DEPARTMENT OF STATE REVENUE

02-20200290.SLOF

Supplemental Letter of Findings 02-20200290
Corporate Income Tax
For the Years 2015 and 2016

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 This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register.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

HOLDING

The Department again disagreed with Indiana Recreational Vehicle Manufacturer that income derived from sales of its vehicles to customers in other states during 2015 should not have been "thrown back" to Indiana and subjected to Indiana's income tax; Manufacturer's agreement to pay the cost of repairs - based on a request submitted by third-party, out-of-state repair facility on behalf of one of Manufacturer's customers - did not cause Manufacturer to exceed the "mere solicitation standard" in that state. The Department also rejected Manufacturer's claim to research expense income tax credits because Manufacturer failed to provide documentation sufficient to verify the labor and supply expenses claimed.

ISSUES

I. Corporate Income Tax - Throw-back Sales.

Authority: 15 U.S.C. § 381; IC § 6-3-2-1(b); IC § 6-3-2-2(a); IC § 6-3-2-2(n); IC § 6-8.1-5-1(c); *Dept. of State Revenue v. Caterpillar, Inc.*, 15 N.E.3d 579 (Ind. 2014); *Indiana Dep't of State Revenue v. Rent-A-Center East, Inc.*, 963 N.E.2d 463 (Ind. 2012); W*endt LLP v. Indiana Dep't of State Revenue*, 977 N.E.2d 480 (Ind. Tax Ct. 2012); *Scopelite v. Indiana Dep't of Local Gov't Fin.*, 939 N.E.2d 1138 (Ind. Tax Ct. 2010); *Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue*, 867 N.E.2d 289 (Ind. Tax Ct. 2007); *Sherwin-Williams Co. v. Indiana Dep't. of State Revenue*, 673 N.E.2d 849 (Ind. Tax Ct. 1996); 45 IAC 3.1-1-38; 45 IAC 3.1-1-64; Black's Law Dictionary (11th ed. 2019).

Taxpayer argues that money it received during 2015 from sales of its vehicles to customers in eleven other states and jurisdictions should not have been "thrown back" to Indiana on the ground that Taxpayer was subject to income tax in those eleven jurisdictions.

II. Corporate Income Tax - Documenting Research and Expense Credits.

Authority: IC § 6-3.1-4-1; IC § 6-3.1-4-4; IC § 6-8.1-5-4; IC § 6-8.1-5-1(c); Treas. Reg. § 1.41-4(d); Treas. Reg. § 1.6001-1; *IDOPCP, Inc. v. Comm'r*, 503 U.S. 79 (1992); *New Colonial Ice Co. v. Helvering*, 292 US. 435 (1934); *United States v. McFerrin*, 570 F.3d 672 (5th Cir. 2009); *Stinson Estate v. United States*, 214 F.3d 846 (7th Cir. 2000); *Conklin v. Town of Cambridge City*, 58 Ind. 130 (1877); *Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue*, 867 N.E.2d 289 (Ind. Tax Ct. 2007); *Indiana Dep't. of State Revenue, Sales Tax Division v. RCA Corp.*, 310 N.E.2d 96 (Ind. Ct. App. 1974); *Audit Techniques Guide: Credit for Increasing Research Activities* (2020).

Taxpayer maintains that the Department erred in disallowing labor and supply research expense credits (RECs) on the ground that it conducted qualifying research activities and incurred the research labor and supply costs during the years at issue.

III. Corporate Income Tax - Statute of Limitations.

Authority: IC § 6-3-4-12; IC § 6-8.1-5-2; 45 IAC 15-5-7.

Taxpayer claims that the Department's assessment of 2015 corporate income tax is barred by the three-year statute of limitations.

STATEMENT OF FACTS

Taxpayer is an Indiana company in the business of constructing and selling recreational vehicles and fifth-wheel trailers. Taxpayer fabricates, assembles, paints, and performs a final "finish" on each of the vehicles produced at its Indiana facilities.

Taxpayer is organized as an LLC and elected to file as a partnership with the Taxpayer's income "flowing through" to the partners.

The Indiana Department of Revenue ("Department") conducted an audit review of Taxpayer's income tax returns and business records. The audit found that Taxpayer had not included in the numerator of its apportionment factor sales made to customers in eleven other states and jurisdictions including Canada. The audit concluded that Taxpayer's activities in those eleven jurisdictions did not subject Taxpayer to an income tax in those locations. Therefore, for the year 2015, the audit "threw back" to Indiana these out-of-state sales amounts. That audit decision resulted in an assessment of additional Indiana income tax.

