

**OFFICE OF TAX APPEALS**  
**STATE OF CALIFORNIA**

In the Matter of the Appeals of:	)	OTA Case Nos. 18010702, 18012114,
<b>SWAT-FAME, INC.; BRUCE STERN AND</b>	)	& 18012115
<b>JUDITH STERN; AND MITCHELL</b>	)	
<b>QUARANTA AND NINA QUARANTA<sup>1</sup></b>	)	Date Issued: March 22, 2019
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**OPINION**

Representing the Parties:

For Appellants: Wilber E. Suggs, Director, alliantgroup

For Respondent: Carolyn S. Kuduk, Tax Counsel

Office of Tax Appeals: William J. Stafford, Tax Counsel III

A. VASSIGH, Administrative Law Judge: These consolidated appeals are made pursuant to section 19324 of the Revenue and Taxation Code (R&TC) from the actions of the Franchise Tax Board (FTB) in denying claims for refund, and pursuant to R&TC section 19045 from the actions of FTB on the protests against proposed assessments.

Office of Tax Appeals Administrative Law Judges Amanda Vassigh, Grant S. Thompson, and Michael F. Geary held an oral hearing in this matter on December 12, 2018. When the hearing concluded, the panel closed the record and took the matter under submission.

**ISSUES**

1. Whether appellants have demonstrated that the activities of Swat-Fame, Inc. (“Swat-Fame” or “company”) constituted “qualified research” under R&TC section 23609.
2. Whether appellants have substantiated Swat-Fame’s “qualified research expenses.”

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<sup>1</sup>Originally, three separate appeals were filed by Swat-Fame, Inc., Bruce Stern, and Mitchell Quaranta for tax years 2008 through 2011. OTA’s records show that on August 1, 2017, the California Department of Tax and Free Administration accepted the inclusion of tax year 2012 into the appeals. The appeals for tax year 2012 included Swat-Fame, Inc., Bruce and Judith Stern, and Mitchell and Nina Quaranta. Since all parties in this appeal refer to all of the aforementioned parties as appellants to the entirety of this consolidated appeal, we do the same.

## FACTUAL FINDINGS

### *Swat-Fame, Inc.*

1. Swat-Fame, an S corporation, is an apparel designer for women and girls clothing. Swat-Fame’s clothing designs are available at major retailers. The company states that each year its design staff develops and refines thousands of new and improved garment designs.

### *Procedural History*

2. Swat-Fame, Bruce Stern and Judith Stern (“Stern”), and Mitchell Quaranta and Nina Quaranta (“Quaranta”) (collectively “appellants”) filed amended California returns seeking tax refunds for increasing research activities under Internal Revenue Code (IRC) section 41,<sup>2</sup> as adopted and modified by R&TC section 23609, for the tax years ending February 28, 2009 (hereinafter tax year “2008”), February 28, 2010 (tax year “2009”), February 28, 2011 (tax year “2010”), and February 29, 2012 (tax year “2011”).<sup>3</sup> When FTB denied the claims, appellants filed timely appeals.
3. Stern and Quaranta also filed California returns claiming research credits for the tax year ending December 31, 2012 (tax year “2012”). Swat-Fame claimed carry-forward credits for 2012.
4. After reviewing the matter, FTB issued notices of proposed assessment (NPAs) on December 30, 2016. FTB later affirmed the NPAs in Notices of Action (NOAs) dated May 31, 2017.
5. Appellants filed timely appeals. The Office of Tax Appeals (OTA) consolidated the appeals, and by agreement of all parties, all evidence at the hearing was taken in OTA case number 18010702, the Appeal of Swat-Fame.

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<sup>2</sup> All undesignated section references are to sections of the IRC as effective during the years at issue.

