2019 – OTA – 341
Nonprecedential

OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeals of: **CHARLES WALDEN AND DEBORAH ANDERSON, CHARLES WALDEN, AND WALDEN STRUCTURES, INC.**	OTA Case Nos. 18010221, 18010222, 18010223 Date Issued: October 16, 2019

OPINION ON PETITION FOR REHEARING

Representing the Parties:

For Appellant: Clay Hodges, Sr. Associate Director, TCS

For Respondent: Jason Riley, Tax Counsel IV

For Office of Tax Appeals: Linda Frenklak, Tax Counsel IV

L. CHENG, Administrative Law Judge: On November 28, 2018, the Office of Tax Appeals (OTA) issued an opinion (Opinion) partially sustaining the Franchise Tax Board's (FTB) proposed assessments and denial of Charles Walden and Deborah Anderson, Charles Walden and Walden Structures, Inc.'s (WSI) (collectively referred to as appellants) refund claims for tax years 2003 through 2006 with respect to five of six sample research and development (R&D) projects for the years at issue.[1] The Opinion found that appellants were not entitled to research credits that they claimed for the years at issue, including claimed credit carryforwards, because WSI did not engage in "qualified research activities" with respect to five of six sampled R&D projects during the years at issue. Specifically, we found that appellants failed to establish, as required by Internal Revenue Code (IRC) section 41(d)(1), that at least 80 percent of WSI's claimed research activities constitute a process of experimentation for the following five sample R&D projects: 1) the Genentech project; 2) the Bramasole project;

[1] The parties agreed to resolve the appeal for the years at issue based on the six sample projects.

3) the Ynez Elementary project; 4) the Mammoth Lakes; and 5) the Welk Resort project (collectively referred to as the five projects).[2]

Appellants timely filed a petition for rehearing (PFR) pursuant to Revenue & Taxation Code (R&TC) section 19048 and California Code of Regulations, title 18, division 4.1, sections (Regulations) 30505 and 30602. Upon consideration of appellants' petition for rehearing, we conclude that the grounds set forth therein do not meet the requirements under Regulation 30604 (see also *Appeal of Do*, 2018-OTA-022P; *Appeal of Wilson Development, Inc.* (94-SBE-007) 1994 WL 580654), and a new hearing is therefore not warranted.

A rehearing may be granted where one of the following grounds exists and materially affects the substantial rights of the complaining party:

(a) an irregularity in the appeal proceedings which occurred prior to issuance of the written opinion and prevented fair consideration of the appeal;

(b) an accident or surprise which occurred during the appeal proceedings and prior to the issuance of the written opinion, which ordinary caution could not have prevented;

(c) newly discovered, relevant evidence, which the party could not have reasonably discovered and provided prior to issuance of the written opinion;

(d) insufficient evidence to justify the written opinion or the opinion is contrary to law; or

(e) an error in law.

(Regulation 30604(a)-(e).)

In their petition for rehearing, appellants argue that, due to an insufficient amount of time for them "to provide adequate testimonial clarification" at the August 21, 2018 oral hearing, the panel of three administrative law judges (panel) erroneously concluded with respect to each of the five projects that there was an "absence of evidence specifically showing which portion, if any, of WSI's activities constituted a process of experimentation." According to appellants' petition for rehearing, appellants' counsel cautioned the panel during the prehearing telephone conferences "against limiting the amount of time for adequate presentation of the evidence

[2] The panel determined that the five projects did not qualify for R&D credits for the years at issue, because they did not constitute qualified research activities under IRC section 41(d)(1); the panel thus did not consider whether the exclusions under IRC section 41(d)(4)(B) or (C) applied. In contrast, the panel determined that the sixth sample project, the Mosque project, qualified for R&D credits for the years at issue, because this project constitutes qualified research activities under IRC section 41(d)(1) and the exclusions under IRC section 41(d)(4)(B) or (C) do not apply. (Opinion, p. 37, fn. 26.) Accordingly, appellants did not address the Mosque project in their petition for rehearing.

offered in support of the Projects." Appellants contend that the panel limited the oral hearing to a one-day format to their "detriment." They state that the panel "extended the working day," by scheduling and holding the oral hearing from a start time of 8:00 a.m. and a finish time of 6:00 p.m. and that "[c]ounsel also exhausted all every minute [sic] allowed during the day, with the closing remarks ending just moments after the 6 p.m. hour." Appellants assert that at the oral hearing, their four "fact and expert witnesses" discussed "documentation (numbering into thousands of pages reflecting [WSI's] iterative processes)." Appellants concede that "all efforts to accommodate the situation" were made, but there was nonetheless "inadequate time to aptly address both the testimonial and documentary back up for each of the Projects[.]" Appellants contend in their petition that this is the reason why the panel erroneously concluded that FTB properly denied "over eighty-three percent (83%) of the credit dollars sought." (PFR, pp. 4-5.)

Appellants argue they are entitled to a rehearing based upon four separate grounds and that the lack of sufficient time to present their case at the oral hearing justifies the grant of a rehearing for four of the five grounds set forth in Regulation 30604. We discuss each of appellants' arguments below.

