BEFORE THE OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

IN THE MATTER OF THE APPEAL OF,	
NOVO NORDISK INC.,	OTA NO. 21047529
APPELLANT.	

TRANSCRIPT OF PROCEEDINGS

Cerritos, California

Wednesday, June 12, 2024

Reported by:
ERNALYN M. ALONZO
HEARING REPORTER

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NOVO NORDISK INC.,	OTA NO. 21047529
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Transcript of Proceedings,

taken at 12900 Park Plaza Drive, Suite 300, Cerritos, California, 90703, commencing at 9:30 a.m. and concluding at 11:08 a.m. on Wednesday, June 12, 2024, reported by Ernalyn M. Alonzo, Hearing Reporter, in and for the State of California.

APPEARANCES:

Panel Lead:	ALJ ASAF KLETTER
Panel Members:	ALJ AMANDA VASSIGH ALJ KENNY GAST
For the Appellant:	TIMOTHY LEE KYLE SOLLIE RICH MOORE
For the Respondent:	STATE OF CALIFORNIA FRANCHISE TAX BOARD BRIAN MILLER NATHAN HALL

I N D E X

E X H I B I T S

(Appellant's Exhibits 1-22 were received into evidence at page 7.)

(Department's Exhibits A-U were received into evidence at page 7.)

OPENING STATEMENT

CLOSING STATEMENT

Cerritos, California; Wednesday, June 12, 2024

9:30 a.m.

JUDGE KLETTER: Let's go ahead and go on the record.

This is the Appeal of Novo Nordisk. It's OTA Case Number 21047529. Today is Wednesday, June 12th, 2024, and the time is 9:30 a.m.

I am Judge Kletter, and with me are Administrative Law Judges Kenny Gast and Amanda Vassigh. While I am lead in conducting this hearing, all three judges are co-equal decision maker.

Our stenographer, Ms. Alonzo, is reporting this hearing verbatim. To ensure we have an accurate record, we ask that everybody speak one at a time and does not speak over each other. Please speak clearly and loudly. And please be aware that Ms. Alonzo may stop the hearing process and ask for clarification or ask you to slow down. After the hearing, Ms. Alonzo will produce the official transcript, which will be available on the OTA website. The hearing transcript and the video recording are part of the public record.

And just to note that the Office of Tax Appeals is not a court. We are an independent appeals body. The Office of Tax Appeals is staffed by tax experts and is

independent of the State's tax agencies.

I'd like for us to have the parties please each identify yourself by stating your name for the record, beginning with Appellant.

MR. SOLLIE: Good morning. My name is Kyle Sollie for the Appellant. And with me is Rich Moore to my immediate right, and Tim Lee, also for the Appellant.

JUDGE KLETTER. This is Judge Kletter. Thank you.

And for Franchise Tax Board.

MR. MILLER: Brian Miller, attorney for representing Respondent Franchise Tax Board.

MR. HALL: And Nathan Hall on behalf of Franchise Tax Board.

JUDGE KLETTER: This is Judge Kletter. Thank you.

The issue that we're hearing today is whether Appellant must include a former member's qualified research expenses incurred in the 2008 tax year for purposes of the California research credit.

At the prehearing conference we discussed the issue statement to the extent that you would like to phrase the issue statement differently. Feel free to do so during your presentation.

With the respect to the evidentiary record, FTB

provided Exhibits A through U. Appellant did not object to the admissibility of these exhibits and, therefore, these exhibits are entered into the record.

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

JUDGE KLETTER: Appellant provided Exhibits 1 through 22. FTB did not object to the admissibility of these exhibits and, therefore, these exhibits are entered into the record.

(Appellant's Exhibits 1-22 were received in evidence by the Administrative Law Judge.)

JUDGE KLETTER: As a reminder for our presentation today, we have 60 minutes for Appellant's presentation, 60 minutes for FTB's presentation, and then 15 minutes for Appellant to provide a closing statement and rebuttal.

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

MR. SOLLIE: I am indeed. Thank you.

JUDGE KLETTER: Please begin.

MR. SOLLIE: And if I may start, we provided the OTA with a PDF by email with demonstratives. All of it is based, either on the record or snippets from the statute or calculations. I brought paper copies, if that would be helpful for the OTA while we're going through, or I don't

know if it's something you've got on your -- on your computers. But if I can approach, I can give paper copies and -- if they're useful.

JUDGE KLETTER: We have the digital copies on our computer, and then we're able to see those.

MR. SOLLIE: Okay. Thank you.

JUDGE KLETTER: Thank you.

PRESENTATION

MR. SOLLIE: So this is a research and development credit case, but it's not the typical R&D case, the typical case that comes before the OTA. There is some dispute over whether or not something is researched over whether or not something is or isn't -- I think often is or isn't in California. And in this case, there's no disagreement between the taxpayer and the FTB over whether qualified research took place, over how much qualified research took place, and over whether the qualified research took place in California. Everyone agrees that all the qualified research -- when we get into the nuts and bolts, all the qualified research took place in Hayward, California.

So there's no -- so it's a little bit of a different case, and that's one of the reasons why there are some technical things. We've got some demonstratives

that we want to walk through because there's technical question, really, about how in the measurement period -- you know, as an R&D credit works, you compare the current year's research with prior years' research. And what the statute wants the taxpayer to do is increase the research. Okay. That's the whole reason for the research and development incentive to increase the research.

So the question that we're going to be talking about today really is, how do we count historical research for purposes of computing whether there was an increase -- a sufficient increase in the taxpayer's research to qualify for -- for a credit. When we get into it, we're going to see that the whole case hinges on whether to count a certain amount of research conducted in 2008. We'll get to it, and we'll go through kind of -- we'll go slowly only because it's pretty technical, about whether certain research that was conducted in 2008 should be counted.

What we're going to show the OTA is that the IRS, which also -- the California's research credit is based on Section 41 of the Internal Revenue Code. The federal research credit, like the California credit, looks to current research and compares it with historical research. And we're going to show the OTA that the 2008 year, which is really the year we're going to focus on here, that the

2008 year was also relevant in the federal historical computation. The IRS looked at it, and the IRS concluded that the research that the taxpayer says ought to be excluded, the IRS agreed should be excluded under the Internal Revenue Code.

And we're going to show -- we're going to walk through in a fair -- it may seem painstaking, but we think it's important to show that it was important to the IRS; that the 2008 research was also important to the IRS. We're going to show with some documentary evidence that the IRS looked at it, and that they reached a conclusion that we think is entitled to deference by the OTA when interpreting the federal provision.

So here, I'm going to do five things in today's presentation. The first thing I'm going to do is I'm going to review the law. It's an area of the law that, you know, not everybody works with every day. And so I -- we're going to go through a little bit just to look at it okay, what' is -- what is the legal background. A lot of it is going to be the Internal Revenue Code, but we're going to show how the Internal Revenue Code is brought into the Rev & Tax Code.

We're going to look at Novo's research calculation under the statute. We're going to talk about the crux of the issue. And the crux of the issue, again,

is going to be for that 2008 tax year. Novo's position is that it disposed of a business, and that the research related to that disposition should be excluded from that historical calculation. We're going to talk a little bit about that disposition.

And the fourth thing we're going to do is that we're going to review the IRS's audit; show you that the IRS looked at the same thing that we're going to be looking at today, and that the IRS agreed with Novo's position in the IRS audit. And then finally, we're just going to -- again, it's a fairly technical tax calculation. We're going to give the OTA, essentially, okay, here's what we want. If you agree with everything we said, here's the tax calculation we want. There's a certain amount of moving parts. There are some research credits carried in. There's research credit used up and so on, so there's no confusion at the end of the day in terms of what Novo is asking for. So those are the five things we plan to do.

So we're going to start on -- in that PDF that we sent on page 2 or Slide 2 with Section 41 of the Internal Revenue Code. And the reason why we're looking at Section 41 of the Internal Revenue Code is because the California Rev & Tax Code, section 23609, adopts by reference -- adopts into California law Section 41 with some changes.

And we'll talk about the changes, but it adopts that into California law. And the provision that is quoted or that we've got clipped into our Slide 2 is from Section 41.

