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OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	)	OTA Case No. 22029660
NANOLAB TECHNOLOGIES, INCORPORATED[1]	)	CDTFA Case ID: 381-722

OPINION

Representing the Parties:

For Appellant: Arthur C. Rinsky, Attorney
Lauren A. Rinsky, Attorney
Thomas Byrd, VP of Finance and Administration

For Respondent: Courtney Daniels, Attorney
Jarrett Noble, Attorney
Jason Parker, Chief of Headquarters Operations

For Office of Tax Appeals: Corin Saxton, Attorney

J. ALDRICH, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 6561, Nanolab Technologies, Incorporated (appellant) appeals a decision[2] issued by respondent California Department of Tax and Fee Administration (CDTFA) denying, in part, appellant's petition for redetermination of a Notice of Determination (NOD) dated August 22, 2018.[3] The NOD is for tax of $309,962, plus applicable interest, for the period July 1, 2013, through June 30, 2016 (liability period).

Office of Tax Appeals (OTA) Administrative Law Judges Michael F. Geary, Sheriene Anne Ridenour, and Josh Aldrich held a virtual hearing for this matter on February 22, 2024. At

[1] Eurofins is the successor in interest to Nanolab Technologies Incorporated.

[2] As discussed below, CDTFA issued a decision, supplemental decision, and second supplemental decision.

[3] Sales and use taxes were formerly administered by the State Board of Equalization (board). In 2017, functions of the board relevant to this case were transferred to CDTFA. (Gov. Code, § 15570.22.) For ease of reference, when this Opinion refers to events that occurred before July 1, 2017, "CDTFA" shall refer to the board.

the conclusion of the hearing, the record was held open pursuant to OTA's March 5, 2024 Post-Hearing Orders, and was subsequently closed effective April 23, 2024.

ISSUE[4]

Whether the transactions at issue were performed pursuant to qualified research and development (R&D) contracts, and, if not, whether the transactions at issue constitute nontaxable repair labor.

FACTUAL FINDINGS

1. Appellant, a California corporation, operates an analytical testing and services laboratory, which serves customers in science, technology, and engineering industries.
2. For the liability period, appellant reported total sales of $65,110,704 and claimed deductions totaling $64,646,062. For the third quarter of 2013 (3Q13) and 4Q13, appellant claimed deductions for nontaxable labor of $6,818,540. For the same quarters, appellant also claimed deductions for exempt sales in interstate commerce of $842,115. For 1Q14 through 2Q16, appellant claimed deductions for sales for resale of $56,985,407. Both parties agree that all these claimed deductions were for labor sales and, as such, to the extent applicable the claimed deduction should be for nontaxable labor.
3. Upon audit, appellant provided sales and use tax worksheet records, account records including sales orders, purchase invoices, vendor invoices, and multiple accounting and journal entry records for the liability period.
4. CDTFA found that appellant had erroneously claimed sales in interstate commerce and sales for resale when these transactions pertain to either taxable or nontaxable labor (the amount allowable as a deduction is in dispute). CDTFA concluded, and appellant did not dispute, that all claimed nontaxable labor sales, including those previously claimed as sales for resale or interstate commerce, were sales of the type at issue throughout the appeals process, as discussed below.

[4] Appellant also argues that it is entitled to attorney fees; however, a reimbursement claim for expenses cannot be submitted prior to issuance of an Opinion granting appellant's appeal. (Cal. Code Regs., tit. 18, §§ 30702, 30703, 30705.)

