniture, furnishings, storage equipment, and other items that are not used directly in research and development activities are subject to tax.

Additionally, to qualify for the exemption, the property must be devoted to a research and development activity that is considered essential and integral to experimental or laboratory research and development.

Certain activities will not be considered to be devoted to experimental or laboratory research and

development. Any items purchased for these purposes will not qualify for the exemption. These activities include:

- heating, cooling, or illumination of office buildings;
- capital improvements to real property;
- janitorial services;
- personnel services or accommodations;
- inventory control functions;
- management or supervisory functions;
- marketing;
- training;
- accounting or similar administrative functions; or
- any other function that is incidental to experimental or laboratory research and development.

### **How is This Exemption Claimed?**

The purchaser must complete [Form ST-105](#), *Indiana Sales and Use Tax Exemption Certificate*, and provide it to the seller at the time of purchase. Otherwise, the purchaser must pay the tax to the seller at the time of purchase and then file a claim for refund (Form GA-110L) with the department.

### **What Documentation Must be Kept?**

A business claiming the exemption is required to maintain records adequate to substantiate the purchase price of the products used in qualified research.

## **RECORDKEEPING**

Claiming a credit for expenses paid or incurred in conducting qualified research in Indiana or claiming the sales and use tax exemption for property used in qualified research activities requires that activities constituting “qualified research” be conducted in Indiana. When claiming an Indiana research expense credit, or the sales and use tax exemption for property used in qualified research, contemporaneous records must be kept which demonstrate that the activity for which a research credit or sales and use tax exemption is claimed constitutes “qualified research” under IRC [§41\(d\)\(1\)](#).

Indiana law does not indicate the specific records to be maintained. IC 6-8.1-5-4 provides a general record keeping requirement for a taxpayer to maintain its books and records, including any source documentation necessary to determine the amount of a person’s tax liability. Additionally, the Internal Revenue Service regulations require a taxpayer claiming a credit under IRC [§41](#) to maintain records in sufficiently usable form and detail to substantiate that the research expenditures claimed are eligible for the credit. While the IRC does not contain a particular approach or accounting methodology for capturing expenditures, it does require identification of the qualified research expenses by business component (qualified activity). The business component reflects the actual activity undertaken to discover new information where the activities reflect components of a process of experimentation. Indiana follows IRC [§41](#), with certain exceptions, for the definition of “qualified research” and qualified research expenses. See Part II for the discussion of what is qualified research.

## **Substantiating Indiana Research Credits and Sales and Use Tax Exemptions**

Documents created at the time the qualified research activities are performed should be prepared and maintained by project and must show:

- Listing of each new or improved business component
- Project scope (including the uncertainty and the alternative methods for resolving the uncertainty)
- Research and testing activities performed in Indiana
- Research and testing activities performed in Indiana through a contract with a third party vendor
- Material and supplies used or consumed in Indiana
- Time spent on research and testing activities by employees in Indiana
- Results of the research (including evaluation of tests performed and summary of uncertainty resolved)

Examples of contemporaneous project documentation may include:

- Project proposals, authorization requests, budgets or work orders that initiate or approve a research project
- Purchase order and invoices, material/supplies withdrawn from inventory
- Job description and time records for each employee spent performing research activities
- Work orders and capital addition requests
- Testing verification data such as test summaries or reports
- Project summaries, progress reports and/or project meeting minutes
- Minutes, notes, status reports or other submissions to management, the board of directors, review committees or other similar groups regarding research projects, activities, progression, findings and expenditures
- Complete copies of contracts (including all modifications), letter agreements, memoranda of understanding, or similar documents for research performed by or on behalf of a third party
- Any funding received by grant, contract, or otherwise by another person (or governmental entity)
- Patent applications
- Prototype and process testing reports
- Work papers documenting how the research credit is computed

**Caution:** This list is not all-inclusive. Additional documents may be necessary to support the expenses used in computing that credit or claiming the activities qualify or are related to the qualified research expenses incurred in Indiana. Generally, this documentation needs to be gathered at the time the qualified research was performed.

