BEFORE THE OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

IN THE MATTER OF THE APPEAL OF,		
ELECTRONIC DATA SYSTEMS CORPORATION & SUBSIDIARIES,	OTA NO.	19014166 19125644 22039829
APPELLANT.		

TRANSCRIPT OF PROCEEDINGS

Sacramento, California

Wednesday, June 14, 2023

Reported by:
ERNALYN M. ALONZO
HEARING REPORTER

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Transcript of Proceedings, taken at 400 R Street, Sacramento, California, 95811, commencing at 10:15 a.m. and concluding at 2:25 p.m. on Wednesday, June 14, 2023, reported by Ernalyn M. Alonzo, Hearing Reporter, in and for the State of California.

APPEARANCES:

Panel Lead:	ALJ SARA HOSEY
Panel Members:	ALJ CHERYL AKIN ALJ JOSHUA LAMBERT
For the Appellant:	YONI FIX LEE ZOELLER KELLY NALL
For the Respondent:	STATE OF CALIFORNIA FRANCHISE TAX BOARD JASON RILEY ELLEN SWAIN

I N D E X

E X H I B I T S

(Appellant's Exhibits 1-99 were received at page 9.)

(Appellant's Exhibits 100-102 were received at page 10.)

(Department's Exhibits A-BB were received at page 9.)

(Department's Exhibits CC-GG were received at page 10.)

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Sacramento, California; Wednesday, June 14, 2023

10:15 a.m.

JUDGE HOSEY: This is the Appeal of Electronic Data Systems Corporation & Subsidiaries, OTA Case Numbers 22039829, 19014166, and 19125644. Today is June 14th, approximately 10:15 a.m. We're in Sacramento, California. Again, I'm lead Administrative Law Judge Sara Hosey and with me today is Judge Cheryl Akin and Judge Josh Lambert.

Can I have the parties identify themselves for the record, starting will Appellant.

MR. FIX: Yoni Fix representing Appellant.

MS. NALL: Kelly Nall representing the taxpayer.

MR. ZOELLER: Lee Zoeller, representing the Appellant.

JUDGE HOSEY: Thank you.

And for the Franchise Tax Board.

MR. RILEY: Jason Riley representing Franchise Tax Board.

MS. SWAIN: Good morning. Ellen Swain for the Franchise Tax Board.

JUDGE HOSEY: Thank you. I want to thank the parties again for submitting the joint state of issues for this appeal. The issues on appeal are: The issues involving jurisdiction:

Number 1, whether OTA has jurisdiction to hear EDS' OTA appeal that was filed on December 10th, 2018, and supplemented with an opening brief on May 22nd, 2019, and involving EDS' claim for refund based on its entitlement to California regular incremental research credit for the 2003 to 2008 tax years.

Number 2, whether OTA has jurisdiction to hear EDS' OTA appeal that was filed on February 25th, 2022, involving EDS' claim refund based on its entitlement to California regular incremental research credit to 2005 to 2008 tax years.

The issues involving qualified research expenses are Number 3, whether for the 2003 to 2008 taxable years, EDS has substantiated a total of 115.2 million in California qualified wages.

Number 4, whether for the 2003 to 2008 taxable years, EDS is entitled under the Cohan rule to estimate a portion, $107.4 million of its qualified research expenses. We have issues involving gross receipts.

Number 5, whether EDS has substantiated its fixed-base percentage. California R&T Section 23609(h)(3) gross receipts from the sale of property averaging a gross receipts and a base amount for the each of the tax years.

Number 6, whether EDS is allowed to use the maximum statutory fixed-base percentage of 16 percent when

computing its California regular incremental research credit for the tax years.

Number 7, whether EDS' California average annual-gross receipts for each of the tax years were large enough to produce a calculated base amount greater than the statutory minimum base amount, i.e., 50 percent of QREs.

Number 8, whether the duty of consistency applies to EDS' fixed-base percentage averaging annual gross receipts and base amount for each of the tax years.

And finally, issues involving easy credits, Number 9, whether the enterprise-zone credit statute should be intercepted -- sorry -- interpreted to allow EDS' June 2012 claim utilizing its enterprise-zone credits against income earned in single collective zone.

And finally, Number 10, whether Section 25137 is applicable to the enterprise zone credit.

Mr. Fix, does that sound right?

MR. FIX: That sounds right.

JUDGE HOSEY: Okay.

MR. FIX: I just want to note the two footnotes in the consolidated statement of the issues of the parties.

JUDGE HOSEY: Go ahead.

MR. FIX: With respect to issue Number 1 under

jurisdiction, you can see Footnote 1 that the parties agree that the answer -- sorry -- with respect two question 2, the answer is yes to the issue Number 2 that the OTA does have jurisdiction over the claim filed February 25th, 2022. So we agree that is resolved. And then the second piece that we have agreed to is in Footnote 2 we're saying that with respect to question 1 under the qualified research expenses section, FTB and EDS agree that EDS has already substantiated $75,966,096 of California qualified wages for the '06 through '08-B tax years.

I just want to make sure that's noted.

JUDGE HOSEY: Thank you, Mr. Fix.

Mr. Riley, does that sound right?

MR. RILEY: Yes, that sounds correct.

JUDGE HOSEY: I want to thank you guys again for working on this together. I know we have a lot to cover for these tax years.

All right. Moving forward with the exhibits, we marked and discussed Exhibits 1 through 99 for Appellant, and A through BB for Respondent, FTB, at the prehearing conference.

Mr. Fix, were there any objections to the Franchise Tax Board's exhibits?

MR. FIX: No.

JUDGE HOSEY: Thank you.

Mr. Riley, were there any objections to the Appellant's exhibits?

MR. RILEY: No.

JUDGE HOSEY: Thank you.

MR. FIX: Judge Hosey, I just want to make sure you said Exhibit 99 for Appellant and since then additional were --

JUDGE HOSEY: Yeah. I was going to go over the additional exhibits.

MR. FIX: I just want to make sure. Thank you.

JUDGE HOSEY: Okay. Thank you.

Having no objections, Exhibit 1 through 99 and A through BB are now admitted as evidence into the record.

(Appellant's Exhibits 1-99 were received in evidence by the Administrative Law Judge.)

(Department's Exhibits A-BB were received in evidence by the Administrative Law Judge.)

JUDGE HOSEY: We have some new exhibits that were submitted after the prehearing conference. We have Appellant's Exhibits 100 through 102.

Mr. Riley, were there any objections to those exhibits?

MR. RILEY: Not an objection. No.

JUDGE HOSEY: Okay. Thank you. Exhibits 100 and

102 are now admitted into the record.

(Appellant's Exhibits 100-102 were received in evidence by the Administrative Law Judge.)

JUDGE HOSEY: We also had exhibits, from the Franchise Tax Board, CC through GG.

Mr. Fix, were there any objections to those exhibits?

MR. FIX: No.

JUDGE HOSEY: Okay. Exhibit CC through GG for the Franchise Tax Board are now admitted as evidence into the record.

(Department's Exhibits CC-GG were received in evidence by the Administrative Law Judge.)

JUDGE HOSEY: Okay. We are going to go ahead and move onto the testimony of our witness Ms. Nall.

Ms. Nall, are you ready?

MS. NALL: Yes, I'm ready.

JUDGE HOSEY: Oh, go ahead, Ms. Nall.

MR. FIX: Before we start, would it be possible for me to just give a one-minute introduction just to put this testimony in context. I think it would be helpful for everyone.

JUDGE HOSEY: Sure. And then I'll swear her in, or do you want me to swear her in first?

MR. FIX: Yeah. I think that we can do that.

Sure.

JUDGE HOSEY: Okay. Go ahead.

OPENING STATEMENT

MR. FIX: So I'll go into this in more detail as part of my presentation. But Ms. Kelly Nall, obviously, has been with this taxpayer for almost 30 years. And as part of her work, she was personally involved in the R&D credits on the federal side, which are relevant for us today. And obviously, she's very familiar with the business, and she's been there for quite a while. So her testimony will help us answer a few of the questions that have been posed and raised, specifically, with respect to establishing the remaining qualified research expenses that are at issue.

Obviously, we've already established some, as well as the type of business that EDS had during these years and what type of gross receipts they incurred in California, specifically, from services versus from sales of property or whatever that would fall under the definition of gross receipts for purposes of the R&D calculation.

So with that, I think we can swear her in.

JUDGE HOSEY: Okay. I just want to let you know question and answer is fine. But also, if she wants to

testify in the narrative and longer form, that's fine too.

Okay. Ms. Nall, we are going to swear you in now for your testimony. Please rise and raise your right hand.

K. NALL,

produced as a witness, and having been first duly sworn by the Administrative Law Judge, was examined and testified as follows:

JUDGE HOSEY: Thank you.

All right. Mr. Fix, please begin.

MR. FIX: Thank you.

DIRECT EXAMINATION

BY MR. FIX:

Q All right. Ms. Nall, let's start with -- can you please describe to us what your current position at HP is and how long you've been employed by HP?

A Yes. I have been employed by the combined companies for just under 35 years. I started with EDS in 2000 -- excuse me -- in 1988. And then in 2008, Hewlett Packard company acquired EDS, and I continued with that company until 2016 when Hewlett Packard Company spun off what became Hewlett Packard Enterprise Company.

Q So you were involved on the federal tax side with R&D's at HPE during the 2003 through 2008; is that correct?

A Yes, that's correct.

Q Great. What other positions have you held at HP and previously named Electric Data Systems, or for short EDS that we'll use today?

A So at EDS my role was mostly manager of federal tax audits. That continued when we were acquired by Hewlett Packard Company. I also took on the management of their federal tax audits and was promoted to director to do this. When we split off and became Hewlett Packard Enterprise and spun off another company, I was also asked to pick up the role of director of mergers and acquisitions for tax purposes.

Q Thank you. So in the course of your responsibilities at EDS, did you become familiar with EDS' business and contracts with its customers?

A Yes, I did. Mainly it was as part of the federal income tax audit of our research tax credits. We had to look at contracts to understand what was in those and provide the information to the IRS for them to make their determinations of the research tax credit.

Q So you were -- you had familiarity with what EDS provided and what types of receipts they earned during

2003 through 2008; is that correct?

A Yes.

Q Can you please give us just a general description of EDS' business during the 2003 through 2008 tax years, please?

A Yes. EDS was a services company. We primarily provided outsourcing of IT functions, outsourcing of back-office functions that would include items like, payroll and accounts payable and things like that. We also provided solutions for other necessary -- I can't think of the word I want to use for the customers to account for things. They were all basically us writing software so we could provide the services to the customer.

Q Thank you. So as part of its service business, did EDS sell property in tangible form or software? Did EDS have significant inventory of tangible personal property products that they sold to their clients?

A Generally, no. Most of the solutions we wrote were customized, so it's not something we could put on the shelf. There is one exception to that. During this period or part of this period, we owned an affiliate called Unigraphics. They were producers of what we call CAD-CAM software. That's c-a-d-c-a-m.

And they wrote software that people -- engineers could use to do drawings without having to make up models.

They did have some off-the-shelf software that was sold, but the amount of sales for those were very minimal compared to the overall receipts for EDS as a whole.

Q So was Unigraphics one of the core -- was it part of the core business? Did it account for the majority of the receipts for EDS?

A No. It was non-core. In fact, we disposed of the Unigraphics subsidiary in 2004 because it was a non-core business. We wanted to focus on our services.

Q Thank you. And as part of its business, did EDS engage in research activities in California during 2003 through 2008?

A Yes. EDS incurred significant qualified research expenditures in the State of California as it provided software solutions to service its clients.

Q And did EDS generate patents as part of its business? And if so, what were those patents generally used for?

A They were patenting various routines and solutions that we were developing for use in servicing the customers. What we did was very innovative, and it help distinguish us from our competitors at the time as to how we would provide these services.

Q So the majority of the patents would have been used as part of the primary service business. But is it

fair to say there'd probably be maybe some patents related to Unigraphic's business that was not a core business and sold in '04?

A That's correct. That's correct. They did have patents as well.

Q Okay. Okay.

MS. SWAIN: Judge, may we object for a moment? We're certainly very willing to give Counsel leeway to get through the questions in an efficient manner, but these have been repeated leading questions, and it's -- we would just appreciate if the questions didn't always contain the answer in them, if they could be a little more -- it can be a direct question.

JUDGE HOSEY: Okay. Mr. Fix?

MR. FIX: No problem.

JUDGE HOSEY: Okay. Thank you.

BY MR. FIX:

Q Ms. Nall, did you get a chance to review Exhibit 97?

A I did.

Q Can you please identify this document and what it contains?

A Exhibit 97 is a compilation of the tax apportionment work papers for each of the years involved, including, I think it starts before 2003 because we needed

those earlier years.

Q Were these specific -- the schedule in Exhibit 97, were these copies provided by you to us as part of this representation?

A They were provided by someone in EDS. I don't know that they came directly from me, but they came from our electronic work papers that we store.

Q So would they be copies of business records held in the regular course of business?

A Yes.

Q Okay. And these underlying schedules that include the apportionment work papers, they include gross receipts by type, by state, by amount, and by entity. Can you please elaborate where -- how these apportionment work papers were created. What would be the source of this information?

A Sure. The original source is our general ledger. We had many accounts for different types of receipts. And while we didn't have to write those out on our federal returns, we did need those for purposes of the apportionment work papers. So we would go back to the account balances in our general ledger system to compile these.

Q So this Exhibit 97, the schedules, and they include the gross receipts, would it also be used for

something other than multi-state apportionment work papers? Would it be used, for example, for the Federal 1112 and/or for financial reporting purposes?

A Of course. The balances in our general ledger are the starting point for book income on the tax returns for federal purposes. So they all feed in there. They're also the starting point for the SEC reporting on a gap basis as well.

Q Thank you. In the course of your responsibilities at EDS over the years, were you familiar with the EDS' federal corporate tax filing preparations, specifically, R&D credits?

A I was. I originally started on the defense of the R&D credit claims that were already filed because my main job was to work with the IRS on those. But as we moved forward and, especially, in these years when we looked at our survey process at the beginning of each compliance cycle together our contemporaneous documentation, I participated in what types of questions we included in those surveys, and that I also participated in the review of some of those surveys when we were trying to make a determination as to whether or not it appeared to qualify for the research credit for federal tax purposes.

Q Okay. Thank you. And as part of EDS'

recordkeeping of -- that was used to create the schedules that we have provided the detail, the qualified research expenses, in those there are FIDs. Can you explain what FIDs are?

A FID is an acronym for financial identification number and it's identification numbers, so F-I-D number. And these were not necessarily a one-to-one correspondence with a particular cost center. They weren't always a one-on-one correspondence with a particular project, but we had financial identifiers, FIDs, so we could gather more granular details about certain types of income and expenses.

Q And so once these reports were generated for purposes of computing federal R&D credit, would you also have provided these to the state tax team that was preparing the California R&D credits?

