OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of: **ELECTRONIC DATA SYSTEMS CORPORATION & SUBSIDIARIES**	OTA Case Nos. 19014166, 19125644, 22039829

OPINION

Representing the Parties:

For Appellant:	Yoni Fix, Attorney Lee Zoeller, Attorney Timothy Lee, Attorney
For Respondent:	Jason Riley, Attorney Ellen Swain, Attorney
For Office of Tax Appeals:	Grant S. Thompson, Attorney

S. HOSEY, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) sections 19324 and 19331, Electronic Data Systems Corporation & Subsidiaries (appellant) appeals actions by respondent Franchise Tax Board (FTB) denying its claims for refund for tax years 2003 through 2008.[1]

Office of Tax Appeals (OTA) Administrative Law Judges Sara A. Hosey, Cheryl L. Akin, and Josh Lambert held an oral hearing for this matter in Sacramento, California, on June 14, 2023. At the conclusion of the hearing, the record was closed, and this matter was submitted for decision.

[1] Appellant claimed refunds totaling $35,277,616, consisting of $20,800 for the 2003 tax year; $3,151,075 for the 2004 tax year; $5,174,624 for the 2005 tax year; $5,596,361 for the 2006 tax year; $8,012,409 for the 2007 tax year; $10,000,523 for the tax year ending August 26, 2008; and $3,321,824 for the tax year ending August 28, 2008. The two 2008 short-tax years arose because appellant was acquired by Hewlett-Packard Company on August 26, 2008, and, following the acquisition, appellant converted into a limited liability company that was treated as a disregarded entity for tax purposes.

ISSUES

1. For the 2003 and 2004 tax years, whether OTA lacks jurisdiction to rule on appellant's argument that it is entitled to the regular California research credit for increasing research activities under Internal Revenue Code (IRC) section 41(a), as modified by R&TC section 23609.[2]
2. To the extent OTA has jurisdiction to rule on appellant's argument that it is entitled to the regular research credit, whether appellant has shown that it is entitled to the regular California research credit under IRC section 41(a).[3]
3. Whether the enterprise zone (EZ) credit statute should be interpreted, or whether R&TC section 25137 should be applied to the EZ credit statute, to allow appellant's claim for refund which applies EZ credits against income earned in a single, collective zone for purposes of computing the credit limitation.

FACTUAL FINDINGS – ISSUE 1

Procedural History – Timeline and Overview[4]

1. Appellant timely filed California tax returns for tax years 2003 and 2004 claiming the regular California research credit under IRC section 41(a). FTB audited the returns and allowed research credits of $615,722 and $666,376 for the 2003 and 2004 tax years, respectively.
2. Appellant timely filed California tax returns for tax years 2005 through 2008 without claiming any California research credits.

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[2] For the tax years at issue, IRC section 41(a)(1) addresses the regular research credit, while IRC section 41(c)(4) provides an opportunity for taxpayers to elect the alternative incremental research credit. California law modifies IRC section 41 by, among other things, only providing a credit for research conducted in California (R&TC, § 23609(c)(2)) and providing that the taxpayer's gross receipts for purposes of the research credit only include gross receipts "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 a purchaser within [California] . . ." (R&TC, § 23609(h)(3)).

[3] This issue includes eight separate issues identified by the parties in their Joint Statement of Issues dated May 18, 2023, under the headings "Issues Involving Qualified Research Expenses (QREs)" and "Issues Involving Gross Receipts."

[4] This section of the factual findings is intended to provide a brief overview and timeline of the procedural history of this consolidated appeal. The relevant documents initially mentioned in this section, such as appellant's three different refund claims for the tax years at issue, will be addressed in additional detail in the factual findings presented below.

3. In 2011, appellant filed refund claims for tax years 2005 and 2006 seeking California research credits (the 2011 refund claims). The 2011 refund claims did not specify whether appellant was seeking the regular research credit under IRC section 41(a), or the alternative incremental credit (AIC) under IRC section 41(c)(4).
4. In 2012, appellant filed refund claims for the 2003, 2004, and 2007 tax years, and the short tax years ending August 26, 2008, and August 29, 2008 (2008 tax years), and supplemented its prior 2011 refund claims for the 2005 and 2006 tax years (the 2012 refund claims). The 2012 refund claims request refunds for research credits based on the AIC, as well as EZ credits.
5. In 2018, FTB denied appellant's 2011 and 2012 claims for refunds for the 2003 to 2008 tax years. Appellant appealed this denial to OTA, and briefing commenced in December 2018.
6. In 2020, during the pendency of this appeal, appellant filed further supplemental claims for refund with FTB for the 2005 to 2008 tax years seeking the regular research credit and EZ credits (the 2020 refund claims).[5] The 2020 refund claims also raise 30 additional broadly stated grounds for refunds.[6]
7. In 2022, appellant deemed its 2020 refund claims denied,[7] appealed the deemed denial to OTA, and requested that the appeal be consolidated with its other appeals. OTA granted appellant's request and postponed the previously scheduled hearing to allow for briefing on the 2020 refund claims.

Appellant's 2011 Refund Claims (2005 and 2006 Tax Years)

8. On April 25, 2011, appellant filed a claim for refund of $5,174,624 for the 2005 tax year, and, on October 14, 2011, appellant filed a claim for refund of $5,596,361 for the 2006

[5] The 2020 refund claims did not include the 2003 and 2004 tax years as the statute of limitations for these tax years had expired.

[6] For example, the claims argue that appellant's income must be adjusted because it "is entitled to exclude from income certain 'gains' that do not reflect economic gains[,]" and its apportionment factors must be adjusted because, "(among other) reasons," it "is entitled to properly compute its sales factor." In addition, the claims argue that the California tax imposed on it violates "the state and federal constitutions and must be recomputed." Appellant has not provided evidence or argument to support these additional stated grounds for its refund claims and OTA will not address them further in this Opinion.

[7] If FTB fails to act on a claim for refund within six months after a taxpayer files the claim with FTB, the taxpayer may consider the claim disallowed and file an appeal with OTA. (R&TC, § 19331.)

tax year, for a total of $10,770,985 in claimed refunds for the 2005 and 2006 tax years. Both claims for refund state that the refunds were claimed "on the basis that [appellant] generated (and could utilize) research and development credits . . . in the tax year covered by this claim," and that appellant "will supplement this claim with further analysis and evidence at a later date." Neither claim for refund included any amended tax returns, schedules, or calculations explaining the research credit amounts or how appellant determined the claim for refund amounts.

FTB's Legal Division Guidance Issued on March 1, 2012

9. On March 1, 2012, FTB issued Legal Division Guidance 2012-03-01 (LDG 2012-03-01). As relevant to this appeal, it states that a taxpayer with California qualified research expenses (QREs) but no California gross receipts under R&TC section 23609(h)(3) may claim the regular research credit.[8]

Appellant's 2012 Refund Claims (2003 to 2008 Tax Years)

10. On June 28, 2012, appellant submitted a letter claiming additional refunds.[9]
    a. For the 2003 and 2004 tax years, and the 2007 and 2008 tax years, the letter claimed refunds totaling $24,506,631, consisting of the following amounts: $20,800 for the 2003 tax year; $3,151,075 for the 2004 tax year; $8,012,409 for the 2007 tax year; $10,000,523 for the tax year ending August 26, 2008; and $3,321,824 for the tax year ending August 29, 2008.
    b. The letter noted the prior 2011 refund claims for the 2005 and 2006 tax years and stated that, in addition to serving as a claim for refund for the 2003, 2004, 2007, and 2008 tax years, the letter "consolidates into one document the discussion in the prior claims for refund with the additional discussion and support presented in the instant claim for refund." The sum of the refunds claimed in the 2012 refund claims is $35,227,616 (the $24,506,631 total refund requested for the 2003, 2004, 2007, and

[8] This document can be found at https://www.ftb.ca.gov/tax-pros/law/legal-division-guidance/2012-03-01.pdf. Prior to the issuance of LDG 2012-03-01, it was unclear whether a taxpayer with no California gross receipts under R&TC section 23609(h)(3) could take the regular research credit.

[9] It is undisputed that the refund claim was timely filed.

2008 tax years, plus the $10,770,985 total refund requested for the 2005 and 2006 tax years).

c. The letter stated: "[i]n general, the grounds for these claims are that [appellant] generated (and could utilize) research and development credits and [EZ] credits during the [2003 to 2008 tax years]." Then, under the heading "Research and Development Credit", the letter further stated: "[a]lthough the default method of calculating the credit is via the regular research credit calculation, a taxpayer may elect to claim the [AIC]." The letter then described the calculation of the AIC and noted that, for the 2003 and 2004 tax years, appellant previously claimed the regular research credit, and for the 2005 through 2008 tax years appellant did not previously claim the California research credit. It stated that appellant "is entitled to make an election to use the AIC, and [appellant] does so elect beginning with 2003."

d. Attached to the letter are schedules showing appellant's claimed AIC amounts. The schedules report a total of $8,325,117 of AIC for the 2003 to 2008 tax years, consisting of: $1,471,459 for the 2003 tax year; $2,004,807 for the 2004 tax year; $1,096,957 for the 2005 tax year; $1,502,197 for the 2006 tax year; $1,411,184 for the 2007 tax year; $812,701 for the tax year ending August 26, 2008; and $25,812 for the tax year ending August 29, 2008.[10]

FTB's Examination and Denial of the 2011 and 2012 Refund Claims

11. On September 17, 2013, FTB issued Information Document Request (IDR) 1 for tax years 2005 to 2008, requesting information concerning the status of the IRS audit.

12. On this same date, FTB also issued IDR 3, for the 2005 to 2008 tax years.[11] IDR 3 requested, among other things: schedules showing the amount of R&D credit carryovers from prior years, credits generated, credits utilized, and credits carried over to other tax years by entity and tax year (referred to as "lapsing schedules"); explanation and documentation to support the claimed California QREs by project, entity and location;

[10] These amounts do not reconcile to the claim for refund amounts which total $35,227,616 for the 2003 through 2008 tax years.

[11] IDR 2 related to appellant's EZ credit claims. As noted below, in IDR 4, FTB later requested information regarding the 2003 and 2004 tax years.

and workpapers and supporting documentation showing how appellant calculated its average annual gross receipts (AAGRs).[12]

13. On November 27, 2013, appellant responded to FTB's requests for information in IDRs 1 to 3.[13] With respect to the research credits, the letter stated that appellant provided: (1) a lapsing schedule; (2) an explanation of the methodology appellant used to compute its California QREs; (3) schedules computing appellant's claimed research wages; and (4) a schedule computing its AAGRs for the 2005 through 2008 tax years.[14]

14. On February 25, 2014, FTB reissued IDR 3 because appellant's November 27, 2013 response did not provide the requested information by project, entity, or location, or provide documentation to support the apportionment percentages used in appellant's calculation of AAGRs.[15]

15. On February 25, 2014, FTB also issued IDR 4 for the 2003 and 2004 tax years. IDR 4 requested essentially the same research credit information that IDR 3 requested for the 2005 to 2008 tax years, including research credit calculations by tax year and entity, an explanation and documentation to support claimed California QREs by project, entity, and location, and workpapers and documentation showing how appellant calculated its AAGRs.

16. On March 25, 2014, appellant responded to FTB's reissued IDR 3. Appellant's response: (1) identified the entities that generated the research credits for each tax year; (2) repeated

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[12] For the tax years at issue, both the regular research credit and the AIC require taxpayers to provide AAGRs of the taxpayer for the four tax years preceding the tax year for which the credit is being determined. (IRC, §§ 41(c)(1)(B) [as to the regular research credit], 41(c)(4)(A) [as to the AIC].) The former versions of the IRC section 41(c)(4)(A) in effect for appellant's 2003 through 2008 tax years provided that the AIC was to be computed based on specified percentages of the QREs for the tax year to the extent those QREs exceed specified percentages "of the average described in [IRC section 41](c)(1)(B)]" (i.e., the taxpayer's AAGRs for the four preceding tax years). IRC section 41(c)(4)(A) was subsequently modified such that the AIC is computed without reference to the taxpayer's AAGRs for the four preceding tax years.

[13] FTB's subsequently issued audit recommendation, dated September 16, 2015, states that appellant provided a partial response on December 5, 2013. However, no such response appears in the record.

[14] The lapsing schedule and wage schedules are not attached to the copy of appellant's response that is in the appeal record. The schedule computing appellant's AAGRs was included in the copy of appellant's response that is in the appeal record.

[15] Appellant's AAGR schedule provided with its November 27, 2013 response to FTB's IDRs indicated that appellant computed its California gross receipts for research credit purposes by multiplying its total net gross receipts for each year by its California apportionment percentage for that year.

its general explanation of the methodology it used to compute its California QREs; (3) stated that appellant provided schedules computing its California research wages for the 2006 and 2008 tax years; (4) referred FTB to appellant's prior AAGR calculations; and (5) indicated that appellant provided workpapers showing how appellant computed the apportionment percentages it used for its AAGR calculations.[16]

17. On May 9, 2014, appellant responded to IDR 4. In its response, appellant: (1) directed FTB to the lapsing schedule appellant previously provided with its November 27, 2013 letter, which covered tax years 1996 through 2008; (2) provided general explanations of the methodologies appellant used to compute its 2003 and 2004 California QREs; (3) stated that appellant provided schedules with its California QRE computations for the 2003 and 2004 tax years; and (4) stated that appellant was providing a schedule computing its AAGRs for the 2003 and 2004 tax years.[17]

18. On June 16, 2015, FTB issued a protest determination letter for the 1996 to 2004 tax years. As to appellant's attempt to elect the AIC, the letter states that such an election must be made on the taxpayer's original tax returns, which appellant failed to do. Therefore, the letter states that appellant cannot take advantage of the AIC.