<sup>3</sup> Schedule K-1s show that for tax years 2008 and 2009, the Stern Family Trust (SFT) owned 60% of the stock of Swat-Fame and Quaranta owned 40%. Schedule K-1s show that for tax year 2011 SFT owned 50% of the stock of Swat-Fame and Quaranta owned the remaining 50%. Schedule K-1s show that for tax year 2012, SFT owned 50% of the stock of Swat-Fame and the “Quaranta Family Trust” owned the remaining 50%. Schedule K-1s for the tax year 2010 are not in the appeal record.

*Amounts in Dispute*

6. FTB denied appellants' refund claims for the following tax years and amounts:

<u>Swat-Fame:</u>	<u>Year: Amount</u>
Claims for Refund:	2008: \$26,143
	2009: \$51,168
	2010: \$107,728
	2011: \$75,008
Proposed Assessment:	2012: \$347,427 <sup>4</sup>

<u>Stern:</u>	<u>Year: Amount</u>
Claims for Refund:	2008: \$158,754
	2009: \$143,530
	2010: \$196,952
	2011: \$165,883
Proposed Assessment:	2012: \$343,045

<u>Quaranta:</u>	<u>Year: Amount</u>
Claims for Refund:	2008: \$107,635
	2009: \$102,129
	2010: \$117,759
	2011: \$169,999
Proposed Assessment:	2012: \$330,348

*Product Development and Testing*

7. Swat-Fame entered into an agreement with alliantgroup to perform a research and development (R&D) study. The R&D study states that Swat-Fame initiated the product development process through a collaboration of Swat-Fame's Design Team, including designers, design assistants, creative directors, and its Sales and Marketing departments, to determine the new and improved silhouettes and fabrics for utilization in the upcoming season's line plan for each of Swat-Fame's brands.
8. According to the R&D study, after receiving feedback from those departments, the designers created new apparel concepts by hand sketching or drafting designs utilizing computer aided design (CAD) modeling programs. Once the initial drawings were complete, the designers reviewed the designs with Mari Forge, Creative Director-Juniors and Evelyn Ober, Creative Director-Branded, along with other Swat-Fame personnel,

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<sup>4</sup> The NOA issued to Swat-Fame for 2012 states that "it affirms a proposed reduction of \$347,427 to the amount of research and development (R&D) credit subject to carryover to future years."

including those in its Sales and Merchandising departments, to determine the styles that would be created into prototypes. The R&D study further states that, throughout this initial concept phase, the Design Team considered alternative fabrications, trims, and other components for utilization in the new garment designs.

*Sample Projects - General*

9. During the pre-hearing process in this appeal, appellants and FTB agreed to resolve this appeal based on OTA's determination with respect to four sample projects.
10. alliantgroup states that it analyzed each individual project by conducting technical interviews with the following Swat-Fame employees: Ms. Forge; Ms. Ober; and Francis Coye, Director of Human Resources.
11. The R&D study provides the following descriptions of the four sample projects:
  - a. Project Name: UB636N (2008)—Swat-Fame undertook this project to design and develop a pair of Bermuda shorts. At the outset of the project, the company faced uncertainty as to the optimal design specifications for the shorts, including the appropriate dimensions and materials. A specific issue faced with the Bermuda shorts related to the fit for the garment. Specifically, the fit of the shorts was challenging because the wash process caused the material to be susceptible to a higher rate of shrinkage. The company conducted fit tests on the shorts before and after the wash processes were applied to determine the amount of additional material required to accommodate for the shrinkage of the fabric.
  - b. Project Name: D11072 (2009)—Swat-Fame undertook this project to design and develop a dress with adjustable straps. The company faced uncertainty as to the optimal design for the dress. In addition, the company faced challenges in implementing certain elements of the design. For example, the straps, commonly known as spaghetti straps, were thin; therefore, the company evaluated the straps location and ability to support the dress during several fit tests.
  - c. Project Name: Z1743D01 (2010)—Swat-Fame undertook this project to design and develop a two-piece set, including a ruffle skirt and leggings. The company faced uncertainty as to the optimal design for both the leggings and the ruffle skirt, with most challenges arising from the skirt design. For example, the company was required to determine the ruffle skirt's fabric measurements to

achieve the desired fit and ensure the skirt fell on the wearer correctly. This meant that the company was required to determine the exact number of ruffles required for each size to develop the product within quality specifications.