The audit also found fault with Taxpayer's claim to research and expense credits attributable to labor and supply expenses incurred during 2015 and 2016. The audit disallowed the expense credits on the ground that Taxpayer failed to document the extent to which its employees engaged in any qualifying research activities. The Department disallowed the credits in their entirety. That decision resulted in yet an additional assessment of Indiana income tax.

Taxpayer protested the audit assessment arguing that Indiana should not "throw back" Taxpayer's sales to out-of-state customers in these eleven jurisdictions. Taxpayer also argued that it was entitled to claim the Indiana research and expense credits and that it had sufficiently documented the nature and extent of those labor and supply expenses. Taxpayer submitted a protest to that effect. An administrative hearing was conducted during which Taxpayer's representative explained the basis for the protest. Letter of Findings 02-20191301 (January 17, 2020), 20200401-Ind.Reg.-045200108NRA, was issued denying Taxpayer's protest.

The Letter of Findings ("LOF") found that Taxpayer had failed to meet its burden of establishing that sales of its vehicles to customers in eleven other jurisdictions should not have been "thrown back" to Indiana because Taxpayer's activities in those jurisdictions did not exceed the "mere solicitation" standard. In addition, the LOF held that Taxpayer did not meet its burden of establishing that it was entitled to claim Indiana's research expense income tax credits.

Taxpayer disagreed with the LOF's conclusions arguing that the LOF "misstates facts, misapplies applicable law, and fails to address arguments raised in the original protest submission." Taxpayer asked for and was granted its request for a rehearing. A supplemental hearing was conducted by telephone during which Taxpayer's representative again explained the basis for its ongoing objections. This Supplemental Letter of Findings results.

I. Corporate Income Tax - Throw-back Sales.

DISCUSSION

The issue is whether Taxpayer has provided the information necessary for it to establish that its activities rendered it subject to income tax in Florida, Alaska, Connecticut, Delaware, Oklahoma, Virginia, West Virginia, Nevada, South Dakota, Wyoming, and Canada. As a result, Taxpayer maintains that income from the sale of its vehicles in those eleven jurisdictions should not have been "thrown back" to Indiana. The Department notes that five of the named jurisdictions do not have an income tax.

A. Audit Results.

The Department's audit concluded that Taxpayer was subject to Indiana income tax on sales to customers in ten other states and Canada because Taxpayer was "*not* subject to income tax in the state of the purchaser[s]." The Department's audit report stated that Taxpayer's activities in those states did not exceed the "mere solicitation" standard. The Department noted that Taxpayer's reliance on warranty repairs - performed by third-party, out-of-state dealers - did not bring Taxpayer within the ambit of the various jurisdictions' income tax authority. As explained in the original audit report:

> [Taxpayer] does not own nor operate these repair facilities in the other states . . . and thus does not have any physical nexus to these states. These are dealers independent of [Taxpayer] and are not part of the company and as such, the dealer's activities are not an extension of [Taxpayer]. The dealers are performing warranty

> repairs which entails sending [Taxpayer] a repair estimate, receiving authorization to go ahead with the repair, making the repairs and then billing [Taxpayer] for the repair changes. In these instances, under warranty means [Taxpayer] has an obligation to its customers and will pay the repair facility the cost to repair the defective good. The [out-of-state] dealer is billing [Taxpayer] for the repair, but this is a sale from the dealer performing the repair to [Taxpayer].

The Department also rejected Taxpayer's assertion that the creation, maintenance, and exploitation of its customers' "goodwill" in the eleven jurisdictions subjected Taxpayer to those jurisdictions' income tax. According to the audit report, Taxpayer defined "goodwill" as "the value of the parts given to customers for repairs made after the warranty period of the recreation vehicles has expired." The Department disagreed finding that costs associated with the exercise of "goodwill" were "not gross receipts derived from sales" and should not have been included in the numerator nor the denominator . . . ."

Finally, the audit rejected Taxpayer's argument that it subjected itself to the eleven jurisdictions' income tax because it paid its own "traveling repairman" to perform customer warranty work within the eleven jurisdictions. The Department rejected that argument because Taxpayer "was not able to provide the relevant source documents, such as travel logs, expense reports, invoices, for these activities to substantiate the traveling repairman's activities."

B. Taxpayer's Response to the Letter of Findings on the Throwback Issue.

As explained in the original LOF, the Department denied Taxpayer's throwback protest as follows:

> Ultimately, the Department does not agree that Taxpayer's expenditures in the eleven jurisdictions to fulfill its obligations to its out-of-state customers exceeds the Public Law 86-272 "mere solicitation" standard. As specified in 45 IAC 3.1-1-38(4), Taxpayer was not "doing business" within the jurisdictions because it was merely spending money in those locations to fulfill its warranty obligations. Simply put, nothing that Taxpayer did subjected Taxpayer to the eleven jurisdiction's taxing authority. On the question of throw-back sales, the Department does not agree that Taxpayer has met the IC § 6-8.1-5-1(c) standard of establishing that the audit assessment was "wrong."