5. CDTFA's audit staff consulted with CDTFA's Audit Information Section (AIS). AIS prepared a memorandum dated January 24, 2018 (AIS Memorandum), which summarizes its position on the amount allocable to taxable versus nontaxable labor.
6. The audit examined appellant's transactions which included: (1) FIB/CE Services; (2) Decapsulation (Decap Services); and (3) Sample Preparation (Sample Prep Services).
    a. Regarding FIB/CE Services, appellant performs FIB/CE Services on devices (e.g., wafer, chip, integrated circuit, PC board, or microchips) provided by appellant's customers. The FIB/CE Services enable circuit editing, modification, cross-sectioning, ion imaging, and failure analysis of live devices. The FIB/CE Service works by using a finely focused gallium ion beam with microscopic resolution to image, etch, or deposit materials on a microchip with a high level of precision. This process is used to reroute connections within a device as well as to create probe points for electrical testing.
        i. The AIS Memorandum described FIB/CE Services similar to the description above. Further, the AIS Memorandum noted that the FIB/CE Services may or may not have involved some type of testing and failure analysis which is incidental to the customization of the customer's sample. The AIS Memorandum concluded that pursuant to R&TC section 6006(b) the FIB/CE Services constitute fabrication labor subject to tax. Alternatively, the AIS Memorandum concluded that the FIB/CE Services are subject to tax as a custom-made item under California Code of Regulations, title 18, (Regulation) section 1501.1(a)(5)a.
        ii. FIB/CE Services appear on appellants sample invoices both as a separate line item and included in a failure analysis description. For example, an invoice dated September 12, 2014, has two items: (1) FA – Decap – Cu (copper) wire and (2) FIB – Circuit Edit – Standard (Hourly). With respect to item 2, there is nothing on the invoice that indicates appellant performed or conducted an analysis in relation to the FIB/CE. On a May 9, 2014 invoice, however, appellant bundled several transactions as "Failure analysis services, including FIB, decap, etc for AC-DC engineering team."

b. Decap Services expose the internal components of the package (i.e., a protective case that surrounds a semiconductor device), allowing an engineer to inspect the die, interconnects, and other features typically examined. The AIS Memorandum concluded that the Decap Services constitute fabrication labor subject to tax.

c. For Sample Prep Services, appellant obtains the customer device, exposes the area of interest, mounts the exposed area for inspection, examines the area of interest, and returns all pieces to its customer for the customer's examination. The AIS Memorandum did not opine on Sample Prep Services, but CDTFA audit staff reached the conclusion that Sample Prep Services constitute fabrication labor subject to tax.

7. Based on the AIS memorandum and the Report of Discussion of Audit Findings, it appears that CDTFA disallowed claimed deductions for nontaxable labor of $3,487,869 on the basis that the labor was not performed pursuant to qualified R&D contracts within the meaning of Regulation section 1501.1 or the transactions constituted taxable fabrication labor. The amount was calculated by using statistical sampling as follows: for amounts $.01 to $999.99 (stratum 1) CDTFA calculated an error rate of 29.4909 percent, which resulted in disallowed claimed deductions of $1,100,637; for amounts $1000 to $9,999.99 (stratum 2) CDTFA calculated an error rate of 13.1859 percent, which resulted in disallowed claimed deductions of $2,006,267; and for amounts over $9,999 (stratum 3) CDTFA calculated $380,965 using an actual basis.

8. Based on the audit results, CDTFA issued the aforementioned NOD, which appellant timely petitioned.[5]

9. In its petition, appellant argued that the FIB/CE Services, Decap Services, and Sample Prep Services are all nontaxable transactions under Regulation section 1501.1. Appellant asserted that its purchase orders and invoices constituted a contract within the meaning of Regulation section 1501.1. Appellant asserted that it conveyed the results of the transactions by email, phone call, or the return of its customer's device so long as the device was not destroyed during the service. Appellant argued that the information conveyed was technical in nature consistent with Regulation section 1501.1.

[5] Appellant subsequently conceded to unreported taxable sales of $3,149 based on the difference between tax accrued and tax reported; therefore, the Opinion does not discuss this item further.