- d. Project Name: M93771 (2010)—Swat-Fame undertook this project to design and develop a two-piece set consisting of a cotton sundress and a shrug, which is a cropped cardigan-like garment. From the outset, the company faced uncertainty as to the optimal design for the dress and shrug, including the smocking feature for the dress. For example, Swat-Fame was uncertain as to the number of rows required to create the desired smocked band that laid flat against the wearer. To overcome this uncertainty, Swat-Fame evaluated alternative designs and conducted fit testing of the garment. Swat-Fame utilized the testing results to determine the right number of rows for the smock that satisfied the fit and functionality requirements.
12. Swat-Fame’s practice was to show their clothing lines to prospective buyers and allow the buyer to request modifications to the garments. At the hearing, Jonathan Greenberg, President of Swat-Fame, testified that Swat-Fame is different than other fashion companies in that they “don’t put product on the wall and the customer says, ‘I want this and this and this.’ It’s more of, ‘I like that dress but can you put that sleeve on it, and can you put that skirt on it?’”
13. Swat-Fame caters to ever-changing customer desires. Mr. Greenberg testified that Swat-Fame is “constantly changing to market needs [and is] really good at adapting to change and following the market.”
14. Products are developed based on fashion trends or can be a version of a garment worn by a celebrity. Swat-Fame’s conceptualization process included discussions about current trends and styles for an upcoming season, and putting together inspiration boards using pictures of garments in various colors or silhouettes that Swat-Fame may want to reproduce.
15. Being in the fashion business, Swat-Fame is driven by deadlines. The financial ramifications of missing a deadline can be a cancellation by the customer, a price concession, and/or losing that customer. Some of Swat-Fame’s divisions release product

- on a seasonal basis (fall, spring, holiday and summer) but most divisions release new lines every month.
16. Depending on the line, there are various considerations that go into designing apparel. There are regulations specific to young children’s clothing; as well as dimensional requirements (measurements of the product); the type of fabric; colorfastness; and the amount of fabric and other material required such as zippers, buttons and clasps.
  17. Best-selling products developed for one line might later be modified for the purposes of another line. A product from a high-end line might be modified for a lower-end line with a change of fabric. Connie Nevarez, Design Operations at Swat-Fame, testified that changing the fabric creates a new style.
  18. Swat-Fame created face cards listing the specifications for each product, because, as Mr. Greenberg testified, they would need warehouses to contain all the actual garments, since Swat-Fame made 600 styles a month. Face cards list related styles, which could be the accompanying style number of the second garment in a two-piece set, or a similar style of a garment previously made or pattern for that style to which Swat-Fame could later refer.
  19. Swat-Fame did not send the fabrics used in the sample projects to outside vendors for technical testing, such as chemical analysis, and Swat-Fame does not employ chemists.

*Sample Project – UB636N*

20. Project UB636N (denim Bermuda shorts) was made with an indigo stretch denim fabric composed of 98% cotton and 2% spandex. Swat-Fame had familiarity with the properties of this fabric. Swat-Fame purchases raw denim, which is rough and transfers color. Then, depending on the look to be achieved, the denim may be treated through lasering and/or washing (with potassium, resin, and/or stonewashing). Garments are also washed with water and detergent. In regard to the temperature of the water, Ms. Nevarez testified that would depend on “what the washhouse wants to use. We . . . don’t tell them what temperature to use.” Swat-Fame experienced problems with the denim shrinking during the wash process. Swat-Fame also experienced difficulty in making the waistband stable and stretchable, which it attempted to address by sewing fusing inside the waistband. However, even the fusing shrank. Another issue is that the back pocket was tearing. As a result of these issues, this project never went into production.