Taxpayer disagreed with the Department's conclusions of law and statements of fact especially regarding Taxpayer's original argument that its exercise of "goodwill" in the eleven jurisdictions subjected Taxpayer to income tax on those locations. As explained by Taxpayer:

> The characterization of the warranty repair work as "goodwill" is a gross misstatement of the facts. Dealers of [T]axpayer's products are not under contractual obligation whatsoever to Taxpayer, and represents multiple manufacturers.
>
> . . . .
>
> The repair work performed on behalf of Taxpayer by the dealers is essential for maintaining Taxpayer's market in the various states. Absent the ability to have covered items addressed in the state of purchase, Taxpayer's products would be unmarketable.

Taxpayer also disagrees with the LOF's characterization of its "representative's" activities in the various jurisdictions. As Taxpayer explains, "This, too, is an inaccurate statement. The 'representative' or 'person' is an employee of the [T]axpayer; a full-time employee that regularly performs activities completely unrelated to solicitation."

Taxpayer likewise disagrees with the LOF's statement that Taxpayer did not file income tax returns in the jurisdictions. Taxpayer believes this is a misrepresentation explaining that "Taxpayer did [not] file income tax returns because the states at issue do not require the filing of income tax returns either because there is no income tax or there is no filing requirement for pass-through entities. Taxpayer filed returns in every other state."

As explained by Taxpayer, "Under IC § 6-3-2-2(n) Taxpayer is taxable in the states at issue because they have 'jurisdiction to subject the taxpayer to a net income tax *regardless of whether, in fact, the state does or does not*.'" (*Emphasis added*).

Taxpayer therefore concludes that the third-party warranty repairs and the activities conducted by its representatives renders Taxpayer subject to income tax in the ten states and Canada.

C. Burden of Proof.

As a threshold issue, it is the Taxpayer's responsibility to establish that the assessment of additional tax is incorrect. As stated in IC § 6-8.1-5-1(c), "The notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." *Indiana Dep't of State Revenue v. Rent-A-Center East, Inc.*, 963 N.E.2d 463, 466 (Ind. 2012); *Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue*, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007). Thus, a taxpayer is required to provide documentation explaining and supporting his or her challenge that the Department's position is wrong. Poorly developed and non-cogent arguments are subject to waiver. *Scopelite v. Indiana Dep't of Local Gov't Fin.*, 939 N.E.2d 1138, 1145 (Ind. Tax Ct. 2010); *Wendt LLP v. Indiana Dep't of State Revenue*, 977 N.E.2d 480, 486, fn. 9 (Ind. Tax Ct. 2012).

In considering Taxpayer's argument, the Department points out 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 this decision are entitled to deference.

D. Supplemental Hearing Analysis.

Although this Supplemental Decision incorporates by reference the statements of fact and law set out in the original LOF, it is useful to provide a brief summary of several relevant points of law especially issues of law which were in effect during 2015 which is the only year subject to the throwback provision.

1. Adjusted Gross Income.

"Indiana imposes a tax on every corporation's adjusted gross income derived from sources within Indiana. IC § 6-3-2-1(b). In cases where a corporation derives business income from sources both within and without Indiana, the 'adjusted gross income derived from sources within the state of Indiana' is determined by an apportionment formula." *Sherwin-Williams Co. v. Indiana Dep't. of State Revenue*, 673 N.E.2d 849, 851 (Ind. Tax Ct. 1996).

IC § 6-3-2-2(a) in pertinent part, states that Indiana taxpayers such as corporations are subject to this state's income tax on money earned from doing business within this state:

> With regard to corporations and nonresident persons, "adjusted gross income derived from sources within Indiana", for the purposes of this article, shall mean and include:
> (1) income from real or tangible personal property located in this state;
> (2) income from doing business in this state;
> (3) income from a trade or profession conducted in this state;
> (4) compensation for labor or services rendered within this state; and
> (5) income from stocks, bonds, notes, bank deposits, patents, copyrights, secret processes and formulas, good will, trademarks, trade brands, franchises, and other intangible personal property to the extent that the income is apportioned to Indiana under this section or if the income is allocated to Indiana or considered to be derived from sources within Indiana under this section. (*Effective July 1, 2013 to December 31, 2015*).