A We provided our complete work papers to the state team for the R&D credits. And that would have included the project listing that we came up with and the cost that were gathered by FID.

Q Okay. And can you maybe elaborate about the procedure of how often the R&D documentation was created, how often it was done, and maybe just elaborate a little more about the process in terms of who was involved in it, and what type of information was used to determine whether

certain expense was qualified or not.

A The R&D survey process started at the end of every fiscal year. I kind of think some of those were just every calendar year. And at the end of every tax year, we would send out the surveys to the managers that had system engineers working for them. They would, in turn, identify projects that they worked on that may qualify for the R&D credit. And then they would provide additional information for us to look at and then summarize and determine a qualification. But this was done on an annual basis in support of the preparation of our income tax returns.

Q Thank you. Have you got a chance to review Exhibits 14 through 60? And if so, can you please identify these documents?

A Yes, I looked through those. They are the year-by-year research tax credit work papers that the starting point would have been our federal work papers. And then there were columns added for state information that was needed for state filings.

Q Thank you. As part of your responsibilities at EDS, were you familiar with EDS' federal credit audits, settlements, and closing agreements with the IRS?

A Yes. I was intimately familiar with those. I never thought I would be a research credit expert, but I

became one. We were audited every year that we filed a return and usually in cycles. And in this case, I think 2003 through 2008 was multiple cycles. But I was the one that was the main person working with the IRS and working with their outside consultants that they used. And I was deeply involved in negotiating the final closing agreement that was reached.

Q And is the copy, that we provided as part of the exhibits, is that an accurate copy of the closing agreement?

A It is.

Q And what was the percentage that was agreed to in the closing agreement in terms of how much R&D credits were allowed by the IRS?

A In that closing agreement, we agreed to 55 percent allowance.

Q Okay. Great. Thank you.

MR. FIX: That's all I have.

JUDGE HOSEY: Thank you. I'm going to move to the Franchise Tax Board to see if they have any questions for you, Ms. Nall.

MS. NALL: Okay.

JUDGE HOSEY: Mr. Riley.

MR. RILEY: Yeah, just one moment.

JUDGE HOSEY: Yeah.

MR. RILEY: Just readjusting stuff here.

JUDGE HOSEY: Okay. Thank you. Just begin when you're ready.

CROSS-EXAMINATION

BY MR. RILEY:

Q Okay. Okay. Good morning.

A Good morning.

Q I've got a few questions for you. In 2010, you were the Director of Federal Tax Controversy?

A That's correct.

Q Representing EDS --

A Yes. Correct.

Q -- but working for HP?

A Well, HP owned EDS.

Q Right. Okay. You know this might be easier if --

MR. RILEY: Ellen, could you give her -- these are just exhibits that are in the record, what is Appellant's Exhibit 1, Respondent's Exhibits V, W, X, and Z. And just so that if the taxpayer -- sorry -- if the witness needs to refresh her recollection, then we've got them on hand.

MS. SWAIN: May I approach the witness?

JUDGE HOSEY: Go ahead. Yeah.

MS. SWAIN: Thanks. May I approach the Judges?

JUDGE HOSEY: Please. Thank you.

BY MR. RILEY:

Q So let's start with Exhibit 1. This Notice of Proposed Assessment lists you as -- your title as of "Director of Federal Tax Controversy"?

A Yes, that's correct.

Q And you stated you're familiar with the federal regular incremental research credit?

A That's correct.

Q And you're familiar with the startup base period?

A Yes. It's been a long time since I calculated it, so don't get too detailed for me.

Q I will -- I will be gentle. Thank you. You are familiar with the dozens of ways in which the -- in which Section 41 federal incremental research credit is modified for California purposes?

A I am not. I do not do state taxes.

Q Okay. And EDS reported a startup base period for California -- the startup base period for California was from 1996 to 2005?

A I'm not aware of that.

Q Okay. Did you prepare EDS' California Form 3523 for the 2005 through 2008 taxable years?

A I did not.

Q Okay. Did you supervise that preparation?
A I did not.
Q Okay.
A The only role I would have had would be supplying historical documents.
Q Okay. For the 2003 through 2004 federal audit, the IRS delivered the Notice of Proposed Assessment to you?
A That's correct.
Q And that notice included an 886-A?
A Yes.
Q The facts of the 886-A for the 2002 through 2004 tax years stated that EDS had, quote, "Hundreds of research projects involving software development?"
A That's correct.
Q Okay. In 2006, you were EDS' manager of federal audit?
A That's correct.
Q You participated in the IRS audit of the base years of 1996 through 1988?
A That's correct.
Q You stated you were intimately familiar?
A That's correct.
Q The IRS discussed the examination changes for the 1996 to 1998 audit with you?

A Yes.

Q In the 1996 through 1998 IRS audit, the IRS specialty software consultant, Mitre Group; correct?

A Correct.

Q There was an examination sample of five projects out of 4,791 total?

A I don't recall the exact number of total projects, but we did have a sample.

Q Could you look at page -- Exhibit V, page 2 of 17? And I believe it is at the bottom. Does that last paragraph refresh your recollection?

A Let me borrow some glasses here.

MS. NALL: Your glasses are dirty by the way.

MR. ZOELLER: Sorry.

MS. NALL: Yes. I see that it was five projects.

BY MR. RILEY:

Q And from 4,791 total?

A Yes.

Q And you were told in advance that the interviews would only focus on tax year 1998?

A Yes, that was a negotiated fact.

Q And you were told in advance the interviews would cover detailed software development questions?

A I think so.

Q You're familiar with the software that the IRS

examined in the 1998 audit?

A Yes, I am.

Q And Mitre Group examined computer-aided manufacturing software?

A Yes. That would have been part of what I mentioned earlier, our Unigraphics Software affiliate.

Q NC Automated -- NC Automation computer-aided manufacturing software?

A Yes. Same thing.

Q That's abbreviated as CAM, C-A-M, software?

A Yes, part of Unigraphics.

Q Mitre Group examined drafting and geometric tolerancing software?

A Yes. Again, that was a Unigraphics project.

Q Okay. Ms. Nall could you please look at Exhibit X? Could you please read the title of that document?

A "Trademark Service Mark Application Principal Register With Declaration."

Q Thank you. Would you agree this is a U.S. trademark application?

A That's what it says it is.

Q And EDS filed this trademark application in 1996?

A I'm looking for the date. Based on the stamp, it says 1996.

Q If you look at page 2, does that --

A It's dated March, I think, 8th, 1996.

Q Okay. And this trademark application is stamped 75070913?

A That's what it says.

Q A trademark for goods and/or services?

A That's how it's written.

Q And about halfway down is a trademark for computer software used in computer-aided design and computer-aided manufacturing?

A I'm sorry where does it say that on here?

Q Roughly halfway down the page here.

A That's what it says. That would have been part of Unigraphics.

Q And computer-aided design and computer-aided manufacturing can be abbreviated as CAD-CAM software?

A I agree with that.

Q EDS' 2003 10-K mentions digital product design applications, doesn't it?

A I --

Q You can look at Exhibit W if you need to.

A Okay. Okay. Where on the exhibit?

Q And I think page 6. And I think that's paper pages rather than -- many?

A Can you point me where on the page I'm looking? Oh, digital project design is shown under UGS Appeal and

Solution. Again, that was our Unigraphics subsidiaries.

Q Okay. And the 10-K mentions NX CAD?

A Yes.

Q And it mentions NX CAM?

A Yes.

Q Okay. And as manager of federal tax, you were aware that EDS sought to renew trademark serial number 75070913 in 2007?

A I was not aware until you showed me this document.

Q Can you please look at Exhibit Z?

A Okay.

Q And could you look at page 4 of 8 in Exhibit Z where it says signature Steven L. Page?

A Yes, I see that.

Q And the signature is dated March 23rd, 2007?

A I see that.

Q And the renewal declaration was signed on behalf of EDS.

A Yes.

Q And this renewal included -- for EDS included specimens?

A I'm looking for where it says specimens.

Q It would be the third paragraph from the top?

A The owner submitting one specimen showing the

mark, so that would be what the mark looked like; right?

Q Correct. The declaration affirmed that the trademarks used on CD-ROMs used in interstate commerce?

A Yes.

Q And could you flip to page 6 of 8?

A Yes.

Q And the CD-ROM -- the specimen CD-ROM on page 6 is labeled 2005?

A It's illegible. It looks like it could be 2005 or 2006, so I can't tell.

Q But 2005 or 2006?

A I think so. It's really hard to read.

MR. RILEY: Okay. Thank you, Ms. Nall. I have no further questions.

JUDGE HOSEY: Thank you, Mr. Riley.

I'm going to move to the Panel to see if they have any questions for you, Ms. Nall.

MS. NALL: Okay.

JUDGE HOSEY: You doing okay?

MS. NALL: Okay.

MR. FIX: I have a question.

JUDGE HOSEY: Oh, go ahead, Mr. Fix.

MR. FIX: Is it okay if I ask her one more question?

JUDGE HOSEY: Yeah. Go ahead.

MR. FIX: Okay. Great.

REDIRECT EXAMINATION

BY MR. FIX:

Q We've been -- part of the question that we've asked and Respondent, revolve Unigraphics that you mentioned. Can you detail -- well, I guess, we've already asked you whether or not it constituted part of the core business. My question is, if -- would Exhibit 97, that includes the, apportionment work papers, would that be a correct reflection of UGI's receipts?

A It would. There's a separate column for that subsidiary on Exhibit 97 for each of the years, and it lists the types of receipts.

Q Is there any reason you would think that those work papers that were from the ledger are incorrect?

A No.

MR. FIX: Okay. Thank you.

JUDGE HOSEY: Okay. Thank you, Mr. Fix.

I'm going to move to my Panel.

Judge Akin, do you have any questions for our witness?

JUDGE AKIN: Judge Akin speaking. No questions. Thank you.

THE WITNESS: Thank you.

JUDGE HOSEY: Thank you.

Judge Lambert, do you have any questions for the witness?

JUDGE LAMBERT: I have no questions. Thanks.

JUDGE HOSEY: Thank you for your time today, Ms. Nall. I appreciate it.

MS. NALL: Okay. Thank you.

JUDGE HOSEY: Okay. We're going to go ahead and move to the argument section for the Appellants.

Mr. Fix, we have about an hour and an half planned. So we're going to go ahead and finish your presentation and then see where we are and whether we would take a break if that sounds like it'll work for the parties.

MR. FIX: That sounds great to us.

JUDGE HOSEY: Okay. Are you ready to begin your presentation?

MR. FIX: I am.

JUDGE HOSEY: All right. Please begin when ready.

MR. FIX: Okay. Thank you.

PRESENTATION

MR. FIX: Thank you, Honorable Judges, and thank you for giving us this opportunity to present to you

today.

I want to start with, you know, on the easel we have a summary -- a simple summary that shows four potential outcomes. And today I'll walk you through how even though it appears, you know, there's been a lot of briefings. There's been over 150 pages of briefings, over 100 exhibits, but this is a very simple case in my view. And I will walk you through how for each outcome, even though we have several issues that the parties have agreed to are at issue, you don't need to necessarily resolve all of them for -- to arrive at a conclusion that EDS is entitled to the refund under Outcome 1 or Outcome 2, Outcome 3, Outcome 4.

I will walk you through and show you how for Outcome 1 there's only, you know, three questions that would need to be answered of the issues listed, and then what additional questions you might need in order to get to Outcome 2 where you get additional tax refund and then same with Outcome 3 and Outcome 4.

So if you follow the slides that I handed, out, I'll start on page 3 in terms of Outcome 1 that you also have listed on the summary page. But the slide is helpful because beneath that you have a discussion of what issues are involved. So for the OTA to grant EDS' refund for amount of $5.8 million related to the '06 through '08

California wage QREs that it incurred, there's only three questions.

And the reason why there's only three questions is because one, as we've discussed in the beginning, jurisdiction is not an issue. That's been agreed by the parties. There's no jurisdiction with respect to '05 through '08 which includes the '06 through '08. And two, the parties have agreed that EDS has substantiated its qualified California wage QREs for '06 through '08. There's no jurisdiction issues around it.

And so the only thing you need to resolve and decide in order to grant us 5.8 of the full 16 are the following 3. First is duty of consistency, and that's Issue 4 if you're referring to consolidated list of issues. Issue Number 2 is EDS' use of 16 percent maximum statutory fixed-base percentage. That's Issue Number 2 under the Gross Receipts Issues in the consolidated list.

And Issue Number 3 is whether EDS, a service company, actual gross receipts from sale of property held primarily for sale to customers in California result in AGR, average annual gross receipts, below 99.4 million on average. And I'll walk you through when we get to Issue Number 3 why we're referring to this number 99.4. And the last issue, Issue Number 3 relates to gross receipts will answer both Issues 1 and 3 under the gross receipts

section.

So if you go to slide 4, let's start with gross receipts. So the Issue Number 1 is the fixed-base percentage, and the question is whether EDS can use the maximum statutory fixed-base percentage of 16 percent. And the FTB has argued that we have to substantiate the underlying QREs and AGRs going all the way to 1984, 1988, or even 1996 that 2005 in order to use a fixed-base percentage. And that is incorrect.

The reason why it's incorrect is because there is a federal tax precedent on point, which California follows, with respect to R&D credits, and that's the Suder Case. And then the Suder Case has the same facts as the facts in this case where the taxpayer, given the fact that we're dealing with very old years -- we're talking about '03 to '08 -- would be required to find the actual California gross receipts going back to 1984 to 1988 and the qualified research expenses that were incurred during those years. We don't have access to those documents.

The taxpayer in the Suder Case also did not. But the taxpayer in Suder, similar to EDS, was able to establish that it's entitled, that it incurred qualified research expenses. And now remember, the parties have already agreed that EDS has substantiated at least 70 -- over 70 million in R&D QREs for '06 through '08. So

there's no question that we have incurred qualified research expenses that have been audited by the IRS and agreed to by the parties.

And so in situations where a taxpayer one, doesn't have access to very old documents from the 80s but has been able to establish with current documentation with respect to the years at issue, that they have incurred qualified research activity and have qualified research experiences that it has substantiated, then that is enough for the taxpayer to go ahead and compute its R&D credits using the maximum fixed-base percentage.

And under the statute, no matter what numbers or facts you have, your fixed-base percentage can never be over 16 percent. And the higher that percentage is the worse you are off. And the reason for that is your credit is computed by taking your qualified research expenses for the year minus your base amount. So the delta between those two numbers you get to take a percentage of and that's your R&D credit.

And so the question is how you compute your base amount and the fixed-base percentage goes into that. The higher that percentage is, the worse we are. And the taxpayer in Suder and the U.S. tax court couldn't substantiate it and said I'm going to use 16 percent. And the IRS, similar to the FTB, objected and said you can't

do that. You have to substantiate it.

And the Court disagreed and said the taxpayer established that it incurred qualified research expenses, and it could not be worse off, and the FTB is not worse off by the taxpayer using 16 percent. And therefore, they should be allowed to use the 16 percent, even if they've not established what their gross receipts were in 1984 to 1998 because they have substantiated their qualified research expenses.