10. On August 1, 2019, CDTFA issued a decision finding that in transactions where appellant performed failure-analysis testing, the purpose of the testing was the discovery of information that is technological in nature, and that the result of the testing was intended to be useful in the customers' development of their products. CDTFA also found that the conveyance of testing information must have been understood by the parties as part of the contract and must have been conveyed to appellant's customers. Based on this analysis, CDTFA found that transactions involving failure analysis services should be accepted as nontaxable, and CDTFA ordered a reaudit to make allowances for transactions in which the invoice or purchase order includes failure analysis.
11. On January 13, 2020, CDTFA completed the reaudit, reducing the disallowed claimed nontaxable labor charges by $160,599, from $3,487,869 to $3,327,270. However, CDTFA continued to disallow transactions described as "FA" on invoices or purchase orders. On September 10, 2020, appellant submitted a request for reconsideration, arguing that "FA" stands for failure analysis.
12. On November 18, 2020, CDTFA issued a supplemental decision ordering a second reaudit to allow as nontaxable any transactions that include charges described as "FA."
13. On April 13, 2021, CDTFA completed the second reaudit, reducing the disallowed nontaxable labor charges by $887,976, from $3,327,270, to $2,439,294. However, because CDTFA only accepted as nontaxable individual charges described as failure analysis or FA (rather than accepting the entire transaction as nontaxable), appellant filed a second request for reconsideration on July 19, 2021.
14. On December 8, 2021, CDTFA issued a second supplemental decision, which upheld the results of the second reaudit and clarified that individual charges for failure analysis should be allowed on a line-item basis, but not the entire invoice or order amount (e.g., when an invoice or purchase order contained multiple transactions).
15. After appellant filed its appeal with OTA, CDTFA conducted a third and fourth reaudit to allow charges for Decap Services as nontaxable, which reduced the disallowed claimed nontaxable labor charges by $22,214 from $2,439,294 to $2,417,080. On February 6, 2023, CDTFA submitted additional briefing, which included a fifth reaudit that allowed Sample Prep Services as nontaxable and reduced the disallowed claimed

nontaxable labor charges by $772,381, from $2,417,080 to $1,644,699.[6] Consequently, the only charges at issue in this appeal are appellant's FIB/CE charges.

16. On January 26, 2024, OTA issued Minutes and Orders of Prehearing Conference (M&Os). The M&Os placed the parties on notice regarding whether the requirements of Regulation section 1501.1(a)(1)b have been met (e.g., "What evidence, if any, supports a finding that the requirements of Regulation section 1501.1(a)(1)b have been met?").

DISCUSSION

California imposes sales tax on a retailer's retail sales of tangible personal property (TPP) sold in this state measured by the retailer's gross receipts, unless the sale is specifically exempt or excluded from taxation by statute. (R&TC, §§ 6012, 6051.) The term "TPP" means personal property that may be seen, weighed, measured, felt, or touched, or which is in any other manner perceptible to the senses. (R&TC, § 6016.) For the purpose of the proper administration of the Sales and Use Tax Law and to prevent the evasion of the sales tax, the law presumes that all gross receipts are subject to tax until the contrary is established. (R&TC, § 6091.)

It is the retailer's responsibility to maintain complete and accurate records to support reported amounts and to make them available for examination. (R&TC, §§ 7053, 7054; Cal. Code Regs., tit. 18, § 1698(b)1).) If CDTFA is not satisfied with the tax returns or the amount of tax required to be paid to the state by any person, or if any person fails to make a return, then CDTFA may determine or estimate the amount required to be paid on the basis of any information within its possession or that may come into its possession. (R&TC, §§ 6481, 6511.)

In the case of an appeal, CDTFA has a minimal, initial burden of showing that its determination was reasonable and rational. (*Appeal of Talavera*, 2020-OTA-022P.) If CDTFA meets its initial burden, the burden of proof shifts to the taxpayer to establish that a result differing from CDTFA's determination is warranted. (*Ibid.*) Unsupported assertions are not sufficient to satisfy a taxpayer's burden of proof. (*Ibid.*)

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[6] Regarding the allowed amounts for Decap Services and Sample Prep Services, it appears the allowed amounts may have included taxable labor because appellant performed modifications to its customer's device and appellant did not undertake work to discover information which is technical in nature. This is evident because appellant previously conceded that in some cases it did not do any testing, but only prepared the customer's sample for the customer's own testing. However, since the allowances are to the benefit of appellant, and they are not in dispute, OTA will not discuss them further.