However, IC § 6-3-2-2(n) (amended January 1, 2017 deleting the throwback requirement) provides that a taxpayer's income is not subject to Indiana's income tax if that income is attributable to conducting business in another state in which it is subject to that foreign state's own tax regime.

> For purposes of allocation and apportionment of income under this article, a taxpayer is taxable in another state if:
> (1) in that state the taxpayer is subject to a net income tax, a franchise tax measured by net income, a franchise tax for the privilege of doing business, or a corporate stock tax; or
> (2) that state has jurisdiction to subject the taxpayer to a net income tax *regardless of whether, in fact, the state does or does not.*

(*Emphasis added*).

45 IAC 3.1-1-38 explains the "doing business" principle.

> Doing Business. For apportionment purposes, a taxpayer is "doing business" in a state if it operates a business enterprise or activity in such state including, but not limited to:
> (1) Maintenance of an office or other place of business in the state
> (2) Maintenance of an inventory of merchandise or material for sale distribution, or manufacture, or consigned goods
> (3) Sale or distribution of merchandise to customers in the state directly from company-owned or operated vehicles where title to the goods passes at the time of sale or distribution
> (4) Rendering services to customers in the state
> (5) Ownership, rental or operation of a business or of property (real or personal) in the state
> (6) Acceptance of orders in the state
> (7) Any other act in such state which exceeds the mere solicitation of orders so as to give the state nexus under P.L. 86-272 to tax its net income.

45 IAC 3.1-1-64, in relevant part, further explains the conditions under which a taxpayer is conducting business in another state:

> "Taxable in Another State" Defined. A corporation is "taxable in another state" under the Act when such state has jurisdiction to subject it to a net income tax. This test applies if the taxpayer's business activities are sufficient to give the state jurisdiction to impose a net income tax under the Constitution and statutes of the United States. Jurisdiction to tax is not present where the state is prohibited from imposing the tax by reason of the provision of Public Law 86-272, 15 U.S.C.A. § 381-385.

2. The Throwback Rule and Public Law 86-272.

The issue then becomes whether Taxpayer's activities brought itself within the purview of the income tax regime of the ten states and Canada. 15 U.S.C. § 381(a) (Public Law 86-272) establishes the minimum standards under which Indiana or any foreign state may permissibly impose tax. In relevant part, the law provides as follows:

> No State, or political subdivision thereof, shall have power to impose, for any taxable year ending after September 14, 1959, a net income tax on the income derived within such State by any person from interstate commerce if the only business activities within such State by or on behalf of such person during such taxable year are either, or both, of the following:
>
> (1) the solicitation of orders by such person, or his representative, in such State for sales of tangible personal property, which orders are sent outside the State for approval or rejection, and, if approved, are filled by shipment or delivery from a point outside the State; and
>
> (2) the solicitation of orders by such person, or his representative, in such State in the name of or for the benefit of a prospective customer of such person, if orders by such customer to such person to enable such customer to fill orders resulting from such solicitation are orders described in paragraph (1).

15 U.S.C. § 381(c) explains under what conditions a company is *not* conducting business in another state.

> For purposes of subsection (a) of this section, a person shall *not be considered to have engaged in business activities within a State* during any taxable year merely by reason of sales in such State, or the solicitation of orders for sales in such State, of tangible personal property on behalf of such person by one or more independent contractors, or by reason of the maintenance, of an office in such State by one or more independent contractors whose activities on behalf of such person in such State consist solely of making sales, or soliciting orders for sales, of tangible personal property.

(*Emphasis added*).

In summary, Public Law 86-272 prohibits states from imposing a net income tax on a foreign taxpayer if the foreign taxpayer's only business activity within the target state is the solicitation of sales. A state may not impose an income tax on income derived from business activities within that state unless those activities exceed the "mere solicitation" of sales.

3. Analysis of the Law Applied to the Facts.

Based on the law summarized above, in every transaction, at least one state has the authority to impose an income or franchise tax on income derived from the sale of tangible personal property. A state may impose tax on a taxpayer only when the taxpayer's activity within the state exceeds "solicitation." Taxpayer, of course, explains that the repair work done in those jurisdictions goes beyond "solicitation." (e.g. "An attempt or effort to gain business." Black's Law Dictionary 1677 (11th ed. 2019)).

Taxpayer's argument necessarily hinges on whether fulfilling Taxpayer's warranty obligation to Taxpayer's customers by means of payments to out-of-state repair facilities gave Taxpayer sufficient contact with those customers' and the repair facilities' home states such that those states "had jurisdiction to impose a net income tax under the Constitution and statutes of the United States." 45 IAC 3.1-1-64.