*Sample Project –D11072*

21. Project D11072 (party slip dress) was a dress that would normally be made in a lightweight poplin fabric. Swat-Fame’s customer wanted the dress in a jacquard fabric, which is heavier and stiffer, with a cummerbund made from charmeuse, a “satin-y” fabric, and an altered neckline. Swat-Fame went through its product design and development process without success. The charmeuse fabric did not achieve the proper appearance since it would not lay flat, even with an under-netting. Considerations had to be made to compensate for the support that would be lost with the altered neckline, and adjustable straps, bra cups, and lining were added to the top of the party slip dress. While Swat-Fame had designed dresses with spaghetti straps and heavy fabrics in the past, this project was ultimately abandoned because it was not possible to create that style with the fabric and alteration to the neckline that the customer requested.

*Sample Project –Z1743*

22. Project Z1743 (ruffled skirt and leggings) was a children’s garment. In making children’s clothing, Swat-Fame takes into consideration applicable regulations, the fact that children are often more active, children’s abilities to pull up a zipper or button a waist, and as Mr. Greenberg testified, “you have to take into consideration the vanity part of it.” in that the cut of a woman’s garment might be more revealing than a child’s garment. This project consisted of a two-piece set. Each piece went through a separate design and development process. The skirt had 13 rows of ruffles of fabric that were sewn together to create layers. The ruffles did not serve a functional purpose. The challenge Swat-Fame faced with the ruffled skirt was that bunching the fabric together to create ruffles made the garment heavier, which caused the seams to easily open up. Swat-Fame had to figure out a way to reinforce the seams while also ensuring that the product could stretch. The accompanying leggings also presented an issue with regard to seams. Instead of a five thread overlock (a stitch used to join two pieces of a garment together) Swat-Fame used a four thread overlock for a durable stitch that would still allow the fabric to stretch.

*Sample Project –M93771*

23. Project M93771 (sundress and shrug) was a two-piece product. Each piece went through Swat-Fame’s design and development process separately. The sundress design required the combining of a printed fabric and a solid fabric, which is usually softened by the dye process. Swat-Fame had made many of these dresses with only a printed fabric. Swat-Fame encountered a problem constructing the neckline because the fabric was so flimsy that it kept falling forward. Swat-Fame corrected this issue by adding a lining between the layers of fabric to give it more structure. A hook-and-eye clasp was added to the sundress to keep the zipper closed. The shrug was a short cardigan with a smocking (elastic thread sewn into the fabric to give it stretch), which raised a challenge in getting the fit right. The stone-wash process ripped the corners of the pockets on the shrug, such problems being a frequent result of the washing process. Swat-Fame remedied this by reinforcing the pockets with extra bar tack stitching. The shrug went back to the pattern-making step for this adjustment in the construction guidelines and was remade.

DISCUSSION*I. Burden of Proof*

Tax credits are a matter of legislative grace, and taxpayers bear the burden of proving they are entitled to claimed tax credits. (*INDOPCO, Inc. v. Commissioner* (1992) 503 U.S. 79, 84.) Statutes granting tax credits are to be construed strictly against the taxpayer with any doubts resolved in FTB’s favor. (*Dicon Fiberoptics, Inc. v. Franchise Tax Bd.* (2012) 53 Cal.4th 1227, 1235.) The taxpayer has the burden of showing that the requirements for the research credit are satisfied. (See, e.g., *Trinity Industries, Inc. v. United States* (5th Cir. 2014) 757 F.3d 400, 415 (*Trinity Industries*), affg. in part, & vacating & remanding in part (N.D.Tex. 2010) 691 F.Supp.2d 688.)

*II. Qualified Research**A. Applicable Law*

To be eligible for an R&D tax credit under IRC section 41(a)(1), as modified by R&TC section 23609, appellants must prove that Swat-Fame performed qualified research, or paid



someone else to perform qualified research, during the years at issue. Qualified research is research that satisfies four tests:<sup>5</sup>

1. Section 174 Test: expenditures connected with the research must be eligible for treatment as expenses under IRC section 174 (IRC, § 41(d)(1)(A));
2. Technological in Nature Test: research must be undertaken for the purpose of discovering technological information (IRC, § 41(d)(1)(B)(i));
3. Business Component Test: the taxpayer must intend that the information to be discovered be useful in the development of a new or improved business component (e.g. product) of the taxpayer (IRC, § 41(d)(1)(B)(ii)); and
4. Process of Experimentation Test: substantially all of the research activities must constitute elements of a process of experimentation for a purpose relating to a new or improved function, performance, reliability, or quality. (IRC, § 41(d)(1)(C), 41(d)(3).)