So, really, what that does is it states the basic rule that the research credit is 20 percent. So it's a 20 percent of the excess of qualified research expenses over the base amount. Remember I talked about there's this historical calculation we have to do. That's the base amount. So essentially what Congress said is, we want taxpayers to be increasing the amount of their research. So what we do is we look at their current year research -- their current qualified research, and we compare it to a -- essentially, a benchmark, a base amount. That's -- we'll go into what that is. It's a fairly technical calculation, but that's the -- and the excess of it. In other words, the increase in the research for your current tax year over that base amount is the amount on which the credit is computed.

So on the next slide, we show the only -- this is Slide 3 or page 3 of the PDF that we're looking at. The only change that's relevant to at least that portion of Section 41 -- there are other changes that are in that California Rev & Tax make to 41, but it's relevant to the clipped change is the -- is the rate. So everything else about what California brings in is the same. California

Rev & Tax 23609 says, yeah, instead of 20 percent, call it 15 percent.

So what we've done -- and we hope this is helpful. Again, just to -- not to -- to baby step this, just to make sure that the OTA can see when we get to talking about 2008, how does that fit into the whole puzzle. So -- so for -- what I clipped here is for the 2011 year just as an example. What happens with 2011 is it creates a credit that carries into our years, the '12 and '13 years for which there is a Notice of Action. But 2011 generated a credit that carries in, so we started with that. So 2011, this base amount you can see on Slide 3, $3.8 million, that's essentially the benchmark. Okay.

The current year research for 2011 was 6.7 million. That is everybody agrees. The FTB and the taxpayer agree Novo had $6.7 million of California research in 2011. The excess of the -- of that $6.7 over the $3.8 is $2.8, and that's -- for the taxpayer that's a good thing. We want more excess because we want to show that we're increasing our California research. The tax rate is the 15 percent. The resulting credit in 2011 is 426. The same kind of calculation for the other years, but we just figure it was worth kind of slowing down and showing the OTA how that works. Okay.

So the next slide -- the reason we're doing this in baby steps because there's all -- it gets -- we keep kind of peeling the onion. The next slide is Slide 4. What's the base amount? Okay. Remember it's -- you get a credit to the extent your current year research exceeds the base amount. Well, what is the base amount? Well, the base amount has its own calculation. So on Slide 4 we show that. The base amount is the product of the fixed-based percentage, and the aggregate of the annual gross receipts of the taxpayers for the proceeding four taxable years. Okay.

And, again, what we've done is kind of slowed down to show, okay, how does that work in Novo's case? So the calculation to the right on Slide 4 is really the same as the calculation on Slide 3, but we've just added this fix-based percentage. So as you can see, that fix-based percentage, that 1.98 percent times the average annual gross receipts -- that is the gross receipts of Novo during those four years -- equals the base amount.

Now, the reason we say this is the taxpayer wants that fix-based percentage to be lower. Because the lower the fix-based percentage, the lower the base amount, and the lower the base amount, the greater -- the current year's expenses will be over that base amount, and that's what generates the credit. So going through all this

because that fix-based percentage really ends up being the percentage that matters. The taxpayer wants it to be lower.

Okay. Now I go to Slide 5. And so now we've got to figure out how we compute the fix-based percentage. And what that is, is we have to look at two -- we look at two numbers, and this is a little bit of a sliding scale. That is, the statute looks at different years depending on how many years it's been that you've been developing credits. We and the FTB agree that the 2011 year, at least, is the eighth year of that sequence. So if you -- if you go to Section 41 of the Internal Revenue Code, it'll say in the case of the seventh year and the sixth year and fifth year there's -- you can ignore all of that. We are in the eighth year.

In the eighth year, the calculation is a half of the percentage which qualified research expenses for the fifth, sixth, and seventh years is to be the aggregate gross receipts of those years. And that's a lot -- there's a lot of language there, but this is my -- our first demonstrative, which we figure would be useful in showing how this works. Again, just to be -- to be clear, so it's -- it is, you take -- we're in the eighth year. So --

And for the FTB's benefit, I'm looking at

Slide 6. So this is just a blowup of Slide 6.

2011 is the eighth year. And what the statute says is you take the qualified -- the average qualified research -- or sorry -- the sum of the -- the aggregate of the qualified research for years 5, 6, and 7, $24 million, and you take the sum of the gross receipts for years 5, 6 and 7, $609 million. You create a fraction, divide the 24 by the 609, then you multiply it by a half, and that's your fix-based percentage. Now, just to -- in case you went, okay, where's the -- where's the action here? The action is, again, the taxpayer wants the historical number to be lower, and the FTB wants it to be higher, because that makes -- this historical number is lower, this percentage is lower.

And it makes sense because what the legislature is trying to do is encourage current year research, trying to -- having you increase your current research. So it's taking your average, and it's using that to compute this base amount. That ends up the base amount which the credit is computed. So that ends up becoming the base amount against which the credit is computed.

So now going to -- going to Slide 7. The other thing, it's just helpful to know -- because it's going to be part of answering our legal question -- is the whole reason we're here is that Congress at the federal level

and the legislature at the California level want to encourage taxpayers to engage in qualified research. So -- so what is that? Because, at the end of the day, we could get abstract about, you know, various other questions that we're going to be looking at. But what are we trying to answer? So what we've done is we've given you the definition in Slide 7 of qualified research. This will become relevant as we work through it to just kind of have this background. So I hope you'll appreciate and indulge me with making sure we walk through this definition.

Qualify -- so this gives the definition of qualified research expenses. Qualified research expenses means the sum of the following amounts, which are paid or incurred by the taxpayer during the taxable year in carrying on any trade or business of the taxpayer. It goes on to say in-house research and contract research expenses. You get a credit for employees that do research. And you're getting credit if you, let's say, were to pay a university to do research for you under contract.

Then flip to Slide 8. And one thing that's interesting, Congress back in '89 added this language to the definition of qualified research expenditures. I think it may be useful for us to understand what the

legislature is trying to incentivize here. Because they wanted to make it clear that -- that for purposes of a startup venture -- and mind you we fall into the definition of a startup company. If you go back to slide -- if you go back to slide --

JUDGE KLETTER: I believe it's Slide 5.

MR. SOLLIE: Slide 5. Yes. Thank you. Thank you, Judge Kletter.

This calculation is under the startup provisions. Now startup, remember this is written in the 80s, and it was whether or not you had your first research expense and your first research gross receipt after 1983. So remember startup is relative. You may think, no, they've been around forever. Are they still startup? But so we are. We both agree that we're computing under the startup rules. And in 1989 what Congress did is said, so for purposes of determining whether you have a qualified trade or business, you have -- you have -- you are conducting a trade or business if your research relates to the act of conduct of a future trade or business. Because there were questions in the legislative record when this was added.

It was, okay, what if you've never sold anything before, are you engaged in trade or business? And what Congress wanted to make clear is, yes, that is a trade. Not having yet sold anything, you're still a trade or

business. After all, that's the whole point of research is you haven't yet got a product. So Congress made this change. We thought that was useful to show. Okay.

Now the issue -- that's back -- this is all background. So thanks for indulging me on that.

The issue for the OTA to decide is this. Novo had a trans -- I'm going to call it a transaction. Not to put the rabbit in the hat, by call -- I love to call it a disposition. But to not put the rabbit in the hat, I'm going to call it a transaction. Novo had a transaction with a business partner called Aradigm. Aradigm was a company that was in the business of developing inhaled pharmaceutical products. Everything from inhaled steroids to all sorts of inhaled pharmaceuticals that -- for patients who would have a difficult time, you now, either using intravenous or pill type of application. So that was Aradigm's business.

So Aradigm licensed to Novo some technology that Novo used in 2006, '07, and '08, for Novo to use this Aradigm technology to come up with commercially viable inhaled insulin. I mean, normal insulin delivery is using needle. And it would be beneficial if it was possible, right, to that that delivery be available through an inhaler, like and asthma inhaler or something like that. It would -- that would --

So Novo and Aradigm entered into an agreement, whereby, Aradigm licensed technology to Novo for Novo's use in developing inhaled insulin. And this was the first time. Novo didn't have an inhaled insulin business. It had -- it formed a separate company to do that insulin -- inhaled insulin development business. And in 2008, Novo concluded that since there were other competing products on the market, that it was not a business priority for it to continue the research. There were other inhaled insulin products on the marketplace, and Novo decided that it was no longer going to continue for itself to develop that product.