19. On September 16, 2015, FTB issued an audit recommendation for the 2003 to 2008 tax years recommending the disallowance of appellant's claims for refund. Among other things, the audit recommendation stated as follows:

    a. While appellant claimed refunds totaling $35,277,616 for the 2003 to 2008 tax years, appellant's calculation of research credits for those years totaled only $8,325,117.

    b. Elections to claim research credits under the AIC method must be made on the taxpayer's original tax return and appellant failed to make such an election on its original tax returns.

    c. Appellant's method of calculating California QREs is "questionable" because it used estimates rather than actual amounts. For example, FTB noted that appellant claimed

[16] The wage schedules for appellant's 2006 and 2008 tax years are not attached to the copy of appellant's response that is in the appeal record. The workpapers reflecting appellant's computation of its apportionment percentages were included in the copy of appellant's response that is in the appeal record.

[17] The lapsing schedule and QRE computation schedules are not attached to the copy of appellant's response that is in the appeal record. The schedule computing appellant's AAGRs was included in the copy of appellant's response that is in the appeal record.

California research payroll of $8,907,482 for the tax year ending August 29, 2008, but its tax return reported only $2,433,530 in California wages for that year.

20. On September 11, 2018, FTB issued a notice denying appellant's claims for refund for the 2003 to 2008 tax years.

21. On December 10, 2018, appellant appealed FTB's notice denying its refund claims. Appellant does not state in the appeal letter that it is claiming the regular research credit.

22. On May 22, 2019, appellant filed its supplemental opening brief.[18] In its supplemental opening brief, appellant states it is no longer arguing that it is entitled to the AIC; rather, appellant argues that it is entitled to the regular research credit, as supported by the federal audit.

Appellant's 2020 Refund Claims (2005 to 2008 Tax Years)

23. On September 29, 2020, appellant filed what it describes as "supplemental" refund claims for the 2005 to 2008 tax years seeking total refunds of $32,105,741, consisting of the following amounts: $5,174,624 for the 2005 tax year; $5,596,361 for the 2006 tax year; $8,012,409 for the 2007 tax year; $10,000,523 for the tax year ending August 26, 2008; and $3,321,824 for the tax year ending August 29, 2008. As to the California research credits, the claims state, "[Appellant] generated, and could utilize, California [research] credits computed using the regular credit method ....."

24. On February 25, 2022, appellant appealed FTB's deemed denial of its 2020 refund claims pursuant to R&TC section 19331 and requested that the appeal be consolidated with its other appeals. OTA granted appellant's request.

[18] The brief was timely filed due to OTA granting extension requests.

DISCUSSION

Issue 1: For the 2003 and 2004 tax years, whether OTA lacks jurisdiction to rule on appellant's argument that it is entitled to the regular California research credit under IRC section 41(a)(1), as modified by R&TC section 23609.

Contentions

FTB argues that since appellant's 2011 and 2012 refund claims are based on the AIC, OTA cannot consider appellant's appeal argument that it is entitled to the regular California research credits, citing *Shiseido Cosmetics (America) v. Franchise Tax Bd.* (1991) 235 Cal.App.3d 478 (*Shiseido*) and other cases. In response, appellant notes that the scope of a taxpayer's refund claim is to be liberally construed, citing *J.H. McKnight Ranch, Inc. v. Franchise Tax Bd.* (2003) 110 Cal.App.4th 978 (*McKnight*) and other cases, and contends that its appeal arguments merely change the relevant mathematical computations rather than requiring new evidence.

FTB initially argued that OTA did not have jurisdiction to consider appellant's claims for refund based on the regular research credit for any of the tax years at issue in this appeal. However, at the time FTB made this argument, appellant had not filed its 2020 claims for refund for the 2005 through 2008 tax years seeking the regular research credit, or appealed the deemed denial of these claims for refund. Per the joint statement of issues submitted by the parties on May 18, 2023, the parties now agree that OTA has jurisdiction to consider appellant's refund claims based on the regular research credit for the 2005 through 2008 tax years because of appellant's subsequently filed appeal on February 25, 2022, in which appellant deemed denied its 2020 refund claims. As a result, only the 2003 and 2004 tax years, which were not included in the 2020 refund claims due to the expiration of the statute of limitations, remain at issue here.

Legal Background

R&TC section 19322 provides that every claim for refund "shall state the specific grounds upon which it is founded." California Code of Regulations, title 18, section 19322(a) states as follows:

> No refund or credit will be allowed after the expiration of the statutory period of limitation applicable to the filing of a claim therefor except upon one or more of the grounds set forth in a claim filed before the expiration of such period. (See [R&TC sections 19306-19314].) The claim must set forth

> in detail each ground upon which a refund or credit is claimed and facts sufficient to apprise [FTB] of the exact basis thereof. . . .

If FTB issues a notice denying a claim for refund or fails to act on a claim for refund within six months after the claim is filed with it, the taxpayer may file an appeal with OTA. (R&TC, §§ 19324(a), 19331; Cal. Code Regs., tit. 18, § (a)(4).)

In *McKnight*, the court found that the purpose of these statutory requirements "is to ensure that [FTB] receives sufficient notice of the claim and its basis" such that FTB "has an opportunity to correct any mistakes." (*McKnight*, *supra*, at p. 986.) *McKnight* noted that, if FTB has actual notice of the taxpayer's arguments from any source while considering a claim for refund, "it has the opportunity to reevaluate its position, reach the correct result, and obviate the need for a subsequent lawsuit." (*Id*. at pp. 986-987.) The *McKnight* court also noted that, in *Wallace Berrie & Co. v. State Bd. of Equalization* (1985) 40 Cal.3d 60 (*Wallace Berrie*), the California Supreme Court found that while the taxpayer had not expressly challenged a regulation in its refund claim, it "indirectly" challenged the regulation and whether the tax agency's conduct demonstrated that it was aware of the issue; therefore, the California Supreme Court found that the taxpayer in *Wallace Berrie* was not barred from raising the issue in its refund suit.[19] (*McKnight*, *supra*, at p. 987.) The *McKnight* court further noted that in *Jimmy Swaggart Ministries v. State Bd. of Equalization* (1988) 204 Cal.App.3d 1269 (*Swaggart*), the court "looked beyond" the initial refund claim to determine whether the tax agency had notice of the ground for refund. (*Ibid*.)

Based on *Wallace Berrie* and *Swaggart*, the *McKnight* court found that "exhaustion [of administrative remedies] hinges on actual notice, not the precise language of the initial refund claim . . . ." (*McKnight*, *supra*, at p. 988.) It further found that this conclusion "comports with longstanding policy" that courts "liberally construe" refund claims and that the purpose of the refund requirements is achieved if the tax agency "may know from said application 'or have some reasonable means of ascertaining' therefrom what the claim of the applicant is" so that it may be investigated. (*Ibid*.) Based on these standards, the court in *McKnight* reviewed the record and found that, "[i]n the course of processing the refund claim, [FTB] received notice of

[19] *Wallace Berrie* addressed the issue in a footnote, in which it also noted that the tax agency did not raise the alleged jurisdictional issue at trial. (*Wallace Berrie*, *supra*, at p. 66, fn. 2.)

the relevant facts surrounding the claim and notice of a legal doctrine under which, indisputably, McKnight owed no tax." (*McKnight*, *supra*, at p. 990.)

Under *McKnight*, the legal question is whether appellant's refund claims, or other information provided to FTB during its consideration of those refund claims, provided sufficient notice to FTB that appellant was seeking the regular research credit such that FTB had "an opportunity to correct any mistakes, thereby conserving judicial resources." (See *McKnight*, *supra*, at p. 986.) In evaluating this issue, OTA is mindful of *McKnight*'s statement that refund claims are to be construed liberally. (*Id.*, at p. 988.) *McKnight* explains that, in evaluating the scope of a refund claim, one is not limited to the express terms of the refund claim; rather, one must also consider whether other facts and circumstances exist which may have put FTB on notice of the scope of, and grounds for, the refund claim. (See *McKnight*, *supra*, at pp. 986-990.)

Both *Swaggart*, *supra*, and *Appeal of Beneficial California, Inc.* (96-SBE-001) 1996 WL 248826 (*Beneficial California*) address factual situations in which the scope of the taxpayer's refund claim was at issue. In *Swaggart*, the taxpayer argued that taxing its religious materials would interfere with the free exercise of religion and violate the First Amendment. Then, during court litigation, the taxpayer argued that it was entitled to a refund because it was not engaged in business in the state and did not have sufficient nexus to California to be taxed without violating the Commerce Clause. When the tax agency protested that this refund ground was not stated in the taxpayer's refund claim, the taxpayer argued that its statement in its refund claim that "California cannot constitutionally impose a sales tax" was sufficient to put the tax agency on notice that it was raising all constitutional issues. (*Swaggart*, *supra*, at p. 1291.) The court rejected the taxpayer's argument.

The *Swaggart* court held that the taxpayer's general denial of tax liability, and the statement that "California cannot constitutionally impose a sales tax," were not sufficient to put the tax agency on notice that it was raising nexus and Commerce Clause issues. (*Swaggart*, *supra*, at p. 1291.) The court explained that the relevant statutory language required that every refund claim state "the specific grounds" upon which it is based.[20] (*Id*. at p. 1292.) The court then noted that in the refund claim, appellant only specified the First Amendment constitutional ground, and no other constitutional grounds were stated. (*Ibid*.) As the applicable statute

[20] The tax refund statute that applies here is similar in that it also requires a statement of the "specific grounds" for the refund claim. (R&TC, § 19322.)

required that the refund claim state the "the specific grounds" upon which it was based, the court found that the refund claim's general statement that "California cannot constitutionally impose a sales tax" was not sufficient to raise the specific ground that the taxpayer was entitled to a refund based on lack of sufficient nexus under the Commerce Clause. (*Id.* at p. 1291.)

As *McKnight* observed, *Swaggart* did not limit its examination to the text of the taxpayer's refund claim; rather, it also considered whether the specific issues raised by the taxpayer were raised before the tax agency. However, the court found no evidence that the taxpayer had raised these specific grounds with the tax agency, noting that the hearing officer stated that the taxpayer's counsel "does not argue nexus." (*Swaggart*, *supra*, at p. 1292.)

In *Beneficial California*, the taxpayer's refund claim stated that, based on a recent court decision, it filed the refund claim "on a domestic 'water's edge' basis to protect [its] rights in the event that worldwide combined reporting becomes [u]nconstitutional on judicial review of [the] case." (*Beneficial California*, *supra*, at p. *1.) Then, on appeal, and after the courts rejected the argument that worldwide combined reporting was unconstitutional, the taxpayer argued that application of California's method of worldwide combined reporting was distortive, and that the taxpayer lacked unity with its affiliates. Since the taxpayer did not raise the distortion and unity issues in its claim for refund, they were found to be time-barred. (*Ibid*.)

These legal authorities establish some key principles. First, a taxpayer's refund claim must state the "specific grounds" upon which it is based. (R&TC, § 19322; see also *Swaggart*, *supra*, and *Beneficial California*, *supra*.) Second, the purpose of the claim for refund statutes is to ensure that the tax agency has sufficient notice so that it can consider the refund ground and correct any mistakes. (*McKnight*, *supra*, 110 Cal.App.4th, at p. 986.) Third, refund claims are to be construed liberally and the taxpayer may establish that the tax agency had notice of the grounds for the refund claim through facts outside the refund claim, such as the agency or the taxpayer's actions or conduct during the time the tax agency was considering the refund claim. (*Ibid*.) OTA evaluates appellant's refund claims with these principles in mind.

The Scope of Appellant's 2012 Refund Claims[21]

As noted previously, appellant's 2012 refund claims state that: "[i]n general, the grounds for these claims are that [appellant] generated (and could utilize) research and development credits and [EZ] credits during the [2003 to 2008 tax years]." Then, under the heading "Research and Development Credit," the refund claims explain appellant's specific grounds for claiming the research credit. The claims state: "[a]lthough the default method of calculating the credit is via the regular research credit calculation, a taxpayer may elect to claim the [AIC]." Appellant describes the calculation of the AIC and notes that, for the 2003 and 2004 tax years, appellant previously claimed the regular research credit. The refund claims then state that appellant "is entitled to make an election to use the AIC, and [appellant] does so elect beginning in 2003." Finally, the refund claims attach schedules showing appellant's calculation of its claimed AIC.

In sum, the refund claims state that appellant is electing to claim the AIC rather than the regular research credit, and then provide calculations showing the amount of AIC appellant claimed. At no point do the refund claims state that appellant is seeking the regular research credit. Even if one views the refund claims liberally, they give no indication that appellant is seeking the regular research credit.