And so the answer to this seems pretty simple, which is, yes, we're allowed to use the 16 percent. It results in the largest base amount that this taxpayer could have, and therefore, the FTB or the IRS would not be disadvantages by it. So that's one piece of the calculation. The FTB will mention some other cases, I'm sure. And all those cases have one thing in common and distinguishable from our facts is those taxpayers didn't establish what their actual fixed-base percentage is, but they are trying to claim a percentage that's smaller than 16 percent. Meaning, they were trying to increase their R&D credit by claiming a smaller fixed-base percentage. We are not doing that. We're similar to Suder.

We continue on to slide 5. We can talk about the second issue that needs to be answered in order for us to result in Outcome Number 1 on the summary page, and that

relates to the minimum base amount. And the question here is whether EDS had gross receipts from sale of property that was held primarily for sale to customers, meaning inventory they are holding for sale to customers as part of your regular business, and those sales took place in California.

And the reason why we're simplifying it here in saying that it needs to be greater than $100 million is because there is a rule on both the federal and the California code, which is essentially your base amount, which is used to compute your R&D credit, can never be less than 50 percent of your qualified research expenses. So take your QREs times 50 percent, that's your minimum amount. So it doesn't matter if you have a small fixed-base percentage or a small average annual gross receipts or AGR, if that amount is less than 50 percent of your QREs, you are required by statue to use that.

And that's the default under the federal and California follows the federal on this point. They don't distinguish from that. So that's the rule. The one distinction between federal and California is how you define gross receipts. For federal purposes, it includes all gross receipts. So if you look at your Form 1120, you include all the gross receipts from line 1 and other gross receipts that you might have.

For California the legislature specifically to incentivize and make California competitive -- and we've included legislature history on this -- wanted to make sure that they are attracting technology companies that don't generally produce large amounts of sales of property, rather more on the software side, and therefore, would have a low amount of gross receipts from sales of property held as inventory, primarily for sale to customers in California. The result of that, as discussed in the legislature history that we have attached, is that the base amount is smaller. And a lot of these taxpayers would end up where EDS ended up, which is if you have a small amount of gross receipts from sales of property held for sale in California, you are forced into the minimum base amount because your amount could be somewhere between zero, if you have zero receipts from sales of property to a smaller amount that might result in a minimum base amount that's larger than your computed base amount.

And so the question here is, what is the threshold that we need to reach in order to impact our R&D credit? EDS has requested in its refund claim an R&D that's computed using the minimum base amount. The reason for that is, is that we don't have a lot of gross receipts from sales of property as we've established in our Exhibit 97 that have detailed apportionment work papers as

Ms. Kelly Nall testified to.

We are a pure, you know, service company that is primarily involved in provision of services, whether that's services in the sense of outsourcing business function of the taxpayer or developing software that is then provided and licensed to multiple customers who don't have the resources to develop it on their own, and they are used as a service. They're not selling the software as part of their business.

Now, as part of the testimony and the apportionment work papers, we've reflected the fact that EDS until 2004 had, you know, over 16 billion a year in gross receipts from services everywhere, but the amount of sales from sales of property is very small because that's not their primary business, not their core business. And, in fact, the one subsidiary in their affiliated group, which they disposed of in 2004, Unigraphics, one, even that specific entity wasn't solely generating receipts from sales of software, you know, off-the-shelf software to customers, but was also providing services.

So as our apportionment work papers in the records established, the amounts of receipts from the sales of property in California are very small. And to figure out what level you need in terms of receipts of sales of property to impact all the R&D credit that we're

requesting, you need an average around $100 million of gross receipts in California to even just reach the same R&D calculation that we reached. So unless you get to 100 million on average every year -- obviously every year the number is different, but it's about 100 million average -- the R&D credit is not impacted.

So it doesn't matter if we have zero in AGRs in California or 50 million or 20 million or 9 million. If it's below the number for that specific year, the R&D credit is the same as we computed using the minimum base amount. And so I think between Exhibit 97, which we have provided, and Kelly has testified to, it is clear that even if worst-case scenario, you want it to include sales of property in California, there weren't even sales of inventory which wouldn't be part of this calculation at all, you're still below the threshold, significantly below the threshold. And we provided exhibits to walk you through them.

Now, specifically, so we've addressed Issue 1 Issue 2. So what's the last issue that we need in order for you to grant us Outcome Number 1? And that's Duty of Consistency. Duty of consistency is a doctrine that the FTB is asserting applies to essentially require EDS to use incorrect numbers in computing it's R&D credits. EDS originally, you know, in prior years, prior to 2003 was

miscalculating its average gross receipts. It's AGRs as well as its fixed-base percentage.

But the good news is that those errors one, were caught by auditors by the FTB; two, were analyzed whether correcting would impact the R&D credit during those years. And the answer was no, it would not impact it. And the reason why is that even when they used incorrect AGRs -- and by incorrect AGRs, what EDS did was instead of using their actual average annual gross receipts, which means their actual gross receipts from sales of property in California. They instead, used their federal number, which includes everything under the sun even types of receipts that are excluded by statute, like services, rents, royalties, and the like, and just applied the California apportionment to it.

So it was an inflated incorrect number that was used. And the auditor -- we've attached audit work papers for prior years where the auditors by the FTB identified this and said this is incorrect. That's not how California computes its AGRs. That's not how they compute the R&D credit. But the auditor there obviously did its research similar to what we provided here, which is identified that this is a service company. And in no shape or form and in no reasonable reality does this taxpayer generate enough sales of inventory of property to

rise to a level that would impact its R&D credit where they need to use a computed base amount instead of the minimum base amount.

And so if you look to one of our exhibits, Exhibit 93, we actually walk through and show that FTB was not harmed by the fact that we use an incorrect or estimated AGR number in prior years, and the fact that we use an incorrect fixed base percentage in earlier years, because it didn't impact the base amount that was used to compute the R&D. And if you correct it to use the actual AGRs during these years and corrected it to use the maximum 16 percent statutory fixed base percentage, the result is the same.

The R&D credit that would be computed before 2003 would be the same as was originally claimed and allowed by the FTB auditor. And that's important because the duty of consistency as discussed in a few of the OTA's decisions, like Appeal of Chen and Appeal of Shaanan and Appeal of Davis, all of them talk about when is the duty of consistency applied to force a taxpayer to use incorrect numbers from earlier years.

And that is only in situations where the taxpayer made a representation to the agency, to the FTB, the FTB relied on it, and now the taxpayer is trying to whipsaw the agency by changing its position once the earlier years

the statute closed, and they received a certain tax benefit in those earlier years from benefiting from that mistake, and now in subsequent years has taken an inconsistent position that allows them to get even more tax benefit.

And that's not the case here. In all of the OTA decisions, it discussed about whether the FTB will be harmed by it. And for it to be harmed, it has to mean that in earlier years we claimed R&D credits greater than what we're being entitled to if we used the actual corrected numbers, and that's not the case. If you look to Exhibit 93, that proves that. And so duty of consistency simply does not apply.

And our case is distinguishable from those three cases, Appeal of Chen, Appeal of Shaanan, and Appeal of Davis, because in all those cases the taxpayer took inconsistent positions that benefited them in early years. And then with respect to the same items, subsequently tried to claim deductions a second time, even though they were entitled to certain deductions in earlier years. And so we are distinguishable from that because FTB is not harmed. Therefore, duty of consistency clearly does not apply.

So now we've established all three items. And so going back to what the three items are, we have one, duty

of consistency. We just discussed why it doesn't apply. Two, we discussed EDS' use of the 16-maximum fixed-base percentage. We've established that you're allowed to use that because that's the worst-case scenario, and in no case would the percentage be higher. And therefore, FTB is not disadvantaged by that, and the Suder case specifically allows for it.

And finally three, we have substantiated, as opposed to Respondent, what our actual gross receipts are as opposed to trying to raise questions and make certain, you know, hypothesis as to how much gross receipts a taxpayer has. We know how much gross receipts we have from the sales of property in California. Those are in our Exhibit 97. That is information that was pulled from the general ledger and that was used for both federal reporting, financial reporting. And there is no reason to believe that it's incorrect. The core business was services.

So by doing that, we've established all three. None of the other issues in this case are relevant for you to determine that we're entitled to at least $5.8 million in refund. Now, if you go to slide 7, there's another layer here. Additional refund at issue. Outcome two says that the OTA would allow for additional actual California wage QREs for '04 and '05.

And the result of the OTA allowing that, it would result with an additional 4.8 million on top of the already granted tax refund under outcome one. For you to grant these additional -- this 4.8, there's only two questions you have to answer. One has to do with jurisdiction over the '04 year R&D credit that was filed -- there was a claim that was filed in 2012, and that's Issue 1 in your jurisdiction issues.

And then one more issue, Issue Number 5, on slide 7 which is whether or not we have substantiated the '04 and '05 actual, not estimated, actual California R&D wages of 39.2 million and 25.3 million respectively. This is Issue Number 1 under QREs issues. And so if we go to slide 8, I'll start with jurisdiction. And jurisdiction, essentially, it says here that it relates to '03 and '04, but obviously at this point the only relevance for us is we're talking about '04 and '05 wage QRE. And so what do we need to answer regarding jurisdiction? This jurisdiction question will answer '04.

And the reason why it's relevant before I go into it is '04 and '05 that provide actual California wage QRE information, the same type of information, same detailed information that's by state, not estimate how much in current California but actual, similar to the same information that was provided for '06 through '08, which

the FTB has already agreed with us, has substantiated that we're entitled to this query.

So there's no difference -- substantial difference between those. It's the same type of information that satisfied the FTB. The only -- there's only two reasons why '04 and '05 are not included in the amount that the FTB had already agreed to. The easy one is for '05. '05 there's not jurisdictional question with respect to it. The only issue was at the time the Appellant filed its brief, we could find the underlying detailed schedules for the '05 QREs that showed the detailed information where it was incurred by project and that would allow us to show you how much actual California wages were incurred in '05.

And so as part of briefing, we worked with the taxpayer and were able to identify that schedule, and that's one of the schedules we provided in Exhibits 100 through 102. So it's identical information to the information that was provided for '06 through '08 that the FTB agreed with. So really with respect to '05, now we've provided the same level of detail. There's no question. We should be entitled to the '05 actual California wage QREs. That's the one question you have to answer to give us '05 QREs.

With respect to '04, there's an additional

question, and that question is do you have jurisdiction over that? Because as we've discussed, FTB has already agreed that we have jurisdiction for '05 through '08, but don't agree with respect to '03 to '04. And so the question here is whether the claim for refund that included the '03 and '04 years, which was filed in 2012, properly raise EDS' request for additional R&D credits.

And that refund claim specifically requested R&D credits for '03 and '04, specifically already included the QRE amounts that we have claimed this entire time. The QRE amounts have never changed. And the fact that under the California statute Section 23609, which follows the IRC 41, allows for R&D credit. But the R&D credit could be computed in two different ways, two mathematical ways. One using a regular method, or one using an AIC method.

So from day one EDS has always requested additional '03 and '04 R&D credits. In fact, on its original return, it claimed partial R&D credits but didn't claim the full amount. And so it filed a refund claim asking for additional R&D credits. Now, section -- the section that's relevant for us here is Section 19322 in the California Rev & Tax Code that requires the refund claim to include two components. One is the specific grounds for the claim, and two is the facts to apprise FTB of the exact basis of the claim.

And California courts have literally interpreted Section 19322 in terms of the notice requiring to provide significant deference to taxpayers, right. They want the taxpayer to be able to preserve their right to claim certain items. And they have literally interpreted it to say we'll look to both what's on the letter claim as well as beyond the four corners of the claim to the extent that the FTB should have been on notice as to what the issue is.

And what's interesting here is that our refund claim back in 2012 said, specifically, the grounds for these claims are that the taxpayer generated and could utilize research and development credits during the tax years covered. So we specifically said we would like R&D credits. Okay. So the grounds and basis are clear. The FTB is trying to claim that our request and our legal basis for the R&Ds has changed. And they are trying to equate the fact that we originally computed using a mathematical method of AIC versus the regular, which is a little bit different. Both are available under the same statute that says you're entitled to R&D credits.

The reason why this was done was because at the time the refund was filed, FTB issued guidance essentially saying if you have essentially zero gross receipts from sales of property, meaning your service company, like a

technology company like EDS, you are not allowed to compute your R&D credit using the regular method. Instead you have to mathematically have to request and compute in using the AIC method. So we did that. Even though on the original return we used the regular, we said we will compute using the AIC.

This is the guidance that's out there. So it's not a new source of authority. Rather, it was the source of the ground for the claim that supports us. The basis is Section 23609. You're entitled to R&D credit. We simply computed it using the AIC method. Now, at audit, the auditor said, well, you can't compute it using the AIC method because you didn't claim it on your original return. And so the only thing that's left for the taxpayer to do is compute it using the regular method.

And so the auditor continues to vet the qualified research expenses and the AGRs and disagrees for various reasons saying these QREs are estimated. These AGRs are estimated. As I mentioned, EDS was, you know, incorrectly computing its AGRs using estimated AGRs, not actual. And so the auditor said, "I don't like how you're computing this. This is incorrect. I'm going to deny your claim."

And so the taxpayer in response is simply correcting its computation and saying, okay. Well, we claim that we're entitled to additional R&D credits. We

computed using AIC. You told us we can't use AIC. So the only thing that's left for us to compute is using the regular method, which originally used for '03 and '04 on our return. And so that's what we're doing here.

But despite that, the FTB is trying to claim that we've completely changed legal theory, even though the only thing that changes is just the FTB's guidance in its legal rule saying, oh, actually, you remember the guidance that we had before 2012 that said that service companies can't really use the regular method? We were wrong. You can actually use it. You'll just have to compute your base amount you using, if you have zero gross receipts from sales of property, you'll use zero. And if your computed base amount is smaller than the minimum base amount, you'll use the minimum base amount. It's very simple.

And so that's what we did. And beyond that, we have worked to correct every issue that the FTB auditor raised. They had issues with respect to the AGRs being estimated. We provided actual. They had questions about our QREs. We provided detailed support showing what our actual wages are and distinguished that from other QREs, like our supplies and contract QREs that were estimated in terms of determining the amount that is in California versus everywhere.

And so our case could be contrasted with -- there's this doctrine that the FTB is citing to the substantial variance doctrine, which is one of federal doctrine that the California courts have departed from, the strict interpretation. And instead, as I mentioned, the McKnight Case and others have allowed for a liberal interpretation of an application of refund claims. And it's trying to claim that our claim where we're computing using the regular method substantially varies from our original claim, even though our original claim said we're entitled to R&D.

And they cite the Lockhead Martin Case. Well, the Lockhead Martin Case we established is completely different from our case. One, the -- in that case the taxpayer was trying to ask the court for additional QREs that were never introduced. We're not doing that. We've been consistent this entire time. We have X amount of QREs. Can we please have R&D credits? Okay. Can you please compute it?