Novo entered into a transaction by which -- and we can talk more about exactly how this works -- but entered into a transaction where all of those license rights that it had required from Aradigm reverted back to Aradigm. Novo transferred patents back to Aradigm, transferred data it had collected for the clinical trials to Aradigm and, essentially, thereafter, Novo no longer was in the inhaled insulin business.

Novo's position is, that is a disposition of a trade or business, like I mentioned, was a future trade or business. That's a disposition of a separate unit. It was the only inhaled insulin business that Novo was doing, and it reverted back to Aradigm. So -- and I give you all

that because now we look at the statute.

So the statute is, if there's a disposition of a major portion of any trade or business -- I'm on Slide 9 -- or a major -- so a major portion of any or trade business or the major portion of a unit or trade or business in a transaction to which A applies -- and what A simply is the reverse, that is there's an acquirer. And an acquirer has to do something, and the disposer has to do something so that there's -- there's an acquisition and a disposition. And the taxpayer furnished information necessary for the application of paragraph A. We'll talk a little bit about that. Then the expenses -- the historical expenses incurred by the taxpayer in that trade or business or in that unit of the trade or business are excluded from the tax calculation. Okay.

What does all that mean? So what Novo's position is -- so this is really just this calculation on -- I'm Slide 10 for the FTB's benefit.

What Novo says is this was it's position. It excluded this $13 million -- was research conducted in Hayward, California. That Novo's position is it disposed of, by transferring all the elements of that business back to Aradigm, because it decided it was no longer going to continue to invest in it, transferred all that business back to Aradigm. And what Novo's position is, that

section of F-3, allows Novo to exclude the $13 million from these prior period qualified research expenditures and, therefore, computed its fix-based percentage by excluding them.

FTB's position is, we don't think there was a disposition. I don't want to -- I'll let Mr. Miller say what FTB's position is. But FTB's position is there was no disposition and, therefore, the $13 million is in this calculation. And as you can see, the fix-based percentage, as opposed to being 1.9 percent for this year. And, again, this is used -- this is for all the years, but I just use one to demonstrate the calculation -- is 3.13 percent. And of course, that increases our base amount and significantly decreases the credit.

So what the case is about for the OTA to decide is, whether or not there's a disposition that allows Novo to exclude the $13 million from the fixed-base percentage calculation. So in Slide 12 there's no definition of disposition, so we give a dictionary definition of disposition: Is to get rid of; to deal with conclusively; and to transfer the control to another. So our -- you know, our view is Section 41-F3 requires a disposition, and Novo has done that. What Novo has done, again, is it had a license to use the Aradigm inhaled medicine technology. It terminated that license. But what that

had a result of doing was, those license rights then reverted back to Aradigm.

It's also clear that Aradigm -- that Novo transferred Aradigm other patents, patents that Novo itself had come up with that related to inhaled insulin. It's also the case that Novo transferred to Aradigm research clinical data, also regulatory filings back to Aradigm. Now, remember Aradigm is still in the business. Aradigm continued to be in the business of developing inhaled pharmaceuticals. So it wasn't like they just -- Novo left the stuff on the street. It was transferred to a company that had the kind of research scientists that knew what do with all of that stuff.

So the next question is, okay, did they dispose it? We think clearly, they disposed of. I don't even -- I don't know we hear from Mr. Miller, but don't know if there's an argument about whether there's a disposition, and the question is whether there's a trade or business. And we think here there is. In particular, remember that for purposes of qualified research, and the definition of qualified research that we looked at, a trade or business includes a future trade or business. That's how it's always looked at in the context of Section 41.

So on Slide 14, we think this is useful. This is Aradigm's annual report for 2008. And we think it's

useful to pause here and see what did Aradigm think it was getting when Novo exited the inhaled insulin business. It terminated the license agreement, so it all reverted back, et cetera. Well, Aradigm says, look, Novo Nordisk must enable the company to continue to pursue commercialization of inhaled insulin. So from Novo's perspective and, at least, Aradigm's perspective, at the time, they understood Novo had to help Aradigm continue to pursue the commercialization of inhaled insulin.

Well, there was another thing that Novo had to do to Aradigm in connection with what we say is a trade or business of inhaled insulin, supply the company with insulin for use in continuing the development of inhaled insulin. So Novo had the contractual obligation, which Aradigm reports in its 10K, to keep providing. You don't go to Amazon or, you know, to -- to just get, you know, insulin for testing purposes, no -- at a pharmaceutical grade commercial level. Novo had the continuing obligation to provide insulin so that Aradigm could continue its work of developing -- of developing inhaled insulin.

What else did Aradigm have to do? What else did -- sorry -- Novo has to do? What else did Aradigm get? Provide the company with full access to the data generated in the development of inhaled insulins. That

was important, right. A lot of what you do when you develop a new pharmaceutical is you do testing, and you take data, and keep the regulators up to speed with what you're doing. And what Aradigm said is, look, what we're getting back from you, Aradigm -- sorry -- Novo, is a future -- what we expect to be a future trade or business. We hope to sell inhaled insulin. And in order to do that, we need to have your clinical trial data and all relevant sections of regulatory filings. As we all know, a big part of getting a pharmaceutical product commercially successful is get to the health regulators on board with what you're doing through the testing.

And the other thing, the final thing is, there's some discussion in the briefing, right, about well, is Novo's termination of the license agreement with Aradigm really, you know, a disposition of a business, a sale of the business back to -- back to -- back to Aradigm. And look, the last thing is, not only did Aradigm get back the intellectual property it originally licensed to Novo, but it also got a portfolio of Novo's patents. Novo Nordisk transferred to the company at no charge, a portfolio of U.S. and foreign patents related to inhaled insulin. Essentially, Novo gave Aradigm -- all Aradigm needed to do to have, essentially, an inhaled insulin development business. It wasn't just that Novo is like, yeah, we're

out. It was, here's all the things we need to do so that you can continue that development of that business.

So on Slide 15 we sort of recap what we think the statutory test is. Does IRC 41(f)(3)(B) apply? That is, does that exclusion apply? Yes, because we, Novo, dispose of a trade or business, which remember, includes a future trade or business, which makes sense. Yes. No one was ever selling inhaled -- I mean, just to pause. No one was every selling inhaled insulin. Even back in 2008, all that was happening was development. So if it was -- if it wasn't a trade or business -- you know if a trade or business requires that you're selling something, then it was never a trade or business. But everybody agrees it was a trade or business. That the development of a future product is a trade or business. We disposed of that trade or business. That is the unit that would be capable of future development. We gave them the patents. We gave them the clinical data. We gave them everything that they would need.

The other legal test that is discussed in the briefs is whether that trade or business is viable. And the reason we -- we're looking at Slide 16 now.

There's a cross-reference in the R&D regs to the regs under IRC section 52, which relates to an appointment, a payroll credit, which has now since been

repealed. And there the question is well, that -- that regulation defines what needs to be transferred as a viable trade or business. And I want to make two comments about viability. First of all, what the regulation is mainly doing -- if you look at this section 1.52-2(b)(ii), there's two sentences in that little paragraph, and one says it has to be a viable trade or business. And the next sentence says, the taxpayer can't merely transfer physical assets.

This employment credit, like the research credit, only applies if taxpayers increased the amount of employment that they did. So kind of like the same way, you needed to do a historical look back. And what the -- what the regulation writers were saying is -- and like, by the way, like Section 41, if you disposed of a business or acquired a business, you had to count or reduce your history by the disposition or acquisition. And what the regulation writers were looking at is, look, if you are simply selling somebody a building but there's no business related to the building, then you can't either -- you're not required to add or subtract from your history for purposes of the payroll credit. So really that viability is meant to contrast with -- as the regulation says, the mere acquisition of physical assets.

The other thing too, is when you're looking at

that section 52, if the OTA looks at that for, okay, how does that fit in? Just remember the distinction between the credit in that case, which is a payroll credit where you would expect there to be people employed in a variety of things, compared to what we've got, which is a research credit where you expect there to be intellectual property taking a more prominent role. So in thinking of whether it's a viable trade or business, I think it's relevant when you're looking at the authorities and looking at that regulation to see what was Congress trying to get at, and what was the IRS trying to do with the regulation, and what's the difference between those credits.

The final -- the final couple of slides, Slide 17, again, we wanted to emphasize that -- that Aradigm was transferring -- we turn to slide 17 -- that Aradigm was transferring patents that originated from Novo Nordisk. And, again, to emphasize that the clinical data was going. It wasn't just like, hey, we're terminating this agreement; mic drop, and we're out. It is providing Aradigm what it would need. Now, there is -- obviously, in the briefings a question about, okay, it looks like Aradigm wasn't going to then pick up the ball and develop it on its own. And the answer is, that's right.