Appellant points to the claims' statement that the general grounds for the refund claims are that appellant was entitled to research credits (and EZ credits). Appellant argues that this statement was sufficient to put FTB on notice that appellant was seeking research credits. However, that is not the issue. It is uncontested that FTB was aware that appellant was claiming research credits. The issue is whether appellant's refund claims, or other facts and circumstances, put FTB on notice that appellant was seeking the regular research credit as opposed to the AIC.

Moreover, appellant's argument relies on one sentence of the refund claims while disregarding the entirety of the claims' discussion of the specific grounds for the claims. OTA

[21] OTA only considers the 2012 refund claims here because FTB concedes that OTA has jurisdiction over appellant's argument that it is entitled to the regular research credit for the 2005 through 2008 tax years. Appellant's 2011 refund claims related to appellant's 2005 and 2006 tax years only, which have been conceded by FTB. Because appellant's refund claims for the 2003 and 2004 tax years were only included in the 2012 refund claims, only the 2012 refund claims are relevant to the analysis here.

finds that when reading the refund claims' explanation of the basis for appellant's research credit claims, it is clear that appellant is seeking the AIC, rather than the regular research credit.

Appellant's general statement that it is entitled to research credits, which was followed by specific grounds explaining it was seeking the AIC, did not put FTB on notice that it was seeking the regular research credit. In this respect, this appeal is similar to *Swaggart*, *supra*, as the taxpayer in *Swaggart* also argued that a broad legal ground followed by specific grounds included additional specific grounds which were not originally stated in the refund claim. However, appellant's argument is weaker than the taxpayer's argument in *Swaggart* because the additional grounds that the taxpayer sought to raise in *Swaggart* were at least consistent with its original specific grounds. A taxpayer can concurrently argue both that taxing religious materials violated the free exercise of religion and the First Amendment, and also that the taxpayer did not have sufficient nexus to California to be taxed in California without violating the Commerce Clause. However, a taxpayer cannot concurrently argue that it is entitled to both the AIC and the regular research credit in the same tax year. (Treas. Reg. § 1.41-8(b).) Therefore, OTA finds that appellant's argument is inconsistent with the specific grounds stated in its refund claims.[22]

Nothing in the record suggests that during its evaluation of appellant's refund claims for the 2003 and 2004 tax years, FTB had reason to think appellant was seeking the regular research credit. Moreover, OTA finds that nothing in the record suggests that appellant was seeking the regular research credit. For more than six years, appellant and FTB exchanged correspondence, information, and arguments concerning appellant's refund claims. None of the correspondence or other materials indicates that appellant was seeking the regular research credit. During 2014 and 2015, FTB issued three IDRs seeking information and documents to support appellant's claims for refund. None of the IDRs request information that is needed to calculate the regular research credit but not needed to calculate the AIC.

Unlike the AIC, the regular research credit generally requires the calculation of the taxpayer's QREs and gross receipts during a base period. (IRC, §§ 41(a)(1)(B), 41(c)(1)-(3).) If appellant wished to obtain the regular research credit, it would have provided FTB with its

[22] As appellant correctly notes, *McKnight*, *supra*, explains that FTB may receive actual notice of the grounds for a refund claim "from sources other than the four corners of the initial claim." (*McKnight*, *supra*, at p. 987.) Therefore, OTA does not restrict its analysis to the language of the refund claims. OTA also considers whether FTB otherwise had actual notice that appellant was seeking the regular research credit during the time it was considering appellant's refund claims for the 2003 and 2004 tax years.

regular research credit calculations,[23] as well as provided evidence or argument as to the calculation of QREs and gross receipts during its base period or explain why appellant believed this requirement did not apply. Appellant did not. Similarly, if FTB thought appellant was seeking the regular research credit, it would have requested information regarding appellant's base period. FTB did not. The absence of any such correspondence between FTB and appellant suggests that FTB did not believe appellant was seeking the regular research credit and, moreover, that appellant was not claiming the regular research credit at that point in time.

Also, if appellant was seeking the regular research credit, one would have expected appellant to raise the issue of whether it was entitled to the regular research credit when FTB notified it that it was not eligible for the AIC.[24] More than three years elapsed between the dates FTB notified appellant that it could not use the AIC and FTB issuing the claims for refund denials. If appellant had been seeking the regular research credit during this period, it would have responded by advising FTB that it was claiming the regular research credit and asking FTB to consider whether it was entitled to the credit. However, there is no such response in the appeal record.

Appellant argues that while it is true it "originally computed" its credit under the AIC, FTB rejected that computation; therefore, "the only plausible method left for [a]ppellant to use to compute the [research] credit was the default regular research credit [] method." However, FTB had no reason to be put on notice that appellant was seeking the regular research credit when appellant stated it was seeking the AIC.

Moreover, FTB had no reason to be on notice that appellant was entitled to the regular California research credit. From the information appellant provided to FTB, it was not self-evident that appellant would be entitled to any California research credit, because (among other things), FTB reasonably disputed whether appellant: incurred its claimed California QREs; accurately calculated its California gross receipts for purposes of the California research credit; and properly evaluated whether it was entitled to a research credit on an entity-by-entity basis.

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[23] Appellant only provided FTB with calculations of its claimed research credits under the AIC.

[24] Specifically, on June 16, 2015, FTB issued a protest determination letter stating that appellant could not take advantage of the AIC method because it failed to elect the AIC method on its original tax returns. The determination letter addressed several tax years, including the 2003 and 2004 tax years. Also, FTB's September 16, 2015 audit recommendation advised appellant that it was ineligible for the AIC because it failed to claim it on its original tax returns for the years at issue.

Contrary to appellant's contentions, the regular research credit is not merely a different mathematical computation method. Rather, the regular research credit has different substantive requirements in that, unless an exception applies, it generally considers the taxpayer's QREs and gross receipts during a prior base period, which is evidence that is not required for the AIC.[25]

However, while the general rule is that the taxpayer must provide QREs and gross receipts from a base period to obtain the regular research credit, there are potential exceptions. For example, in LDG 2012-03-01, FTB stated that taxpayers without California gross receipts could obtain the regular California research credit. On appeal, one of appellant's arguments is that it did not have to provide QREs and gross receipts from a base period because it had no California gross receipts under LDG 2012-03-01.[26]

This argument was not raised in appellant's refund claims and is inconsistent with appellant's representations to FTB during FTB's examination of those refund claims. During FTB's examination, appellant provided charts stating that it had hundreds of millions of dollars of California gross receipts during the years at issue. Therefore, based on the information provided by appellant, appellant was not eligible to take advantage of LDG 2012-03-01 because appellant had California gross receipts. As such, FTB had no reason to believe that appellant sought to apply LDG 2012-03-01 to obtain the regular research credit.

Moreover, LDG 2012-03-01 was issued months prior to appellant's filing of its 2012 refund claims,[27] and appellant did not raise it in those refund claims or during FTB's examination of the claims. Because appellant never raised LDG 2012-03-01, and because LDG 2012-03-01 has no application to a taxpayer with California gross receipts, such as appellant, FTB had no reason to think that LDG 2012-03-01 allowed appellant to claim the regular research credit without providing QREs and gross receipts from its 1984 to 1988 base period.

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[25] In addition, the regular research credit requires that the QREs taken into account for the base period be determined "on a basis consistent with the determination of [QREs] for the credit year." (IRC, § 41(c)(5)(A).)

[26] For purposes of the California research credit, California law provides that the taxpayer's gross receipts include only receipts "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 a purchaser within [California] . . . ." (R&TC, § 23609(h)(3).) For example, a taxpayer's gross receipts from a sale of services do not constitute gross receipts for purposes of the California research credit, even if the receipts qualified as gross receipts for purposes of the federal research credit. However, in LDG 2012-03-01, FTB stated that taxpayers without California gross receipts could obtain the regular California research credit.

[27] LDG 2012-03-01 was issued on March 1, 2013, and appellant's 2012 claims for refund were filed with FTB on June 28, 2012.

Appellant contends the issuance of LDG 2012-03-01 contributed to the "change in the computation" of its research credit during this appeal. However, appellant filed its appeal with OTA on December 10, 2018, and it did not argue that it was entitled to the regular research credit until it filed its supplemental opening brief on May 22, 2019, which is more than seven years after the issuance of LDG 2012-03-01. As such, it seems doubtful that appellant's appeal sought to change its legal position based on legal guidance that was issued before it filed its refund claims and more than seven years prior to its change in position.

Even if the change in appellant's position was prompted by LDG 2012-03-01, the change would not alter the scope of appellant's refund claim. In *Beneficial California*, *supra*, since subsequent court decisions undermined the original basis for the taxpayer's refund claim, the taxpayer argued that its refund claim also encompassed other legal theories that were not raised in its refund claim. Due to the subsequent court decisions, the taxpayer had every incentive to attempt to salvage its refund claim by arguing that the refund claim was broad enough to include legal theories other than those stated in the claim. However, *Beneficial California* found that the taxpayer's refund claim did not include the new theories that the taxpayer was advancing.

Like the taxpayer in *Beneficial California*, appellant seeks to salvage its refund claim by arguing that the claim encompassed a legal theory that was not stated in the original refund claims. However, OTA sees no basis to find that legal guidance issued prior to the filing of appellant's 2012 refund claims allows appellant to modify those claims more than seven years later, after FTB denied the claims. Moreover, appellant acknowledges that when it filed its 2012 claims, it had "no reason to mention LDG 2012-03-01 because the guidance relates to the [regular research credit] method." Thus, appellant concedes that it chose not to originally claim the regular research credit. Appellant only changed its position later, during appeal, after it apparently reevaluated whether it had California gross receipts and whether it might be entitled to claim the regular research credit.

Appellant also argues that it did not have to show its QREs and gross receipts from a base period because application of the maximum fixed-base percentage under IRC section 41(c)(3)(C) would entitle it to the regular California research credit. However, appellant did not raise this argument in its 2012 refund claims filled with FTB or during FTB's examination of its 2012 refund claims; therefore, FTB had no reason to believe that appellant was seeking the regular research credit on this ground or any other ground.

Appellant also asserts that the fact it provided FTB with its claimed AAGRs supports its argument that FTB had notice it was seeking the regular research credit. However, the AAGR information appellant provided is required for both the regular research credit and the AIC. (IRC, §§ 41(c)(1)(B) [as to the regular research credit], 41(c)(4)(A) [as to the AIC].) Therefore, appellant's provision of AAGR information was consistent with its claim for the AIC.

Appellant argues that since FTB acknowledged that it was aware appellant claimed the regular research credit on its 2003 tax return, FTB was aware that appellant was also seeking the regular research credit on its 2012 refund claims. However, appellant's 2012 refund claims advised FTB that, while appellant previously claimed the regular research credits on its original tax returns for 2003 and 2004, appellant was now claiming the AIC for all tax years beginning with the 2003 tax year. There is no indication in appellant's 2012 refund claims that, despite the refund claims stating that appellant is seeking the AIC, appellant was still pursuing the regular research credit that it claimed more than six years before when it filed its original 2003 tax return.

Appellant argues that *Wallace Berrie*, *supra*, supports its position.[28] However, as discussed previously, FTB's rejection of appellant's use of the AIC method did not put FTB on notice that appellant was seeking the regular research credit. There is no indication in the record that, prior to appeal, FTB believed or had notice that appellant's refund claims sought a refund based on the regular research credit.

Appellant also points to language in footnote 2 of *Wallace Berrie*, in which the court briefly addressed the scope of the taxpayer's refund claims and found that the taxpayer indirectly attacked the tax agency's regulation in its refund claims. (*Wallace Berry, supra*, 40 Cal.3d at p. 66, fn. 2.) In contrast, appellant's refund claims state appellant is claiming the AIC. Since a taxpayer cannot obtain both the AIC and the regular research credit in the same tax year, appellant's claim for the AIC is inconsistent with appellant purportedly also claiming the regular

[28] Appellant notes that *Wallace Berrie*, *supra*, found that, while the taxpayer did not challenge the validity of a regulation in its refund claim, the refund claim raised the issue indirectly. Appellant also notes that in *Wallace Berrie*, the tax agency dispelled any notion that it was unaware of the taxpayer's position that the regulation was invalid by arguing against the taxpayer's position that the regulation was invalid. It appears that appellant attempts to draw an analogy between the tax agency arguing against the taxpayer's position in *Wallace Berrie*, which showed that the tax agency was aware of the taxpayer's position that the regulation was invalid, and FTB's rejection of appellant's claim that it was entitled to the AIC. Additionally, appellant argues that FTB's action in rejecting appellant's claim for the AIC similarly put FTB on notice that "the only plausible method" for appellant to obtain research credits was the regular method.

research credit. Thus, appellant's refund claims did not indirectly seek the regular research credit.