In support of its argument, Taxpayer provided a sample copy of its "One Year Limited Base Warranty" and "Three Year Limited Structural Warranty." Although there is nothing which establishes that it was these documents that were provided to Taxpayer's 2015 and 2016 customers, for the sake of argument, the Department will accept at face-value the terms of those warranties. The warranties require customers to obtain repairs at "[Taxpayer's] facilities, or [Taxpayer's] designated repair shop or dealer" after the customer notifies Taxpayer.

As explained by Taxpayer's representative, if one of Taxpayer's customers is traveling outside Indiana and the customer finds him or herself in need of repair work, the customer can take the vehicle to whatever dealer or business location could conceivably complete the repair. That location might well be totally unrelated to Taxpayer such as "Joe's Anyplace Autobody" located in Oatmeal, North Dakota. After submitting a request and price estimate to Taxpayer, if "Joe's Anyplace Autobody" receives Taxpayer authorization to conduct the repair for the quoted price, "Joe's Anyplace Autobody" will complete the work and submit Taxpayer a bill; Taxpayer then reimburses "Joe's Anyplace Autobody" at the quoted price for the completed work. It is Taxpayer's contention that because it reimburses a "Joe's Anyplace Autobody" located outside Indiana, it is subject to that state's income tax and is potentially required to file and pay income tax in that state. It is important to note that Taxpayer does not have an ongoing contractual relationship with any of the "Joe's Anyplace Autobody's" of the world. The warranties obligated Taxpayer to compensate the dealers for these warranty expenses because - in whole or in part - Taxpayer "stands behind" those warranties.

Therefore, it is Taxpayer's conclusion that, during 2015 if Taxpayer sold a vehicle to a customer located in the same state as "Joe's Anyplace Autobody," for income tax purposes, the proceeds from that particular RV sale should be "sourced" to the Joe's Anyplace Autobody state and not thrown back to Indiana.

Taxpayer also states that it subjected itself to the jurisdictions' income tax by sending one of its employees to various RV rallies "to make repairs for problems which dealers have not been able to rectify." According to Taxpayer these employees also "deliver replacement vehicles to individual owners and pick up damaged vehicles" and that these individuals do "not perform any solicitation of sales."

To verify that one of its employees made these trips, Taxpayer prepared a list of rallies, the state in which the visit was made, and the month and year in which the visit occurred. Based on Taxpayer's list, its employees made approximately 20 trips during 2015.

Taxpayer provided copies of employee expense reports but no supporting invoices or receipts. The reports document such employee expenses as restaurant meals, hotel charges, fuel costs, supplies, and highway tolls. However, the Department notes that none of the expense reports indicate where the expenses were incurred.

Taxpayer acknowledges that it did not file income tax returns in the jurisdictions under consideration. Nonetheless, the Department agrees that that Taxpayer's failure to file returns or pay income tax in those states and jurisdictions is not necessarily dispositive. IC § 6-3-2-2(n). However, the Department continues to disagree with Taxpayer that it has met its statutory obligation of providing evidence that the Department's position is wrong.

In this instance, even if the relationship between Taxpayers and the third-party dealers was that of independent contractors, Taxpayer's agreement with the third-party dealers - to fulfill the warranties and to perform the warranty-related repairs on Taxpayer's behalf - does not go beyond the mere solicitation of orders. Taxpayer is not the entity extending itself into the independent contractors' states; it is the independent contractors which are soliciting business from Taxpayer. Although independent contractors are acting on behalf of one of Taxpayer's former RV customers, it is the contractors which are soliciting repair work from Taxpayer. Taxpayer is simply spending money in those states to fulfill its obligations, and the Department does not agree that spending money in foreign jurisdictions potentially subjects Taxpayer to those jurisdictions' income tax regime.

Ultimately, the Department does not agree that Taxpayer's expenditures in the eleven jurisdictions to fulfill its obligations to its out-of-state customers exceeds the Public Law 86-272 "mere solicitation" standard. As specified in 45 IAC 3.1-1-38(4), Taxpayer was not "doing business" within the jurisdictions because it was merely spending money in those locations to fulfill its warranty obligations. Simply put, nothing that Taxpayer did subjected Taxpayer to the eleven jurisdiction's taxing authority.

In addition, even if the Department were to agree with Taxpayer's analysis of the law, Taxpayer's documentation is inconclusive at best. Taxpayer *states* that its third-party, out-of-state repairs are substantial and potentially obligate it to pay income tax in the eleven jurisdictions in which the repairs were conducted. Taxpayer *states* that the documentation it provided (travel expense reports) is sufficient to establish that its employees' activities in those states potentially obligates it to pay income tax in those locations. After the reviewing the documentation provided, the Department must respectfully disagree.

