OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of: **FIRST SOLAR, INC.**	) OTA Case No. 21088511)

OPINION

Representing the Parties:

For Appellant:	Robert Garvey, Representative Rocchina Oesterling-Post, Vice President of Tax
For Respondent:	Nathan H. Hall, Attorney IV Jason Riley, Attorney IV
For Office of Tax Appeals:	Andrew Jacobson, Attorney III

O. AKOPCHIKYAN, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19045, First Solar, Inc. (appellant) appeals an action by respondent Franchise Tax Board (FTB) proposing additional tax of $2,278,464, and applicable interest, for the 2013 tax year.

Office of Tax Appeals Administrative Law Judges Tommy Leung, Kenneth Gast, and Ovsep Akopchikyan held an oral hearing for this matter in Sacramento, California, on June 13, 2023. At the conclusion of the hearing, the record was closed and this appeal was submitted for an opinion.

ISSUE

Whether appellant has established error in FTB's denial of research and development (R&D) credits for the 2013 tax year.

FACTUAL FINDINGS

1. On December 9, 2005, Gen3Solar, Inc. was formed as a Delaware corporation. It changed its name to OptiSolar Inc. (OptiSolar) on November 6, 2006.

2. OptiSolar was headquartered in Haywood, California, and had its manufacturing facilities in Hayward and Sacramento, California.

3. A third-party audit firm audited OptiSolar's consolidated financial statements for the period of December 9, 2005, to December 31, 2008, and certified that OptiSolar's financial statements fairly presented the company's financial position in accordance with generally accepted accounting principles (the audited financial statements).

4. The audited financial statements indicate that OptiSolar was a development stage company and planned to manufacture, sell, and install solar power products using proprietary processes and technologies. The audited financial statements refer to this activity as OptiSolar's "manufacturing and technology business."

5. The audited financial statements also indicate that OptiSolar was constructing and operating solar farms in California and Canada and had executed power purchase agreements to sell electricity from those solar farms to power companies. The audited financial statements refer to this activity as OptiSolar's "solar project pipeline."

6. On April 3, 2009, after a series of organizational restructurings, OptiSolar sold its solar project pipeline, but not its manufacturing and technology business, to appellant in exchange for shares of appellant's common stock.[1]

7. The audited financial statements indicate a cumulative net loss of $157,995,832 for the period of December 9, 2005, to December 31, 2008, due in large part to R&D costs, manufacturing start-up costs, and administrative expenses. The audited financial statements also indicate that, as of December 31, 2008, OptiSolar had "federal and state [R&D] and tax credit carryforwards of approximately $2.2 million and $2.4 million, respectively, available to offset future regular taxable income."

8. On its 2013 California franchise tax return, appellant reported and claimed $2,208,925 of R&D tax credit carryforwards from OptiSolar, which was reportedly generated as follows: (1) $228,808 in 2006; (2) $684,414 in 2007; (3) $1,108,830 in 2008; and (4) $186,873 in 2009 through appellant's acquisition of OptiSolar's solar project pipeline (the OptiSolar R&D credit).

[1] The parties do not dispute that appellant acquired from OptiSolar the R&D tax credits at issue in this appeal.

9. FTB subsequently audited appellant's 2013 California franchise tax return. At the conclusion of the audit, FTB disallowed the entire OptiSolar R&D credit on the basis that appellant "did not retain records in sufficiently usable form and detail to substantiate that the expenditures claimed are eligible for the credit."

10. On July 26, 2021, FTB issued a Notice of Action on Proposed Assessment and affirmed the disallowance of the entire OptiSolar R&D credit for the 2013 tax year.[2]

11. This timely appeal followed.

DISCUSSION

Tax credits are a matter of legislative grace and statutes allowing tax credits must be strictly construed against a taxpayer, with any doubts resolved in favor of FTB. (*Appeal of Pino*, 2020-OTA-375P, citing *Dicon Fiberoptics, Inc. v. Franchise Tax Bd.* (2012) 53 Cal.4th 1227, 1235; *General Motors Corp. v. Franchise Tax Bd.* (2006) 39 Cal.4th 773, 790.) A taxpayer has the burden of establishing that it is entitled to an R&D tax credit. (*Appeal of Pino*, *supra.*)