Aradigm was a -- if you look at the 10K, which is in the record, is a relatively small business. It's got

scientists that can lead research, but it needs a big partner like Novo to get over the commercialization. So it does need to look for a research partner. So -- but that doesn't mean that inhaled insulin, as we saw from this -- from their 10K in 2008, that doesn't mean they thought the inhaled business wasn't viable. That just meant, look, we need to look some -- for some help, you know. Us, 15 research scientists here at Aradigm, a pretty small company, aren't able to do it just by ourselves. We do need another research partner, another Novo who can help do the, you know, the regulatory testing and the big commercialization efforts that need to happen so that a -- regulatory efforts that need to happen so that a drug can be approved.

Slide 18, again, is just the license agreement. This just emphasizes all the things that after the termination had to go from Novo to Aradigm, and that's confirmed again on Slide 19. There's an appendix with the patents that were -- that were transferred.

Now, I'm going to spend a little bit of time. So that's essentially the law for this -- for the OTA to decide is -- the question is, under 41(f)(3), was there a disposition by Novo of its business -- of its inhaled insulin business back to Aradigm -- taxpayer says there was -- such that the 2008 expenditures are excluded from

that fixed-base calculation that we looked at. Okay. Now, here's the other thing that we think is relevant to the OTA's consideration of this case, and that is that historical research -- those historical research credit or research expenditure amounts were also relevant at the federal level. And I'd like to look at that with the OTA if you'll indulge me. I definitely want to do this with the demonstrative because it's -- there's a fair amount of moving numbers here, but these are all exhibits.

I'm now on Slide 21. And these are all exhibits from the record, but they're from the IRS audit. And just to be clear that we think, one, the IRS looked at this; and two, because I think the briefing. It was a little unclear from the briefing. Well, exactly how is what the IRS looked at relevant to what California cares about, and that's what I'd like to look at with you. So what this is, is a picture of the closing document with the IRS related to Novo's audit for the '11 and '12 cycle. And what I'd like to focus your attention on is this side of the exhibit. Okay.

There are aggregation rules in the Treasury Section 41 Regulations that divide the -- divide Novo into an aggregation groups. And the group we care about is this group. This group here, these two are Novo Nordisk of North America. So these two are the ones, and we'll

see how that ends up coming over to California. But the number to watch is in the '11 and '12 cycle, the IRS -- so here we have the 2011 year. The current year is $88 million worth of the research. And for purposes of the federal credit, it was relevant to look back at the three preceding years.

Now, here's the thing. Here's what the FTB is concerned about. Novo used a different election federally than it did in California. Federally, Novo used the alternative simplified credit under Section 41(c)(5). Okay. What the alternative simplified credit does is it takes current year, okay, and then it takes the preceding three years, multiplies it by half, and the difference is what the credit is based on. So just like in California where you compare the current year with the prior year, but federal just has a different set of prior years. But the important thing is that in the 2011 and 2012 audit cycle, the 2008 QREs were relevant. Just like we saw for California, 2008 was relevant. Remember that's our question. In the federal audit, 2008 is relevant to determine the credit. Okay.

And this is what the -- so we're going to see the $66 million number, and we're going to prove this. That number excludes the inhaled insulin business. So the IRS looked at this. And you can see from the -- from the full

Exhibit 10 that they knew about NNDT, and they were looking very closely at NNDT and it what it was doing. And the IRS agreed that for the historical look back from 2008, under Section 41(f)(3), NNDT's expenses should be excluded because it was disposed of. Okay.

And I'm going to show you now that -- how that -- not only was it excluded here, but it was included earlier. So let me just kind of walk you through it. I -- I know this is -- this is what -- why, you know, these exhibits are worth going through. So this -- so I'm now on slide -- for the FTB's benefit -- Slide 22. This is the business unit that ends up being relevant. So this $66 million number, we just clipped it again here. This is the same thing as this side of the -- of this exhibit as here.

Now, the IRS audited Novo for the 2007 through 2010 cycle. Okay. And what did it do? Well, in -- in -- again, this is Novo Nordisk North America, the $66 million number. Here's NNNA. This is the same group, the same number. So for 2010, Novo Nordisk -- so the IRS agreed that Novo Nordisk should use the $66 million number. Okay. And you may say, well, did the IRS know about that $13 million that we care about, or did they just take Novo's number? They did, and we'll show you why.

So this is -- this is for the 2007 to 2012 cycle -- so 2007 to 2010 cycle, okay. In -- and this is -- we've now clipped this one. We put it here, all right, to just kind of make sure. So the same $66 million number here. Okay. But what about the 2009 year? For 2009, for Novo Nordisk North America, Novo reported $80 million. The reason for that was there was some hangover of, you know, terminated the license in 2008 but wanted to be conservative in terms of when it had completely disposed of its business. So it didn't yet exclude it from its computation in 2009. It wasn't fully comfortable that it had one everything it needed to do to dispose of the business until 2010. So conservatively in 2009, Novo included -- remember, this is NNI. This is 2008 -- included the NNDT expenses in the three-year history.

And, again, if you go to these exhibits, you will see for each of these in the alternative simplified credit calculation, that it's relative to federal income tax; whether or not this anybody is 80 or 66; whether or not this 13 is in. It -- it -- so put differently, for every one of the years that the IRS audited, 2010 and 2011 in particular, had they put an 80 here, that is, had they included the NNDT, the federal credit would have been less.

So the IRS would have been motivated to say, hey, this -- remember this one audit cycle. Hey, we noticed you're at 80 here for 2009, and then the same -- and then you group down to 66. What's the deal? Right. Because by bringing it down, you're increasing the amount of your federal credit. But the IRS knew that was right because NNDT had been -- or the inhaled insulin business had been disposed of by Novo. And under Section 41(f)(3), it was proper for them to reduce the amount of their historical research by the $13 million. And that -- so that $13 million, remember all this research is taking place in Hayward, California. Okay.

So we now go to the California audit. That 13 number, that is the difference between this one and this one. Okay. That's the same $13 million number that is at issue before us. Okay. So what we're asking this OTA to do -- so the IRS audited it in the same cycle. It said, yeah, we get it. You disposed of that -- that inhaled insulin business to Aradigm. It should be excluded from your historical calculation beginning in 2010 and also in 2011. It mattered for two tax years for two audit cycles. The IRS agreed with it.

And what we're saying is the FTB likewise -- because remember, we're looking at the same Section 41(f)(3) whether or not that's excluded in the Internal

Revenue Code, that the FTB and the OTA would be appropriately differential to the IRS' decision. We have a lot of materials in the briefs about all the times the FTB is coming out and saying we follow what the federal does, and we think this is an area where there's really -- there's no difference. It's the same.

The question is, under 41(f)(3), is the amount excluded? And here is just how that fits in. That's that same $13 million number. That's the number that ends up being the difference between Novo's position and the FTB's position. So, again, we walk through the whole statutory basis, but it's the same 13,991,093 number that the FTB -- or that the IRS agreed ought not to be included in the historical computation for -- for computing the credit.

So last series of things that we just wanted to sort of mention was look, the IRS is charged by Congress with interpreting federal law. Actually, if you look at the audit materials in Exhibit 9, you will see that the IRS actually took it to their subject matter experts to do with NNDT. This was a carefully considered decision by IRS. They looked at it. It was actually relevant to this computation, this exact question, this determination under (f)(3).

And what we have included in the materials are just clips from exhibits. For example, on Slide 28 we

have a clip from Exhibit 16, which is the FTB's model of audit procedures, RAR and federal determinations. And we had highlighted the language under FTB policy, "If the IRS has examined and changed, or no-changed, an issue, we will not pursue it unless there is clear information to show that the IRS is wrong. This is a rare event."

So, look, I think, was -- was the inhaled insulin disposed of? I mean, I certainly think it's -- it's possible to read the law the way the FTB does. We certainly think our read is the better read in light of what the research credit is intended to accomplish. But we think here, certainly, you're not going -- everything you hear from the FTB, you're not going to think, oh, the IRS in doing what they did clearly wrong. The IRS made a judgment call in light of the statute, interpreted the statute, and we think that that interpretation -- and so does the FTB, at least in other context, is entitled to deference.