### **Gathering Contemporaneous Documentation to Support an Indiana REC Claim**

Reg. § 1.41-4(d) provides that taxpayers must retain records in sufficiently usable form (i.e. in an Internal Revenue Service (IRS) audit ready format per the IRS Audit Technique Guidelines for research tax credit claims) and detail to substantiate claimed QREs which include wages, supplies and contract research and QRAs at the project level. To that end, it is critical that sufficient contemporaneous documentation be identified, gathered, properly compiled, and retained as forms of substantiation documentation to assist in ensuring that the Department does not disallow the REC claim should an examination become necessary.

In cases in which a company is regulated by the government such as Life Science companies (e.g. pharmaceuticals, bio-technology & medical devices) then the FDA record keeping requirements can be used to support research activities. In cases where companies apply for a patent or have a patent granted, then these forms of contemporaneous documentation serve as the strongest forms of proof.

From a best practice perspective, the following are a limited set of timely examples of contemporaneous documentation that the IRS typically requests during the course of an examination:

Complete Project Lists identifying the full Scope of Research Based Projects vs. the Actual Claimed Research Projects after Conducting Systematic Project Based Quantitative Interview

- Patents or Patent Applications
- Annual R & D or Technology Plans
- Research Project Authorization Requests
- Internal and External Correspondence on R & D
- Design Requirements or Functional Specifications
- Testing Scripts or Testing Logs
- Modifications Reports or Error Logs
- Technical Reports or Plans
- Laboratory Notebooks
- Ingredient Consumption Worksheets and/or
- Raw Material Usage Records

The Department recommends that the more contemporaneous documentation from the aforementioned list that can be obtained and should be obtained and meticulously compiled in an IRS audit ready format as it will strengthen the merits of the REC claim and overall REC filing position.

### **Are Studies Done Subsequent to the Research Sufficient to Substantiate Research Credits Claimed Upon Audit?**

The Department of Revenue, when auditing records relating to research credit, has found credits calculated based on interviews, estimates, and data manipulation done several years after the research was performed, which is then presented as the only proof of the credits claimed.

These studies often do not establish the required connection between qualified research expenses and qualified research activities. While most accounting systems contain information to identify and measure expenditures, they don't contain information that details whether research and development activities meet the statutory requirements under IRC [§41](#). The studies rely on surveys, interviews, and other input from internal personnel, often referred to as Subject Matter Experts (SMEs). The method attempts to create a connection between the qualified research expenses and qualified research activities by the assignment of a time percentage by the SME to the qualified research activity.

Project based accounting captures research costs at the "business component" level, and it generally establishes the required nexus, whereas cost center accounting typically does not. Various types of methodologies are used in studies to reconstruct the amount claimed for the research credit. Most studies reflect a combined hybrid approach. The hybrid method may be a combination of project and cost center methods, adopting portions of each approach for which records are most easily available. The manner in which the information is compiled should support the relationship between the accounting records and the research activities or qualified research expenses. Studies lacking this relationship have failed to establish nexus, and therefore studies alone do not establish qualified research activities and expenses. In other words, the nexus problem is the inability to connect specific research project(s) and the underlying activities to the qualified expenses incurred in Indiana.

A common example of the hybrid/nexus problem is in the case of qualified wages established by capturing W-2 wage amounts by cost center and multiplying a qualified percentage to individual employee's wages or department total wages. The determination of the "qualified" percentage is based on oral testimony from a selected manager's recollection or estimate of the amount of time particular employees devote to qualified activity, excluded activity, or other nonqualified activities. These managers/employees are often referred to as SMEs and may or may not have worked in the areas or performed services for the taxpayer during the years for which they will be opining. These representations may or may not be supported by measurable corroborative records.

Random and unsupported allocations (estimates) are insufficient to support a claim and are generally not accepted. Allocation percentages applied to Indiana incurred expenses associated with documented qualified research activities may be accepted only when there is substantial evidence and records to support such allocations.