California allows a tax credit for amounts paid or incurred for research conducted in California. (R&TC, § 23609.) Eligibility for and the amount of the credit are determined in accordance with Internal Revenue Code (IRC) section 41, as modified by R&TC section 23609. A taxpayer must satisfy four tests to establish that it engaged in qualified research (the four qualified research tests):

1. *IRC Section 174 Test*: the research expenses qualify for treatment as expenses under IRC section 174 (IRC, § 41(d)(1)(A));

2. *Technological in Nature Test*: the research was undertaken for the purpose of discovering information that is technological in nature (IRC, § 41(d)(1)(B)(i));

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

4. *Process of Experimentation Test*: substantially all of the taxpayer's activities constituted elements of a process of experimentation related to a new or improved function, performance, reliability, or quality. (IRC, § 41(d)(1)(C), (d)(3).)

[2] FTB also denied R&D tax credit carryforwards reportedly generated by another company that appellant acquired. Appellant does not dispute the disallowance of those credit carryforwards.

(*Appeal of Pino*, *supra*.)

"A taxpayer claiming a credit under [IRC] section 41 must retain records in sufficiently usable form and detail to substantiate that the expenditures claimed are eligible for the credit." (Treas. Reg. § 1.41-4(d).) "A taxpayer is not required to keep records in a particular manner so long as the records maintained substantiate [its] entitlement to the credit." (*Appeal of Pino*, *supra*, citing *Suder v. Commissioner*, T.C. Memo. 2014-201, at p. *21, and *Shami v. Commissioner* (5th Cir. 2014) 741 F.3d 560, 567 (*Shami*).)

In this appeal, FTB disallowed the OptiSolar R&D credit on the basis that appellant did not establish that the claimed expenses are eligible for the tax credit. The record contains the following relevant evidence: (1) OptiSolar's audited financial statements, which contains a total line item for R&D expenses (but does not include the audit working papers or any document itemizing the expenses that make up the total amount); (2) a list of fifteen patent applications that OptiSolar submitted between November 20, 2007, and March 26, 2009 (FTB conceded that eight applications resulted in the issuance of patents); (3) documents related to an IRS audit of appellant's 2011 tax year (the IRS did not adjust the federal R&D tax credit, but the documents do not indicate that the IRS examined the R&D tax credit); and (4) testimony by Dr. Marvin Keshner, who co-founded and served as the Chief Technology Officer of OptiSolar from inception through at least appellant's acquisition of OptiSolar's solar project pipeline in 2009.

Appellant acknowledges that the evidence in the record is limited due in part to the passage of time. However, appellant contends that the evidence nevertheless establishes that appellant is entitled to claim the entire OptiSolar R&D credit. Appellant relies heavily on the audited financial statements, which appellant contends either satisfy or serve as a substitute for having to satisfy the four qualified research tests in IRC section 41(d)—even though appellant acknowledges on appeal that the third-party audit firm never analyzed whether the R&D expenses in the audited financial statements satisfy the four qualified research tests.

Appellant's position regarding the audited financial statements is based on the methodology and rationale underlying an IRS directive entitled *Guidance for Allowance of the Credit for Increasing Research Activities under I.R.C. § 41 for Taxpayers that Expense Research and Development Costs on their Financial Statement pursuant to ASC 730* (the IRS Directive). The IRS Directive provides that the IRS's Large Business and International (LB&I) Division

will generally accept R&D expenses listed in audited financial statements as sufficient evidence of qualified research expenses. The IRS Directive and its related FAQs explain that the IRS Directive is an administrative solution "intended to provide an efficient manner of determining qualified research expenses for LB&I taxpayers that meet the requirements of this Directive and to more efficiently manage LB&I's audit resources."

The IRS Directive and its related FAQs also state: (1) the IRS Directive does not determine whether the R&D activities reflected in the audited financial statements are qualified research under the four qualified research tests in IRC section 41(d); (2) a taxpayer must make certain adjustments to the amount of R&D expenses reflected on the audited financial statements to qualify for treatment under the IRS Directive (the record in this appeal does not contain those adjustments); and (3) a taxpayer must retain the underlying books and records that support its adjustments and make them available on audit (the record in this appeal does not contain documents that would substantiate those adjustments). If a taxpayer cannot substantiate those adjustments on audit, an IRS territory manager may determine that the IRS Directive does not apply to the taxpayer. In short, the IRS Directive and its FAQs provide that the IRS Directive is an administrative solution to save audit resources, the IRS Directive has specific requirements, and the IRS Directive does not determine whether a taxpayer's activities satisfy the four qualified research tests in IRC section 41(d).