On Slide 29, we talk about -- the FTB talks about, well, when is -- when -- when does the FTB usually vary from what the IRS does? And -- and here they actually say, right, you know. However, it may sometimes -- I'm looking at the highlighted language on Slide 29. However, it may sometimes be unclear what exactly the IRS examined in their audit. We think -- we

think it's clear that we've shown the IRS examined exactly this 13,199 number. Okay. So that's not the case.

And how that relates to research performed in California? We all agree all this research was performed in Hayward, California. So we think this is not the kind of case where there is something different between what the IRS did and what the FTB needs to do where they ought to be coming up with a different conclusion than what the IRS did.

On Slide 30, again, this was just another instance. This is from the FTB's S corporation model. But, of course, S corporations follow the same Section 41 credit. And, again, the instances in which the FTB says that they differ from the IRS is when there's a -- when there's a question about whether or not something is in California, which makes all kinds of sense. And, again, finally on Slide 31 and this -- this is a snip of this state tax news. And here, again, the FTB says, "It's our practice to follow an on-point federal determination in the context of the federal credit claim."

There's a small caveat. The FTB goes on to say, "To that overall following the federal rule, staff needs to make any modification for the few differences between state and federal law." And here, again, we -- the reason we went through this painstaking walk through what the IRS

did is to show, at least with regard to the impact of counting those historical credits, there's no difference between state and federal law.

And that brings us to the end of the presentation. The one other thing we did at the end of -- this is also in the case statement. But, again, because there's a fair amount of -- there's a fair amount of complexity with the calculation, on Slide 32, we have a calculation. This is like all the little calculations we we're going through just for the 2011 year, we kind of brought them all forward, and Slide 32, we have summarized for the OTA.

If you agree with Novo's position that the inhaled insulin business was disposed of and transferred to Aradigm, and you exclude that $13 million like the IRS did, this slide shows what we believe is the proper recomputation of the -- of the credit and resulting tax over these tax years. The impact, of course, is on 2012 and 2013. The 2011 is there because it's a change in the credit that gets carried into the years that we care about. So we include that in the calculation.

JUDGE KLETTER: This is Judge Kletter. Thank you for your presentation.

I'm going to turn to my Panel Members to ask if they have any questions.

Judge Vassigh, do you have any questions?

JUDGE VASSIGH: I did not at this time. Thank you.

JUDGE KLETTER: And, Judge Gast, do you have any questions?

JUDGE GAST: I do not at this time as well. Thank you.

JUDGE KLETTER: And I will also hold my question. Thank you, again, for your presentation.

I'm going to ask Mr. Miller, are you ready to begin your presentation?

MR. MILLER: May I have one to two minutes to make a couple of adjustments, and I'll be ready.

JUDGE KLETTER: Okay. Yeah. Please, go ahead.

(There was a pause in the proceedings.)

JUDGE KLETTER: This is Judge Kletter. Mr. Miller, are you now ready to begin your presentation?

MR. MILLER: I'm ready. Thank you.

JUDGE KLETTER: Please go ahead. You'll have 60 minutes.

PRESENTATION

MR. MILLER: This case is about Appellant Novo shutting down a California research collaboration, then claiming California research tax credit. Novo, a

pharmaceutical company, collaborated with Aradigm to develop an inhalable insulin product. Aradigm, a medical equipment development company, owned patented technology to a device that could deliver inhalable medicine to patients. Aradigm granted licenses to Novo to use its inhaler technology to develop the inhalable insulin product then, if successful, to manufacturer the product for market.

Novo formed NNDT in 2004 as a subsidiary to conduct the research and development. NNDT had employees, equipment, and a facility in Hayward, California. In 2008, Novo terminated the Aradigm collaboration and ceased all research activity by November. Employees were laid off, equipment was sold, and leases were ended. In 2010, two years later, NNDT was liquidated, and Novo assumed NNDT's assets and liabilities. Novo told shareholders it did not think that it should continue investment in inhalable insulin, and Novo told us that the decision was, essentially, a financial decision. Currently, there is one insulin -- inhalable insulin product on the market that I found, Afrezza. But it appears that that's the only one. And it also appears that the market just didn't take to inhalable insulin despite the alternative to an injection.

That said, so I'll begin with your presentation

this morning with a basic review of how the California research credit is computed. Now, Appellant's presentation did describe the computation, but I'm going to emphasize some different -- different elements. Then I will discuss each of Appellant's three main arguments. First, I'll explain that there was no acquisition and disposition of NNDT's trade or business. Without both an acquisition and disposition, the law does not allow Novo to adjust NNDT's QREs out of the research credit computation.

Second, I'll address Appellant's contention that FTB news letter articles trump the law, that the tax notes articles trump its requirement of it to prove that it's entitled to additional research credit.

And, finally, I'll conclude by citing applicable regulations and an OTA opinion to address Appellant's third main argument that a federal examination of Appellant's federal research credit blocks the California Franchise Tax Board from examining the computation of the California research credit.

Here's a high-level outline of how the California research credit is computed. Appellant elected to apply the regular incremental credit, which is computed in three steps. The first step is determining the fix-based percentage -- the fixed-based percentage, pursuant to the

regular incremental credit, is fixed at 3 percent for the first five years a taxpayer had both gross receipts and QREs. And then for years six through ten, aggregated QREs of specified previous years are divided by aggregate gross receipts of the same years resulting in a percentage.

In our case, Novo was in its ninth and tenth years in 2012 and 2013, and Novo's aggregated QREs incurred in 2008 where part of the statutorily designated group of years applied to compute the fixed-base percentage. These QREs were divided by gross receipts of the same group of years with the answer expressed as a percentage. Now, eliminating QREs from the computation, as Novo did, reduces the fixed-base percentage. This effects the size of the important base amount.

In the second step, base amount is computed by multiplying the fixed-base percentage by the taxpayer's average annual gross receipts of the four years preceding the credit year. Please note that the base amount is not QREs. The base amount is a portion of a taxpayer's gross receipts. NNDT's 2008 QREs are within the fix-based percentage computed in Step 1, not the base amount.

Now, for the third step for the credit computation, current QREs that exceed the base amount are identified. The base amount is a measuring stick used to determine whether a taxpayer's current year research

expenditures exceed previous year research activity. The research credit is not available merely by doing research. The California research credit is available when a taxpayer increases California research activity over previous inquiries. In Novo's case before us today, Novo contends that NNDT's 2008 QREs should be disappeared from the computation of the fix-based percentage. Excluding NNDT's QREs decreases the fix-based percentage because there are fewer QREs to gross receipts.

Reducing the fix-based percentage decreases the base amount. Reduced base amount in this appeal causes the amount of Novo's current year qualified research expenditures to exceed base amount. So in summary, by eliminating NNDT QREs from the credit computation, Appellant causes the formula to appear to represent an increase in research activity. But in reality, rather than increase activity, Appellant actually terminated a research project in California.

Turning to Appellant's first main argument. Novo contends that it disposed of NNDT's trade or business in 2008, and that it is entitled to eliminate NNDT's 2008 QREs from the credit computation. Appellant cites to Section 41 subsection (f)(3), which allows a disposing party to shift QREs from its computation to an acquiring party who then applies the QREs to its research

computation. However, in Novo's case, its termination of NNDT's collaboration does not satisfy the law's requirement that there be both an acquisition and a disposition.

The plain language of Section 41 subsection (f)(3), titled Adjustments for Certain Acquisitions, conditions QRE adjustments, both on an acquisition and a disposition. So paragraph (a) of (F)(3) states, "If a person acquires the major portion of a separate unit of a trade or business of a predecessor, then the acquiring person's QREs shall increase by the amount of QREs paid or incurred in the predecessor" -- "by the predecessor in previous years."

The precondition of subparagraph (a) is that there must be an acquisition if the major portion or a separate unit of trade or business of another person, and if this preconditioned of an acquisition is met, than QREs are adjusted. So paragraph (b) states that if the predecessor furnishes to the acquiring person such information as is necessary for the application of (a), then QRE's paid or incurred by predecessor shall be reduced. The condition for reducing QREs is the predecessor furnishes information to the acquiring person. It is not enough to merely provide the information to a different taxpayer or person because the statute requires

that the information be provided to an acquiring person. There must be an acquisition to have an acquiring person.