Wallace Berrie also noted that the tax agency failed to raise the alleged jurisdictional issue at trial and instead simply addressed the merits of the taxpayer's argument that the regulation was invalid. (*Wallace Berrie*, *supra*, at p. 66, fn. 2.) *Wallace Berrie* therefore concluded that the tax agency was "well aware" that the taxpayer was challenging the regulation. (*Ibid*.) That is not the case here. FTB has consistently argued that appellant cannot claim the regular research credit because appellant did not claim the regular research credit in its refund claims. Therefore, *Wallace Berrie* does not support appellant's argument.

In summary, neither the text of appellant's refunds claims nor the subsequent conduct of FTB or appellant during the audit of these refund claims suggest that appellant was seeking the regular research credit. On the contrary, the record suggests that, prior to appeal, appellant was seeking the AIC, and FTB had no notice or reason to believe appellant was seeking the regular research credit. If appellant had claimed the regular research credit in its refund claims, or even during FTB's subsequent examination of those claims, FTB could have considered the issue at the initial administrative level before any further administrative appeal or court litigation. This is what is contemplated by California's refund statutes. (See *McKnight*, *supra*, 110 Cal.App.4th at pp. 986-987.) As appellant did not raise any of these arguments prior to appeal, OTA concludes appellant was not seeking the regular research credit and did not put FTB on notice that it was seeking the regular research credit.

Conclusion

Appellant's 2012 refund claims did not claim a refund based on the regular research credit; therefore, OTA does not have jurisdiction to consider appellant's regular research credit arguments for the 2003 and 2004 tax years based on the 2012 refund claims. Appellant indicates that it is no longer pursuing the AIC and, in any event, appellant cannot claim the AIC because it did not claim it on its original tax returns. (See Treas. Reg. § 1.41-8(b)(2).) Accordingly, appellant's 2012 refund claims do not entitle it to a refund of any research credits (regular or AIC) for the 2003 and 2004 tax years.

However, in 2020, appellant filed additional refund claims for the 2005 to 2008 tax years. Unlike appellant's 2012 refund claims, the 2020 refund claims claimed the regular research credit. As FTB did not act on the 2020 refund claims for six months, appellant deemed the

claims denied under R&TC section 19331 and appealed this deemed denial to OTA. FTB concedes that OTA has jurisdiction over the regular research credit issue for the 2005 through 2008 tax years as a result of appellant's February 25, 2022 appeal of the deemed denial of the 2020 refund claims. OTA therefore addresses below whether appellant has demonstrated that it is entitled to the regular California research credit based on its 2020 refund claims for the 2005 to 2008 tax years.

Issue 2: Whether appellant has shown it is entitled to the regular California research credit for the 2005 to 2008 tax years.

FACTUAL FINDINGS – ISSUE 2[29]

25. Appellant primarily provided information technology and business process outsourcing services.

IRS Examination

26. On June 23, 2008, appellant entered into a Research Credit Memorandum of Understanding (2008 MOU) with the IRS regarding its claimed federal research credits for the 2003 and 2004 tax years. Under the 2008 MOU, the IRS and appellant agreed to defer examination of appellant's research credits until appellant's next examination cycle, which included appellant's 2005 and 2006 tax years. The parties further agreed that the results of the next audit cycle would be "extrapolated for the purpose of calculating the adjustments to the research credits claimed for the [2003 and 2004 tax year] in which the cumulative research carry forward into the 2005 tax year will be revised accordingly."

27. On October 1, 2009, appellant and the IRS entered into a closing agreement (2009 Closing Agreement) as to appellant's research credit claims for the 2003 to 2006 tax years. The 2009 Closing Agreement states that, in order to minimize administrative burdens on the parties, appellant and the IRS agree that the IRS research credit examination for the 2003 to 2006 tax years would be "limited solely to the expenses incurred by [appellant] in its 2006 tax year that are attributable to [a six project sample]" and that the results of that review would be "extrapolated for the purpose of calculating

[29] Because OTA has already concluded that appellant is not entitled to research credits for the 2003 and 2004 tax years, these factual findings will focus on the documentation and evidence provided by the parties for the 2005 through 2008 tax years only.

the adjustments, if any, to the credits claimed by [appellant] under IRC [section] 41 for the [2003 to 2006 tax years]."

28. On September 24, 2010, the IRS issued a Notice of Proposed Adjustment and a Form 886A, Explanation of Items, (2010 IRS NPA/Revenue Agent Report) setting forth proposed adjustments to appellant's claimed research credits for the 2003 and 2004 tax years. The 2010 IRS NPA/Revenue Agent Report indicates the following:

    a. The IRS engineer examining the six sample projects for the 2006 tax year found that the research credit issue "was extremely difficult to examine, would continue to be time-intensive for the [IRS], and [appellant] was spending a tremendous amount of resources attempting to obtain the necessary documents."

    b. "Based on the current cycle analysis [referring to the 2005 and 2006 tax years] of the information provided, the Engineer determined that [appellant] was involved in qualifying research activities," and "[t]he question that needed to be determined was the amount of Credit that [appellant] was entitled to."

    c. The engineer estimated that "the allowance rate would be up to 45 [percent] of the claimed QRE's, equating to a 45 [percent] allowance of the [c]redit."

    d. Appellant's consultants estimated that, once it provided all its documentation, the documentation would support an allowance of between 57 percent and 77 percent. Appellant suggested that "for resolution purposes [it] would accept an allowance rate of 55 [percent]." While the IRS audit manager was inclined to accept this proposed allowance rate for the 2003 to 2008 tax years, there nevertheless was "concern that the acceptance could be construed as settling the case based on hazards of litigation, [and] it was decided to submit" the issue to the IRS Office of Appeals.[30]

    e. The parties agreed to allow 55 percent of appellant's claimed research credits for the 2003 and 2004 tax years, and the proposed resolution for the 2007 and 2008 tax years was forwarded to the IRS Office of Appeals.

29. According to federal account transcripts dated January 7, 2020, for a period of several years the IRS examined appellant's federal tax returns for the years at issue, and its examination of appellant's federal tax returns for 2007 and 2008 had not closed as of early 2020.

[30] The record does not include any documentation or correspondence from the IRS Office of Appeals.

30. On June 30, 2021, OTA asked appellant to clarify whether the IRS examination of its research credit claims, and any IRS appeal proceedings related to that examination, had closed. Appellant responded that the IRS concluded its examination on September 24, 2010, citing the 2010 IRS NPA/Revenue Agent Report and "a closing agreement where [appellant] agreed to reduce its federal QREs to 55 percent of the total claimed federal QREs)."[31]

Appellant's 2020 Refund Claims Seeking the Regular Research Credit

31. On September 29, 2020, appellant filed "supplemental" refund claims for the 2005 and 2008 tax years seeking total refunds of $32,105,741, consisting of refunds of $5,174,624 for the 2005 tax year; $5,596,361 for the 2006 tax year; $8,012,409 for the 2007 tax year; $10,000,523 for the tax year ending August 26, 2008; and $3,321,824 for the tax year ending August 29, 2008. With respect to the research credit, the claims state as follows:

> [Appellant] generated, and could utilize, California [research] credits computed using the regular credit method In computing its California [research] credits, only receipts from sales of tangible property count as receipts for purposes of computing the annual average gross receipts. *See* Cal. [R&TC section] 23609(h)(3). Also, [appellant] should be allowed to compute its California [research] credits using both: (1) actual California [QREs], and (2) reasonably estimated California QREs that have been computed based on available evidence when certain evidentiary support is not available for a portion of its California QREs under the *Cohan* rule. *See Cohan v. Commissioner*, 39 F.2d 540 (2d Cir. 1930) . . . .

Appellant's Claimed QREs for the 2005 through 2008 Tax Years

32. With its appeal, appellant provides a chart of its claimed California QREs. The chart reflects the total claimed California QREs (i.e., wages, supplies, and contract expenses) of $53,685,304 for the 2005 tax year; $73,786,769 for the 2006 tax year; $71,805,103 for the 2007 tax year; $46,863,177 for the tax year ending August 26, 2008; and $588,241 for the tax year ending August 28, 2008.

[31] The 2009 Closing Agreement only notes that appellant's allowable credit for the 2003 through 2006 tax years will be computed based on a sample of six projects from the 2006 tax year. It does not state that appellant and the IRS agreed to reduce the federal QREs to 55 percent of the total claimed federal QREs. No other close agreement is in the appeal record. However, the 2010 IRS NPA/Revenue Agent Report does indicate that the parties agreed to allow 55 percent of appellant's claimed research credit for the 2003 and 2004 tax years.

The Parties' Concessions on Appeal

33. In its supplemental opening brief appellant states, "For purposes of this appeal, [appellant] concedes the same 45 [percent] across-the-board QREs that it conceded in the [f]ederal audit." Appellant then provides revised computations of its California QREs computed by multiplying the above amounts by 55 percent.[32]

34. At the hearing and in the joint statement of issues dated May 18, 2023, FTB concedes and the parties agree that appellant "has substantiated $75,966,096 of California qualified wages" for the 2006 through 2008 tax years. This amount is equal to the reduced wages reported by appellant for the 2006 through 2008 tax years after application of appellant's 45 percent concession.[33]

Appellant's 2005 Wages[34]

35. For the 2005 tax year appellant provides the following explanation of how its federal wage QREs were determined:

> [Appellant] captured its QRE information for each [research] project by [financial identification (FID)] numbers. Employee wages, contract expenses, and supply expenses were tracked for each project by FID. For every FID, a survey was filled out at the end of the year by a financial consultant in which a detailed analysis of the project was prepared in order to determine whether the project consisted of qualified research activities and how much of the expenses incurred were QREs. These surveys identified the employees that incurred the time working on the [research] projects, their role on the [research] project, and the percentage of their time (calculated using man-months) that was associated with qualified research activities.[35]

[32] The IRS estimated, based on a review of six sample projects, that "up to" 45 percent of the claimed expenses for 2003 and 2004 were qualified; appellant countered with a higher estimated percentage; and then appellant and the IRS eventually agreed to use 55 percent to resolve the matter.

[33] Specifically, the $79,966,096 total wages conceded by FTB consists of: $28,134,545 for the 2006 tax year; $28,395,716 for the 2007 tax year; $19,194,894 for the tax year ending August 26, 2008; and $240,940 for the tax year ending August 29, 2008.

[34] Because OTA concluded that appellant is not entitled to California research credits for the 2003 and 2004 tax years in Issue 1 above, and FTB conceded the claimed research wages for the 2006 through 2008 tax years, only appellant's California research wages for 2005 remain at issue and will be discussed in these factual findings.

[35] The 2005 surveys completed by appellant's "financial consultant" are not in the appeal record. However, appellant does provide sample surveys from the 2006 tax year which are discussed in more detail below.

36. Appellant notes that "the method used to determine qualified wages in California for 2005 wages is substantially similar to the method used in 2004[,]" and provides an example for the 2004 tax year. The example notes that two research projects (Projects 1 and 2), tracked their expenses under FID number 2250100113, and notes that other projects which were not qualified research were also tracked in that FID. Appellant notes that it tracked the time spent by each of its employees on the research projects in that FID in man months. The total time spent on FID number 2250100113 was 222.74 "man-months." Of that time, 15 "man-months" were spent on Project 1 and 45 "man-months" were spent on Project 2. Appellant then notes that it recorded $1,002,981 of wages under that FID which was allocated to the two qualified projects based on the percentage of time spent on each project. 6.7343 percent (15 divided by 222.74) was allocated to Project 1 and 20.2029 percent (45 divided by 222.74) was allocated to Project 2. Thus, of the $1,002,981 total wages associated with the FID, $67,544 ($1,002,981 x 6.7343 percent) was allocated to Project 1, and $202,631 ($1,002,981 x 20.2029 percent) was allocated to Project 2.

37. Appellant then states that it computed its California research wages "based on actual California wage expenses" but that it "was not able to produce the detailed QRE by FID and by state for 2005." As support appellant provides a "2005 QRE by State" schedule. However, this schedule only indicates that appellant multiplied its total federal research wages of $488,642,912 by its California "GL Payroll Ratio" of 9.400779 percent to compute its California research wages of $45,936,240.

Appellant's 2005 Supplies and Contract Expenses

38. For the 2005 tax year, appellant provides the following explanation of how its federal and California supplies and contract expense QREs were determined:

> [Appellant] used estimated methods to determine the supply expenses and contract expenses that are qualified and that are attributable to California. . . . . [Appellant] allocated its purchases of supplies billed to FIDs to qualified projects based on the proportion of man-months associated with each project. Similarly, [appellant] estimated, based on the experience of its financial employee, the percentage of its contractor costs that were associated with each projects [sic] billed to that FID. On this basis, [appellant] determined its total qualified expense for supplies and contractors across the [U.S.]. [Appellant] then allocated those expenses to

> California in proportion to the total Form W-2 wage expense associated with that FID in each state.

39. Appellant's "2005 QREs by State" schedule indicates that appellant computed its California supplies and contract expenses for 2005 by multiplying its total federal research supplies and contract expenses of $3,249,405 and $79,180,606, respectively, by its California "GL Payroll Ratio" of 9.400779 percent, to compute California supplies and contract expenses of $305,469 and $7,443,594, respectively.

Appellant's 2006 through 2008 Supplies and Contract Expenses

40. For the 2006 through 2008 tax years, appellant provides the same general explanation of how it determined its federal supplies and contract expense QREs. Appellant notes that its supply and contract expenses were tracked by FID and "were not tracked by location."