Appellant has not cited any authority in support of its position that the IRS Directive or its underlying methodology satisfies or serves as a substitute for having to prove that OptiSolar's activities satisfy the four qualified research tests. Although appellant has not cited the *Cohan* rule, the *Cohan* rule does not support appellant's position in this appeal.[3] While audited financial statements may provide a reasonable evidentiary basis to make estimates regarding the *amount* of an R&D tax credit under the *Cohan* rule, audited financial statements do not establish, as a threshold matter, that a taxpayer's activities satisfy the four qualified research tests. (See, e.g., *Little Sandy Coal Company, Inc. v. Commissioner* (7th Cir. 2023) 62 F.4th 287, 301 [the court declined to invoke the *Cohan* rule to estimate the allowable R&D tax credit because the taxpayer failed to prove the process of experimentation test (the fourth qualified research test)].)

[3] The *Cohan* rule provides that "if a taxpayer proves that [the taxpayer] is entitled to a tax benefit but does not substantiate the *amount* of the tax benefit, the court 'should make as close an approximation as it can, bearing heavily if it chooses upon the taxpayer whose inexactitude is of [the taxpayer's] own making.'" (*Shami*, *supra*, 741 F.3d at 568, italics in original, citing *Cohan v. Commissioner* (2d Cir. 1930) 39 F.2d 540, 544.)

Even after layering on the other evidence—the patents, the IRS audit, and Dr. Keshner's testimony—the record does not establish that OptiSolar's activities satisfy the four qualified research tests. While the issuance of a patent gives rise to the patent safe harbor in Treasury Regulation section 1.41-4(a)(3)(iii), which provides that an issuance of a patent is conclusive evidence that a taxpayer has discovered information that is technological in nature (the second qualified research test) and is intended to be useful in the development or improvement of a business component (the third qualified research test), the patent safe harbor does not establish the first and fourth qualified research tests. (*Shami*, *supra*, 741 F.3d at p. 572 ["a taxpayer still must prove that the expenditures are of the type deductible under [IRC section] 174" (the first qualified research test) and that "substantially all of the research activities constituted a process of experimentation" (the fourth qualified research test)].) In addition, "the issuance of a patent with respect to a discrete business component does not mean that all research conducted by the taxpayer is qualified." (*Ibid*.)

While Dr. Keshner's testimony was credible, his testimony, either alone or together with the other evidence, did not provide sufficient detail to satisfy the first and fourth qualified research tests. For example, although Dr. Keshner briefly summarized some of the steps in OptiSolar's research activities, his testimony did not contain sufficient detail to establish that "substantially all" of OptiSolar's research activities reflected in the audited financial statements constituted a process of experimentation for a qualified purpose. (See *Appeal of Pino*, *supra* ["merely stating the existence of an evaluative process does not show that [the company] actually engaged in that process, or that, if the process occurred, it was a qualified process of experimentation under the law"]; see also *Union Carbide Corp. and Subsidiaries v. Commissioner*, T.C. Memo. 2009-50 at pp. *78-80 [discussing the requirements of the first and fourth qualified research tests].) Dr. Keshner's testimony also did not tie OptiSolar's research activities to the total line item R&D amount on the audited financial statements, or establish what qualified research expenses may have been incurred in California versus in Canada.

Lastly, appellant contends that the IRS audited appellant's federal income tax return for the 2011 tax year and made no changes to the OptiSolar R&D credit. However, the IRS audit documents do not indicate whether the IRS examined the federal R&D credit and, in any event, FTB is not bound by IRS decisions which it believes to be erroneous. (*Appeal of Der Wienerschnitzel International, Inc.* (79-SBE-063) 1979 WL 4104.)

Accordingly, appellant has not established that the claimed expenses satisfy the four qualified research tests in IRC section 41(d).

HOLDING

Appellant has not established error in FTB's denial of R&D credits for the 2013 tax year.

DISPOSITION

FTB's action is sustained.

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Ovsep Akopchikyan
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Ovsep Akopchikyan
Administrative Law Judge

We concur:

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Kenneth Gast
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Kenneth Gast
Administrative Law Judge

DocuSigned by:
Tommy Leung
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Tommy Leung
Administrative Law Judge

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