On the question of throw-back sales, the Department does not agree that Taxpayer has met the IC § 6-8.1-5-1(c) standard of establishing that the audit assessment was "wrong."

FINDING

Taxpayer's protest is respectfully denied.

II. Corporate Income Tax - Documenting Research and Expense Credits.

DISCUSSION

The issue is whether Taxpayer has provided sufficient information required to document the nature and extent it incurred labor and supply expenses specifically attributable to qualifying research activities aimed at the development of new or improved RV technology.

A. Burden of Proof.

As in Part I above, Taxpayer bears the statutory responsibility of establishing that the denial of the credits and the consequent assessment of additional tax is wrong. As stated in IC § 6-8.1-5-1(c), "The notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid." *Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue*, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007).

B. Audit Results.

The Department's audit report indicated that Taxpayer claimed approximately $4.6 million dollars is qualifying labor and supply research expenses during the years at issue. The claimed qualifying expenses entitled Taxpayer to approximately $400,000 in credits. By claiming the credits, Taxpayer reduced its 2015 and 2016 Indiana income tax liability.

The audit report indicated that Taxpayer based its claim to the credits on Taxpayer's activities involved in the "conception, design, prototype build, evaluation, [and] final design" of Taxpayer's recreational vehicles and fifth wheel trailers. Taxpayer claimed qualifying labor expenses attributable to "the company president, general managers & product managers, plant managers & assistant plant managers, engineers, sales managers & product managers, manufacturing support manager, the Vice President of Service Operation, and purchasing department employees."

In arriving at the amount of labor expenses, Taxpayer provided the Department during the audit "an analysis of hours spent on qualifying activities during an average week." The analysis was based on interviews conducted with Taxpayer's subject matter experts. Taxpayer's experts estimated the expenses based on their "knowledge of the activities performed within [their] department." The experts "estimated the number of hours [which] were then used to calculate a qualifying percentage, which then determined the total amount of qualifying wages engaged in qualifying research."

As to the claimed labor expenses, the Department's audit report concluded that the Department was "unable to verify the [T]axpayer's calculations for hours and wages claimed in the calculation of the Research Expense Credit." The audit found that Taxpayer's interviews of an individual in each of Taxpayer's departments was insufficient to accurately verify the labor expenses claimed. The audit report indicates that the interviewee did not perform all the activities claimed and did not keep a log of the employees' qualifying activities as statutorily

required.

The Department's audit also disallowed the claimed supply expenses. The audit did so because the supply expenses were allocated to Taxpayer's "cost center" in general and not to individual qualified research project expenses. In effect, the audit concluded that Taxpayer was unable to track supply expenses to any particular qualifying research project.

C. January Letter of Findings' Conclusions.

The January 2020 Letter of Findings concluded that Taxpayer had failed to meets its statutory burden of establishing to what extent Taxpayer - as a builder of recreational vehicles - conducted research entitling it to claim for supply and labor expenses associated with that activity. As explained in the LOF:

> In this case, Taxpayer asks that the Department broadly interpret the REC record keeping requirements to encompass - as stated in the audit report - "estimates of the hours engaged in qualified research by the various employees within his department." The Department is unable to agree that Taxpayer has met its burden of establishing - by means of reliable, contemporaneous records - that its employees and executive staff were actively engaged in qualifying research activities to the extent claimed.

D. Taxpayer's Rehearing Arguments.

Taxpayer argues that the original LOF misapplied the REC documentation standard. In particular, Taxpayer points to IC § 6-3.1-4-4 which provides:

> The provisions of Section 41 of the Internal Revenue Code and the regulations promulgated in respect to those provisions are applicable to the interpretation and administration by the department of the credit provided by this chapter, including the allocation and pass through of the credit to various taxpayers and the transitional rules for determination of the base period. (effective Jan. 1, 2016).

The amended Indiana statute struck out references to the regulations "*in effect on January 1, 2001*."

Taxpayer concludes that as of January 1, 2016, the Department may no longer impose record keeping requirements to the claimed 2016 RECs as it did in the original LOF. However, Taxpayer fails to explain what record keeping standards the Department should apply.

Instead, Taxpayer continues to assert that its original information gathering was "sufficient to comply with IRC 41 requirements." Taxpayer explains that "[e]ight different individuals . . . provided detail regarding employee qualification detail for themselves and their direct reports" and that this information was "base[d on the individuals' first-hand experience and knowledge of their own personal activities as well as the direct reports for who they are [responsible] for overseeing on a daily basis."