41. Appellant explains that once its federal supplies and contract QREs were computed, it then allocated those expenses "to California by multiplying those expenses by the percentage of overall [research] wage expenses for [appellant] incurred in California. . . ."

42. Appellant provides a "Qualified Research Expenses by Legal Entity" schedule in which it computes California QRE ratios of 11.67 for the 2006 tax year, 9.36 for the 2007 tax year, 11.24 for the tax year ending August 26, 2008, and 11.24 for the tax year ending August 28, 2008, which appellant then applied to its total federal supplies and contract QREs each year to estimate its California amounts. These ratios were computed by dividing appellant's California qualified research wages for the applicable tax year by the total federal qualified research wages for that tax year.[36]

Documentation Provided by Appellant on Appeal to Support its QREs

43. Appellant provided documents it describes as workpapers for the tax years at issue.[37] For the 2005 and 2006 tax years, appellant provides "QREs by Project" schedules for each year, listing hundreds of projects for the 2005 and 2006 tax years, and the claimed federal QREs (wages, supplies, and contract expenses) for each project. For 2006, appellant also

[36] Appellant states that for the 2006 through 2008 tax years, it used Form W-2 information for each identified employee to determine if that employee worked in California.

[37] Appellant states that the documents were prepared at the end of each year. The record does not include evidence to corroborate this statement.

provides a "2006 QREs by Employee by State" schedule which lists the wages claimed for each employee and the state where each employee was located.

44. For 2007 and 2008, appellant provides "Qualified Wages by Employee Name and ID" schedules for each year listing the claimed federal research wages for each employee. Appellant also provides "Qualified Wages by Employee ID by State" schedules for each year listing where each employee was located. For 2008, appellant also provides a "Total QREs by FID" schedule listing the name for each FID and the total federal QREs claimed for each FID.

45. Appellant also provides six examples of its employee survey process.

    a. The survey documentation provided for these projects all relates to the 2006 tax year. The survey documentation includes project summaries and charts summarizing the project and stating that there were technical uncertainties, hypotheses, and processes of experimentation. The surveys appear to have been developed either at the end of the year or sometime after the conclusion of the projects. The surveys do not include any contemporaneous records from when the reported research activities were conducted, such as correspondence, contracts, drawings, or work plans. The surveys are not signed and are not dated, other than indicating the applicable tax year. The surveys do not indicate whether at least 80 percent of appellant's California research activities for each surveyed project/business component constituted a process of experimentation or whether the research activities were conducted in California.

    b. For one of the six projects, the survey indicates the work done was similar to prior work done by appellant and presented few technical challenges that appellant was unsure of how to resolve. However, other portions of the survey claim there were technical uncertainties requiring experimentation. One of appellant's employees completed the survey and determined that, for the vast majority of employees that worked on the project, 100 percent of their time on the project constituted qualified research activities.

46. Appellant provides a document indicating that "significant changes have been made to the 2006 survey process."

Appellant's California Research Gross Receipts and AAGRs

47. With its November 27, 2013 response to FTB's document requests, appellant provided a schedule showing appellant's calculation of its California research gross receipts and AAGRs, which appellant determined by multiplying its total net gross receipts for each year by its California apportionment factor for that year.
    a. The schedule reflects that appellant had net gross receipts ranging from $6.48 billion to $10.77 billion for the 2003 through 2008 tax years.
    b. The schedule computes the following California gross receipt amounts: $889,412,170 for the 2003 tax year; $1,231,676,985 for the 2004 tax year; $1,525,501,371 for the 2005 tax year; $937,374,089 for the 2006 tax year; $841,965,897 for the 2007 tax year; $685,586,996 for the tax year ending August 26, 2008; and $3,640,858 for the tax year ending August 28, 2008.
    c. The schedule then computes the following claimed AAGRs: $726,940,239 for the 2005 tax year; $1,016,169,503 for the 2006 tax year; $1,145,991,154 for the 2007 tax year; $1,159,129,585 for the tax year ending August 26, 2008; and $1,022,857,089 for the tax year ending August 28, 2008.
48. On appeal, appellant initially asserts that California gross receipts for research credit purposes only includes "receipts from the sale of tangible property" in California, and appellant as "a service provider" had no gross receipts from the sale of tangible property in California and "zero [California] AAGR[s] for purposes of computing the base amount."
49. Appellant later acknowledges that it had California gross receipts from the sale of property in California. Appellant provides a spreadsheet reporting, for the 2001 to 2007 tax year, and its first 2008 tax year (i.e., tax year ending August 26, 2008),[38] $56,905,869; $67,434,396; $12,059,663; $8,886,590; $20,012,568; $19,411,506; $8,302,784; and $6,998,607, respectively, in "Total Potential Receipts from Sales of Property in [California] (i.e., [California] gross receipts for purposes of AAGR calculation)." Appellant indicates that these amounts include "sales of real and tangible

[38] The spreadsheet does not provide information for the second 2008 tax year (i.e., tax year ending August 28, 2008).

personal property" as well as "income from partnerships and miscellaneous receipts ([including] intercompany transactions) to be conservative."

DISCUSSION

Legal Background

Tax credits are a matter of legislative grace. (*Appeal of Pino*, 2020-OTA-375P.) Statutes granting tax credits are to be construed strictly against the taxpayer with any doubts resolved in FTB's favor. (*Appeals of Swat-Fame, Inc., et al*., 2020-OTA-046P (*Swat-Fame*).) The taxpayer has the burden of showing that the requirements for the research credit are satisfied. (*Ibid.*)

For purposes of the California research credit, qualified research only includes "research conducted in California." (R&TC § 23609(c)(2).) To be eligible for research tax credit under IRC section 41(a)(1),[39] appellant must prove that it performed qualified research, or paid someone else to perform qualified research, during the years at issue. In general, qualified research is research that satisfies four tests:

1. Section 174 Test: expenditures connected with the research must be eligible for treatment as expenses under IRC section 174 (IRC, § 41(d)(1)(A));

2. Technological in Nature Test: research must be undertaken for the purpose of discovering technological information (IRC, § 41(d)(1)(B)(i));

3. Business Component Test: the taxpayer must intend that the information to be discovered be useful in the development of a new or improved business component (e.g., product) of the taxpayer (IRC, § 41(d)(1)(B)(ii)); and

4. Process of Experimentation Test: substantially all of the research activities must constitute elements of a process of experimentation for a purpose relating to a new or improved function, performance, reliability, or quality. (IRC, § 41(d)(1)(C) & (d)(3))

(See also *Swat-Fame*, *supra*.)

For purposes of the process of experimentation, at least 80 percent of the research activities for a business component must constitute a process of experimentation. (Treas. Reg. § 41-4(a)(6); see also IRC, § 41(d)(1)(C).) A process of experimentation requires a structured

[39] With some modifications, California conforms to IRC section 41 pursuant to R&TC section 23609.

process using the scientific method to discover information. (*Swat-Fame*, *supra*.) Each of the four requirements of IRC section 41(d)(1), including the process of experimentation requirement, must be applied separately to each business component. (IRC, § 41(d)(2); *Swat-Fame*, *supra*.) A "business component" is a "product, process, computer software, technique, formula, or invention" that is to be sold, leased, licensed, or used in the taxpayer's trade or business. (IRC, § 41(d)(2)(B).)

A taxpayer must identify the business components generating the qualified research and explain how its activities as to those business components satisfy the statutory requirements. (See, e.g., *Bayer Corp. and Subs. v. U. S.* (W.D.Pa. 2012) 850 F.Supp.2d 522, 540; *U. S. v. Quebe* (S.D. Ohio 2017) 321 F.R.D. 303 (*Quebe*).) If the requirements of IRC section 41(d) are not met at the level of an identified business component, the requirements are then applied "at the most significant subset of elements of the product, process, computer software, technique, formula, or invention to be held for sale, lease, or license." (Treas. Reg., § 41-4(b)(2).) This is referred to as the "shrinking-back" rule. The shrinking-back continues "until either a subset of elements of the product that satisfies the requirements is reached, or the most basic element of the product is reached and such element fails to satisfy the test." (*Ibid*.) In addition, the taxpayer must substantiate its claimed QREs for each claimed business component. (See, e.g., *U. S. v. Davenport* (N.D. Tex. 2012) 897 F.Supp.2d 496, 518; *Bayer Corp. and Subs. v. U. S.*, *supra*, at p. 544.)

Certain types of research are specifically excluded from the definition of qualified research. They include research conducted after the beginning of the commercial production of a business component; research related to the adaption of an existing business component to a particular customer's requirement or need; research related to the reproduction of an existing business component, efficiency surveys, market research or testing, routine data collection, routine quality control testing or inspection; foreign research; research in social sciences, arts or humanities; and funded research. (IRC, § 41(d)(4); *Swat-Fame*, *supra*.)

Additionally, the regular research credit is not available unless the taxpayer's total QREs exceed a "base amount." (IRC, § 41(a)(1).) The applicable base amount is the higher of two alternative base amounts. (IRC, § 41(c).) The first base amount, the "minimum base amount," is 50 percent of the taxpayer's qualified research expenses for the taxable year. (IRC, § 41(c)(2).)

The second base amount is the product of "the fixed-base percentage" and the taxpayer's AAGRs for the preceding four taxable years. (IRC, § 41(c)(1).)

The "fixed-base percentage" is essentially a percentage determined by comparing the taxpayer's QREs during a base period with the taxpayer's gross receipts during this same base period. Generally, the base period is tax years beginning after December 31, 1983, and before January 1, 1989. (IRC, § 41(c)(3)(A).) However, "start-up companies," as defined by statute, compute their fixed-base percentage by comparing QREs to gross receipts for tax years beginning after December 31, 1993. (IRC, § 41(c)(3)(B).)

A simplified example may help to understand the operation of these rules. Consider a taxpayer with two dollars of QREs and $100 of gross receipts for the current tax year. For the preceding four tax years, the taxpayer's AAGRs were also $100. During its base years, the taxpayer's QREs constituted three percent of its gross receipts. In this example, the taxpayer's minimum base amount is one dollar (i.e., 50 percent of its QREs for the tax year at issue). Its second base amount, computed by reference to its fixed-base percentage, is three dollars (i.e., the product of its fixed-base percentage of three percent and its $100 of AAGRs). This three-dollar base amount exceeds the one-dollar minimum base amount. Therefore, the taxpayer only receives the regular research credit if its QREs for the year at issue exceed three dollars. As the taxpayer only had two dollars of QREs in the tax year at issue, it is not entitled to the regular research credit.

The example illustrates that a taxpayer may conduct qualified research activities and have some QREs but nevertheless not be eligible for the regular research credit. Therefore, a taxpayer cannot demonstrate that it is entitled to the regular California research credit simply by showing that it conducted some qualified research in California during the tax year for which the credit is claimed.[40]

Former IRC section 41(c)(7), which is applicable to the tax years at issue, limits gross receipts for purposes of computing AAGRs for research credit purposes to only those "gross receipts which are effectively connected with the conduct of a trade or business within the [U.S.], the Commonwealth of Puerto Rico, or any possession of the [U.S.]." However, California does not fully conform to the federal definition of gross receipts in IRC section 41(c)(7). Instead,

[40] For the tax years at issue, this is also generally true of the AIC, which only provides a credit if the taxpayer's QREs for the year at issue exceed a percentage of its AAGRs for the preceding four taxable years. (Former IRC, § 41(c)(4)(A).)

R&TC section 23609(h)(3) modifies the definition of gross receipts in IRC section 41(c)(7) "to take into account only those gross receipts 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 a purchaser within this state . . . ." Thus, for California research credit purposes, gross receipts only includes receipts from the sale of property to California customers; it does not include gross receipts related to sales of services, or other gross receipts unrelated to the sale of property in California.

In LDG 2012-03-01, FTB notes that R&TC section 23609(h)(3) does not fully conform to the federal definition of "gross receipts" with respect to receipts from services.[41] In addressing whether a seller of tangible property can obtain the California research credit, LDG 2012-03-01 states that if the computed base amount is higher than the minimum base amount, the taxpayer may only obtain the credit for qualified research expenses that exceed the computed base amount. Therefore, if a taxpayer with gross receipts cannot substantiate its base amount and/or its fixed-base percentage, the taxpayer may not obtain the research credit.

Analysis

As discussed below, appellant has not demonstrated that it satisfies the requirements for the regular California research credit. Among other things, appellant has not shown that substantially all of its claimed California research activities for any business component (or a subset thereof) constituted a process of experimentation or shown that its claimed QREs exceed its base amount. In addition, appellant has not provided a reasonable basis to estimate any amount of the regular California research credit.