Well, it seems like the only way to compute is Y. Oh, actually, Y is not available to you. You have to compute it using the other method, method X, which is regular. And so that's what we did. And so we're distinguishable from Lockhead Martin. And it's clear in other cases that taxpayers are not required to engage in

Herculean efforts to provide every detail and additional evidence that the FTB requests.

We have made reasonable efforts to provide all the information. As you see we provided over 100 documents -- detailed documents of QREs by project, by type, by state, and obviously that has now risen to the level of satisfying the QREs with respect to actual, but there's still some disagreement regarding the estimated. And so jurisdiction in our view is satisfied.

And so '03 and '04 we have jurisdiction. The 2012 refund claim was -- clearly raised the R&D credit. And so if we satisfy that then the only question is '04 and '05 the actual wage QRE similar to the wage QRE detail that we provided for '06 through '08 that the FTB has agreed on? And the answer is yes, it's identical. And so we should be entitled to these additional QREs.

And so to summarize, on page 10 you could see the parties already agreed on 75.9 million of QREs for '06 through '08. By adding '04 and '05, you're adding -- that amount will increase to a total of 140.5 million of QREs, which as summarized on the summary page on the easel, that results in an additional refund of 4.8. So now we've answered two more questions that are off the table. Do we have jurisdiction -- does OTA have jurisdiction over '03 and '04? Yes. Does EDS substantiate its '04 and '05

actual California wage QREs? Yes.

Okay. So now we've established that Outcome 2 has also been satisfied. So what other questions do you have? Let's go to Outcome 3 on slide 11. Outcome 3 would require the OTA to allow the '04 to '08 California estimated QREs relate to supplies and contract expenses. So this is where we're going to talk about the Cohan Rule. If you agree with us with respect to the issue here, we would be entitled to an additional 3.2 million of tax refund on top of the refund granted under Outcome 1 and Outcome 2.

And there's only one additional question you have to answer in order to grant us this additional 3.2. And that is -- as you can see on slide 11 -- is that we have reasonably estimated our '04 to '08 California R&D supplies and contract expenses. And this is Issue 2 in your consolidated QRE issues. And so when are you allowed to estimate qualified research expenses? The Cohan Rule, which is a federal case which has been adopted for R&D cases in the federal and California.

Obviously, it's been mentioned by the OTA in several decisions. It simply says that when a taxpayer can show activities that were qualified research activities, which we have and FTB has already agreed on that we've established already a part of our QREs, then

the court should allow the taxpayer to estimate the expense amount associated with those activities in some reasonable basis for making such estimate based on available data.

And so what's important here is that EDS as opposed to the actual wage QREs that we have provided for '04 through '08, the supplies and contract expenses, which are much smaller in California during these years, were estimated. And by estimated, it doesn't mean that we're estimating how much, you know, we incurred on each project. No. If you look at the detailed exhibits, they are as detailed as the wage exhibits that the FTB has already signed off on.

It provides for QREs by project, by FIDs, this unique financial identification code. And it provides for the type, the project, the year. The only thing that's missing is the state it was incurred. And so these are the same supplies and contract expenses that were audited by the IRS that we're allowed 55 percent of. And so the only thing that's left to reasonably estimate is, how much of these total supplies have already been blessed by the IRS were incurred in California?

And to do that, EDS used a very reasonable method. They used the actual California wage QRE data. So it took its California wage. So California R&D wages

that the FTB has already signed off on, and they put that in the numerator. And then in the denominator, we put our total California R&D wages QREs that the FTB had signed off on, and that gives us a ration.

That gives you an idea of how much of your research activities of your employees are involved in research activities that are in California -- excuse me -- versus other states. And so that ratio was then used, multiplied against the total QREs that were already vetted and allowed by the IRS. And that's how we determined how much -- excuse me -- would be allocated to California. We think this is a reasonable method because the supply contractors and the contractor expenses are incurred in connection with where you have employees engage in R&D activities.

If you have an R&D employee and they need supplies to actually work on their projects, they're going to use them where they are located. So it makes sense that if we have the -- a ratio to tell us how much of those employees are in California, it would make sense that it would be pretty reasonable that a similar proportion of the supplies would be used in California versus elsewhere. Similarly, the contractor, it's also, we think, it's reasonable to assume that those contractors would also be working hand-in-hand with employees would

also be working in similar locations. Therefore, it's similarly reasonable to use that as a proxy.

And so EDS was able to use in these '04 through '08 years, which I will point out are different from '03, in a very reasonable and accurate manner. We're using information on the QRE wage side that has been blessed by the FTB to reasonably approximate how much of the supplies and contract in California. And so if you agree with us that this is a reasonable methodology for '04 through '08, what this means is that this would result in additional 3.2 million of tax refund.

So that leaves us with the last outcome here. Outcome Number 4 or slide 14 in the slides that I handed out. And that involves whether the OTA will allow for the '03 estimated California QREs. If they do, then we're entitled to an additional $2.5 million of tax refund on top of the total that's already been granted in Outcome 1, 2, and 3. So the question is, what is the issue? The issue is, are you going to allow for an additional 38.8 million of estimated California QREs associated with the '03 year. This is Issue Number 2 in your QRE issues.

And so if you look at slide 15, it splits into two types. You have both 36.3 million of qualified wage expenses and 2.6 million of qualified supplies and contract expenses. So the difference between 2003 and the

2004 through 2008 years that we just discussed, is that both the wages, supplies, and contract QREs were estimate. So remember for '04 through '08 the wages were not estimated. They were actual. '05 and '06 we already had signed off on.

'03 was the year before they changed the methodology in terms of recording and complying this information on a yearly basis. And so we didn't have the state-by-state information for the wage piece. And so the same methodology to reasonably estimate an apportion QREs for supplies and contracts was also used for wages. And the methodology was we use the California payroll apportionment. So different from '04 through '08 where we use a California R&D wage factor. Here we're using just simple California payroll apportionment factor to apportion the total federal wage supplies and contract QREs that have been blessed by the IRS.

Now, this seems like a less accurate methodology than '04 through '08, and we acknowledge that. But it's still reasonable, given what we had available to us. And the FTB -- this was a method that was used prior to '03. Year over year auditors allowed for it. And so we think it's reasonable. Because similarly it would correlate to where these QREs are incurred. It would be where you have employees. And so we think it should be allowed as well.

And so finally, if you allow for all four of those outcomes, that results in a total of $16.4 million of tax refund. And so just to kind of summarize, for Outcome 1 for you to grant $5.8 million, you only need to answer three questions. Duty of consistency does it apply or not? We think not. Issue Number 2, is EDS allowed to use the maximum statutory 16 percent fixed base percentage? We think yes. See Suder Case.

Issue Number 3, did EDS have actual gross receipts from sales of property held as inventory, primarily for sale to customers, in California above a certain amount. On average it has to be over $100 million for it to reduce our R&D credit computed minimum base amount. Answer is no. We have substantiated what our -- not just what our QREs are, but we've substantiated what our actual gross receipts are as opposed to the FTB, which instead wants us to use incorrect earlier estimations that FTB auditors themselves in prior years said, and for these years, that is incorrect.

And so to us, instead of speculation, we are actually providing with actual reliable information as to how much of those receipts are. Specifically, the Unigraphics entity that the FTB has already asked about. Their QREs from sales of property, because they did sell some software until they were sold off in '04, is included

in our calculation. And so that should show you that even when include them, our QREs are not impacted. So that's Outcome Number 1.

Outcome number 2, if OTA also allow us to also include our '04 and '05 actual California wage QREs, we're entitled to an additional 4.8 million of R&D of tax refund, and you only have to answer two additional questions on top of the three we've already answered. One, do you have jurisdiction over '03 and '04? And the answer is yes. And two, have we substantiated our actual '04 and '05 California wage? The answer is yes. It's the same as we provided for '06 through '08 that they have to be signed off on.

Outcome Number 3. OTA will allow us to reasonably estimate under the Cohan Rule, the '04 and '08 supplies and contracts expense QREs. If you do, it's another 3.2 million. To do that you only have to answer one additional question on top of the ones we've already answer. Did we reasonably estimate it? We think so. And finally, to grant us an additional 2.5 million to take us up to the 16, OTA needs to allow for the '03 estimated California QREs. If you think it's reasonable to use the California apportionment in '03, which was allowed in prior years, even though different it's from '04 through '08, then you would be adding another 38.8 million of

QREs, which results in additional 2.5 million of tax refund.

Thank you. I'd like to reserve remaining time.

JUDGE HOSEY: Okay. Thank you, Mr. Fix.

We're going to go ahead and take a break now for lunch. We'll take an hour and 15 minutes. I think that's going to be 12:45. I know we're all traveling, so we can get some extra time to grab something to eat. And I just wanted to remind the parties that we keep the stream live and break it up later for when we post. So just know that we're still live on live stream. But we'll be back at 12:45 for Appellant's presentation and rebuttal time for the Appellants, and any questions from the Panel.

Any questions before we go on break? Okay. Thank you. See you at 12:45.

(A lunch recess was taken.)

JUDGE HOSEY: Okay. We're back in the Appeal of the Electronic Data Systems Corporation and Subsidiaries.

We are now moving toward the argument portion for the Respondent Franchise Tax Board.

Mr. Riley, are you ready to begin your presentation?

MR. RILEY: I am.

JUDGE HOSEY: Please begin when ready.

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PRESENTATION

MR. RILEY: Good afternoon, Judges.

So we've discussed the four parts of the case. We're going to talk about jurisdiction. We're going to talk about qualified research expenses, and we're going to talk about gross receipts and enterprise zone hiring credit.

First, I'm going to start out with jurisdiction. OTA does not have jurisdiction over the 2003 and 2004 taxable years for the regular incremental research credit. OTA's jurisdiction is set out in Regulation 30103(a) and the circumstances applicable to claims for refund include instances where FTB mails a notice which denies any portion of a perfected claim for refund, or FTB fails to act on a claim for a refund within six months after the claim is filed with FTB.

These regulations are consistent with Revenue & Taxation Code Sections 19323, 19324. And 19331. So how does that apply in this appeal? First, Appellant's June 2012 claim for refund did not include the regular incremental research credit.

Second, Appellant's 2019 opening brief cannot alter the June 2012 claim because FTB took final action on the June 2012 claim in 2018.

Third, if the opening brief was a claim, then OTA

does not have jurisdiction because Respondent did not deny it under 19323 or 324. And Appellant did not appeal a deemed denial under 19331 of the 2019 -- May 2019 opening brief.

Fourth, any claim of regular incremental research credit for 2003 and 2004 years is barred by statute of limitations, which expired March 30th, 2016. And finally, as the parties have discussed, Appellant's 2020 claim was timely, and OTA has jurisdiction over the 2005 through 2008-B taxable years.

Now, Appellant has asked whether the June 2012 claim included a claim for regular incremental research credit using zero gross receipts. And the facts of this case indicate that no, the June 2012 claim only included the alternative incremental research credit. In June of 2012, Appellant filed a claim for refund, and that claim for the 2003 to 2008-B taxable years was very specific. And it was based on specific schedules included with that claim.

Appellant claimed the alternative incremental research credit. Appellant's schedules used facts of $1 billion in California average annual gross receipts and for an amount of $8.3 million. The June 2012 claim was denied September 11th, 2018. And -- excuse me -- that is FTB took final action on the claim on September 11th,

2018. Now, at the time that claim was filed that was -- you know, Appellants had mentioned that their FTB had put out Legal Division Guidance 2012-3-1. That was put out in March of 2012.

Appellant's June 2012 claim was filed three months after. So Franchise Tax Board did not change a position with respect to zero gross receipts. Okay. They filed this claim after.

Now, where was I here?

Okay. So the June 2012 claim was denied September 11th, 2018. That is FTB took final action on the claim, and substantively that claim is dead, and it cannot be altered post mortem. The claim can be appealed, but it can no longer be altered. I can think of Appellant's 2012 claim for refund as a rocket leaving for outer space. You can load that rocket up with whatever you like. But once that rocket takes off, that is once final action has been taken, there is no changing what you pack into that claim. You could catch a different rocket at a different time and claim something different, like Appellant did with its September 2020 claim for refund.

But after final action, you cannot alter the facts or theory of the original claim, the 2012 claim that has long since ignited and left the launch pad. So the 2012 claim was denied with final action as of September

11th, 2018, and Appellant appealed that claim denial in 2018.

But when Appellant filed its opening brief in May of 2019, Appellant attempted to change its legal theory from the alternative incremental research credit to the regular incremental research credit. Change its facts from a billion dollars in average annual gross receipts to zero dollars in gross receipts, and increase the claim amount from $8 million to $30 million.

A taxpayer is precluded from raising issues in an appeal from a denial of a refund claim that were not addressed in the initial refund claim. Appellant never took the position of regular incremental research credit or zero gross receipts during the course of the exam. It raised those issues for the first time at appeal in May of 2019 -- issues and facts in May of 2019.

Appellant cited J.H. McKnight but that case is distinguishable because Appellant never raised the incremental research credit or zero gross receipts prior to final action on the June 2012 claim in September 11, 2018, which brings up the doctrine of variance. The doctrine of variance applies as precedential Board of Equalization cases are also precedential before OTA. And the Appeal of Chromalloy apply the doctrine of variance to California, as discussed in Respondent's opening brief at

page 27 to 30, and the reply brief at pages 13 to 15.

But the doctrine states that a taxpayer may not present claims in a tax refund suit that substantially vary the legal theories and actual basis that set forth in the tax refund claim presented to FTB. Remember, Appellant did not articulate a formal amendment raising their new legal theory or new facts prior to FTB taking final action in September of 2018. And so Appellant does not fall under any recognized exception to the doctrine of variance.

What does that mean for this appeal? The key here is that the regular incremental research credit does not get into the June 2012 claim for the alternative incremental research credit. Appellant cannot hollow out the legal substance of the 2012 claim and replace it with a substantively different position after final action on the claim. Luckily for Appellant it had an open statute of limitations for the 2005 through 2008-B taxable years. And as I mentioned, the taxable -- sorry -- the statute of limitation for the 2003 and 2004 years expired March 16th, 2016.

But for 2005 through 2008-B, Appellant could file a new claim for refund using whatever legal theory it chose, and that's exactly what Appellant did. Appellant filed a new claim for refund in September 2020, claiming

the regular incremental research credit for the open taxable years of 2005 through 2008-B, which Appellant timely deemed denied under 19331 and appealed to OTA.

And as Judge Hosey noted in the March 2022 order consolidating these appeals, it appears that the jurisdictional issue raised in the initial appeal is now largely moot because of Appellant's deemed denial of its new claims for refund claiming California regular incremental research credit. The big picture here for 2003 and 2004, those are barred by statute of limitations. But Appellant can go forward with the 2005 through 2008-B as it has under its September 2020 claim, which was deemed denied and appealed.