Taxpayer disputes the audit's determination to not give credence to the "first-hand knowledge" provided and criticizes the audit's insistence on "time logs or entry detail which did not exist . . . ."

E. Legal and Factual Analysis.

The issue is whether Taxpayer has sufficiently documented the labor and supply expenses directly attributable to qualifying research projects. Has Taxpayer met its burden of establishing that the Department's proposed assessment of additional tax was "wrong?" IC § 6-8.1-5-1(c).

1. Indiana Credits, Deductions, Exemptions, Exclusions.

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

The Department held that a taxpayer who claims the tax credit is required to retain records necessary to substantiate a claimed credit. Indiana and federal law require that a taxpayer maintain and produce contemporaneous records sufficient to verify those credits. *See* Treas. Reg. § 1.41-4(d). (*See also* IC § 6-8.1-5-4(a) which requires that taxpayers *keep* records). Where such a credit is claimed "the party claiming the

same must show a case, by sufficient evidence, which is clearly within the exact letter of the law." *Indiana Dep't. of State Revenue, Sales Tax Division v. RCA Corp.*, 310 N.E.2d 96, 100-01 (Ind. Ct. App. 1974) (citing *Conklin v. Town of Cambridge City*, 58 Ind. 130, 133 (1877)).

Citing *Stinson Estate*, the circuit court in *United States v. McFerrin* summarized that "[t]ax credits are a matter of legislative grace, are only allowed as clearly provided for by statute, and are narrowly construed." *United States v. McFerrin*, 570 F.3d 672, 675 (5th Cir. 2009). *See also New Colonial Ice Co. v. Helvering*, 292 US. 435, 440 (1934) ("Whether and to what extent deductions shall be allowed depends upon legislative grace; and only as there is clear provision therefor can any particular deduction be allowed.")

2. Record Keeping Requirements.

Treas. Reg. § 1.41-4(d) sets out the record keeping and documentation requirements for expenses related to the research credit.

> Recordkeeping for the research credit. A taxpayer claiming a credit under section 41 must retain records in sufficiently usable form and detail to substantiate that the expenditures claimed are eligible for the credit. For the rules governing record retention, see § 1.6001-1. To facilitate compliance and administration, the IRS and taxpayers may agree to guidelines for the keeping of specific records for purposes of substantiating research credits.

(*Emphasis added*).

Treas. Reg. § 1.41-4(d) points to Treas. Reg. § 1.6001-1 which states in relevant part:

> [A]ny 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.

In addition, the audit report also referred to Chapter 7 of *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 January 14, 2020).

> Under the final regulations, a taxpayer must retain records in sufficiently usable form and detail to substantiate that the expenditures claimed are eligible for the credit. *See* I.R.C. § 6001; Treas. Reg. § 1.6001-1. The taxpayer must clearly establish full compliance with all of the relevant statutory and regulatory requirements. Failure to maintain records in accordance with these rules is a basis for disallowing the credit.

As to Taxpayer's general record keeping responsibility under Indiana law, IC § 6-8.1-5-4(a) provides:

> 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 concluded that even assuming Taxpayer conducted qualifying research activities, Taxpayer had not prepared, maintained, retained, or presented records necessary to substantiate that Taxpayer's claimed research expenses were specifically attributable to Taxpayer's "conception, design, prototype build, evaluation, [and] final design" of Taxpayer recreational vehicles and fifth wheel trailers.

The Department rejects Taxpayer's argument that it is sufficient to merely produce documentation based on interviews with and the recollection of its key personnel because the argument oversimplifies the federal and Indiana regulatory requirements. Of course, any documentation must be based on information provided by its personnel, but a taxpayer must also "retain records in sufficiently usable form and detail to substantiate that the expenditures claimed are eligible for the credit." Treas. Reg. § 1.41-4(d). The emphasis in the current regulation is that documentation must be "retained;" there is nothing to indicate that records may be recreated based on its employees' recollections.

It is Taxpayer's statutory obligation to maintain and produce to the Department contemporaneous records

sufficient to verify the credits which it claims pursuant to IC § 6-3.1-4-1 and IC § 6-8.1-5-4. This is especially true in the case of the RECs for which the I.R.C. imposes stringent and detailed parameters and which - if Taxpayer seeks to obtain the benefit of those credits - Taxpayer is required to meet. Treas. Reg. § 1.41-4(d).

Indiana case law clearly speaks to the issue of the documentation necessary 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 a tax must be supported by records necessary to substantiate the claimed credits and the corroborative records must be "retained."