The above tests are applied separately to each business component. (IRC, § 41(d)(2)(A).) A “business component” is defined as a product, process, computer software, technique, formula, or invention that the taxpayer holds for sale, lease, or license or uses in its trade or business. (IRC, § 41(d)(2)(B).) If a business component as a whole fails the qualified research tests, a court may apply the “shrinking-back rule,” which allows the court to apply the qualified research tests to a subset of the business component if doing so will allow the subset to satisfy those tests. (Treas. Reg. § 1.41-4(b)(2).)

Certain types of research are specifically excluded from the definition of qualified research. They include research conducted after the beginning of the commercial production of a business component, research related to the adaption of an existing business component to a particular customer’s requirement or need, foreign research, research in the social sciences, arts, or humanities, and funded research. (IRC, § 41(d)(4).) Furthermore, research relating to style, taste, cosmetic, or seasonal design factors is not for a qualified purpose under the process of experimentation test and is thus not qualified research. (IRC, § 41(d)(3)(B).)

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<sup>5</sup> For purposes of the California research credit, “qualified research” only includes research conducted in California. (R&TC § 23609(c)(2)(A).)

1. *The Section 174 Test*

The section 174 test requires that expenditures connected with the research activities qualify under IRC section 174. Section 174 provides alternative methods of accounting for “research or experimental expenditures” that taxpayers would otherwise capitalize. (Treas. Reg. § 1.174-1.) The Treasury Regulations define “research or experimental expenditures” as “expenditures incurred in connection with the taxpayer’s trade or business which represent research and development costs in the experimental or laboratory sense.” (Treas. Reg. § 1.174-2(a)(1).) An activity generally constitutes “research and development” in the “experimental or laboratory sense” if (1) the information available to the taxpayer does not establish the capability or method for developing or improving a product or process or the appropriate design of a product or process (i.e., an uncertainty exists); and (2) the activity is intended to discover information that would eliminate that uncertainty. (Treas. Reg. § 1.174-2(a)(1) and (2).) Because a taxpayer need only be uncertain as to “the capability or method . . . or the appropriate design” of the improvement, an uncertainty may exist even if the taxpayer knows that it is technically possible to achieve a goal but is uncertain of the method or appropriate design to use to reach that goal. (Treas. Reg. § 1.174-2(a)(1).)

2. *The Technological in Nature Test*

The technological information test requires the taxpayer to conduct research for the purpose of discovering information that is “technological in nature.” (IRC, § 41(d)(1)(B)(i).) Section 41(d)(1)(B), and the regulation provisions implementing and interpreting it, consists of two parts: a requirement that the research be undertaken to discover information, and a requirement that the information sought be technological in nature.

With regard to the requirement that the information sought be technological in nature, Treasury Regulation section 1.41-4(a)(4) provides as follows:

[i]nformation is technological in nature if the process of experimentation used to discover such information fundamentally relies 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.

### 3. *The Business Component Test*

The business component test requires that the research is intended for the purpose of discovering information that is useful in the development of a new or improved business component of the taxpayer. (IRC, § 41(d)(1)(B)(ii).) A “business component” is defined as “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.” (IRC, § 41(d)(2)(B).)

Treasury Regulation section 1.41-4(b)(2) provides that, if the requirements of section 41(d) are not met at the level of the identified business component, the requirements are then applied “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” (the “shrinking-back” rule). The shrinking-back continues “until either a subset of elements of the product that satisfies the requirements is reached, or the most basic element of the product is reached and such element fails to satisfy the test.” (Treas. Reg. § 1.41-4(b)(2).)