And as mentioned, the parties agree that the 2020 claim was timely filed. Respondent opened an audit. Appellant submitted the materials related to its opening brief, but it did not substantiate that it was a zero gross receipts taxpayer or otherwise substantiate its California 23609(h)(3) gross receipts. Appellant deemed the claim denied prior to the completion of that audit.

After six months, a taxpayer is entitled to consider a claim deemed denied and then file for an appeal. But the act of filing an appeal it is not a substitute for substantiating the claim.

I'm going to move onto qualified research

expenses now. With Appellant's wages and other expenses, you know, the issue as stated I think we -- you know, Mr. Fix talked a bit about the -- the footnotes here, and Respondent is -- the parties are in agreement that for 2006 through 2008-B, the wage -- the wage qualified research expenses for those years are 75 -- $75 million roughly. Those are fine. Okay.

As noted, the 2003 and 2004 taxable years are not properly before OTA. So the answer to whether Appellant has substantiated those, I mean, we have to answer that question no. And based on Appellant's exhibits, the new exhibits, I think it's Exhibit 21, I'll discuss the 2005 taxable years the wages for 2005. But for purposes right now I'll, you know, Respondent is willing to say that the 2006 through 2008-B taxable years, the wage QREs we're okay with those. That's consisting of roughly $76 million in wages.

The 2004 wages, again, 2004 is barred by statute of limitations, and it's not part of the September 2020 claim. The wages for 2005, now Respondent is willing to accept the actual wages for 2005. But as far as the wages that rely on estimated locations of federal employees, we do not -- we do not acquiesce to those. Whether for the 2000 --

So the second issue, of course, here is whether

2003 through 2008-B taxable years whether EDS is entitled under Cohan to estimate a portion of its California qualified research expenses. First, again, 2003 and 2004 re-barred by statute of limitations and not properly before OTA. So the question to that question for those years is no.

And as for the QREs relating to the September 2020 claim, the estimates for 2005 through 2008-B taxable years, the answer is still no but for a different reason. It should be obvious that California research must be performed within California because Section 23609(c)(2) declares that mandate loud and clear.

Appellant's supply and contract expenses are not eligible as they are based on multiplying Appellant's federal supply and contract expenses by a -- an estimate of California percentage of wages. It's not exactly Appellant's apportionment -- California apportionment, but it is a -- it is not based on actual California qualified research expenses. Appellant, quote, "Allocated expenses to California applying company-wide percentage wages in California to the qualified research and expenses. This does not meet the statutory or record keeping requirements.

So as for the 2005 wages, these are also in part

based on estimated locations within the United States, rather than actual locations within California. I believe Appellant called them the "none-provided category." But in the GM versus Franchise Tax Board Case, the California Supreme Court stated that the law requires actual California research expenses, rather than apportioned federal research expenses. Nowhere in the statute does the legislature indicate that it wished to apply a different rule based on apportioned rather than actual contributions to research.

So let's talk a bit about the 2005 wages that Appellant now included in Exhibits 100 and 101. And like Respondent said, there looked to be about $34.5 million that were based on actual employee wages earned within California. But they've also included this proportional allocation of the none-provided location wages, which it's not based on an actual location within California. These appear to be those wages where Appellant estimated their location within the United States. And that's not good enough. That does not meet Appellant's burden.

The statute requires expenses to have occurred within California. An estimate of where in the United States that occurred, well, that doesn't meet the statutory requirement. And this would be analogous to the situation that the California Supreme Court in GM versus

Franchise Tax Board called absurd, that is the State of California giving a tax credit based on expenses that did not occur within California.

Appellants then based its contract and supply wages as a slice of its federal estimated contract and supplies. And again, the Supreme Court held that we don't do that in California. We don't hand out a tax credit for something that happened somewhere else. Moreover, Appellants have talked about Cohan. Cohan only allows for a reasonable estimate of expenses. It's not reasonable to base an expense for California on wages or supplies or contract expenses paid in Michigan or Ohio or Texas or none provided. It's not reasonable, and it's a result the California Supreme Court characterize as absurd.

Analogous to General Motors where the Supreme Court observed that basing a California tax credit on out-of-state expenses would benefit corporations without California tax liability. And Respondent doubts the legislature intended such an absurd result when it wrote that statute.

Regarding Appellant's 45 percent concession related to the final federal determination, Respondent will accept that concession with respect to 2006 -- well, I guess 2005 through 2008-B actual wages. But Respondent cannot accept the federal determination with respect to

the contract and supply expenses or the none-provided category.

And I'll discuss in a moment, but Respondent cannot accept a final federal determination relating to California 23609(h)(3) gross receipts. Because while California conforms to the calculation method, California does not conform to the federal definition of gross receipts that go into that calculation. In sum for QREs, Appellant is not entitled to the estimating QREs for the 2005 through 2008-B taxable years, and the 2003 and 2004 taxable years are barred by statute of limitations.

So the allowable wage QREs are roughly, when considering the concession, $19 million for 2005, $28.1 million for 2006, $28.4 million for 2007, and 19.1 for 2008-A, and $241,000 for 2008-B. Though, expenses are just one aspect of the calculation of the California research credit, and Appellant has a major substantiation of gross receipts problem. With respect to gross receipts, the first question was whether EDS substantiated its based-amount components, its fixed-base percentage. California 23609(h)(3), gross receipts from the sale of the property, its average annual gross receipts and base amounts for each of the taxable years at issue.

And the simple answer here is no, they have not. But to explain that answer I will map out and answer three

basic questions. What are California 23609(h)(3) gross receipts? Why do Appellant's have California 23609(h)(3)gross receipts? And why do 23609(h)(3) gross receipts matter?

First, I should remind everyone that tax credits are a matter of legislative grace, and taxpayers bear the burden of proving they are entitled to the claimed tax credits. Statutes granting credits are to be construed strictly against the taxpayer with any doubts resolved in FTB's favor. So the burden of proof is on Appellant. And what have they done with that burden? They've avoided both acknowledgment and identification of their actual California 23609(h)(3) gross receipts.

So let's start with the definition of gross receipts. Here's what they are. Property. That's what the statute says. It doesn't state tangible personal property. It doesn't state intangible personal property. We're talking about property and whether it's necessary to look beyond the plain language of Revenue & Taxation Code Section 23609(h)(3). In this appeal it's not. The statute is clear. These words matter. And so I'm going to read them directly into the record.

23609(h)(3) states, Section 41(c)(7) of the Internal Revenue Code relating to gross receipts is modified to take into account only those gross receipts

from the sale of ordinary property -- from the sale of property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business that is delivered or shipped to purchaser within the state, regardless of FOB point or other condition of sale.

Again, we are talking about property. The legislature's deliberate word choice made no distinction as to the type of property includable. Property is a broad and inclusive term. It is not limited to just tangible property or intangible. It is both. The California Supreme Court in GM versus Franchise Tax Board supports FTB's position that 23609 is not tied to apportionment principles under Chapter 17. The legislature could have used the term tangible personal property. It knows how to say so.

We know the legislature knows how to say tangible personal property because it did say so in a different statute, Chapter 17, Section 25135. It chose not to in 23609(h)(3), and it did not tie 23609 to Chapter 17. Had the legislature wanted to tie 23609 to apportionment principles, it knows how to say so. And it did not say so. Back in 1992 -- back in the 1992 legislative session, any language attempting to tie the 23609(h)(3) to apportionment principles died with those bills in 1992.

The legislature then put forth three bills to

modify the language again in 1993. In 1993, the language of those bills never had any connection to Chapter 17 or 25135. And because the language is clear, we need not read into it. In Lennane versus Franchise Tax Board, the legislature is presumed to have meant what it said in the plain meaning of the statue governs. The legislature said property. And the plain meaning of property includes any type of property. And that's the whole case right here. It's very simple because 23609(h)(3) gross receipts include tangible and intangible property, and Appellant's claim is unsubstantiated. They failed to carry their burden of proof, and the Appellant is not entitled to the research credit.

And with this broad definition of property, here's why Appellant's have 23609(h)(3) gross receipts. Appellant has argued the following opposing position. In the June 2012 claim, it claimed a billion dollars of average annual gross receipts in each of the 2006 through 2008-B taxable years, and $750 million in average annual gross receipts in 2005. In its May 2019 brief, it claimed to have zero dollars of average annual gross receipts because it mistakenly excluded intangible property receipts, but it has some unidentified amount of intangible receipts.

In its September 2020 claims, it stated that

those were based on its arguments in May 2019 brief. In the appeal of the September 2020 claim, Appellant's supplemental brief claims $67 million in tangible property receipts and also some unidentified amount of intangible receipts. It claimed those $67 million intangible property receipts are de minimis, and no matter what happens they would get all of the credit they claimed.

Respondent disagrees. Appellant admits it has California 23609(h)(3) gross receipts in the form of tangible property. Appellant further eroded its position by admitting that property in 23609(h)(3) means tangible and real property. It admits it has 23609(h)(3) gross receipts in the forms of tangible and real property. But the problem remains that Appellant has failed to identify and allow examination of its intangible property receipts. This is Appellants burden, which it failed to carry.

In addition to Appellant's admissions of having property gross receipts, Respondent can establish from publicly available information from the Securities and Exchange Commission, the US Patent and Trademark Office, United States Department of Labor, the United States Court of International Trade, and the Internal Revenue Service that documents from those sources all indicate Appellant had both tangible and intangible property receipts.

Starting with the U.S. Patent Office. As stated

in their opening brief, Appellant sought and received dozens of patents for tangible products and intangible products. Many for system method and computer program products and specifically for system method and computer program products for determining wall's thickness. That is for computer-aided design and manufacturing software. It's the CAD-CAM software we heard about in the testimony this morning.

U.S. Trademark Office. Appellant sought a trademark protection for a computer software used in computer-aided design and computer-aided manufacturing. Again, that's CAD-CAM software. This is Trademark Number 65070913. To get a trademark one must disclose how it will be used in interstate commerce. EDS made sworn declarations of its bona fide intent to use the mark in interstate commerce and included specimens of how the trademark is used in commerce for computer software.

The trademark is affixed to the CD roms and used in interstate commerce. And Appellant renewed that same trademark 75070913 in 2007, demonstrating its continued intent. The specimen showing its use in interstate commerce is labeled 2005 or as we heard this morning, maybe it's 2005, maybe it's 2006.

Internal Revenue Service. Appellant had several audits and several IRS Form 886 Revenue Agent Reports.

The IRS contracted with specialist software engineers at MITRE Group who specifically examined Appellant's none-internal use software applications; those software programs Appellant held for sale, lease, or license. For example, those software applications included an excam, a computer-aided manufacturing software, and drafting and geometric dimensioning tolerancing software, the same type of CAD-CAM computer software products for which Appellant received U.S. patent and trademark protection.

The SEC 10-K for 2003. Appellant's 2003 10-K publicly disclosed the same NX CAM, CAD-CAM computer software its SEC filing. With respect to the CAD-CAM software, software revenue is generated primarily by the sale of perpetual software licenses. And the 10-Ks refer to more than simply CAD-CAM software. The 10-Ks refer -- the 10-Ks differentiate between services and products. The 2007 10-K application talks about application development. We create new applications providing full life-cycle support through delivery. These are custom applications development.

Among Appellant's primary competitors, it included package software vendors and resellers. The 10-K cautions that our services or products may infringe upon the intellectual property rights of others. With respect to the Cunningham versus Electronic Data Systems Case,

again, it's -- it's not simply CAD-CAM software. Here is a contract -- it's an excerpt of one of Appellant's contracts that illustrate instances of the full transfer of software to client free of licensing fees for, quote, "new software."

And in this instance, it was related to airlines, the Department of Labor and the Court of International Trade. In this case of the former employees of Electronic Data Systems versus the Department of Labor, EDS stated with respect to the software that they helped create, with the sales of these products to the customer complete ownership of the products was transferred from EDS to the customer, including all usage and copyrights of the products.

The U.S. Department of Labor later determined that EDS had produced both tangible and intangible articles, and clarified that the production of intangible articles can be distinguished from the provision of services. The Department of Labor concluded that significant portion of the workers at EDS were engaged in the production of articles of software. Quote, "The former employees spent a considerable amount of their work time on the development of significant enhancements that included new code and the development of new software."

The Court of International Trade ordered that the

Department of Labor's decision was, quote, "Supported by substantial evidence."

These were just a few of the available examples from the public record. They all demonstrate that Appellant had intangible software receipts. But it's not Respondent's burden to prove what Appellant's gross receipts are. That's their job, specifically, the taxpayer's burden. But the point here, there is a richness and variety of evidence from the public record that Appellant has tangible property receipts and intangible property gross receipts.

The Court of International Trade declared Appellant produces significant amount of software that Appellant sells to its customers. These are intangible property gross receipts. Appellant hasn't identified those intangible property receipts. They are unsubstantiated and Appellant has failed to carry its burden of proof. What we do know is that Appellant's average annual gross receipts are probably somewhere between the $67 million in tangible and real property it claimed in its supplemental brief and the $1 billion, $1.15 billion, $1.16 billion per year that they claimed that they reported with their June 2012 claim.

Appellant had California 23609(h)(3) gross receipts, and Appellant's failure to include them in their

base amount components has made an accurate calculation of the regular incremental credit impossible. We know they had gross receipts in their startup base years. They claimed $475 million, which they admitted they were not using their actual California gross receipts, but they had some amount of California gross receipts in their base years.

The June 2012 claim included a billion dollars of average annual gross receipts in each of the 2006 to 2008-B taxable years. Again, they admitted that those were improperly calculated, that they are not based on their actual gross receipts, but they have not substantiated what they actually are. They admit to having some -- as yet unidentified amount of intangible software gross receipts. The public documents demonstrate they had software receipts and software sales that could be distinguished from services.

When it comes to their intangible property receipts, Appellant has chosen to ignore the obvious. They're refusing to address their unpleasant facts that multiple sources, apart from EDS, agree that they have these software receipts. But denial doesn't carry their burden of proof. Appellant needs to prepare its accounting in sufficiently usable form and detail to prove entitlement to the California research credit. And that

includes identifying their 23609(h)(3) gross receipts, that it's difficult, or that it occurred many years ago, or that it's different for federal purposes that's immaterial. This is Appellant's burden.

I will briefly mention de minimis gross receipts. Appellant had claim that they had de minimis gross receipts that they could -- but de minimis gross receipts are defined by the Treasury regulations as anything under $25,000. Appellant was calling $67 million de minimis, but Appellants got far more than di minimis gross receipts. And they can't exclude these gross receipts in order to try and claim fall under Legal Division Guidance 2012-3-1.

I've talked about what gross receipts are and why they had them. Now, here's why gross receipts matter. EDS has substantiated -- so has EDS substantiated its fixed-base percentage, California 23609(h)(3) gross receipts from the sale of property, average annual gross receipts, and base amount for the taxable years? The simple answer is no to each, for the simple reason that gross receipts are required for each of these base-amount components, the fixed-base percentage, 23609(h)(3) average annual gross receipts and base amount.