In this case, Taxpayer asks that the Department broadly interpret the REC record keeping requirements to encompass - as stated in the audit report - "estimates of the hours engaged in qualified research by the various employees within his department." Taxpayer insists that Indiana's legislature, by deleting the references to the federal regulations rendering the "prepared before or during the early stages of the research project" standard moot. Essentially, Taxpayer would substitute a "take our word for it" (TOWFIT) standard. In applying the TOWFIT benchmark, Taxpayer stakes its claim to having spent $4.6 million dollars conducting experimental research in the development of recreational vehicle technology which expanded upon the common knowledge of the technology shared by others in the RV industry.

The Department does not, of course, question the good faith or veracity of Taxpayer. It does find the TOWFIT standard on which Taxpayer relies unworkable, unverifiable, and inconsistent with both the law and common sense. The Department finds that reliance on the TOWFIT standard is at odds with the Indiana case law which requires that a taxpayer's claim to income tax credits must be established with "sufficient evidence" which is "clearly within the exact letter of the law." *RCA Corp.*, 310 N.E.2d at 100-01.

The Department is unable to agree that Taxpayer has met its burden of establishing - by means of reliable documentation *retained* from the outset of the research - that its employees and executive staff were actively engaged in qualifying research activities to the extent claimed. The Department is unable to agree that Taxpayer has met its statutory burden of establishing that the assessment of additional income tax was wrong.

FINDING

Taxpayer's protest is respectfully denied.

III. Corporate Income Tax - Statute of Limitations.

DISCUSSION

Taxpayer argues that the Department was barred by the three-year statute of limitations from issuing the 2015 income tax assessment and that the Department erred in failing to address this issue in the original LOF.

Taxpayer is correct to the extent that the original LOF did not address the statute of limitations issue.

Taxpayer filed its 2015 corporate income tax return April 13, 2016. The Department issued the assessment of additional 2015 tax by means of a proposed assessment dated June 24, 2019, some 1,162 days after the return was filed.

Taxpayer argues that the June 24 proposed assessment is barred because it was issued past the time permitted under Indiana law.

IC § 6-8.1-5-2(a) provides in part as follows:

> (a) Except as otherwise provided in this section, the department may not issue a proposed assessment under section 1 of this chapter more than three (3) years after the latest of the date the return is filed, or either of the following:
> (1) The due date of the return.
> (2) In the case of a return filed for the state gross retail or use tax, the gasoline tax, the special fuel tax, the motor carrier fuel tax, the oil inspection fee, or the petroleum severance tax, the end of the calendar year which contains the taxable period for which the return is filed.

See also 45 IAC 15-5-7(a).

However, the Department's audit found that its review of the 2015 return indicated that Taxpayer failed to file a Composite Return reporting the income distributed to its non-resident partners. IC § 6-3-4-12 (effective January 1, 2015) requires that all nonresident partners must be included in a composite return schedule, and the partnership must continue to withhold Indiana adjusted gross income tax for all nonresident partners. Specifically, the statute provides in part:

> Every partnership shall, at the time that the partnership pays or credits amounts to any of its nonresident partners on account of their distributive shares of partnership income, for a taxable year of the partnership, deduct and retain therefrom the amount prescribed in the withholding instructions referred to in section 8 of this chapter. Such partnership so paying or crediting any nonresident partner:
>
> (1) shall be liable to the state of Indiana for the payment of the tax required to be deducted and retained under this section and shall not be liable to such partner for the amount deducted from such payment or credit and paid over in compliance or intended compliance with this section; and
>
> (2) shall make return of and payment to the department monthly whenever the amount of tax due under IC 6-3 and IC 6-3.6 exceeds an aggregate amount of fifty dollars ($50) per month with such payment due on the thirtieth day of the following month, unless an earlier date is specified by section 8.1 of this chapter.

IC § 6-8.1-5-2(f) provides:

> If a person files a fraudulent, unsigned, or substantially blank return, or if a person does not file a return, there is *no time limit* within which the department must issue its proposed assessment.

(*Emphasis added*).

In this case, the three-year limitations period did not begin to run, and the assessment is not barred because Taxpayer failed to file the composite return. As a result, the audit "calculated the amount of Indiana income attributed to the nonresident partners . . .[a]nd proposes an adjustment for composite tax calculated per audit."

SUMMARY

Taxpayer's fulfillment of its warranty responsibilities within jurisdictions outside Indiana by means of the engagement of third-party dealers is not sufficient to render Taxpayer subject to those jurisdictions' income tax.

Taxpayer has not established it was entitled to the RECs originally claimed.

The 2015 income tax assessment is not presumptively barred by the three-year statute of limitations.

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