OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeals of: **SWAT-FAME, INC.; B. STERN AND J. STERN; AND M. QUARANTA AND N. QUARANTA**	) OTA Case Nos. 18010702, 18012114, & 18012115)))))

OPINION ON PETITION FOR REHEARING

Representing the Parties:

For Appellants: Wilbur E. Suggs, Director, alliantgroup

For Respondent: Carolyn S. Kuduk, Tax Counsel III

For Office of Tax Appeals: Mai C. Tran, Tax Counsel IV

A. VASSIGH, Administrative Law Judge: On March 22, 2019, we issued an opinion sustaining respondent Franchise Tax Board's (FTB) denial of tax refunds for tax years 2008 through 2011 and proposed assessments for tax year 2012 based on appellants' claimed California Research & Development Credit (R&D Credit). We held that appellants failed to demonstrate that Swat-Fame, Inc. (Swat-Fame) engaged in qualified research as required by Revenue and Taxation Code (R&TC) section 23609 and Internal Revenue Code section 41. We reviewed four sample projects: (1) the Bermuda shorts project (UB636N); (2) the dress with adjustable straps project (D11072); (3) the two-piece set legging and skirt project (Z1743D01); and (4) the two-piece set sundress and shrug project (M93771). We determined that appellants failed to demonstrate that substantially all of the activities related to each of the sample projects constituted a process of experimentation for a qualified purpose. Appellants then filed a timely petition for rehearing dated April 22, 2019, pursuant to R&TC section 19048.

A rehearing may be granted where one of the following five grounds exists, and the substantial rights of the complaining party are materially affected: (a) an irregularity in the appeal proceedings that occurred prior to the issuance of the written opinion and prevented fair consideration of the appeal; (b) an accident or surprise that 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 the 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. (Cal. Code Regs., tit. 18, § 30604(a)-(e); see also *Appeal of Do*, 2018-OTA-002P[1]; *Appeal of Wilson Development, Inc.* (94-SBE-007) 1994 WL 580654.) Upon consideration of appellants' petition for rehearing, we conclude that the grounds set forth therein do not constitute good cause for a new hearing.

In the petition for rehearing, appellants contend that there was insufficient evidence to justify the opinion or the opinion is against law.[2] Appellants contend that we adopted an improper legal standard as to the process of experimentation test by improperly framing the test as whether Swat-Fame substantially engaged in the scientific method. Appellants argue that, had we applied the correct legal standard, we would have determined that Swat-Fame satisfied the process of experimentation test based on testimonial evidence in the record. Appellants further contend that the panel's[3] conclusion that Swat-Fame's research is disqualified by the style or cosmetic exclusion ignores testimonial evidence of Swat-Fame's research activities regarding the fit and function of the garments. Appellants also assert that we incorrectly determined that appellants failed to show that 80 percent or more of Swat-Fame's activities were elements of a process of experimentation for a qualified purpose.

California Code Regulations, title 18, section 30604(d) provides that a rehearing may be granted on two distinct grounds of insufficiency of the evidence to justify the opinion, or the

[1] Precedential opinions by Office of Tax Appeals can be found on its website: <www.ota.ca.gov>.

[2] FTB discusses why appellants have not demonstrated that a rehearing should be granted based on an error in law. Courts have found that a new trial may be granted based on an error in law if its original ruling as a matter of law was erroneous. (*Collins v. Sutter Memorial Hospital* (2011) 196 Cal.App.4th 1, 17-18, citing *Ramirez v. USAA Casualty Ins. Co.* (1991) 234 CalApp.3d 391.) A claim on a petition for rehearing that there was an error in law is a claim of procedural wrong. For example, courts have found an error in law occurred when there was an erroneous denial of a jury trial (*Johnson v. Superior Court* (1932) 121 Cal.App. 288), an erroneous ruling on the admission or rejection of evidence (*Nakamura v. Los Angeles Gas & Elec. Corp*. (1934) 137 Cal.App. 487), an erroneous application of the law by a jury (*Shapiro v. Prudential Property & Casualty Co*. (1997) 52 Cal.App.4th 722), and an erroneous instruction to a jury (*Maher v. Saad* (2000) 82 Cal.App.4th 1317). It does not appear that appellants argue that an error in law occurred. Rather, appellants assert that the opinion is against (or contrary to) law.

[3] In this context, "panel" refers to the three-judge panel that decided the issues, which is not the same panel that considered this petition for rehearing.

opinion is contrary to law. (*Bray v. Rosen* (1959) 167 Cal.App.2d 680, 683.) To find that there is an insufficiency of evidence to justify the opinion, we must find that, after weighing the evidence in the record, including reasonable inferences based on that evidence, the panel clearly should have reached a different opinion. (Code Civ. Proc. § 657; *Bray v. Rosen, supra*, 167 Cal.App.2d at p. 684.) To find that the opinion is against (or contrary to) law, we must determine whether the opinion is "unsupported by any substantial evidence." (*Appeal of Graham and Smith*, 2018-OTA-154P, citing *Sanchez-Corea v. Bank of America* (1985) 38 Cal.3d 892, 906 (*Sanchez-Corea*).) This requires a review of the opinion to indulge "in all legitimate and reasonable inferences" to uphold the opinion. (*Sanchez-Corea, supra*, 38 Cal.3d at p. 907.) The relevant question is not over the quality or nature of the reasoning behind the opinion, but whether the opinion can or cannot be valid according to the law. (*Appeal of NASSCO Holdings, Inc*. (2010-SBE-001) 2010 WL 5626976.) In our review, we consider the evidence in the light most favorable to the prevailing party (here, FTB). (*Sanchez-Corea*, *supra*, 38 Cal.3d at p. 907.)