So in this case, was there an acquisition of a major portion or a separate unit of a trade or business? Our position is that Appellant has not demonstrated with a preponderance of the evidence that Aradigm acquired a major portion or a separate unit of a Novo trade or business. Under the law, an acquisition is defined as the transfer of a viable trade or business, and an acquisition is not merely acquiring physical assets.

So as a recap of the facts in this case, which the parties articulated in their briefs and exhibits and today, Novo and Aradigm engaged in a collaborative effort to develop an inhalable insulin product. Aradigm had patented technology for a device that delivered vaporized medicine and was essentially an alternative to injections. Novo had expertise developing pharmaceuticals, including insulin products. It is like Aradigm independently developed a bow, and Novo endeavored to develop an inhalable insulin arrow that would work with Aradigm's bow.

For Novo to develop an insulin product that could be delivered with Aradigm's device, Aradigm transferred patents related to pulmonary delivery and granted an exclusive royalty-bearing license to patent a technology

intended for Novo to use to develop an inhalable insulin product, then if successful, manufacturer the product for the marketplace. Novo also granted Aradigm non-exclusive royalty-free licenses to new Novo technology that would be developed during the collaboration related to devices or packaged product to manufacture and sell an inhalable insulin product.

The license agreement. The license agreement had no end date but could be terminated by either party. Pursuant to the license agreement, when Novo terminated the agreement in 2008, the license granted by Aradigm terminated, and Novo was granted a perpetual world-wide non-exclusive royalty bearing license under the Aradigm patents and other intellectual property to develop, manufacture, and offer for sale in the field of pulmonary administration of insulin. Novo would have to pay royalty on sales for any such use of Aradigm's intellectual property, but it no longer had an exclusive license. The license agreement also contains provisions for unwinding the collaboration, wherein among other things, Novo would provide Aradigm with data generated under the development program and provide Aradigm with insulin product if it continued the development program.

So we do not dispute that NNDT ceased operations by mid to late-2008, terminated nearly all employees, sold

physical assets, and canceled real property leases. We also did not dispute that Novo adhered to all of the unwinding provisions of the license agreement with Aradigm, including transferring patent and license rights and research data to Aradigm while retaining certain nonexclusive royalty-bearing licenses to Aradigm's intellectual property. We also did not dispute that this termination of the collaboration was financially motivated. We also did not dispute that Aradigm did not engage in research to develop an inhalable insulin product and did not collaborate with a third party to continue the product after Novo's termination.

But we do dispute Novo's contention that the termination and unwinding of the collaboration with Aradigm was an acquisition and disposition of NNDT's trade or business. Aradigm did not receive a viable trade or business. It reacquired intangibles from NNDT, and data from research activities conducted during the collaboration were also provided. This was all pursuant to the prearranged agreement.

However, Aradigm -- after the collaboration, Aradigm was essentially left where it was at the beginning of the collaboration with Novo. It had a delivery device, which it had before. They still had a bow but not much else. There were no employees and no facility to continue

inhalable insulin development. Minor adjustments would not make it a self-staining enterprise. Aradigm would have to make a significant investment in employees, facilities and equipment, which are major, not minor developments.

So in summary, when Novo abandoned the project, it merely implemented the prearranged unwinding of the collaboration with Aradigm. Novo's return of intellectual property rights and data pursuant to termination of the license agreement without employees, physical space, or other significant operating assets does not constitute the transfer of a viable business. Furthermore, Novo did not dispose, or certainly did not fully dispose of its interest in inhalable insulin. Regulations do not define disposition in the context of Section 41. But in the context of conditions for eliminating QREs, it should mean to fully transfer a research and development trade or business.

When Novo terminated the collaboration, it retained nonexclusive license interest in the development of inhalable insulin. If Aradigm's delivery device was ever used with inhalable insulin in the future, Novo would have to license to manufacturer and market the product. So while Novo terminated the collaboration, the window was left open for it to return to the business in the future.

This is not a full disposition of a trade or business but merely a temporary halt. In summary, pursuant to the code, both an acquisition and disposition were required for Novo to adjust the NNDT QREs from its California research credit computation. This case there was neither, and Appellant is not entitled to eliminate the 2008 QREs.

Now, turning to Appellant's main second argument. Novo contends that FTB may not examine its California research credit computation and basis this on FTB's articles and tax notes, which is a newsletter we publish to the public. The OTA has already ruled in the precedential Electronic Data System's opinion that FTB's news releases do not change the California statutory requirements for calculating whether a taxpayer is eligible for California research credits. In this case, FTB's tax note articles do not change the fact that under the law, Novo is not entitled to adjust QREs from its California research credit computation. There still was no acquisition and still no disposition for the inhalable insulin business.

And finally, to Appellant's third main argument, Appellant contended that FTB is bound to the determinations of an IRS audit because the federal audit examined the QREs that are used to compute Appellant's California research credit. However, as the OTA ruled in

the precedential Black and Black opinion, FTB may base its proposed assessment on a final federal determination, but it is not bound to a final federal determination and can conduct an independent investigation. Black and Black cited Regulation section 19059(d), which states that FTB may conduct an independent investigation, and cited the 1979 presidential case Appeal of Der Wienershnitzel International, which held that FTB is not bound to a federal determination.

Thus, regardless of whether the IRS audit is examined Appellant's computation of its federal research claim -- credit claim, FTB is not barred from conducting its own independent and audit examination of Appellant's computations of its California research credit. Based on the audit reports that we were provided, the RARs that we were provided, the IRS did look at the number of QREs that were incurred in 2008. We do not disagree with that. But the report did not affirmatively say that the 2008 QREs were eliminated from the fixed-base percentage. It does not even say that they really looked at it. So FTB is not certain whether that issue was actually examined. So that's another reason why we are not prevented from conducting our own examination.

So in conclusion, Novo has not demonstrated with a preponderance of the evidence that it is entitled to

exclude NNDT's 2008 QREs from the computation of its 2012 and 2013 California research credit. Second, FTB's newsletters are not legal authority for the elimination of NNDT's QREs. And, finally, the IRS examination of Novo's federal research credit claim does not preclude FTB from conducting its own independent examination of Appellant's California research credit.

Thank you. We're glad to answer any questions you may have.

JUDGE KLETTER: This is Judge Kletter. Thank you for your presentation.

We'll turn it over to my Panel.

Judge Vassigh, do you have any questions for the parties?

JUDGE VASSIGH: I do.

For Appellants, I think you might have addressed this. I just want to double check. Does FTB agree that Treasury Regulation 1.52-2(b)(ii), regarding the job credits, is analogous in this case, such that the explanation of viability applies here?

MR. MILLER: You're asking me?

JUDGE VASSIGH: Yes.

MR. MILLER: Yes, we do agree.

JUDGE VASSIGH: Thank you.

MR. MILLER: Yes.

JUDGE VASSIGH: Okay. I don't have any questions right now, other than that.

JUDGE KLETTER: And I have just a couple before I turn it over to Judge Gast.

I know that in the briefing there was some discussion of the aggregation rule and also the consistency rule. I was wondering if both of the parties could please just mention it, if those are in dispute in your view.

MR. SOLLIE: Shall I go first, Judge Kletter?

I think the consistency rule is -- is -- gives some interpretive guidance to the OTA when deciding how to interpret section (f)(3). In other words, it -- I think it is useful for the OTA to consider whether the increase in the business that is in the tax year -- so let's take 2011 for example. Is the business of Novo Nordisk in 2011 similar to the businesses in the prior years that make up the fix -- that are behind the computation of fix-based percentage?

That -- what the consistency rule tells the OTA is, look, there ought to be some correlation between the business conducted in tax year and the business in its historical years. So I think it's instructive. I think it's -- it is a coherent -- there's a coherent through line of thought throughout Section 41, which is it's not

just as Mr. Miller suggested that the taxpayer just increase research, but that it increased research in business, in a kind of business, or in the businesses that its conducting in California.

And we think that's the reason for section (f)(3) exclusion is, look, if you sell a business, the business you continue to conduct in California is different than the business you were conducting before you sold it. And so in that way, Judge Kletter, yes, the consistency rule in that sense is helpful to understand what Congress is getting at with the whole plan under Section 41.

JUDGE KLETTER: This is Judge Kletter, and I just wanted to ask. So sounds like the consistency rule, you're saying, is helpful for interpretation purposes, but our -- the consistency rule and also the aggregation rule, are they in dispute in this case directly?