### 4. *The Process of Experimentation Test*

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.” (Treas. Reg. § 1.41-4(a)(5)(i).) A process of experimentation “involves [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).” (*Ibid.*) “Uncertainty concerning the development or improvement of the business component (e.g., its appropriate design) does not establish that all activities undertaken to achieve that new or improved business component constitute a process of experimentation.” (*Ibid.*)

The process of experimentation test has three elements: (A) substantially all of the research activities for each business component must constitute (B) elements of a process of experimentation (C) for a qualified purpose. (IRC, § 41(d)(1)(C).)

A. *Substantially All*

The “substantially all” element means that 80 percent or more of the taxpayer’s research activities for each business component, measured on a cost or other consistently applied reasonable basis, must constitute a process of experimentation for a qualified purpose. (Treas. Reg. § 1.41-4(a)(6).) If a business component fails the process of experimentation test because of the “substantially all” requirement, a court may apply the shrinking-back rule, discussed above, until an element that satisfies the test is reached. (*Suder v. Commissioner*, T.C. Memo. 2014-201 (*Suder*).

B. *Process of Experimentation*

This test requires a “structured method of discovering information.” (*Union Carbide Corp. and Subsidiaries v. Commissioner*, T.C. Memo. 2009-50 (*Union Carbide*), affd. (2d Cir. 2012) 697 F.3d. 104.) As the Tax Court in *Union Carbide* pointed out, a process of experimentation “requires the use of the scientific method.” (*Union Carbide, supra*, T.C. Memo. 2009-50 at 201.) Whereas a simple trial and error method is not sufficient, a “systematic trial and error methodology can be a process of experimentation” (Treas. Reg. § 1.41-4(a)(5)(i)), which suggests a methodical plan involving an iterative testing process in which a hypothesis is tested, data analyzed, and the hypothesis refined and re-tested “so that it constitutes experimentation in the scientific sense.” (*Union Carbide, supra*, T.C. Memo. 2009-50 at 202.) If only one alternative is tested, the taxpayer should conduct a series of experiments with the alternative in order to constitute a process of experimentation. (*Ibid.*)

C. *Qualified Purpose*

A purpose is qualified “if it relates to a new or improved function, performance, reliability or quality of the business component.” (Treas. Reg. § 1.41-4(a)(5)(ii).) However, research is not qualified if it is conducted for a purpose that “relates to style, taste, cosmetic, or seasonal design factors.” (IRC, § 41(d)(3)(B).) For instance, where a business developed software and telephone products and systems, the Tax Court found that the experimentation undertaken with respect to 11 of the 12 projects was for a qualified purpose, because they were undertaken to add a new feature or function to the company’s phone systems or to improve an application used to program the phone system by redesigning it. (*Suder, supra*, 2014 WL 4920724 at \*52.) However, the Tax Court found that the twelfth project, Chameleon, was not

undertaken for a qualified purpose, but to “change the look and feel of the VIP user interface. It gave the ability to change the colors, fonts, button shapes, and button sizes on the screen” and did not change the functionality of the user interface. As a result, the Tax Court found that the Chameleon project was “undertaken for style, taste or cosmetic purposes,” and was thus not qualified research. (*Id.* at \*53.)

### *III. Analysis Regarding Qualified Research: Sample Projects*

Since it appears to us that the core issue in this appeal is whether appellants’ research satisfies the process of experimentation test, and most of the arguments and testimony centered on the process of experimentation, we will begin our analysis with that test. As noted above, the process of experimentation test has three elements: (1) substantially all (i.e., 80% or more) of the research activities for each business component must constitute (2) elements of a process of experimentation (3) for a qualified purpose. (IRC, § 41(d)(1)(C).) This test must be applied to the claimed research activities with respect to each business component, which in this matter are the four sample projects. Appellants claim that Swat-Fame’s entire design and sewing process for the sample projects constituted a process of experimentation. FTB argues that appellants merely took steps to resolve uncertainty or to improve a business component, and that these steps were not taken for a qualified purpose but rather, were adjustments made for aesthetic purposes.