In general, appellant's arguments fail because rather than demonstrating that it satisfied the requirements for the regular research credit, appellant asks OTA to rely on the conclusions of its employees regarding whether applicable legal requirements are satisfied. While testimony of an employee was provided at the hearing, she claimed only knowledge of the federal research credit filing, not the California research credit filing. The issue here largely involves whether claimed research activities and (associated QREs) occurred in California. Because the witness was not involved with the California research credit filing, her testimony did little to resolve this

[41] LDG 2012-03-01 indicates that a taxpayer without any California gross receipts may calculate its research credit using its minimum base amount, without reference to a base period. As appellant now agrees that it had California gross receipts, this is not relevant to the determination of whether appellant has demonstrated that it is entitled to the regular California research credit.

issue. Additionally, OTA cannot assume that for each of the identified projects, appellant's employees correctly concluded that appellant conducted a process of experimentation, that at least 80 percent of appellant's activities associated with the project constituted a process of experimentation, that appellant satisfied other applicable requirements, or that appellant incurred the claimed QREs in connection with its qualified research activities.

Appellant's Claimed California Research Wages for Tax Year 2005

As previously noted, FTB concedes that appellant has substantiated $75,966,096 of California qualified wages for the 2006-2008 taxable years.[42] Therefore, as to appellant's claimed qualified wages, the only tax year left to address is 2005.

According to appellant, it determined its California QREs using FIDs that it assigned for cost-accounting purposes. Appellant states that a financial consultant then determined whether the project constituted qualified research activities. As an example of its process, appellant discusses an FID that relates to two projects that appellant contends involved qualified research, as well as other projects for which appellant did not claim QREs.[43]

Appellant states that 222.74 "man-months" were recorded under the FID, and, of that time, 15 and 45 "man-months" were recorded on the two qualified research projects. According to appellant, it captured $1,002,981 of total wages for the FID; however, because most of that FID did not relate to research projects, it used the percentage of "man-months" spent on the two projects to determine the qualified research wages associated with the projects. On this basis, appellant concluded that 6.73 and 20.20 percent of the wages associated with FID constituted qualified research wages, and that there were $67,554 ($1,002,981 x 6.73 percent) and $202,631 ($1,002,981 x 20.20 percent) of qualified wages for the projects.

The documentation provided does not show that appellant correctly applied the law to the evidence to determine that the wage expenses constituted QREs. For example, appellant does not show that 80 percent of the California research activities for each identified project/business component constituted elements of a process of experimentation for a qualified purpose.

[42] The disagreement is with respect to the remaining claimed California qualified wages appellant claimed for the 2003-2005 taxable years. However, as discussed previously in Issue 1, OTA has no jurisdiction to review appellant's claim of a regular research credit for the 2003 and 2004 tax years, because appellant did not set forth that claim in a timely refund claim.

[43] The documentation provided for these projects relates to the 2004 tax year.

For the 2005 tax year, appellant provides workpapers listing hundreds of projects and the federal QREs identified by appellant in connection with each project. Again, OTA cannot determine from the workpapers whether appellant's employees correctly determined that substantially all of the claimed California research activities constituted a process of experimentation and that other applicable requirements were satisfied. In addition, OTA cannot determine from the workpapers whether appellant incurred the expenses stated on in its workpapers and whether those expenses were incurred in connection with qualified research activities.

Appellant provides six examples of its employee survey process. The survey documentation provided for these projects all relates to the 2006 tax year. However, the six survey examples appellant provided from 2006 are not representative of appellant's process for determining whether it performed qualified research for other projects during the 2005 tax year. There is no evidence to show that the activities described in the surveys are representative of appellant's activities associated with its other projects. Although the IRS and appellant agreed to use these projects as a sample, there is no sampling agreement between FTB and appellant. According to documentation provided by appellant, its survey process significantly changed for the 2006 tax year, so the six examples do not appear to be representative of any surveys used in the 2005 tax year.

The survey documentation includes project summaries and charts summarizing the project and stating that there were technical uncertainties, hypotheses, and processes of experimentation.[44] The documentation appellant provided does not appear to include any contemporaneous supporting documentation from when the reported research activities were conducted, such as, correspondence, contracts, drawings, or work plans. There is no evidence to show that the employees completing the survey had relevant legal experience or that they completed the surveys impartially. The employees who completed the surveys have not provided testimony, and the surveys are not signed or dated (other than noting the tax year).

As noted previously, the surveys do not ask whether research activities were conducted in California or whether 80 percent of activities associated with the project constituted a process of experimentation. However, appellant indicates that, for the 2005 tax year, it first determined the

[44] For one of the six projects, the survey reports that the work done was similar to prior work done by appellant and presented few technical challenges but also reports that, for the vast majority of employees that worked on the project, 100 percent of their time on the project constituted qualified research activities.

total "man-months" spent on an FID, and then it allocated those "man-months" between qualified research projects. For the 2005 tax year, appellant states that it computed its California research wages "based on actual California wage expenses," but its "2005 QREs by State" schedule provided as support only indicates that its federal research wages were multiplied by its California "GL Payroll Ratio" for 2005 of 9.400779 percent. Appellant does not provide any explanation or evidence to support its computation of this ratio. [45]

The methodology described by appellant is not sufficient to substantiate the amount of appellant's qualified wage expenses in California for the 2005 tax year. It relies on the conclusions of appellant's employees as to whether the legal requirements for the regular California research credit were satisfied. OTA cannot assume that appellant's employees correctly determined that the legal requirements were satisfied. This is particularly true where, like here, those employees have no demonstrated expertise in the area, have not provided testimony, and have not signed statements under penalty of perjury. Additionally, appellant has failed to substantiate that the claimed 2005 California wages were in fact paid to employees in California.

Appellant's Estimation of California Supplies and Contract Expenses for Tax Years 2005-2008

For the 2005 through 2008 tax years, appellant uses a two-step process to compute its estimated California supplies and contract expenses QREs. First, for each FID identified as involving qualified research, appellant estimates how much of the total supplies and contract expenses recorded in that FID relate to its research projects (Step One). Once appellant has computed its total federal supplies and contract QREs as described in Step One, it then allocates or estimates the California amounts in Step Two using ratios or percentages computed by appellant.

[45] Appellant's explanation of its methodology for the 2005 tax year appears to state that appellant computed this ratio by dividing the total California payroll for each applicable FID by the total payroll for that FID. However, appellant has failed to substantiate that this was in fact the methodology used for 2005 as appellant was "not able to produce the detailed QRE by FID and by state for 2005." Even if appellant was able to substantiate its use of this methodology for the 2005 tax year, this methodology is nevertheless problematic because it uses overall FID payroll information, rather than employee-specific information, to allocate reported qualified wages between California and other states. For example, it appears that, if half of wage expenses in a single FID were paid to California employees and the other half were paid to Massachusetts employees, but all the qualified research activities occurred in Massachusetts, appellant's methodology would erroneously allocate half of the FID's wage expenses as qualified wage expenses in California.

Step One

Appellant provides an example of its process for assigning its supplies and contract expense within an FID to its research projects.[46] Appellant states that its records showed $142,014 in supply expenses and $125,000 in contract consulting expenses for an FID and that it allocated its purchases of supplies to two qualified research projects "based on the proportion of man-months associated with each project." On this basis, appellant allocated 6.73 percent of supplies to one project, and 20.2 percent of supplies to another project. Then, "based on the experience of its financial employee," it estimated that 25 percent of its contractor expenses were associated with one project, with the remainder allocated to the other project. Appellant then allocated these expenses to California and other states "in proportion to the total Form W-2 wage expense associated with that FID in each state."

This stated methodology suffers from at least two flaws. First, appellant does not provide evidence of the supply and contract expenses it describes. Appellant's workpapers for the 2005 through 2008 tax years simply list the expenses as qualified expenses, as if it were a proven fact. Without supporting evidence, OTA cannot determine whether appellant's determination of its total qualified supply and contract expenses are correct. Second, the methodology assumes that appellant's supply expenses recorded correlate with "man-months" worked on qualifying projects, as opposed to the "man-months" worked on other non-qualifying activities or projects within the same FID. There is no evidence to show that this is a realistic assumption. For example, it could be that an expensive computer or lab equipment was purchased for one of the non-qualifying activities or projects recorded within the FID, while most qualified hours were associated to qualifying projects. Therefore, OTA cannot properly determine how much of the total supplies and contract expenses recorded in that FID relate to appellant's research projects.

Step Two

Appellant explains that it did not track where it incurred qualifying supply and contractor expenses. As a result, appellant estimated how much of the federal supplies and contract expense QREs were incurred in California.

For the 2005 tax year, appellant allocated its federal supplies and contract QREs to California using its California "GL Payroll Ratio" for that tax year. It is unclear how appellant

[46] This is the same example as discussed above for appellant's 2005 California research wages.

computed its "GL Payroll Ratio" for 2005. While appellant states it based this ratio on "actual California wage expenses," appellant has failed to provide evidence substantiating this statement. Rather, based on the "2005 QRE by State" schedule appellant provided, it appears that appellant merely applied its general ledger apportionment percentage for the entity generating the credit to its federal supplies and contract expense QREs for 2005.

The first problem with this estimation strategy is that it assumes that appellant correctly determined the amount of its total federal qualified supplies and contract expense QREs.[47] Additionally, this methodology assumes that an entity that has 10 percent of its total payroll in California also incurs 10 percent of its total qualified contract and supply expenses in California. There is no reason to think that this is the case. A multistate taxpayer with, for example, 10 percent of its payroll in California, could have all its research activities in California, none of its research activities in California, or something in between. Therefore, appellant's methodology does not provide a reasonable basis to estimate appellant's California QREs.

For the 2006 through 2008 tax years, appellant allocated its total federal supplies and contract QREs to California using percentages computed by dividing its California research wages for the tax year by its total federal research wages for that year, and then applied the resulting percentage to the total federal supplies and contract expenses or expenses computed as noted above under Step One.

The first problem with this estimation strategy is that it again assumes that appellant correctly determined the amount of its total federal qualified supplies and contract expense QREs.[48] The second problem with this strategy is that it assumes that the location of appellant's supply and contract expenses correlates with the location of its qualified wages. The record does not show that this assumption is reasonable. For example, it could be that an expensive computer or lab equipment was purchased for a few employees located in one state while most qualified hours were associated with employees working in a different state.

Appellant also argues that it should be permitted reasonably estimated California QREs under *Cohan v. Commissioner*, 39 F.2d 540 (2d Cir. 1930) (*Cohan*). However, the *Cohan* rule is only applied if the taxpayer provides some rational basis on which an estimate may be made. (*Cohan*, *supra*.) Here, appellant estimating California QREs by referencing apportioned federal

[47] See the discussion under Step One above.

[48] See the discussion under Step One above.

QREs (expenses conducted outside of California) is not a rational basis for determining California research expenses. Appellant has not established a basis to apply the Cohan rule to estimate its California QREs.

IRS Proceedings

Appellant appears to recognize that its documentation is lacking, because it does not ask OTA to grant research credits for all its claimed California QREs. Instead, it "concedes the same 45 [percent] across-the-board QREs that it conceded in the [f]ederal audit," and essentially asks OTA to apply an agreement with the IRS to allow 55 percent of its claimed federal research credits.

For several reasons, the IRS proceedings do not provide a basis for allowing 55 percent of its claimed California QREs. First, unlike the IRS or FTB, OTA has no authority to resolve an appeal based on the hazards of litigation or to avoid a lengthy audit, and it also has no authority to enter into a closing agreement to administratively resolve an appeal. Moreover, while OTA may consider an IRS determination, it is not bound by it. (*Appeal of Der Wienerschnitzel* (79-SBE-063) 1979 WL 4104.)

Second, California's research credit differs significantly from the federal research credit. Most significantly, California only provides a research credit for qualifying research that is conducted in California. Appellant's agreement with the IRS does not assist OTA in determining whether, or how much of, appellant's QREs were incurred in California.

Third, appellant's agreement with the IRS was an administrative compromise. In general, the IRS personnel and appellant determined that auditing appellant was onerous. An IRS engineer estimated, based on a review of six sample projects, that "up to" 45 percent of the claimed expenses for 2003 and 2004 were qualified; appellant countered with a higher estimated percentage; and then appellant and the IRS agreed to use 55 percent to resolve the matter. If anything can be determined from appellant's IRS documentation, it is that the IRS estimated that appellant was not entitled to most of the federal QREs it claimed.

Fourth, the IRS and appellant agreed to be bound by an IRS examination of six sample projects from the 2006 tax year. Appellant and FTB have reached no such agreement here, and OTA has no reason to believe that the six sample projects which the IRS agreed to examine are representative of appellant's California research activities in 2006 or any other tax year at issue.

(See *Bayer Corp. and Sub. v. U. S.*, *supra*, 850 F.Supp.2d at p. 543 [rejecting the taxpayer's attempt to force the tax agency to use a sampling methodology].)

Appellant's Gross Receipts and Base Amount Calculations

As previously noted, the regular research credit is not available unless the taxpayer's total QREs exceeds the greater of the "base amount" provided in IRC section 41(c)(1) or the minimum base amount provided in IRC section 41(c)(2). The base amount is defined as the product of "the fixed-base percentage" and the taxpayer's AAGRs for the preceding four taxable years (IRC, § 41(c)(1)), while the minimum base amount its defined as 50 percent of appellant's QREs for the credit year (IRC, § 41(c)(2)).