MR. SOLLIE: I don't think that they're --

JUDGE KLETTER: Do you --

MR. SOLLIE: I don't think they are in dispute directly because I think that from the taxpayer's position, (f)(3) so clearly takes the expenses out that there's nothing left to do with the consistency rule. But I think that they do help sort of frame the -- the things Congress is trying to incentivize through the research credit.

JUDGE KLETTER: And that also the case for the aggregation rule?

MR. SOLLIE: Yes. Yes.

JUDGE KLETTER: Thank you.

And Mr. Miller.

MR. MILLER: Well, the thing with the consistency rule is it is about computing the QREs. It is not about whether later, after the fixed-base percentage is determined, whether those QREs are removed or not. It's about each -- each unit determining the QREs in a consistent manner. If the law changes after QREs are determined in a prior year, the QREs have to be updated. The prior year the QREs are updated so that they are consistent with the current year use of the QREs and the fix-based percentage.

In this case, it would not -- there -- Appellant's have pointed to nothing that shows any inconsistency in the computation of the 2008 QREs. As a matter of fact, they point to the IRS determining how much the QREs are, and they do not dispute what the IRS said for the amount of the QREs. So I don't think the consistency rule applies here at all.

JUDGE KLETTER: And for the aggregation rule?

MR. MILLER: The aggregation rule is about the gross receipts being aggregated together in the

computation. I don't see how it applies to the removal of prior year QREs.

JUDGE KLETTER: Thank you. Now, I have one other question. You know, I want to refer to Slide 15. And I think for both parties we have discussed these requirements of disposition, trade or business, viability. But in (f)(3)(B)(I), it says dispositions. There's actually, I guess, an alternative. But it says it's both in this (i) that says, "A taxpayer disposes of the major portion of any trade or business or the major portion of unit of a trade or business. So question for both properties, how do you interpret that? How do you apply that? Is that relevant?

MR. SOLLIE: It is relevant. And the taxpayer's position is that Novo Nordisk disposed of its inhaled insulin business as a result of the transactions that we have been discussing, and that that is a unit of a trade or business. And it's a unit -- I mean, if you -- if you look, even in the FTB's own audit -- you can on the slide that's in front of you on the floor there -- that it is broken out.

I mean, that Novo conducted the business through a separate legal entity. And I think for that reason, we think it's clear that from Novo Nordisk's perspective, inhaled insulin was a separate unit, and that that

separate unit was disposed of by it and acquired -- to Mr. Miller's argument -- acquired by Aradigm. And we think that acquisition is proved by the portion of the 10K that we showed earlier.

JUDGE KLETTER: And this is Judge Kletter. Thank you.

And for, Mr. Miller, do you have any comment on the language in (f)(3)(B)(i) about disposing of the major portion of any trade or business or of a unit of a trade or business.

MR. MILLER: Right. So paragraph (i) refers to subparagraph (a). Subparagraph (a) is acquisitions. So first of all, it only applies if there's an acquisition because it refers back to the acquisition paragraph. So it only matters -- it only applies if there was an acquisition.

Number two, was there -- was it a major portion of a trade or business or a major portion of a unit? We do not disagree that it was a separate unit as Appellant argues. However, there was not an acquisition because pursuant to the Code, an acquisition has to be -- to be a viable trade or business, it must have only -- need only minor adjustments.

When the Aradigm -- after the collaboration was terminated, then Aradigm would be required, in order to

make it a viable business, to make major adjustments, not minor. It would have to hire employees. It would have to buy equipment. It would have to secure facilities. It would have to begin interacting with the FDA. Those are not minor. Those are major, major adjustments.

JUDGE KLETTER: This is Judge Kletter. Thank you.

It looks like Judge Vassigh may have some additional questions. So I'll turn it over to her.

JUDGE VASSIGH: Thank you, Judge Kletter.

This question is for Appellants. Mr. Miller noted that Novo retained certain rights after transferring and that this would make it a halt rather than a disposition. I'd like to hear your response.

MR. SOLLIE: Yeah, we -- it's interesting. We take the same perspective that Mr. Miller does to whether there was an -- I think sort of the acquisition side. Because I think Mr. Miller is right that in order for there to be a disposition, there needs to be an acquisition. And we think it's clear. And that was -- when we looked together at the Novo -- sorry -- at the Aradigm annual report, we think it's clear from what is in that annual report at Exhibit P that was on Slide 14, that Aradigm understood that it was require -- acquiring from Novo a unit of its trade or business.

In other words, the inhaled insulin business was being acquired by Aradigm from Novo. And all of it was being acquired, all of the patents. I mean, Novo not only did it revert the licenses that Aradigm had originally given to it to the ARX technology, but also Novo transferred to Aradigm other patents, other Novo Nordisk patents. All of the stuff that Aradigm would need to continue the work that had been done when it was at Novo was -- was delivered to Aradigm.

I'd also like to address, if I may, because I think it's relevant to your question, what Mr. Miller mentioned about the employees that -- that Novo terminated employees at Hayward. And we agree. From Novo's perspective, it was exiting the business because it was disposing of it to Aradigm. We do want to mention, though, if you look -- if you look at the 10K that is in the record of -- I think it's in Exhibit P. Aradigm was a functioning research corporation. It was a publicly held functioning research corporation and with scores of employees who were all research scientists.

It had its own facilities in California. So this idea that well, Aradigm acquired all this stuff, the patents, the data, et cetera, but, yeah -- but, you know, it didn't acquire the employees, so the business must have just died. There was nothing to acquire. That's not the

case. Aradigm had research scientists and lots of them, and was in the business of continuing the work that Novo had done.

So I think that's relevant too, to see whether there was an acquisition, whether the acquisition was of a unit, whether the unit was viable, whether it was capable of running, and it was. In Aradigm's hands, they had the research scientists. Again, Exhibit P shows on page 44 -- I'm sorry -- page 24, the scores of employees that Aradigm had to continue to pick up where the NNDT had left off.

Did I answer the question?

JUDGE VASSIGH: I believe you it did. Thank you.

MR. SOLLIE: Okay.

JUDGE KLETTER: I'm going to turn it over to Judge Gast.

Do you have any questions for either of the parties?

JUDGE GAST: Yeah. I have a few questions for the taxpayers and, of course, FTB can jump in. So, you know, when we talk about whether there was a disposition and an acquisition by Aradigm, when I'm looking at the Regulation 1.52-2, the Treasury Reg, what example in there do you think supports that this wasn't a mere transfer of assets, the IP, that there was a business -- research business related to insulin transferred that was then

being operated by Aradigm?

MR. SOLLIE: I do think we have to be careful with using the examples in the Section 52 Regulation. The cross reference into the 52 Regulation is from section 41 regulation. And I think it uses it for the purpose of just dealing with the definitions of whether a separate unit of a trade or business was transferred. I think the reason you have to be careful with some of the examples is, Section 52 and its examples are related to the Section 52 credit, which was an employment credit.

So, naturally, what the -- what the author -- the Treasury authors of Section 52 were getting at was, look we're trying to track numbers of employee. And so the kind of questions and the kind of examples that they were giving at, were related to operating businesses, industrial businesses, retail business -- not research businesses -- but those kinds of businesses. Because the thing Congress was trying to incentivize, under the old Section 52 credit was employing more people in those kinds of businesses.

Where I think the thing that is trying to be incentivized in Section 41, is more research. We want you to do more research. And although some aspects of research relate to people, it doesn't really relate to facilities as much. And sometimes the research related

isn't even related to your own people. It's related to contract research, which qualifies as a qualified research expenditure. So I think -- I think all of those examples in 52 need to be viewed through the lens of what the different credits were attempting to accomplish.

JUDGE GAST: Okay. Thank you. So you're position is, in this situation, even though Treasury Reg -- I think it's 41-7, you know, cross reference is this job's credit regulation, that you don't need a transfer of actual facilities. Really, just the IP and the data related to that is kind of what's contemplated with IRC 41 reference to dispositions and acquisitions.

MR. SOLLIE: Yeah, the IP and the data, but I think that -- I think that isn't just like there was an auction of IP and data and Aradigm raised its hand and said we're going to acquire that. I mean, Aradigm, if you look at Exhibit P and you look at what business was Aradigm in. Aradigm was in inhaled pharmaceutical business. So, yeah, it's true that unfortunately for the terminated Novo employees who were working on the Novo side at -- with inhaled insulin, they -- they didn't -- didn't go over to Aradigm.