In support of their position, appellants emphasize the presence of uncertainty as to the method or design required to achieve a result. Appellants illustrated, during the hearing, every step of their product design and development process, from conceptualization to testing to creating a prototype for manufacturing. The level of attention to detail and efforts to perfect each element of a garment are impressive. However, the question is whether appellants substantially engaged in the scientific method as this test requires. (Treas. Reg. § 1.41-4(a)(5)(i).) Below we examine each sample project to determine whether the process of experimentation requirement is satisfied.

#### *Project UB636N – Bermuda Shorts*

According to the R&D study, Swat-Fame faced uncertainty as to the optimal design specifications for the Bermuda shorts, because the wash process caused the material to be susceptible to a higher rate of shrinkage than usual. The Bermuda shorts were made with a denim fabric that Swat-Fame had used to make full-length jeans in the past, so Swat-Fame was

not unfamiliar with the characteristics of this particular fabric. Swat-Fame sent the product to a third party for washing and did not direct that party as to what temperature to use in washing. One imagines that a process of experimentation regarding a shrinkage issue that results from washing would involve a hypothesis and re-testing by washing again at that same temperature. There is no evidence that Swat-Fame engaged in a methodical experimentation process in regard to the issues with shrinkage. We do not have any information to indicate that Swat-Fame recorded the temperature of the wash that resulted in shrinkage, then refined the design and re-tested the effect of the washing process on the product under the same conditions. Swat-Fame also experienced difficulty making the waistband stable, and attempted to fix this problem by adding fusing to the waistband. This did not solve the problem as the fusing also shrank in the wash. Again, there is no evidence that Swat-Fame engaged in a methodical experimentation process regarding this problem, either.

While treatment of denim such as lightening or lasering may employ scientific principles and equipment, such treatment is clearly for the purposes of aesthetics, relating to style and seasonal design, so such activities would not have a qualified purpose. Also, while portions of this process may have involved a process of trial and error, a significant portion of the project was for the purpose of aesthetics, and appellants have not shown that at least eighty percent of its activities with respect to this project constituted a “systematic trial and error methodology.” (Treas. Reg. § 1.41-4(a)(5)(i).) In addition, while it is not required that more than one alternative be tested, we do not see a series of experiments with an alternative that would constitute a process of experimentation. (*Union Carbide, supra*, T.C. Memo. 2009-50.)

#### *Project D11072 – Party Slip Dress*

Swat-Fame sought to achieve the optimal design for a party slip dress with spaghetti straps in the fabrics requested by its customer. This caused issues as the jacquard fabric was heavy and stiff, and the charmeuse fabric would not lay flat as a cummerbund is designed to. Swat-Fame attempted to use alternative approaches to achieve the design (bra cups in the top, lining in the cummerbund). While perhaps thorough, we do not have evidence that the method of the alternative approaches was a structured or scientific method. The Tax Court in *Union Carbide* explained that the process of experimentation test “requires the use of the scientific method sense, not merely taking steps to resolve uncertainty or to improve a product.” (*Union Carbide, supra*, T.C. Memo. 2009-50 at 201.)

FTB argues in its opening brief that “the need for straps to support the dress would be a component of the dress’ style.” While this is true, spaghetti straps also serve a functional purpose (keeping the dress up) in a slip dress style. However, while the weight of the fabric raised challenges in this project, and Swat-Fame tried several alternative approaches to making it work, ultimately the issues were the result of the customer’s decision to use jacquard and charmeuse fabrics. The customer’s choice of fabrics was driven by style and aesthetic considerations. (IRC, § 41(d)(3)(B).) As a result, appellants have not shown that this project involved a process of experimentation for a qualified purpose.