1. Whether there were irregularities in the proceedings that prevented appellants from having a fair consideration of their appeals

Appellants contend that, pursuant to Regulation 30604(a), a rehearing should be granted because there were irregularities in the appeal proceedings that prevented a fair consideration of their appeal. They state that the "time constraints required an accelerated, and resultantly abbreviated, presentation of all evidence – through both testimony and documentation." (PFR, p. 12.) Appellants also state that, because the time constraints "resulted in the omission of testimony regarding assignment of qualified research expenses to their related exercises, a rehearing must occur if justice is to be achieved." (*Id.*)

The parties and the panel's lead Administrative Law Judge (ALJ) held prehearing conferences on July 19, 2018, and August 14, 2018. Prior to the August 21, 2018 oral hearing, the parties drafted Stipulations of Facts, and appellants identified the following four individuals as their expected witnesses at the oral hearing: 1) Charles Walden, the chief executive officer of WSI during the tax years at issue; 2) Kevin Lord, the director of engineering of WSI during the tax years at issue; 3) Joel Minor, the chief financial officer of WSI during the tax years at issue; and 4) Robert Wonish, a senior director of Alliantgroup, appellants' tax representative. Most

importantly, the parties agreed to the allotment of time for opening arguments, witnesses' testimony, closing arguments, and appellants' rebuttal, as reflected in the lead ALJ's prehearing order dated August 16, 2018, which allocated a maximum of 15 minutes for each party's opening statement, approximately four and one-half hours for appellants' witnesses' testimony on direct examination, approximately two and one-quarter hours for cross-examination of appellants' witnesses by the FTB, a maximum of 30 minutes for each party's closing argument, and a maximum of 10 minutes for appellants' rebuttal. Appellants indicate in their petition for rehearing that, at the prehearing conferences, they expressed their concern about the one-day oral hearing format prior to agreeing to it. Appellants do not contend, and the evidence does not show, that the various stages of the oral hearing deviated from the time allotments set forth in the August 16, 2018 prehearing order or that during the oral hearing, appellants objected to or otherwise expressed any concern regarding the oral hearing's time allotment.

An irregularity in the proceedings is not established by appellants' assertion that a one-day oral hearing was not sufficient for their purposes. (See *Appeal of Victoria Joy Le Beau*, 2018-OTA-161P.) There is no merit to appellants' argument that irregularities occurred at the oral hearing because it proceeded according to the timetable set forth in the August 16, 2018 prehearing order.[3] Appellants apparently contend that they would have prevailed with respect to these five projects had the panel allocated more than one full day for the oral hearing. Yet appellants do not identify what specific testimony or other evidence would have been presented had they had additional time or how that evidence would have yielded a different result. Instead, appellants seem to merely disagree with the panel's factual findings and legal conclusions concerning the five projects. Accordingly, appellants have failed to establish that there were irregularities in the proceeding that materially affected their substantial rights and that they were prevented from having a fair consideration of their appeals.

2. Whether there was an accident or surprise that ordinary caution could not have prevented.

Appellants contend that, pursuant to Regulation 30604 (b), the time constraints equate to an accident or surprise that occurred that ordinary caution could not have prevented. They contend that surprise resulted from their inability to present adequately and completely their

[3] To the extent that inadequate evidence of qualified research was presented, the burden was upon appellants to use their oral hearing time to present relevant evidence on critical issues, and the failure to do so does not create grounds for a rehearing.

case. Appellants state that "although ordinary caution was exercised by counsel in seeking additional time (in an additional amount of days) to present its case, such was not allowed, placing [WSI] and its attorneys on perilous ground, regarding their ability to complete its entire case in chief." (PFR, pp. 12-13.)

Interpreting section 657 of the Code of Civil Procedure, the California Supreme Court held that the terms "accident" and "surprise" have substantially the same meaning. (*Kauffman v. De Mutiis* (1948) 31 Cal.2d 429, 432; See also *Appeal of NASSCO Holdings, Inc.* (2010-SBE-001) 2010 WL 3705073.) Further, to constitute an accident or surprise, a party must be unexpectedly placed in a detrimental condition or situation without any negligence on the part of that party. (*Id*.) A new hearing is only appropriate if the accident or surprise materially affected the substantial rights of the party seeking the rehearing. (Code Civ. Proc., § 657; *Appeal of Wilson Development, supra*.)

As discussed above, there is no dispute that the oral hearing proceeded substantially in conformity with the time allotments set forth in the August 16, 2018 prehearing order, which reflected the parties' agreement prior to the oral hearing. Additionally, during the oral hearing, there was no objection to the time allotments nor any request or discussion about extending the hearing beyond the nine hours allotted. Moreover, appellants concede that they raised their concerns about the one-day format at the prehearing conferences prior to the issuance of the August 16, 2018 prehearing order. As such, appellants fail to establish that they experienced, to their detriment, an accident or surprise that could not have been prevented. Appellants' claim that surprise resulted from their inability to present adequately and completely their appeal at the oral hearing is without merit and thus does not provide a valid basis for a new hearing.