It wasn't as if Aradigm was sort of randomly just buying assets laying around. I mean, Aradigm was in the business of developing inhaled pharmaceutical products,

including this insulin product, which it bought from -- from Novo. So I think that -- I that when you look at what Aradigm did, and you look who Aradigm was that -- and, again, that's why we put that -- put that clip from the Aradigm 10K on the exhibit, which as they were interested not only getting those assets.

They wanted to get Aradigm their own technology back. They wanted the research technology back. They wanted to get regulatory information back. They wanted to get insulin. They wanted Novo to continue to provide them with insulin so they could -- so that they could continue the research that had been done by those NNDT employees.

So I don't think entirely -- I don't think it's entirely just, well, we sent some assets to them, you know. Good luck with that. We think that it was a -- the inhaled insulin research was a separate unit as a -- as a functioning -- or at least as viable -- as described in Mr. Miller's brief -- capable, a functioning business. And we think it certainly was.

JUDGE GAST: Thank you. And is there evidence that Aradigm operated that research when they got it back? Or were they looking to license it out to a third party?

MR. SOLLIE: Well, there certainly if you look at -- I -- I think the most compelling evidence about what Aradigm was doing is the annual report that's in Exhibit

P. Because the annual report shows one, is that Aradigm is a functioning business that is in the business of doing inhalables research. It also talks about what Aradigm isn't. And Aradigm isn't -- doesn't -- wasn't looking for itself to be a manufacturer. Wasn't looking itself necessarily to do large-scale clinical trials.

So Aradigm was going to do the piece that essentially bridge the gap between, you know, what a small company with just a few score of employees like Aradigm was; continue to do research; continue to look for a partner who could do the clinical trials and do the manufacturing. Because, again, I mean, Aradigm just if you look at that -- if you look at Exhibit P, you'll see it isn't the kind of business that's going to start up a $500 million manufacturing plant. That's -- that's not its business. And it's not necessarily a business that's going to do a large-scale clinical FDA trial at scale because there are large pharmaceutical companies that can do that.

So I think -- I think, Judge Gast, what that Exhibit P shows is, what Aradigm was going to do is what Aradigm is does best, which is the high-end Ph.D. research work.

But the other stuff, it was going to look for a partner. So to get -- to get the inhaled insulin to

market, in the first instance required it go to Novo. And it was going to look for someone to help it do the clinical trials and the manufacturing and so on. But it wasn't as if it was just going to sit there and -- at least in 2008 -- was going to sit there and do nothing with it. I mean, as you saw from the exhibits, its view was we want to complete the research on this product and find a commercial partner and a clinical trial research partner.

JUDGE GAST: Thank you. And then one more question I have relate to the IRS audit. Is there anything in the record that shows why the IRS excluded NNDT's QREs for 2008 for the simplified credit? Is there an explanation that they actually looked at the issue and audited it?

MR. SOLLIE: Well, there's no narrative. I mean -- I mean, it could be beautiful for the taxpayer if there was a multi-paragraph narrative that sticks -- runs, essentially, is like the -- the brief for the taxpayer in this case. There's not that. I do think that the thing that's most compelling, though, is that in the same cycle, the 2007 to 2010 cycle, you have the IRS using two different numbers for the -- the measurement period, the prior period calculations. And in one, the NNDT's that is before the disposition. The NNDT numbers were included.

And in the other, again, in the same cycle, they were excluded.

And the reason I say I think that's important because as often, you know, the IRS auditors don't write up everything that they looked at. But it was certainly front and enter in front of them that the NNDT number was being excluded in a couple of years in the cycle, but not in all of the years of the cycle. The other thing too that is important is when you look at those exhibits related to IRS audit. It was the -- NNDT was the focal point of their audit, particularly for the '07 through '10 cycle.

So there are lots of pages of discussion about NNDT, you know, becoming like Novo. There could be a lot of things that the IRS was paying attention to. But it's clear from looking at all of the language, the multiple pages of discussion of NNDT, that it wasn't as if that was an afterthought. No one was thinking about NNDT, generally.

So I guess, the answer to your question is yes. We think that the contrast between it being in and out in the same audit cycle shows that the IRS auditors thought about it and excluded it purposely. Two, we think all the discussion about NNDT shows that it was a very heightened subject of inquiry, that is the NNDT research business.

So that -- and we can put those together that it's a -- it's a fair inference that the IRS did exactly what we said they did, which was exclude -- intentionally exclude the NNDT QRE from the 2008 back years -- back year.

JUDGE GAST: Thank you. No further questions.

JUDGE KLETTER: This is Judge Kletter. I just have one other question. Taxpayers mention that, you know, for federal purposes, it was the federal simplified credit and California's incremental credit. This is a question for FTB. I'm just wondering, you know, does the calculation of the federal simplified credit have any bearing on the California research credit? Are they, you know, calculated similarly or differently? Or is there any bearing of one on the other?

MR. MILLER: Oh, yes. They are completely different. Number one, California does not allow taxpayers to use the alternative simplified credit. The QREs for the federal method are a set of three years. Whereas, in the California method, we're using a larger set, more years. So they are different. So not every year would the 2008 QREs be looked at by IRS.

JUDGE KLETTER: This is Judge Kletter. Thank you. I'm just going to ask my Panel again if they have any further questions.

Judge Vassigh, do you have any further questions?

JUDGE VASSIGH: I do not. Thank you.

JUDGE KLETTER: And, Judge Gast, do you have any other questions?

JUDGE GAST: I do not as well. Thanks.

JUDGE KLETTER: And I do not have any questions as well, myself. So I'd like to turn it over to Mr. Sollie.

You'll have 15 minutes in which you can make a final statement or rebuttal to anything that was said during the questions or during FTB's presentation or anything else that you've prepared or would like to say before the case is submitted. Mr. Sollie, are you ready to begin?

MR. SOLLIE: I am.

JUDGE KLETTER: Please go ahead.

CLOSING STATEMENT

MR. SOLLIE: I -- so I think there's one thing I want to respond to. Mr. Miller said that we think that, you know, the FTB's tax notes article trumps the law. That's definitely not what we are -- what we're trying to communicate to the OTA. Our position is that the IRS, when its interpreting federal law, has historically and currently been entitled to deference and have been given deference by the FTB; that the FTB understandably and

respects and defers to the IRS' judgment on questions of federal law.

And so what we -- why with we went through, you know, with our exercise of the IRS audit and, you know, the dialogue with Judge Gast about what we think it's clear that the IRS looked at, is because we think that the IRS, when it is interpreting provisions that are relevant to the California calculation, even if they're used differently. So in a way we agree and in a way we disagree with Mr. Miller. We agree that the mechanics of the computation of the regular California credit is somewhat different from the mechanics of the calculation of the federal -- of the federal credit, alternative simplified credit. So we agree with that.

But the question for the OTA to decide is section (f)(3). What does section (f)(3) mean? And section (f)(3) talks about the measurement period. It uses this term measurement period. And it says if expenses are related to an acquired or is disposed of business during the measurement period, then those expenses are either included or excluded. And the measurement period is very broadly defined.

The measurement period under (f)(3) is any period that's relevant to the computation under of the credit under Section 41. So in that sense, 2008 being in the

year in the measurement period, is precisely on point with the thing that FTB and OTA is to decide. And we think for that reason, we think that the OTA would fairly defer to the IRS' decision about whether to exclude these expenses from 2008 because it's a period during the measurement period.

That's the only additional thing. I think the other rebuttal point that we had made, we did through our dialogue.

JUDGE KLETTER: So just to confirm, that's the end of your presentation?

MR. SOLLIE: Let me -- if I could confirm with my --

JUDGE KLETTER: Oh, I'm sorry. Okay.

MR. SOLLIE: Yes, we're concluded. Thank you.

JUDGE KLETTER: Thank you so much to the parties for their presentations today. This concludes this hearing, and we will meet and decide the case based on the documents presented and the arguments presented. And OTA will issue our written decision no later than 100 days from today.

This case is submitted, and the record is now closed. And this concludes this hearing session. Thank you so much.

(Proceedings adjourned at 11:08 a.m.)

HEARING REPORTER'S CERTIFICATE

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

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

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

I have hereunto subscribed my name this 5th day of July, 2024.

_____
ERNALYN M. ALONZO
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