*Project Z1743D01 – Ruffle Skirt and Leggings Two-Piece Set*

Swat-Fame encountered difficulties with the amount of fabric required to create the ruffles on the skirt causing the seams to split. The uncertainty in this project was how to reinforce the seams while still allowing the ruffled skirt and the leggings to stretch. While we are not persuaded there was much uncertainty involved in reinforcing seams for leggings, we are willing to contemplate that some trial and error was necessary to arrive at the optimal design specifications. However, “[i]t is not sufficient that the taxpayer use a method of simple trial and error to validate that a process or product change meets the taxpayer’s needs.” (*Union Carbide, supra*, T.C. Memo. 2009-50 at pp. 201-202.) In regard to the ruffled skirt, the purpose of the ruffles was for style and they did not serve a functional purpose. As a result, appellants have not shown that they engaged in a process of experimentation for a qualified purpose in this case.

*Project M93771 – Sundress and Shrug*

This sundress is another example of a project in which a new fabric is used for a familiar design. As with the party slip dress, the fabric attempted in this project created problems. In this case, the neckline kept falling forward, which Swat-Fame corrected by adding a lining between the layers of fabric. A hook-and-eye clasp was added to keep the zipper closed. Appellants have not shown that adding a lining to give flimsy fabric more “hold” and adding a hook-and-eye clasp to keep a zipper from opening are solutions that required a process of experimentation, and the evidence does not show that Swat-Fame engaged in a systematic process of experimentation in making these adjustments. Likewise, the problem with the shrug, ripped corners in the pockets as a result of stonewashing, appears to have been resolved using a known solution: extra bar tack stitching. While the process of stonewashing the shrug and correcting a problem are

part of Swat-Fame’s product development process, we are not persuaded that there was significant uncertainty in how to solve these issues or that a systematic process of experimentation took place.

We are unpersuaded that Swat-Fame’s activities in these sample projects constituted “qualified research” under R&TC section 23609. Even if Swat-Fame may have been engaged in a process of experimentation for some activities with these projects, appellants have not demonstrated that 80 percent or more of Swat-Fame’s activities for any of the four projects constituted elements of a process of experimentation for a qualified purpose. Many of Swat-Fame’s activities appear to be simple trial and error as opposed to engaging in the scientific method. Appellants did not provide evidence from which we could apply the shrinking-back rule (i.e., to determine whether the section 41(d)(1) requirements might be satisfied with respect to a smaller portion of the project), and therefore the credit must be denied in its entirety. (See *Trinity Industries, supra*, 757 F.3d at pp. 404-405.) Furthermore, many of Swat-Fame’s activities are for the purpose of the style or aesthetics of a garment, as opposed to a qualified purpose related to the function, performance, quality, or reliability of a garment. (IRC, § 41(d)(3)(B), Treas. Reg. § 1.41-4(a)(5)(ii).)

Because appellants have not demonstrated that substantially all of Swat-Fame’s activities for any of the sample projects constituted elements of a process of experimentation for a qualified purpose, we need not discuss the other tests for qualified research (i.e., the Section 174 test, the technological information test, and the business component test) or whether appellants adequately substantiated Swat-Fame’s qualified research expenditures.<sup>6</sup>

#### HOLDINGS

1. Appellants have not demonstrated that the activities of Swat-Fame constituted “qualified research” under R&TC section 23609.
2. As a result of the above holding, there are no qualified research expenses.

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<sup>6</sup> We also need not address FTB’s alternative arguments that Swat-Fame’s activities constitute (i) adaption of an existing business component and (ii) research conducted after the beginning of commercial production.



DISPOSITION

FTB’s actions denying appellants’ claims for refund are sustained. Further, FTB’s actions on appellants’ protests are sustained.

DocuSigned by:  
*Amanda Vassigh*  
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Amanda Vassigh  
Administrative Law Judge

We concur:

DocuSigned by:  
*Grant S. Thompson*  
FC572D5881AE41B...  
Grant S. Thompson  
Administrative Law Judge

DocuSigned by:  
*Michael Geary*  
1A9B52EF88AC4C7...  
Michael F. Geary  
Administrative Law Judge