FTB contends that appellant has not substantiated that its California QREs for the 2005 through 2008 tax years exceed its base amount for those tax years such that appellant would be entitled to regular California research credits. FTB asserts that appellant has failed to substantiate both its base period amounts used to compute the fixed-base percentage (i.e., gross receipts and QREs for its base years) and its AAGRs for its 2005 through 2008 tax years. Appellant counters that it can use the maximum fixed base percentage of 16 percent provided in IRC section 41(c)(3)(C) as an alternative to substantiating its base period amounts, citing to *Suder v. Commissioner*, T.C. Memo. 2014-201.[49] Appellant argues that its California gross receipts are so minimal, that even using the maximum fixed based percentage of 16 percent, it is essentially impossible that it had sufficient AAGRs to cause its base amounts to exceed the minimum base amounts for the tax years at issue.

As support, appellant provides a schedule computing California research gross receipts ranging from $8.9 million to $67.4 million for its 2001 through 2007 tax years. Based on these gross receipt amounts, appellant provides additional schedules showing that based on its claimed California QREs for the tax years at issue, its minimum base amounts exceed the base amount (computed by multiplying its AAGRs for the preceding four tax years by 16 percent) for each of the tax years at issue. For example, for the 2006 tax year, appellant computed its AAGR for the preceding four tax years to be $27,098,304 based on the California research gross receipt amounts noted above. Applying the maximum fixed based percentage of 16 percent to this

[49] FTB disagrees, citing to *U.S. v. Quebe*, *supra*, 321 F.R.D. 303. FTB contends *Quebe* provides that a taxpayer is required to substantiate the right to the credit and if a taxpayer is unable to substantiate its fixed-based percentage, a complete disallowance of the research credit is required even though the maximum fixed-base percentage is 16 percent.

amount results in a base amount of $4,335,729 ($27,098,304 x 16 percent). Because appellant claimed California QREs totaling $40,582,723 for 2006, this base amount ($4,335,729) does not exceed the minimum base amount of $20,291,361 (computed as 50 percent of its QREs for the 2006 tax year).

Assuming, without deciding, that appellant can use the maximum fixed base percentage of 16 percent as an alternative to substantiating its base period amounts, OTA still concludes appellant has failed to adequately demonstrate that its QREs for each of the 2005 through 2008 tax years exceed its base amounts for those years. There are two issues with appellant's computations and assertions. First, in computing the minimum base amounts for each year, appellant assumes that all of is claimed California QREs will be allowed at appeal; however, as noted above, the only QREs which have been allowed on appeal are the wages totaling $75,966,096[50] for the 2006 through 2008 tax years. These smaller QRE amounts mean that appellant's minimum base amounts will be smaller, making it more likely that the base amount computed based on appellant's AAGRs will exceed the minimum base amount. For example, for the tax year ending August 29, 2008, appellant's revised California QREs based on the wages conceded by FTB are only $240,940. Per appellant's computations, appellant's AAGR for this tax year is $13,681,366. Applying the maximum fixed based percentage of 16 percent results in a base amount of $2,189,019 ($13,681,366 x 16 percent). This amount exceeds the minimum fixed base amount for the tax year ending August 29, 2008, of $120,470 ($240,940 x 50 percent). Because appellant's total QREs allowed on appeal of $240,940 are less than this base amount ($2,189,019) appellant is not entitled to the regular research credit for its tax year ending August 29, 2008, using appellant's own computations of its California research gross receipts and AAGRs.[51]

[50] As noted above, this total amount consists of $28,134,545 for appellant's 2006 tax year; $28,395,716 for appellant's 2007 tax year; $19,194,894 for the tax year ending August 26, 2008; and $240,940 for appellant's tax year ending August 29, 2008.

[51] Appellant's minimum base amounts for 2006 and 2007 tax years and the tax year ending August 26, 2008, (computed based appellant's revised QREs allowed on appeal for these tax years) still exceed the base amounts for these tax years computed based on appellant's reported California research gross receipts and AAGRs for these tax years. However, as will be discussed below, appellant has not adequately substantiated its revised California research gross receipts and resulting AAGRs provided on appeal.

Second, appellant has not adequately substantiated the California research gross receipts and resulting AAGR amounts it provides on appeal. Appellant's position regarding its California research gross receipts has changed throughout the FTB audit and the subsequent appeal with OTA. During the FTB audit of its research credit claims, appellant provided a schedule showing that it had California gross receipts ranging from $686 million to $1.53 billion for the 2003 through 2008 tax year[52] and AAGRs ranging from $727 million to $1.16 billion for the 2005 to 2008 tax years. These amounts were computed by applying appellant's California apportionment percentage for the applicable tax year to its total net gross receipts for the tax year. On appeal, appellant initially asserts that it has zero California research gross receipts for all relevant tax years, based in part on its conclusion that California's definition of gross receipts for research credit purposes in R&TC section 26309(h)(3) excludes sales of intangible property. Appellant also asserts that it has zero gross receipts from the sale of tangible personal property in California. Appellant maintains this position throughout most of the briefing in this appeal. Finally, in its final supplemental brief filed in June 2022, appellant concedes that it has some California research gross receipts and provides a schedule listing its "potential" gross receipts, noting that its computations include "sales of real/tangible personal property, and income from partnerships and miscellaneous receipts (even from intercompany transactions)."

R&TC section 26309(h)(3) defines gross receipts for California research credit purposes as "only those gross receipts from the sale of property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business that is derived or shipped to a purchaser within this state . . . ." OTA agrees that appellant's initial method of computing its California gross receipts by applying its California apportionment percentage to total net gross receipts, was incorrect. However, given its changing position on appeal, appellant has not substantiated that

[52] Appellant's tax year ending August 29, 2008, is excluded from this analysis since that tax year was only three days, and as a result, the gross receipts for this tax year are not representative of appellant's other tax years.

its final computation of its California gross receipts includes all required sales of property to customers in California (including both tangible and intangible property).[53]

While appellant asserts that its figures include all of its "potential" California research gross receipts from the sale of property to customers in California, appellant fails to provide any detailed or meaningful information about the various different revenue streams/gross receipts which were excluded from its California research gross receipt computations and why appellant determined that such revenue streams/gross receipts were properly excluded from its California research gross receipts.[54] Appellant does not provide any explanation of its methodology for including or excluding particular types of gross receipts from its California research gross receipt computations. Instead, appellant generally asserts that its computations include all sales of property to California customers and that the excluded sales are primarily comprised of gross receipts from the sale of services. Ultimately, because appellant has failed to provide any detailed information about the types of revenues/gross receipts that were excluded from its California research gross receipt computations and the reason for their exclusion, OTA is unable to properly determine whether appellant's computation of its "potential" California research

[53] While appellant initially asserted that R&TC section 23609(h)(3) includes only sales of tangible personal property and does not include sales of intangible property, appellant appears to have abandoned or conceded this argument. When asked about this at the hearing, appellant stated, "if it's simply software, in the sense that you're licensing, that should not be included." Thus, appellant appears to distinguish between *sales* of intangible property, which it appears to admit would be included in California research gross receipts pursuant to R&TC section 23609(h)(3), and *licensing* of intangibles, which it contends would not be included. To the extent that appellant is intending to assert that R&TC section 23609(h)(3) does not include the *sale* (as opposed to the *licensing*) of intangible property, OTA disagrees. R&TC section 23609(h)(3) includes gross receipts "from the sale of property held primarily for sale to customers in the ordinary course of business. . . ." Had R&TC section 23609(h)(3) intended to include only sales of tangible personal property it would have stated "from the sale of tangible personal property" not just "from the sale of property" generally. "Property" generally includes both tangible and intangible property. This Opinion, does not, however, opine on whether California research gross receipts pursuant to R&TC section 23609(h)(3) includes or excludes *licensing* of intangibles as opposed to *sales* of intangibles.

[54] Appellant provides apportionment schedules as support for its computations. However, appellant's apportionment schedules are more than 3,000 pages long, and do not contain any discussion of specific revenue streams/gross receipts or why such revenue streams/gross receipts were excluded or included in appellant's California gross receipt computations.

gross receipts properly includes all sales of property to customers in California, including any potential sales of software to California customers.[55]

OTA acknowledges that appellant is largely a service provider and agrees that gross receipts from the sales of services are excluded from California's definition of research gross receipts. However, appellant had total net gross receipts ranging from $6.48 billion to $10.77 billion for the 2003 through 2008 tax years. Even if only a small fraction of these amounts were found to be California research gross receipts, appellant's resulting base amounts could potentially exceed its QREs for the relevant tax years, resulting in no allowable research credit.[56] Appellant has the burden of showing that the requirements for the research credit are satisfied. (*Swat-Fame*, *supra*.) Appellant has failed to substantiate its gross receipts and AAGRs and has therefore failed to substantiate that its QREs as modified on appeal exceed its base amounts for the 2005 through 2008 tax years. As a result, appellant has failed to substantiate that it is entitled to the regular research credit for the 2005 through 2008 tax years.[57]

Issue 3: Whether appellant has shown it is entitled to claimed EZ credits.

Additional Factual Findings for Issue 3

2011 Refund Claims (2005 and 2006 Tax Years)

50. Appellant's 2011 refund claims do not state that appellant is claiming EZ credits or set forth grounds for claiming a refund of EZ credits.

[55] Again, OTA is referring to gross receipts from *sales* of software (rather than gross receipts from *licensing* of software) here. At the hearing appellant answered "yes" to the question of whether its computations included "actual sales of software." However, given that software can be classified as either tangible or intangible property, and appellant's changing position regarding whether sales of intangible property are properly included in California research gross receipts, OTA is uncertain whether appellant adequately included any potential *sales* of software to customers in California in its California gross receipt computations. Without more information about the specific types of revenues that were excluded (including any software *sales* by appellant during the relevant tax years), OTA is unable to determine whether appellant properly computed its California research gross receipts and resulting AAGRs.

[56] OTA notes that given the revised QREs, appellant's fixed base percentage would equal and fully eliminate appellant's QREs if appellant has AAGRs ranging from $120 million to $177 million for the 2006, 2007, and first 2008 tax year (the second 2008 tax year is already addressed above). This would be less than two percent of appellant's total gross receipts which exceeded $10 billion for these years.

[57] Because OTA has determined that appellant failed to substantiate its California research gross receipts and AAGRs, OTA need not address the duty of consistency argument raised by FTB.

Appellant's 2012 Refund Claims (2003 to 2008 Tax Years)

51. As previously noted, on June 28, 2012, appellant submitted a letter claiming refunds for the 2003 and 2004 tax years, and the 2007 and 2008 tax years, and supplementing its 2011 claims for refunds for the 2004 and 2005 tax years. The letter states that appellant generated EZ hiring credits pursuant to R&TC section 23622.7 and an income tax credit from sales and use taxes paid on qualified assets purchased and placed in service in the EZs pursuant to R&TC sections 23612.2.[58] The letter also states that appellant's EZ apportionment percentage understates its business activities within California EZs, its EZ business income, and its resulting EZ credits. On this ground, the letter states that appellant seeks relief under R&TC section 25137 to prevent distortion in the EZ formula.

Appellant's 2020 Refund Claims (For the 2005 to 2008 Tax Years)

52. As to EZ credits, the refund claims state as follows:

> [Appellant] is entitled to utilize additional [EZ] Credits to further reduce its tax. The [EZ] credit statute should be interpreted consistently with legislative intent to create and increase job-opportunities [sic] in California. Therefore, the language of the statute must be interpreted to treat multiple geographic locations that meet the "zone" criteria as a single "zone," which would allow [appellant] to use the [EZ] credits against income earned in a single, collective "zone." *See* Cal. Rev. & Tax. Code [sections] 23622.7, 25137.

Amount of Additional EZ Credits Sought by Appellant

53. As support for its EZ claims, appellant provides an "EZ Lapsing Schedule" for the 2001 through 2005 tax years, which shows the amount of EZ credit carryovers from prior years, credits generated during the tax year, the amount of credit appellant contends it may utilize during the tax year under its "zone aggregation theory," and credits carried over to other tax years. The lapsing schedule indicates that appellant is seeking additional EZ credits of $0, $1,424,668, and $815,768, for the 2003, 2004, and 2005 tax years, respectively.[59]

[58] These EZ credit statutes were repealed after the years at issue.

[59] This is consistent with appellant's supplemental opening brief which indicates that appellant is seeking "to utilize a total of $2,240,436 of [EZ] in the 2004 and 2005 tax years" (i.e., $1,424,668 + $815,768).

Analysis

As noted previously, appellant has the burden of showing error in FTB's denial of its claimed credits. (*Swat-Fame*, *supra*.) As the California Supreme Court explained in considering another taxpayer's challenge of FTB's method of determining the amount of the taxpayer's allowable EZ credit, statutes granting tax exemptions "must be strictly construed against the taxpayer, 'resolving any doubts in favor of [FTB].'" (*Dicon Fiberoptics, Inc. v. Franchise Tax Bd.* (2012) 53 Cal.4th 1227, 1235.)

Here, appellant notes that it operated in multiple California locations, including multiple locations designated as EZs. Appellant argues that for purposes of computing the credit limitation under R&TC section 23622.7(j), appellant should be able to "treat all geographic locations that meet the 'zone' qualifications as one unified zone" so that it can "compute its [EZ] credit using a single zone." Appellant contends that this interpretation of the statute would be "consistent with the intent of the Legislature" and would advance the policy objective of assisting economically distressed areas and creating opportunities for economically disadvantaged workers.