Appellants assert that the standard applied by the panel as set forth in *Union Carbide Corp. and Subsidiaries v. Commissioner*, T.C. Memo. 2009-50 (*Union Carbide*), affd. (2d. Cir. 2012) 697 F.3d. 104, is not the correct standard for determining whether the projects satisfied the process of experimentation test. Appellants assert that the proper test is found in *U.S. v. McFerrin* (5th Cir. 2009) 570 F.3d 672 (*McFerrin*), which provides that the evaluation of whether a project satisfies the process of experimentation requires: (1) the identification of uncertainty concerning the development or improvement of a business component; (2) the identification of one or more alternatives intended to eliminate that uncertainty; and (3) the identification and the conduct of a process of evaluating the alternatives (through, for example, modeling, simulation, or a systematic trial and error methodology). (*McFerrin, supra*, 570 F.3d at p. 677, citing Treas. Reg. § 1.41–4(a)(5)(i).)

We considered whether Swat-Fame's activities involved a structured method of discovering information. According to *Union Carbide*, a process of experimentation requires "the use of the scientific method sense," which consists of a methodical plan involving a series of trials to test a hypothesis, analyze the data, refine the hypothesis, and retest the hypothesis. (*Union Carbide, supra*, T.C. Memo. 2009-50.) Therefore, we considered whether Swat-Fame substantially engaged in experimentation in the "scientific method sense." Appellants misinterpret *McFerrin, supra*, 570 F.3d 672, for the proposition that experimentation in the

scientific method sense is no longer required. Contrary to appellants' assertion, the *McFerrin* court did not address whether the process of experimentation test under Treasury Regulation section 1.41-4(a)(5) excludes the scientific method. Rather, *McFerrin* merely analyzed whether the district court that reviewed the underlying case used the outdated proposed regulation's facts and circumstances test or the three-part process of experimentation test under Treasury Regulation section 1.41-4(a)(5). *McFerrin* acknowledged that the proper test is the three-part test as provided by Treasury Regulation section 1.41-4(a)(5). This is the same test discussed by *Union Carbide*. Furthermore, the courts interpreting Treasury Regulation section 1.41-4(a)(5), including the Fifth Circuit in *McFerrin,* continue to interpret a systematic methodical plan as requiring the use of experimentation in the scientific method sense. (See *Union Carbide*, *supra*, T.C. Memo. 2009-50; *Trinity Industries, Inc. v. U.S.* (5th Cir. 2014) 757 F.3d 400, 414; *Suder v. Commissioner,* T.C. Memo. 2014-201; *U.S. v. Davenport* (N.D. Tex. 2012) 897 F.Supp.2d 496, 506.) Therefore, we did not apply the wrong standard in considering whether the projects satisfied the process of experimentation test.

Further, there was substantial evidence to support our opinion. We note that appellants have the burden to demonstrate that they are entitled to the R&D Credit. (*INDOPCO, Inc. v. Commissioner* (1992) 503 U.S. 79, 84.) The evidence in the record, including the R&D Credit study and the testimony of appellants' president and the person in charge of design operations, shows that Swat-Fame failed to engage in a methodical experimentation for each project and that portions of the projects were for disqualified purposes of style and aesthetics. Appellants assert that we failed to properly consider their testimonial evidence. However, we do not weigh the evidence when determining whether our opinion is contrary to law. (*Appeal of Graham and Smith*, *supra*, 2018-OTA-154P, citing *Sanchez-Corea*, *supra*, 38 Cal.3d at p. 906.) Rather, we view the evidence in the record in the light most favorable to FTB and consider whether there is any substantial evidence to support our opinion. We find there is substantial evidence to support our opinion that Swat-Fame failed to satisfy the process of experimentation test, and appellants accordingly failed to show they are entitled to the credit. Therefore, a rehearing on the ground that our opinion is against (or contrary to) law is not warranted.

In light of the above, we find that appellants have not shown that there is insufficient evidence to support our opinion. We considered the testimonial evidence provided by Swat-Fame's president, J. Greenberg, and Swat-Fame's design operations, C. Nevarez. After

weighing their testimonial evidence with the remaining evidence in the record, however, we are not convinced that we should have reached a different conclusion. As for appellants' assertion that our opinion failed to properly consider regulatory requirements for children's clothing, we considered appellants' assertion prior to our opinion. In weighing that assertion against the evidence in the record, it is not clear that we should have reached a different conclusion as to whether the two-piece set legging and skirt project had a qualified purpose. Therefore, a rehearing on the ground of insufficiency of evidence to support our opinion is not warranted.

Appellants have not satisfied the requirements for granting a rehearing and, as such, their petition is denied.

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Amanda Vassigh
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Amanda Vassigh
Administrative Law Judge

We concur:

DocuSigned by:
F8E81582726F448...
Richard Tay
Administrative Law Judge

DocuSigned by:
Michael Geary
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Michael Geary
Administrative Law Judge

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