3. Whether appellants have identified newly discovered, relevant evidence that they could not have reasonably discovered provided prior to the Opinion.

Appellants contend that, pursuant to Regulation 30604(c), the time constraints amount to newly discovered, relevant evidence, which they could not have reasonably discovered and provided prior to the decision. Appellants contend that, because relevant evidence, albeit not newly discovered, was prevented "from being adequately presented," such evidence "would objectively constitute new evidence to the panel." They assert that, even though Regulation 30604(c) "contemplates evidence that could not be provided prior to the decision, it bears repeating that all relevant documents were duly provided." Appellants state, however, that "the

accompanying testimony lending explanation to the [relevant documents] was unable to be supplied due to inadequate time." (PFR, pp. 12-13.)

There is no merit to appellants' argument that they purportedly discovered new relevant evidence that they could not have reasonably discovered prior to the issuance of the panel's opinion. In fact, appellants concede that they have no newly discovered relevant evidence that they did not possess prior to the Opinion and that they provided the panel all relevant documents for its consideration prior to the issuance of the Opinion. Therefore, appellants are not entitled to a new hearing based on this argument.

4. Whether the Opinion is based on insufficient evidence or is contrary to law

Regulation 30604(d) consists of two separate and distinct grounds, that the opinion is against the law or, alternatively, that there is insufficient evidence to support the opinion. Here, appellants contend that there was insufficient evidence to support the Opinion or the Opinion is contrary to law. Appellants' argument reveals that only the latter ground is involved in this petition for rehearing, because appellants merely contend that the panel "misapplied the governing authority." Appellants make no contention that there was insufficient evidence to support the Opinion; therefore, we will not further address sufficiency of the evidence.

The Opinion would be determined to be contrary to law (or against the law) only if it is unsupported by substantial evidence in the appeal record. (*Sanchez-Corea v. Bank of America* (1985) 38 Cal.3d 892, 906.) "In contrast to the grounds of insufficient evidence and excessive or inadequate damages, 'the phrase 'against law' does not import a situation in which the court weighs the evidence and finds a balance against the verdict, as it does in considering the ground of insufficiency of the evidence.'" (*Id.*, citing *Musgrove v. Ambrose Properties* (1978) 87 Cal.App.3d 44, 56.) Where the evidence is insufficient *as a matter of law*, a verdict or decision may be considered against law and a new hearing granted on that ground. (*Fergus v. Songer* (2007) 150 Cal.App.4th 552, 567.) In determining whether the Opinion was unsupported by substantial evidence for purposes of a petition for rehearing, we consider the evidence in the light most favorable to the prevailing party, which in this appeal is FTB. (*Sanchez-Corea, supra*, 38 Cal.3d at p. 907.)

Here, appellants bear the burden of establishing that they are entitled to a new hearing because the Opinion is contrary to law. In their petition, appellants state that the panel "misapplied the governing authority" because "[it] seems to believe that instead of evaluating

each of the Projects as a whole, to assess its qualification for the Sec. 41 [R&D] credit, that appellant must prove each of the individual activities for each revision to show the elements of a process of experimentation for each of the Projects." (PFR, p. 13.) However, appellants do not explain the basis of their assertion that the panel held appellants must prove each individual activity had to be part of the experimentation process. Nowhere in the Opinion does it state that the panel found that to be a requirement in order for appellants to satisfy the experimentation test. Instead, the Opinion states that with regard to the process of experimentation test, IRC Section 41(d)(1)(c) requires that "substantially all" of the claimed research activities with respect to each business component constitute "elements of a process of experimentation" for a qualified purpose. (Opinion, p. 25.) The panel further stated that it would analyze "whether appellants have shown that at least 80 percent of its claimed research activities constituted a process of experimentation." (Opinion, p. 28.) In other words, the panel followed the guidelines set forth in *Trinity Industries, Inc. v. United States* (N.D.Tex.2010) 691 F.Supp.2d 688 that at least 80 percent of the costs of each project, *not each individual activity for each revision*, had to constitute a process of experimentation in order to satisfy the experimentation test. (Opinion, p. 28.) Appellants have simply misstated the panel's application of the law.

Having made no erroneous application of the law, we find that there was sufficient evidence in the record to support the panel's determination in sustaining FTB's actions because appellants failed to establish that at least 80 percent of appellants' claimed research activities with respect to each of the five projects constituted a process of experimentation. Accordingly, the Opinion is not contrary to law.

Based on the foregoing, appellants have not satisfied the requirements for a new hearing under Regulation 30604 and *Appeal of Wilson Development, Inc.*, *supra*, and *Appeal of Do*, *supra*. Accordingly, appellants' petition for rehearing is denied.

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Linda C. Cheng
Administrative Law Judge

We concur:

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Douglas Bramhall
Administrative Law Judge

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Amanda Vassigh
Administrative Law Judge