To determine legislative intent, the first step is to look to the words of the statute. (*Ordlock v. Franchise Tax Bd.* (2006) 38 Cal.4th 897, 909.) The words of the statute are given their usual and ordinary meaning but are considered in the context of the relevant statutory scheme. (*Ibid*.) "If the statutory language is clear and unambiguous, then we need go no further." (*Hoechst Celanese Corp. v. Franchise Tax Bd.* (2001) 25 Cal.4th 508, 519 (*Hoechst Celanese*.)

For the tax years at issue, R&TC section 23622.7(a) allowed a credit to taxpayers who employed a qualified employee "in an [EZ] during the taxable year." In determining the amount of the credit arising from the employment of a qualified employee, qualified wages generally do not include any wages paid or incurred after "the zone expiration date," which term "means the date *the [EZ]* designation expires, is no longer biding, or becomes inoperative."[60] (R&TC §§ 23622.7(b)(1)(C), 23622.7(b)(3) [italics added].)

[60] The statute provides an exception for qualified employees employed within "the [EZ]" during the 60-month period prior to the zone expiration date. (R&TC, § 23622.7(b)(1)(C).)

R&TC section 23622.7(g) defines an EZ as "an area designated as an [EZ] pursuant to [the Enterprise Zone Act (EZA) set forth in former Government Code (Gov. Code) sections 770 et seq.]." For the tax years at issue, the EZA provided for the designation of multiple EZs rather than a single state-wide EZ comprised of multiple areas.[61]

Additionally, R&TC section 23622.7(j) generally provides that:

- the amount of the credit under "this section" (i.e., R&TC section 23622.7) and R&TC section 23612.2 (which provides an EZ credit against sales and use tax) "shall not exceed the amount of tax which would be imposed on the taxpayer's business income attributable to the [EZ]"; and
- the income attributable to the EZ shall be determined based on multistate apportionment provisions modified to compare the taxpayer's property in the [EZ] and its payroll in the [EZ], to its property and payroll throughout California.

In sum, R&TC section 23622.7 provides that the credit is based on wages paid to a qualified employee in an EZ. The amount of allowable credit is limited to the taxpayer's California "business income attributable to the [EZ]," which is determined by reference to the taxpayer's property and payroll in the EZ, as compared to the taxpayer's property and payroll throughout California. OTA finds that the language of R&TC section 23622.7 is clear and unambiguous.

The Legislature could have provided that the amount of the credit is only limited by the total amount of the taxpayer's California business income, or by the aggregate amount of business income earned by the taxpayer in all EZs. Similarly, the Legislature could have created a single EZ that included various geographic areas in the state. However, the Legislature did not select any of these potential alternatives. Instead, the Legislature chose to designate multiple EZs and limit the amount of the credit to the tax attributable to the relevant EZ, with the tax attributable to the EZ based on the EZ's property and payroll.

However, appellant argues that R&TC section 23622.7 "must be interpreted to treat multiple geographic locations that meet the 'zone' criteria as a single 'zone.'" In support,

[61] See, e.g., former Gov. Code sections 771(c) [limiting the areas where EZs could be designated], 772 [explaining the areas that were eligible to designated as EZs], 773 [providing rules for designating EZs], and 774 [addressing existing EZs].

appellant states that R&TC section 23622.7(a) provides for "a credit" against "the 'tax'" and allows unused portions of this "singular credit" (in appellant's words) to be carried forward to later tax years. On this basis, appellant contends that the statute provides ". . . a single credit applied against the single tax in a single zone."

Appellant's interpretation is strained and contrary to the plain language of the statute. To support its interpretation, appellant relies on the words "a credit" and "the 'tax'" in R&TC section 23622.7(a). Specifically, appellant argues that these singular words show that references to "the [EZ]" in R&TC section 23622.7(j) refer to a single EZ consisting of the aggregate of all EZs where the taxpayer engages in business. However, the words "a credit" and "the 'tax'" do not imply that references in R&TC section 23622.7(j) to "the [EZ]" refer to all EZs where the taxpayer engages in business. When R&TC section 23622.7(a) refers to "a credit," it refers to the credit for "a taxpayer who employs a qualified employee in an [EZ] during the taxable year." Thus, R&TC section 23622.7(a) refers to the credit for wages paid to that qualified employee. The subsequent language of R&TC section 23622.7(a) confirms this interpretation, as it calculates the amount of the credit based on that employee's qualified wages. It is not clear how the reference in R&TC section 23622.7(a) to "the 'tax'" supports appellant's interpretation. In theory, the credit for an employee might be applied against "the 'tax'" regardless of whether the credit was limited to the tax attributable to the EZ or limited to the tax attributable to all EZs. OTA finds that the use of the words "the 'tax'" does not suggest that R&TC section 23622.7(j) refers to all EZs when it refers to "the [EZ]."

In interpreting a statute, one must strive to "harmonize statutes, reconcile seeming inconsistencies in them, and construe them to give force and effect to all of their provisions." (*Pacific Palisades Bowl Mobile Estates, LLC v. City of Los Angeles* (2012) 55 Cal.4th 783, 805.) Here, the provisions are easily harmonized as they act in tandem: R&TC section 23622.7(a) calculates the credit for any qualified employee in an EZ based on the qualified wages paid to the employees; and R&TC section 23622.7(j) limits the amount of the resulting credit, and any EZ credit obtained under R&TC section 23612.2 which may be utilized in an applicable tax year, to the tax attributable to "the [EZ]."

Appellant argues that R&TC section 23622.7(j) creates a problem on the ground that it does not specify the relevant EZ. However, as discussed below, the text and context of R&TC section 23622.7(j) indicate that its reference to "the [EZ]" refers to the EZ where the credit was

generated.

R&TC section 23622.7(a) provides that a taxpayer may receive a credit for employing "a qualified employee in an [EZ]." R&TC section 23622.7(b) then explains that the credit is available only for qualified wages which generally do not include wages paid after the zone expiration date, which is generally defined as the date "the [EZ] designation" ends. Thus, R&TC section 23622.7(a) refers to qualified wages paid in "an [EZ]," and R&TC section 23622.7(b) generally limits the credit to wages paid prior to the date the EZ's zone designation ends. Then, R&TC section 23622.7(c)(1) again refers to this same EZ (i.e., the EZ where the credit is generated) when it refers to a local government administering "the [EZ]."

When reading R&TC section 23622.7(j) after reading these preceding subdivisions of R&TC section 23622.7, OTA finds that it is clear that R&TC section 23622.7(j) refers to the same EZ referenced in the prior subdivisions of the same statute. When R&TC section 23622.7(j) limits the amount of credit available to the tax which would be imposed on business income attributable to "the EZ," the only EZ it could be referring to is the EZ where the credit was generated.[62]

Appellant contends that R&TC section 23622.7(i) provides a "single credit carryover" rather than multiple credit carryovers. However, this subdivision does not state or suggest that there is one single EZ that encompasses all the geographic locations that would qualify as an EZ in which the taxpayer does business. Rather, it is more naturally read to state that the amount of any allowable credit that is not used may be carried over.

Appellant also contends that the legislative history and public policy concerns support its interpretation. As the statute is not ambiguous, OTA need not address these contentions. (See *Hoechst Celanese*, *supra*.) Nevertheless, appellant's legislative history and public policy arguments are not persuasive.

In support of its legislative history and public policy arguments, appellant cites a single provision in the EZA: a legislative finding in R&TC section 771(b) that states "[i]t is in the economic interest of the state to have one strong, combined, and business-friendly incentive program . . . ." It is true that the Legislature sought to provide a strong, combined, and business-friendly incentive program, and it did provide such a program. However, one of the

[62] As noted previously, R&TC section 23622.7 imposes the same limitation on EZ credits generated under R&TC section 23612.2. For the tax years at issue, R&TC section 23612.2 allows an EZ credit for qualified property purchased and placed in service in an EZ. After the years at issue, R&TC section 23612.2 was repealed.

requirements of the program was that the amount of credit from an EZ could not exceed the tax attributable to the EZ. Also, appellant's argument ignores the other provisions of the EZA, which contemplate multiple EZs rather than a single EZ as contended by appellant. (See, e.g., former Gov. Code, section 773 [providing rules for designating EZs].)

Appellant contends that its interpretation of the statute would advance the overall goals of the statute "to spur business in economically distressed areas and to create opportunities for economically disadvantaged workers." However, R&TC section 23622.7 advances the Legislature's goals while also imposing limitations on the amount of the credit. The best evidence of the Legislature's intent is the language it chose to implement the EZ credit statute, because "it is the language of the statute itself that has successfully braved the legislative gauntlet." (*Young v. California Fish and Game Commission* (2018) 24 Cal.App.5th 1178, 1193.)[63]

Appellant also contends that OTA should apply R&TC section 25137 "to treat all geographic locations that meet the 'zone' qualifications as one unified zone." In general, R&TC section 25137 allows FTB to require, or the taxpayer to request, an alternative multistate apportionment methodology if the apportionment provisions of the Uniform Division of Income for Tax Purposes Act (UDITPA) "do not fairly represent the extent of the taxpayer's business activity in this state."

Appellant contends that R&TC section 23622.7 "adopts by reference" R&TC section 25137. However, FTB contends that R&TC section 25137 has no application here because, by its terms, it addresses multistate apportionment rather than the apportionment of business income to an EZ.

R&TC section 23622.7(j)(2) provides that the taxpayer's California business income "shall be further apportioned to the [EZ] in accordance with Article 2 (commencing with [R&TC] section 25120 of Chapter 17, modified for purposes of this section in accordance with paragraph (3)." R&TC section 25137 is a part of Article 2 of Chapter 17; therefore, it is included

[63] Appellant briefly argues that "the California Constitution prohibits preferring intra-city business (hiring in a single zone) over intercity business (hiring in multiple zones)," citing *General Motors Corporation v. City of Los Angeles* (1995) 35 Cal.App.4th 1736 (*General Motors*). *General Motors* involved a tax imposed by the City of Los Angeles and the application of commerce clause principles to local tax schemes affecting intercity commerce within the state.

The California Constitution and applicable regulations prohibit OTA from refusing to enforce a statute based on it being unconstitutional, unless an appellate court has made a determination that such statute is unconstitutional. (Cal. Const., art. III, § 3.5; Cal. Code Regs., tit. 18, § 30104(a).)

within the provisions that the Legislature incorporated by reference.

However, R&TC section 23622.7 (j)(2) modifies the provisions of Article 2 of Chapter 17 for purposes of apportioning the taxpayer's business income to an EZ. It provides that, for purposes of the EZ credit, the provisions will be modified so that the taxpayer's California business income will be apportioned to "the [EZ]" on the basis of fractions comparing the taxpayer's property and payroll "in the [EZ]" to the taxpayer's property and payroll throughout California.

By its terms, R&TC section 25137 only applies where the application of UDITPA provisions "do not fairly represent the extent of the taxpayer's business activity in this state ....." However, for purposes of apportioning business income to an EZ, R&TC section 23622.7 modifies UDITPA to determine the tax attributable to the EZ by only taking into account the taxpayer's property and payroll in the relevant EZ, as compared to all its California property and payroll.

With this modification, R&TC section 25137 might arguably apply where determining the tax attributable to the EZ, by comparing the taxpayer's property and payroll in the relevant EZ to all its California property and payroll, does not fairly represent the extent of the taxpayer's business activities in the state. However, this would not reflect R&TC section 23622.7(j)(2)'s modifications of the UDITPA provisions for EZ credit purposes. The EZ credit apportionment provisions are not intended to measure the extent of the taxpayer's business activities in the state; rather, they are intended to measure the extent of the taxpayer's business activities in an EZ.

Accordingly, if R&TC section 25137 was to apply, it would only apply if comparing the taxpayer's property and payroll in an EZ to its property and payroll elsewhere in California did not fairly reflect the extent of the taxpayer's business activity in the EZ. Appellant has made no such showing. Appellant has not provided any evidence to show that the amount of business income apportioned to an EZ did not fairly reflect its business activities in the EZ.[64] As a result, even if R&TC section 25137 might be applied in theory, appellant has shown no basis to apply it here.

[64] For this reason, OTA need not address whether appellant has shown by "clear and convincing evidence" that the approximation provided by the EZ credit property and payroll provisions does not fairly reflect appellant's business activities in an EZ and that its proposed alternative is reasonable. (See *Microsoft Corporation v. FTB* (2006) 39 Cal.4th 750, 765.)

HOLDINGS

1. For the 2003 and 2004 tax years, OTA lacks jurisdiction to rule on appellant's argument that it is entitled to the regular California research credit.
2. For the 2005 to 2008 tax years, appellant has not shown that it is entitled to the regular California research credit.
3. Appellant has not shown that it is entitled to additional EZ credits.

DISPOSITION

FTB's actions are sustained.

DocuSigned by:
Sara A Hosey
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Sara A. Hosey
Administrative Law Judge

We concur:

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Date Issued: 9/20/2023