And I want us all on the same page here because gross receipts is the case. First, I've talked a lot

about what 23609(h)(3) gross receipts are. They are average annual gross receipts are just that. It's the average of the prior four years gross receipts. Second, the base percentage for this taxpayer relies upon a calculation of the startup statutory formula which uses a base year's gross receipts in the denominator of that fraction and the base year QREs in the numerator. So again, gross receipts are required for this calculation.

Third, the base amount is then the product of a taxpayer's fixed-base percentage and the 23609(h)(3) average annual gross receipts. So when gross receipts aren't properly substantiated and reported, a taxpayer cannot make one, a fixed-base percentage calculation; two, an average annual gross receipts calculation; and three, cannot make a base amount calculation. Practically speaking, the base amount is a hurdle. And if my left hand here is a hurdle and my right hand is the taxpayer's stack of QREs, when you push them forward and they impact the hurdle, only those QREs that exceed the hurdle are allowed. So in this instance just the fingers. Okay. And the fingers, that part, that is a way the credit is then based on.

And that base amount is what a taxpayer must exceed in order to claim California regular incremental research credit. Here, the word incremental means an

increase over the base amount. That's what Congress wanted in adopting the regular incremental research credit, and that's what the legislature wanted with federal conformity.

So gross receipts are imperative. Properly identifying them is mandatory for calculation of each of the base amount components and therefore, mandatory for calculation of the California regular incremental research credit.

In the case of Quebe versus United States, the Court held that a taxpayer that had assigned itself fixed-base percentage had not substantiated its right to the regular incremental research credit. To substantiate the credit, a taxpayer must come forward with both QREs and gross receipts evidence demonstrating they are entitled to use the startup base period to calculate their fixed-base percentage and bas amount.

As OTA reiterate in the Appeal of Pino, a taxpayer shall keep such permanent books of account or records as are sufficient to establish the amount of a credit claimed, and that the taxpayer must retain records in sufficiently usable form and detail to substantiate the expenditures claimed are eligible for the credit. Appellant has not properly identified or substantiated its California 23609(h)(3) gross receipts.

Perhaps most telling, Appellant has no contingency plan. It has never said we don't think it applies because we have this giant. We're not base sensitive. We have so much QREs, but here -- here it is. Here's, you know, here's the amount of intangible property receipts just in case we are wrong on our interpretation of the definition of property for California gross receipts under 23609(h)(3).

Their supplemental brief included a new spreadsheet that radically altered their zero gross receipts position and now identifies tangible and real tangible properties. But it does not now identify Appellant's intangible software receipts. So Appellant failed its burden of proof, and it is not entitled to the California regular incremental research credit.

Whether EDS is -- Issue Number 2 under gross receipts, whether EDS is allowed to use the maximum statutory fixed-base percentage of 16 percent when computing its California regular incremental research credit for the tax years. Appellant is not a zero gross receipts taxpayer and Legal Division Guidance 2012-3-1 does not apply. I think that's the only place where FTB said use 16 percent. Okay.

The internal revenue code section 41(c)(3)(C) is not an election. One cannot simply assign themselves a

fixed-base percentage. It is based on the facts of a mathematical calculation. A calculation is mandatory under the statute. If the taxpayer has an unsubstantiated fixed-base percentage, it's not entitled to the research credit. Appellant's supplemental brief stated that it was not required to substantiate its fixed-base percentage because they're just going to rely on Suder versus Commissioner.

But nowhere in Suder does it say that the taxpayer did not make the calculation. The taxpayer may have had a 16 percent fixed-base percentage, but it does not state that the taxpayer did not make a calculation of that. In the context of the calculation, Quebe says the taxpayer is obligated to substantiate the right to the credit. And the IRS would treat Appellant's unsubstantiated fixed-base percentage as follows: If a taxpayer cannot prove their fixed-base percentage, a complete disallowance of the research credit is required, even though the maximum fixed-base percentage is 16 percent.

Remember, Appellant used 16 percent of its own accord because it was incapable of making the actual calculation in the absence of identifying its California 23609(h)(3) gross receipts. Appellant's argument that it's okay to use 16 percent because it's the least

favorable to the Appellant is disingenuous. The reason they made that argument initially was because of their zero gross receipts position. Their unsubstantiated reporting of a zero-base amount means there is no hurdle to exceed.

Even if they used a more favorable base percentage, like a 3 percent. Multiplying 3 percent or 16 percent by a zero -- by zero gross receipts means zero. There is no base amount to exceed. So saying that it is -- it benefits Franchise Tax Board somehow, that whether we use this -- this no hurdle is -- it's disingenuous because it doesn't take into account the -- there were other facts such as the -- the QREs and their actual California gross receipts.

Yet, as Respondent discussed in its supplemental brief at pages 20 and 22 -- 20 to 22, a properly substantiated base amount can and would change Appellant's regular incremental research credit. The fixed-base percentage calculation is mandatory. The Research Inc. Case states that a taxpayer must make a fixed-base percentage calculation. If they can't, they're not entitled to the research credit. And if that calculation is over 16 percent, then 16 percent applies. But they must make a calculation. It's not an election.

Issue 3 under gross receipts, whether EDS'

average annual gross receipts for each of the tax years were large enough to produce a calculated base amount greater than the statutory minimum base amount. What we're talking about here is a concept called base sensitivity. Is Appellant base sensitive? That's the idea that no matter what Appellant does, Appellant has so many QREs that it will exceed its base amount by such a large margin, it will generate maximum amount of credit. But this calculation does not exist in isolation.

Appellant's QREs are not set in stone. The base amount when properly calculated will rise and there will become a point where Appellant has fewer and fewer QREs because they are based on federal numbers, or they are -- they're based on a none-provided location, and the QREs run headlong into the base amount, and they may fail to exceed it. Yet, any answer on Appellant's actual base sensitivity is unknowable without Appellant's proper inclusion of its 23609(h)(3) gross receipts.

We have Appellant's representative's statements on gross receipts, but Appellant has base amount components that are unsubstantiated because Appellant has failed to demonstrate what they actually are. Appellant put forth hypotheticals in their briefs, but Appellant's hypotheticals in the briefs were -- they don't take into account removing Appellant's QREs for the -- the

essentially apportioned QREs, that none-provided wages in 2005 year or the contract or supply QREs for 2005 through 2008 taxable years because those are all based on apportioned federal QREs.

We discussed the GM versus Franchise Tax Board Case previously where the California Supreme Court held that inclusion of apportioned items would create an absurd result. So Appellant is left with wages of -- QRE wages of $19 million, $28 million, 28 million, and $19 million for 2005 through 2008-A. And that makes it much harder to exceed a properly calculated base amount. And if we could, we would add to that the substantial intangible gross receipts from the sale of software, but they didn't tell us what those were.

And remember, for example, the Court of International Trade stated that EDS had substantial software sales. Well, the software sales don't have to be much. Respondent's supplemental brief put forth a hypothetical on base sensitivity. If just one-sixth of the initially claimed $1 billion average annual gross receipts from the June 2012 claim were related to intangible software receipts or $166 million out of that $1 billion, that would give Appellants a hypothetical base amount of $26.6 million, which Appellant's $28 million in 2006 would then exceed by just $1.4 million giving

Appellant a credit of about $200,000, which is very different from the $5.6 million that it alleges in this appeal.

And let's not forget to add in those tangible property receipts that they have just admitted to. Of course, this was just a hypothetical. In the real world, Appellant has failed to substantiate its intangible gross receipts and therefore, each of its base amount components, fixed-based percentage, average annual gross receipts, and its base amount. A calculation is thus impossible, and Appellant is not entitled to the California regular incremental research credit.

Finally under gross receipts, whether the duty of consistency applies to EDS' fixed-base percentage average annual gross receipts and base amount for each of the tax years. OTA has recognized the duty of consistency in precedential decisions in the Appeal of Chen and Chi and Appeal of Davis and Hunter Davis. It generally precludes a party from gaining an advantage by taking one position and then seeking a second advantage by taking an incompatible position where one, the taxpayer represents something upon which FTB relies -- sorry -- one, the taxpayer represents something, two, upon which FTB relies, and three, the attempt by the taxpayer to change the previous representation after the statute of limitations

has run in a way that harms Franchise Tax Board.

Here, for example, Appellant represented that it had 400 average annual gross receipts of $475 million in the 1998 taxable year. FTB allowed Appellant credit based on this representation, and Appellant changed the representation to we have zero gross receipts. The harm is by granting of an unsubstantiated tax credit. It's not the difference between $475 million and zero, because of zero gross receipts. It is a difference between $475 million and substantiated. If it's unsubstantiated they cannot make a calculation.

Based on Appellant's representations of unsubstantiated gross receipts, that tax year should have resulted in a complete denial of the regular incremental research credit. EDS now alleges it knew it was incorrect. Mr. Fix admitted that EDS was not using its actual California gross receipts, but it filed its tax return under penalty of perjury all the same. Appellant didn't substantiate or otherwise correctly report its California at 23609(h)(3) gross receipts.

Appellants have claimed California gross receipts in their base years. Respondent has shown Appellant has California gross receipts in the taxable years at issue. Again, without knowing their actual California gross receipts, Appellant cannot calculate a base amount, and we

will know whether and to what extent Appellant exceeded or failed to exceed that uncalculated base amount.

I will briefly touch on Appellant's enterprise zone hiring credit claim. Appellants have stated that there's a single zone, that the statue does not create a single zone where enterprise zone hiring credit can be used irrespective of where it was generated. Rather, the statute calls for isolated consideration of only business income arising from an individual zone when determining allowable credit.

The law does not allow a taxpayer to use a credit generated in a particular zone to offset income earned outside that zone. For example, if a taxpayer earns credit in a zone, such as Bakersfield or Fresno, it cannot syphon that credit off from those enterprise zones and use that credit against business income in Los Angeles or San Francisco. Only attributable business income from the individual enterprise zone can be considered to represent all the income of the taxpayer subject to tax.

The credit that can reduce tax shall not exceed the amount of tax which would be imposed on the taxpayer's business income attributable to the enterprise zone determined as if that attributable income represented all of the income of the taxpayer subject to tax under this part. It is a special calculation for determining the

credit attributable to each particular enterprise zone, a zone-by-zone bases.

It's not taking all the taxpayer's income, but all of the income attributable to a particular enterprise zone. Look at the structure and the operation of each individual enterprise zone. For the relevant tax years, there were roughly 42 separately designated enterprise zones in California, each designated by the Department of Housing and Community Development, HCD. These zones were not funded by HCD or any other state agency. Each community containing one of those 42 zones provided their own funding and their own staffing of their enterprise zone.

To ensure success, the community had to maintain a substantial and sustained level of targeted economic revitalization to ensure the success of their particular zone. The communities were accountable for their zones. They had to achieve their own locally-based goals. Clearly the development of a viable, profitable, and sustainable businesses within a particular zone is supported by matching tax credit with attributable income and corresponding tax liabilities within that particular zone.

How would this objective be achieved if the credit is earned in one place and syphoned off to another?

It wouldn't. Appellant's interpretation, in addition to being contrary to law, it would be to the detriment of the community that funded and staffed the enterprise zone if Appellants could take what they had extracted and used it against business income elsewhere.

And with respect to Appellant's 25137 petition, that doesn't apply here. Revenue & Taxation Code Section 25137 may be invoked only where the standard apportionment and allocation formula does not fairly represent the extent of a taxpayer's activities in this state. The Uniform Division of Income for Tax Purposes Act or UDITPA applies to Chapter 17, Article II, Section 25137. The enterprise zone hiring credit appears in Chapter 3.5. UDITPA does not apply.

The reference to UDITPA in the enterprise zone hiring credit statute is for the limited purpose of apportioning business income attributable to the enterprise zones to calculate the limitation on the enterprise zone credit. It is not for apportionment on a multistate level. The enterprise zone hiring credit formula operates as a credit limitation, not a multistate apportionment method.

And this concludes Respondent's argument, and Respondent reserves any remaining time from the hour and a half for its closing statement. Thank you.

JUDGE HOSEY: Thank you.

I think we're going to hold questions from the Panel until after, Mr. Fix, your rebuttal if that works. I would request that you address the easy credit issues in your rebuttal if that works for you.

MR. FIX: I'm fine doing that, assuming I have enough time. I'd rather --

JUDGE HOSEY: Okay.

MR. FIX: -- address R&D first.

JUDGE HOSEY: Yeah. Whatever you would like to address. Hold on.

MR. FIX: Yeah.

JUDGE HOSEY: Okay. Begin when ready.

MR. FIX: Yeah, I think the easy credit is addressed just fine in our briefs, so I'll focus on the R&D.

JUDGE HOSEY: Okay. Thank you.

CLOSING STATEMENT

MR. FIX: Okay. Thank you.

So I'd like to address -- I'm going to address his arguments in order and then kind of bring it back to how does this -- what does this matter? Does it impact all the different outcomes that we have on the summary or not, to kind of bring it home in terms of what issues you

need to decide with respect to each of one of these refund amounts.

So let's start with -- just in order, jurisdiction. Respondent seems to say that you don't have jurisdiction under the OTA's Section 30103. But 30103(a)(4) specifically says if FTB fails to act on a claim for refund within six months, you can appeal to the OTA, and that's what we did. And it's not that we waited until six months had passed and didn't want them to have the opportunity to do that. In fact, they had, you know, our original claim was filed back in 2012. We've gone through a full audit of the QREs. The QRE amounts never changed.

Really, the only thing that changed was the method of computation, but the underlying information was the same in terms of the underlying QREs. We had provided the auditor assigned to the claim, the secondary claim, all the information that was provided with respect to -- at OTA. All 99 exhibits we're talking about, they had access to it. And what did they do? They sat on it for over a year.

At some point after ten years, taxpayers should be allowed to appeal it. By statute if we're allowed to appeal to the OTA, it had jurisdiction. We can't be held prisoner by an agency that might have constraints on

resources or decides to prioritize other cases. I think ten years is enough.

Second, in terms of saying that there's a different position and mentioning the substantial variance doctrine, I think it's clear that this is not substantially the computation under the regular method or the AIC, they are both mathematical ways to compute an R&D credit under the same statute. This is not a new legal theory. This is to be compared to the substantial variance cases that have disallowed taxpayers from essentially coming in and saying I'm claiming an easy credit on my original refund claim, and now I'm actually going to change my position.

I'm going to claim a different -- completely different credit under a different section at court. I'm going to claim an R&D instead of easy credit. That's not the case. Also the cases that talk about substantial variance involve taxpayers that are requesting for additional QREs that the agency did not have a chance to review. That is not the case for us. Same QREs the entire time. It's just a matter of computation. And so it's simply a method of computation. It's not a new legal guide, you know, a new legal theory.