## **AUDITING THE RESEARCH CREDITS AND SALES TAX EXEMPTION**

The department uses guidance from the IRS in auditing the research credit. The IRS Audit Techniques Guide for research credits is posted on its website at: [irs.gov/businesses/research-credit](https://www.irs.gov/businesses/research-credit).

When DOR finds that the IRS has already audited a company's research credit, any determination by the IRS is followed by DOR (excluding settlements) to the extent the expenses in question were incurred in Indiana. However, if DOR finds that the IRS limited its scope of review to only certain research projects or locations that did not include Indiana operations, DOR auditors may review the computations and documentation of research credits for those operations in greater detail, making adjustments as appropriate. The primary reasons for adjustments to an Indiana research credit include:

- The IRS adjusted the federal research credit
- Research was claimed by the incorrect entity (funded research)
- Research performed was not qualified research as defined in IRC [§ 41\(d\)\(1\)](#)
- Expenditures for qualified research could not be adequately substantiated
- Inadequate contemporaneous documentation to determine qualified activity or expense
- Fixed base percentage computed incorrectly
- Including expenses and contract research performed outside of Indiana
- Including supplies which are not directly consumed in research (manufacturing, administrative, etc.)
- Including wages not directly related to conducting qualified research

**Indiana follows the record keeping procedures required by the IRS. Rules governing record retention are** included in Treasury Regulation Section 1.6001-1. Detailed records must be maintained in a usable form to validate expenditure claims.

### **Reviewing Documentation**

The Department follows the IRS determination that interviewing employees to reconstruct the activities believed to qualify – or not qualify – is generally insufficient in determining what employees did and whether such expenses qualify for the research credit. Without additional evidence, the credit claimed may be

adjusted. During an audit (review), the department may request records generated at the time the research activities were performed. Some examples include, but are not limited to:

### *Research Activities*

- List of research activities – new or improved business components and location where activity was conducted.
- Description of the new or improved function, performance, reliability, or quality of each of these business components.
- Description of the process of experimentation, in chronological order, of all the steps or activities undertaken when developing or improving a product or business component. For example, present a time-line description of the company's development processes and procedures.
- Documentation showing the scope of the research activities, including things like the problem to solve, potential solutions, concerns, and project authorization requests.
- Procedure manual, project checklist, technical abstract, lab schedule, lab report, project status report, summary experiment data results, etc. for products or business components developed or improved, and claimed for the research credit.
- Issue logs, meeting minutes, chronological timeline, internal memos, emails, patent applications, abstracts, work orders, budgets, capital addition requests, purchase orders, invoices, contractual agreements with customers, grants, etc. related to the research.
- Workpapers generated while calculating the credit.

### *Wages*

- Organizational chart
- Names and work titles of the employees whose wages are included in the computation. Also include:
  - Position description, what each employee did, and the amount of their time and wages included in the credit.
  - Timesheets covering the time.
  - Social Security numbers and W2s.
  - Breakdown of wages claimed by employee, year and qualified project.
  - Any other documentation tying them to the R&D credit claim.

### *Supplies*

List of the supplies claimed showing they are tangible property (link to definition or provide definition of) used in conducting qualified research and used or consumed by an employee of the company performing qualified activities, the corresponding amount, and invoices.

Supplies do not include: land and land improvements, capital equipment, or general and administrative supplies such as travel or telephone expenses.

### **Contracted Research**

- Names, addresses, and FEINs of any contractors and amount claimed for each contractor.
- The location where the contractor conducted the claimed activities.
- Description of the research activities performed.

- Description of ownership relationships between the company claiming the credit and the contractor.
- Contractual agreements and invoices.

## **QUESTIONS OR ADDITIONAL INFORMATION**

If you are unable to find an answer to your questions, contact the department by email at [Bkolb@Dor.IN.Gov](mailto:Bkolb@Dor.IN.Gov) or by phone at **317-232-2566**.