And the point where Respondent tries to point out that the legal ruling where the FTB changes its position

with respect to who can -- who can use the regular method of computing an R&D method. In 2012, it's three months after the 2012 claim was filed. Well, the taxpayer was not aware of that. It's simply guidance issued by the FTB. It's not in the statue. So if the taxpayer is looking in the statute, there's no change.

The taxpayer was aware of the longstanding position by the FTB, which is essentially, if you have zero gross receipts, can't use the regular method. Therefore, you have to compute it using the AIC method. That's what we were doing. Once we figured out that that was incorrect and even the FTB auditor said you can't use that, we were -- we were defaulted to the only position left. Now, the important part is that the refund claim itself didn't say we are only claiming refund claims under the AIC method. No. The refund claim specifically says we are claiming R&D credits that we generated and are allowed to utilize.

The fact that the method of computation, the mathematical computation involved the AIC method does not mean that is the -- we're limited to that. And in fact, the substantial variance cases talk about not only does it have to be substantially varied in legal theory, but if a taxpayer is either explicitly or impliedly raise the issue, they should be allowed to proceed.

I think it's a hard argument to make that we didn't. We didn't even imply that we're entitled to R&D credit or that the FTB was surprised by it when they know we originally claimed for '03 and '04 R&D credits under the regular method, and that at audit they said we can't commute it using AIC. Instead, you're left with the regular method.

In terms of gross receipts, sales of property, there were several arguments made. None of them actually point to any numbers. The FTB would like you to believe that we have not substantiated our AGRs, that our business is the sale of TPP or -- or intangibles on tangible personal property; the fact that we have trademarks is somehow determinative; the fact that our 10-K say -- use the word services and products, somehow, you know, that's the smoking gun. Labor cases that talk about that there's, you know, there are some sales of software and they are somehow significant, you know, determination by the Department of Labor.

All these are just, you know, anecdotes and examples. None of them actually tie to the actual question in the statute, which is how much gross receipts from sales of property held for sale to customers were in California? And we have come forward and met all of the requests for information at this point where we've

provided actual substantiated work papers for these years by entity, by receipt, by type, and it shows that nowhere are the sales of a property close to the threshold that would impact our R&D credit. It's just not there.

So the fact that you have some sales of intangible software on TPP, yes, we've already admitted that. It's in our work papers. It's presented there. Ms. Kelly Nall testified to that that all those sales of software -- this CAD-CAM that the FTB is banking on -- that is simply part of an affiliate. That was not the core business. It was sold in '04. And even when it was part of the combined group, it was such a small part of the affiliated group. We're talking about a company with, you know, over $16 billion in service receipts. Okay.

Just to put it into context, you know, instead of just talking in hypotheticals and saying significant, let's put actual numbers. Because we actually provided work papers, contemporaneous business records that show the actual receipts. We show the actual receipts for the specific entity that they're so worried about, Unigraphics. And we show how much we're in California. And those numbers are small.

And when he says that we use the word de minimis and de minimis is -- you know, how could $67 million could be de minimis? Well, when you're talking about a company

that in totality has close to $20 billion, yeah, it's de minimis. It's less than 3 percent. And so more importantly the entity that all of the information that he's providing and focusing and trying to make appear larger than life related to Unigraphics was so small.

Let me give you actual numbers that are in Exhibit 97 that actually have the gross receipts. Not just everywhere because most importantly it's gross receipts in California. Unigraphics in 2001 had a total of $6 million of sales of property in California. Okay. We're not saying $6 million everywhere, in California. To take it a step further, do you know how much receipts they had in California also from services? Because this specific entity didn't just sell, you know, off-the-shelf software.

They also provide services. In totality, they had $14.9 million in that year. $14.9 million, that's nowhere close. It doesn't bring you closer to having enough AGRs. Even if for some reason you wanted to re-characterize our service receipts into something else that they're not, you would still not get there. But the problem is that you can't make all these speculations and say well, they haven't substantiated what their actual numbers are and they -- they must be significant because this case from the Department of Labor said so.

All those cases one is in a different context. Two don't actually give you actual numbers, specifically, for California. And so we actually provided documentation that is reliable, that we have, you know, someone from the company where they're close to 35 years that testifies to the business and confirm that these are reliable documents. And these reliable documents actually provide what the sales of property are.

And so to say that those are reliable, what more do you want from the client? You know, the Bayer case talked about you can't compel a taxpayer to, you know, go along with these herculean requests by the government. At some point you've met your burden, and we have, because these same numbers were audited for financial purposes and for federal purposes. And I would have hoped that we wouldn't get to this point because the FTB at prior audits, which Respondent focuses on for 1988 and other years where the EDS miscomputed their -- their gross receipts by simply apportioning their total receipts even though they were service receipts and apportioning them, which they shouldn't be in there, the FTB auditor identified it and said this is wrong. This is incorrect.

But actually took a step further and said let me look at the client the taxpayers provided me, which is returns that shows total gross receipts for the company

and how much cost of goods sold are associated with sales in that year, and nowhere -- and the auditor in our exhibits, the auditor said there's no chance that this could come close to enough to impact the R&D credit. So for the FTB to simply say they haven't substantiated it, I don't know how we could substantiate even further than this. Because all that Respondent has done is simply provide anecdotal examples without actually giving you context. We're providing you context and actual numbers.

And again, just one more point in terms of patents and -- don't be confused by the fact that some of these patents were used by this Unigraph's [sic] entity. There's a lot of patents and it's clear these patents were used as part of the service business. This is a service company, a leader in the service industry. That's -- those are the receipts, and we have actually provided and substantiated those receipts.

Now in terms of fixed-base percentage, Respondent mentions the fact that in earlier years a startup method was used and somehow that's important. Again, the Respondent even admitted the startup method fixed-base percentage that was used in earlier years was incorrect because they used estimated AGR, so no actual. But let's take it a step further. The FTB was aware of this. The auditor identified it and said this is incorrect.

But again, it doesn't matter because of the type of business we're in, we just don't generate enough sales of property, and property include -- you know, it's a nice academic exercise that we went through today in terms of real property, tangible personal property, and tangible persona property on TPP. But the bottom line is all of that is included in our apportionment work papers. And when you include all of that, it's still below. And so for Respondent to simply say you haven't substantiated it, they haven't shown us anything that would contradict what we have provided. None of their exhibits contradict what we have provided.

Now, Respondent also would like you to believe that you cannot use the 16 percent fixed-base percentage, that it's a hurdle and that there's a bunch of case, the Quebe case and other cases that talk about that you have to compute your fixed-base percentage in order to claim an R&D credit. And the Quebe case, that's an Ohio case, a district court case. There are a few other cases. All these cases have one thing in common where the -- where the Court said you are -- you have to actually substantiate your fixed-base percentage.

The taxpayer was claiming a fixed-base percentage smaller than 16 percent. They were trying to benefit because the smaller the fixed-base percentage is, the

smaller your base amount is, and as a result you would have a bigger R&D credit. But in the one case that's precedential, Suder Case, U.S. Tax Court case, with similar facts where the taxpayer did not have the information to substantiate its fixed-base percentage, but did substantiate that it was in qualified research activities and substantiated its entitlement to R&D credit, the Court expressly denied the IRS' argument that it has to substantiate what its actual number is.

Because as the Court said, 16 percent is the maximum. You -- there's -- there's no point to -- to this exercise if they're using 16 percent. So to -- to try to say that the FTB wouldn't -- would not be benefited from us using 16 percent is incorrect.

Another thing that was said, I just want to point out is not what we're arguing and is not a position that I've read anywhere, which is it seemed to say that you -- that the argument is that if you have zero -- only if you have zero gross receipts, you could use the 16 percent. That's -- I haven't seen that. That's not -- that's nowhere. The only precedent that's on point that says you can use the 16 percent is the Suder Case. The Suder case does not -- it doesn't involve the fact that you have a taxpayer with zero AGRs, and as a result it is using the 16 percent.

16 percent is beyond taxpayers that only have zero gross receipts. We are clearly. You know, we started off by figuring out that our AGRs were incorrectly computed and are estimated. We've made the effort to come forward and say, actually, we're a service company. FTB pushed back and said no. You have to substantiate how much gross receipts you have. You're not a zero gross receipts taxpayer. So we have. We provided that and showed them it's still below the thresholds that would impact our R&D credit.

We're still using the minimum base amount in all these scenarios. Even in scenarios where they would disallow part of our estimated. We are still below those thresholds. So don't be confused by, you know, the fact that base sensitivity. There is no base sensitivity. Regardless of if we're just stuck with the '06 through '08 wage QREs under Outcome 1, or if we get all of them under all scenarios, there is no reduction to our R&D credit with exception of the '08-B year which only generate $25,000 of R&D credit. It's a short year when it was sold.

That's the only reduction. That shows you we have no base sensitivity. So we've substantiated our QREs. We've substantiated our AGRs. To me, we've met our burden. For -- to create precedent where the FTB can

simply come in and say not enough, not enough, I think at some point it is enough. And taxpayers should be allowed to what they are entitled to. And clearly this taxpayer engages in qualified research activity.

Now duty of consistency. As you know, for the duty of consistency to apply, there has to be some sort of whipsawing of the agency. The taxpayer has to have gained an advantage from it. We have established that we have not. The fact that in earlier years, prior to '03, we provided calculation that show that the R&D credit, whether when you compute it using actual AGRs and the maximum 16 percent fixed-base percentage or compared to how it was originally filed and audited by the FTB, the result is the same. We always end up using the minimum base amount because we don't have enough gross receipts from sales of property, and our Exhibit 97 establishes that.

Okay. I guess this is still on the same point. He was saying that we cannot calculate our base amount. I think we've clearly established that we can. Between the fact that we're allowed to use the 16 percent fixed-base percentage and the fact that we have actual AGRs that are reliable from general ledger, we can. The FTB on the other hand has not provided any sort of documentation to counter our numbers.

And so just to kind of wrap this up, bringing it back to Outcomes 1 through 4, for us to get the first item, $5.8 million, we only need to answer 3 questions. Remember, duty of consistency, which we have established FTB has not been harmed. It has not been surprised. Didn't rely on it, actually audited it. And all these other cases at the OTA when duty of consistency applied, the FTB essentially accepted the return as filed and the taxpayer actually benefited from -- from the fact that they weren't audited and they were trying to get double deductions and the like. That is not the case here.

Two, 16 percent maximum fixed-base percentage, we're clearly allowed to that. See Suder. It's on point. To go against that, essentially, going on point federal case law. They have not presented anything to the contrary.

And finally in terms of proving Number 3, which is gross receipts -- actual gross receipts from sales of property, we are always going to be below the amount of AGRs needed to meet the minimum base amount under all scenarios.

Outcome 2, for us to get another 4.8, we need to get -- that requires the OTA to agree that we have also substantiated '04 and '05 California wages. The documentation that was provided for those years is similar

to the one for '06 through '08 that was accepted. Obviously, for '04 there is an issue with respect to jurisdiction. However, we believe that jurisdiction has been established for the reasons that I mentioned. Therefore, '04 given that there's jurisdiction, we should be allowed the same actual R&D wages for '04. Those are not estimates. And for '05, similarly, we believe those are actual and so should be allowed.

Outcome Number 3, for us to get an additional 3.2 million, this requires the OTA to allow us to estimate our -- our estimated QREs for supplies and contracts and contractor expenses. FTB would like to simply say it disagrees with and doesn't think it's reasonable. I think adopting precedent where you're not allowing it in this case where, specifically, for '06 through '08, they are admitting that our QREs are actual, and we have substantiated them. So meaning we have very detailed information as to where our R&D employees are working.

And to say that supplies wouldn't follow that, or contractor, to me is -- is a problem because you're essentially creating a precedent, Cohan Rule, and making it, essentially, a dead rule. If it doesn't work for EDS, who will it work for? Because the Cohan Rule essentially says, if a taxpayer doesn't have, you know, the exact numbers for their QREs, they can estimate it. Okay.

We are better than that. We actually have detailed information by project, by type, by state -- sorry -- by type, by amount, and by year. And the only thing that's missing for '04 through '08 is the state. And so we're not estimating -- we're not starting with these imaginary numbers. We have concrete numbers. And we're simply coming up with a reasonable method. If this is not reasonable, then I ask the question what is? Because otherwise you're essentially saying the Cohan Rule stands for nothing.

And finally, for Outcome Number 4 that would allow us for another $2.5 million requires you to agree that we reasonably estimated '03 QREs. And again, we admit that '03, even though the underlying documentation is as detailed and reliable on a federal level with respect to our supplies and contractors and wages, the problem is that we don't have the R&D wage California ratio to use. So instead with use the California.

But again, this was the methodology that we used in prior years because it's still reasonable, even though it's not as accurate and the '04 to '08 is better. '03 is still reasonable, and it was allowed by FTB in the past. For the FTB now to change its position just because seems to be unfair to the taxpayer that has gone above and beyond for the last close to 11 years to meet its burden.

So I simply ask for you to take that into account when considering our case.

Thank you.

JUDGE HOSEY: Thank you, Mr. Fix.

Are you doing okay?

THE STENOGRAPHER: Yes. Thank you.

JUDGE HOSEY: Okay. We're going to move to questions from the Panel. I'm going to start with Judge Akin.

Do you have any questions for the parties?

JUDGE AKIN: Let me get the microphone here. I do. Give me just one second to get to my notes. Okay. I have a question for -- a couple of questions. They are all related for Appellants. So I just wanted to clarify what Appellant's position is regarding whether the definition of gross receipts in R & T Section 23609(h)(3) includes or does not include intangible property.

MR. FIX: So thank you. That was addressed in our brief. And the short of it is, we believe that the legislative history implies that if it's simply software, in the sense that you're licensing, that should not be included. And in fact, the focus was for tangible, and that was purposeful in order to provide for a benefit to technology companies in California.

But that being said, I don't -- it does not

matter for purposes of this case. And the reason for that is all sales of software that took place by EDS' subsidiary, Unigraphs [sic], all of that taken into account in our apportionment work papers. And when you include all of those sales, we are still below the threshold to impact our R&D credit.

JUDGE AKIN: When you say your apportionment work papers, can you direct me to which specific exhibits you're referring to?

MR. FIX: Yeah. Exhibit 97. So we had provided an Excel file with schedules. You know, there were business record that showed by legal entity, all the total receipts by state, by type for the years at issue and before the purposes of AGRs and totaled all that up in a summary slide for -- to see the total amount when you add up all those receipts. And some of those receipts frankly, we're including not just sales of tangible personal property which those amounts would pick up any sales of CDs, which she references, but also sales of real property.

Even though some of those receipts weren't sales necessarily of inventory, so as part of the business it would be a lot of tangible personal property, real property, that the EDS would have as part of providing services, servers, computers, and the like that it owned

and it would lease or use as part of its data centers. But obviously, those become obsolete and you sell those. That would create just a 4797 sale of business property not of inventory.

But what we did and the reason why we note that is we're being conservative. We're even including that. Take you a step further, we also were including other receipts that are flowing up from partnerships, our frankly, service receipts. But for your purposes to show you how not sensitive we are to adding those, when you add them up, it still doesn't rise to the level of impacting our R&D credit.

JUDGE AKIN: Understood. Follow-up question on that. So the numbers that are on Exhibit 97, so the cover where you have the totals. Those would not include those numbers, the figures that you have for each of the tax years would not include licensing receipts for licensing of software because it's Appellant's position that that would not be included in the definition of gross receipts for the California research credit. Am I correctly summarizing your position?

MR. FIX: That's correct. And licensing -- so royalties, rents, and services are excluded from the definition and frankly, that's the position from all FTB guidance as well. I think what the FTB's position is

today is that sales -- that we had sales of software as he pointed out in exhibits on CDs that those are actually sales of software that are tangible.

So whether you're selling software or you're selling actual products, a computer, those should be included. But it is not my understanding that we're disagreeing on licensing. Because if it's a pure license that we get paid for, then it would be included as royalty. He was referencing actual sales.

JUDGE AKIN: Okay. Thank you. Just to make sure I'm following correctly, those figures would include then the what you perceive to be the actual sales of software, so the CDs of the software example?

MR. FIX: That's correct. Yes. That would be picked up, and you could see the trend going. After '04 when Unigraphics was sold, you could see a decline in those receipts for obvious reasons because it was not a core business of ours, and we weren't in the business of selling software. As Ms. Nall testified to, we're a service company primarily generating, you know, over $16 billion a year in services.

The amount of sales of property were de minimis and any -- any sort of number was associated mostly with Unigraphs [sic] which was de minimis compared to the whole business. And when you even narrow it down even further,

you know, sales in California, that's just a small number. It's -- we're talking like $6 million as opposed to $100 million that would be needed to make a difference.

JUDGE AKIN: And so the service revenue for the other entities besides Unigraph [sic], did that ever include the sale of software? I assume it probably sometimes includes licensing of software, but did it ever include sales of software to those customers as well?

MR. FIX: My understanding is that the characterization of a sale, whether it's a service, a license, or a sale of TPP is all done -- and correctly done at the ledger level. And that flows to both audited financials 1120 and apportionment work papers. So the answer is the service line would not -- should not include any sales of software. Sales of software would show up as a sale of TPP if it was a sale on CD, like off the shelf.

JUDGE AKIN: Would it include sales of intangible software, the service line?

MR. FIX: No. The service line would include service receipts.

JUDGE AKIN: Okay. I think that I'm going to shift directions a little bit. I had one additional question. It's related to the claim for refund. And from what I see in the record it looks like Franchise Tax Board, their auditor sent a recommendation recommending

disallowing the R&D credit under the alternative incremental method in -- looks like September 16th of 2015. Did Appellant after Franchise Tax Board sent that recommendation, ever inform Franchise Tax Board that they would instead be claiming the regular incremental method, you know, the credit under that method following the audit recommendation that was in September of 2015?

MR. FIX: So I believe after the position letter by the FTB and we received Notices of Action, those were appealed to preserve our rights. And then were discussions with a bureau within the FTB, the FTB Settlement Bureau. Those did not, you know, go further, and we came back to the OTA and went into briefing. But the underlying point is that our refund claim raised our entitlement to R&D credits.

And the auditor reviewed both -- the auditor could have just stopped and said the AIC method is not allowed. Done. The auditor went further and actually audited our QREs, audited our AGRs and made a determination for that. Why did he do that? Because it's obvious that if you are not allowing the AIC method, you're allowed the regular, which was implied by the fact that we simply requested in our refund claim R&D credits. Whether he used regular AIC is simply a mathematical method of computing it.

JUDGE AKIN: Understood. Thank you.

I think that's all my questions for this time.

JUDGE HOSEY: Thank you.

Judge Lambert, any questions for the parties?

JUDGE LAMBERT: Hi. I have no questions. Thanks.

JUDGE HOSEY: Thank you.

I just have one question for the Franchise Tax Board. The 16 percent only applying to the gross receipts when they're zero for the basis, what's the support for that? Is that in the statute?

MR. RILEY: No. I believe the only place that it's ever stated that a taxpayer should use 16 percent is within Legal Division Guidance 2012-3-1. I believe that's the only place where it states if -- because you're a purely service -- a pure service taxpayer with no other type of -- no intangible receipts, no -- I mean, it just -- it really only talks about services. If you are a service taxpayer, then you would use the startup method and the 16 percent. It's the only place that says "use".

JUDGE HOSEY: Okay. Thank you for clarifying.

MR. FIX: Judge Hosey, can I comment on that?

JUDGE HOSEY: Yeah. Go ahead, Mr. Fix.

MR. FIX: I just want to put it into context. The legal ruling that he's referring to is simply the

FTB's interpretation and an example. It does not mean that is exclusive to the only situation that would apply. And the FTB in California follows federal with respect to the fixed-base percentage, follows the statutory section that says that the maximum fixed-base percentage is 16 percent and therefore, is required to follow on point federal precedent on this point, which is the Suder Case.

The Suder Case does not say the 16 percent is limited to if you have zero gross, you now, gross receipts and also couldn't establish your fixed-base percentage. That's not in the case. The case simply says, if you establish you have QREs but you can't establish your historic, you know, fixed-base percentage, would require to go back to the 1984 to 1998, then you're allowed to do it. Disagreed with the IRS on the position that the FTB is taking now.

Thank you.

JUDGE HOSEY: Okay. Thank you.

I'm going to go back to Judge Akin for another question. Go ahead.

JUDGE AKIN: Yes. I just wanted to follow up with Franchise Tax Board my question about the gross receipts and -- the California gross receipts and the intangible property and software. I wanted to give Franchise Tax Board an opportunity to respond to that and

explain potentially why they think maybe Appellant's numbers are not fully accounting for their software sales. I believe that's Franchise Tax Board's position.

MR. RILEY: Yeah. I would be happy to address that.

I think two things. The first is that their definition of gross receipts has differed from what Franchise Tax Board and the law, the definition of gross receipts. The definition that they put forth in their opening brief, which I've -- sorry -- was that intangible software receipts are excluded. Okay. Intangible software receipts, Respondent went over this in its opening brief.

Software could be tangible or it could be intangible. If it's on a computer CD, that would be tangible. If it's downloaded, then that would be an intangible. But in either instance, that can be purchased. Okay. And in either instance, it is delivered. It wasn't with you. It is now. That's a delivery.

Both of those methods you purchase it at a store. Or if you purchase it online and it is delivered to you electronically, both of those are deliveries of in one instance a tangible on CD. In the other instance, an intangible on computer -- on electronic download. Both of

those would be includable in California's definition of gross receipts. Because the definition, of course, says property. So that's both the tangible and the intangible.

MR. FIX: Respondent is done. Do you mind if I -- I just want to add to that.

JUDGE AKIN: Let me just check and see if Respondent was done with that response, but I will turn it back to you.

MR. FIX: Thank you.

MR. RILEY: Yeah. I mean, I think -- I think that we're -- yeah. That's, you know, their definition has never really included that in their briefing. You know, that's really the thrust of their briefing that hey, we are a zero gross receipts taxpayer. We don't have to include our intangible software receipts, and so we're not going to include them. And also, we're not going to identify what they are.

JUDGE AKIN: Okay. Understood.

And go ahead, Mr. Fix.

MR. FIX: Thank you.

I want to make it clear one, I disagree. That is not the thrust of our briefs. What is important here is that yes, the -- if you have a sale of software meaning, you're transferring all the rights of that software, then that would be a sale. And that can be delivered on a

CD-ROM, or it can be downloaded. But if you are simply licensing someone a non-exclusive right as part of your service, and that's what EDS does. That's what we've testified to. That's what the 10-Ks talk about. The primary thing that we provide our services.

So if you would like to use our payroll software to do payroll, or if you're trying to access some other technology that we have developed and we're providing you with a service and you are paying for us to do that, that is about our business, and those are licensing receipts. Those are not sales of intangibles. Those are licensing receipts. And the FTB both in their legal guidance and in their tax return instructions, as well as in the legislative history, are extremely clear; rents, royalty, services, not included. Okay.

So back to the numbers. Instead of talking hypotheticals. As I mentioned, it doesn't matter whether we agree today on sales of software or not because the bottom line is we have provided actual numbers of our receipts from sales of software that were correctly and accurately, you know, cut by our general ledgers and used to create our apportionment work papers.

So to me it's a nice academic exercise, but it's not necessary because we've included everything that would have been a sale of software, and that clearly does not

rise to the level of impacting our R&D.

Thank you.

JUDGE AKIN: Thank you.

And one additional follow-up question for the Franchise Tax Board. Do you agree with Appellant that, you know, receipts from the licensing of software where, you know, not all the rights are transferred, that would not be included in the definition of California gross receipts under -- what is it? -- 21609(b)(3)?

MR. RILEY: So I think, you know, one of the things that Mr. Fix mentioned was the California -- the tax form. The tax form is not -- that's not the law. Okay. So if it says something on the tax form, that's not a source of authoritative law. And I believe OTA has precedential opinions on the -- a tax form not being -- or the instructions to a tax form not be instructive. As far as the rents or -- I'm sorry. The three that you mentioned were?

JUDGE AKIN: I'm specifically wondering Franchise Tax Board's position with respect to gross receipts from the licensing of software, whether that would be included in the R&D gross receipts for California under 23609(h)(3).

MR. RILEY: Well, it would -- you know, the -- I think it would be it would depend. It would depend on an

actual examination of those items, you know. I think the rents and royalties, I think that part may be out. But I think generally, the licenses, you know, generally licenses may be out. But there is a -- the word generally does not completely foreclose them being included.

And I guess the -- with respect to the intangible software itself, you know, when there are courts out there saying, hey, the things that you did, you produce both tangible and intangible articles, and you sell these products, the complete ownership of it, transferred to customers, including usage and copyrights of it, that certainly sounds like the Court is saying that this is a sale of these software articles.

And so whether or not Appellant has included it for the purposes of its Exhibit 97 in this appeal, you know, I can't -- I can't speak to the -- the, you know, whether or not they chose to include those. But it certainly seems like there are sources saying that we can differentiate between the, you know, software licenses, or we can differentiate between your services and the software, and we kind of -- we know what a sale is. And so when you're transferring that complete ownership, that's like a sale. So.

JUDGE AKIN: Understood. That does answer my question, and I do think I'm done at this point hopefully.

Thank you.

JUDGE HOSEY: Okay. Thank you.

Since we had some questions and each party has some remaining time for their presentations, would the parties like some time for a closing statement before we finish up today? I can --

Mr. Fix?

MR. FIX: I reserve that time.

JUDGE HOSEY: Okay. Mr. Riley, would you like to make a final statement?

MR. RILEY: Sure.

JUDGE HOSEY: Okay. Go ahead. Thank you.

CLOSING STATEMENT

MR. RILEY: Appellant has a tough sell here. The law in this case was written by the California State Legislature, and the law was upheld by the California Supreme Court in 2006. So the Supreme Court really has done the heavy living with GM versus Franchise Tax Board. The Court said that California State Legislature knew what it was doing.

The legislature knew what it was doing when it used the term "property" in 23609(h)(3) to include whatever kind of property, tangible and intangible, and that the legislature knew what it was doing by not tying

Section 23609 to apportionment principles.

Mr. Fix stated that that their intangible property is included, but it doesn't seem to be reflected on their Exhibit 97. But to this point, their definition of property has been excluding intangible gross receipts. GM versus FTB is a 2006 case. In the 17 years since the California Supreme Court decided the case, the legislature has not come back and said to the Supreme Court hey, you guys were wrong, Supreme Court.

And in light of this, Appellant is arguing that the legislature, I mean, essentially doesn't know what it's doing and that the Supreme Court doesn't know either. And that's a tough sale based on what we confidently know with the crystal-clear Supreme Court ruling and the legislature's plain language. So neither 23609(h)(3) definition of gross receipts nor 26309(c)(2) qualified research are tied to apportionment principles.

Property is a broad and inclusive definition of 23609(h)(3) gross receipts. QREs must occur within California, and they cannot be based on apportionment because that would be absurd in the words of the Supreme Court. The documents from the USPTO, the SEC, the IRS, the Department of Labor, the Court of International Trade, and their own contracts demonstrate that Appellant sells software, new software, and maybe substantial amounts of

software.

In a tax credit case, it is Appellant's burden to prove entitlement. Appellant chose not to substantiate its intangible software gross receipts for California. Appellant is left with unsubstantiated gross receipts and cannot make a calculation of its fixed-base percentage, average annual gross receipts, or its base amount. Appellant cannot use apportioned expenses in California. Appellant is not entitled to the California research credit, and Respondent's determination should be sustained.

Thank you.

JUDGE HOSEY: Thank you, Mr. Riley.

Mr. Fix.

MR. FIX: Thank you. I'll keep it short.

FURTHER CLOSING STATEMENT

MR. FIX: The bottom line is we have met our burden. We have substantiated, despite what the FTB would hope, we have actually provided documentation and evidence that's in the record. It's been corroborated by someone from the company with over 35 years of experience with actual reliable data and business records from those years.

And so we -- any sales of software would be

included in Exhibit 97, including for the Unigraphs [sic]. And so we've substantiated our gross receipts from sales of property, including sales of software to the extent that we had some and specifically in California. All that FTB has provided on the other hand is mere speculation, anecdotes. No numbers were provided. No actual, you know, evidence to prove that we had a certain amount of receipts that were included already.

And so given the fact that we've established our gross receipts, our AGRs, we are entitled to fixed-base percentage. And that gives you a menu of outcomes. The menu of outcomes is you either only provide us with the, you know, R&D credits resulting from QREs that the FTB has already agreed to, or you also allow us for additional actual, not estimated QREs from '04 and '05. And then finally, you have to make a decision whether or not the Cohan Rule is alive and well in California, and we think it is.

Thank you.

JUDGE HOSEY: Thank you.

Okay. I think we're ready to submit the case. Evidence has been admitted into the record, and we have the arguments and your briefs, as well as the oral arguments presented today. We now have a complete record from which to base our decision, and we're ready to submit

the case.

The record is now closed. This concludes the hearing for this appeal. The parties should expect our written opinion no later than 100 days from today.

With that, we're off the record, and the hearings are concluded for the day. Thank you, everybody, for your time on this.

(Proceedings adjourned at 2:25 p.m.)

HEARING REPORTER'S CERTIFICATE

I, Ernalyn M. Alonzo, Hearing Reporter in and for the State of California, do hereby certify:

That the foregoing transcript of proceedings was taken before me at the time and place set forth, that the testimony and proceedings were reported stenographically by me and later transcribed by computer-aided transcription under my direction and supervision, that the foregoing is a true record of the testimony and proceedings taken at that time.

I further certify that I am in no way interested in the outcome of said action.

I have hereunto subscribed my name this 19th day of July, 2023.

_____
ERNALYN M. ALONZO
HEARING REPORTER