# Appendix A: INDIANA RESEARCH EXPENSE TAX CREDIT #822 (SCHEDULE IT-20REC)

2017 Corporate/Partnership Income Tax Forms

## Appendix B: INITIAL INFORMATION DOCUMENT REQUEST FORM



**STATE OF INDIANA**  
DEPARTMENT OF REVENUE

Date: \_\_\_\_\_

Representative: \_\_\_\_\_

Taxpayer: \_\_\_\_\_

RE: Initial Information Document Request

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**Indiana Income Tax - Years \_\_\_\_\_ through \_\_\_\_\_**

1. Federal returns as filed with the IRS (with all supporting schedules and statements).  
Attached  Don't Have
2. State returns (with all supporting schedules and statements). Attached  Don't Have
3. Has the IRS audit performed an audit or review of your income tax? If so, please provide any:
  - a. RAR Reports Attached
  - b. Communication between the IRS Attached
  - c. Documentation Requests sent by the IRS AttachedA list of documentation provided to the IRS for review Attached

**Indiana Research and Expense Credits Years \_\_\_\_\_ through \_\_\_\_\_**

4. Please provide a list of all projects. Attached  Don't Have
5. Please provide a brief description of each project that describes what happened in enough detail and using terms that someone who is not an expert nor experienced in your field could understand what occurred. Attached  Don't Have
6. For Qualified Wages:
  - a. A spreadsheet that shows how many hours each employee worked on each project/business component. Attached  Don't Have
  - b. How many hours the employee worked in total for each year in the audit period.  
Attached  Don't Have
  - c. The job title of each employee. Attached  Don't Have
  - d. Work location of each employee. Attached  Don't Have
  - e. If you do not have any of the above, please provide any/all documentation you do have to support qualified wages reported. Attached  Don't Have
7. For Qualified Supplies:
  - a. A spreadsheet that shows for each of the supplies invoices: invoice date, invoice number, vendor name, description of the purchase, qualified supply invoice amount, total amount, and project/business component for which the supply was consumed.  
Attached  Don't Have

b. If you do not have the above, please provide any/all documentation you do have to support qualified supplies reported.

Attached  Don't Have

8. For Qualified Contract Research:

a. A spreadsheet that shows for each contract research invoice: invoice date, invoice number, vendor name, description of purchase, amount, and project/business component to which the contract research was related.

Attached  Don't Have

b. Copies of the contracts and/or engagement documents. Attached  Don't Have

c. If you do not have any of the above, please provide any/all documentation you do have to support qualified contract research reported. Attached  Don't Have

9. Research and Development Stud

a. Did an outside consultant provide a research and development study? If so, please provide the study. Attached  Don't Have

b. When did you meet with a consultant? Who attended the initial engagement meeting?

Attached  Don't Have

i. Please provide any documentation that was retained regarding the engagement, such as:

- |   |                                   |                                     |
|---|-----------------------------------|-------------------------------------|
| 1. Interview Notes                                  | Attached <input type="checkbox"/> | Don't Have <input type="checkbox"/> |
| 2. Agreements and Contracts                         | Attached <input type="checkbox"/> | Don't Have <input type="checkbox"/> |
| 3. Engagement Letters                               | Attached <input type="checkbox"/> | Don't Have <input type="checkbox"/> |
| 4. Any other documentation regarding the engagement | Attached <input type="checkbox"/> | Don't Have <input type="checkbox"/> |

10. Please provide a schedule showing when a credit was claimed, the years to which the credit was applied, and the amount of credit available for carryforward.

Attached  Don't Have

11. Additional documentation requested:

a. Attached  Don't Have

b. Attached  Don't Have

c. Attached  Don't Have

d. Attached  Don't Have

12. Please provide any other documents that you believe will be helpful in the initial review of the research expense credit.

Attached  Don't Have

- a.
- b.
- c.

Please note that this is an initial information document request, and the information and documentation provided in response to this request will serve as an initial basis for our review. After receiving the documentation and information requested, the department will follow-up with additional questions and a list of additional information and documentation needed.

**Please provide the above requested information/documentation by:**