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Here, CDTFA examined appellant's claimed deductions for the liability period. CDTFA disallowed deductions for transactions that it found to be taxable fabrication labor or not excluded from tax within the meaning of Regulation section 1501.1. The measure was calculated by using a statistical sampling of appellant's records for two of the three strata and on an actual basis for the third stratum. Appellant claims the disallowed transactions were nontaxable based on Regulation section 1501.1. Appellant bears the burden of showing that its sales qualify for the deduction for nontaxable labor or exclusion from sales tax. (*Appeal of Snowflake Factory LLC*, 2020-OTA-270P; *Appeal of Thomas Conglomerate*, 2021-OTA-030P.) Any doubt must be resolved against the right to a deduction or exclusion from sales tax. (See *Associated Beverage Co. v. State Bd. of Equalization* (1990) 224 Cal.App.3d 192, 211.) Based on the foregoing, OTA concludes that CDTFA's determination was reasonable and rational. Therefore, the burden of proof shifts to appellant to establish that a result differing from CDTFA's determination is warranted. (*Appeal of Talavera*, *supra*.)

R&D

A sale includes the producing, fabricating, processing, printing, or imprinting of TPP for a consideration for consumers who furnish either directly or indirectly the materials used in the producing, fabricating, processing, printing or imprinting. (R&TC § 6006(b); Cal. Code Regs., tit. 18, § 1526(a).) A sale also includes a transfer for a consideration of the title or possession of TPP which has been produced, fabricated, or printed to the special order of the customer. (R&TC, § 6006(f).) Producing, fabricating, and processing include any operation which results in the creation or production of TPP or which is a step in a process or series of operations resulting in the creation or production of TPP. (Cal. Code Regs., tit. 18, § 1526(b).) Producing, fabricating, and processing do not include operations which constitute merely the repair or reconditioning of TPP to refit it for the use for which it was originally produced. (*Ibid*.) Fabrication also does not include services performed pursuant to a qualified R&D contract. (Cal. Code Regs., tit. 18, § 1501.1)

Persons engaged in the business of rendering services pursuant to a qualified R&D contract are consumers of TPP which they use incidentally in rendering the service. (Cal. Code Regs., tit. 18, § 1501.1(b)(1), (2).) With the exception of certain prototypes or prototype tooling transferred for other than informational and testing purposes, or where a functional use is made, tax does not apply to receipts derived from qualified R&D contracts. (Cal. Code Regs., tit. 18,

§ 1501.1(b)(2).) A qualified R&D contract is a contract for service where: (1) the service provided under the contract is undertaken for the purpose of discovering information which is technological in nature, the results of which are intended to be useful in the development of a new or improved product, process, technique or invention, and (2) the contract calls for delivery of a report detailing information developed by the contractor or other TPP incidental to the true object of the contract. (Cal. Code Regs., tit. 18, § 1501.1(a)(1)a,b.)

A qualified R&D contract does not include a contract for the design and production of custom-made items. (Cal. Code Regs., tit. 18, § 1501.1(a)(1)b.) A contract to design, develop, and manufacture a custom-made item is a contract to sell TPP, and, unless the sale of the property is a sale for resale, tax applies to the gross receipts from the sale of the property. (Cal. Code Regs., tit. 18, § 1501.1(b)(3).) Gross receipts include the entire amount of the contract price without regard to the fact that the research, design, and development charges may be separately stated. (*Ibid.*) Tax applies to the entire contract price without regard to the fact that the research, design, and development charges may be separately stated. (*Ibid.*)

Generally, custom-made items are intended for functional use and not for informational and testing use. (Cal. Code Regs., tit. 18, § 1501.1(b)(3).) "Functional use" is use for which the property was designed which occurs after completion of the R&D. (Cal. Code Regs., tit. 18, § 1501.1(a)(6).) As relevant here, "informational and testing use" includes, but is not limited to, developing data, algorithms, ideas and/or knowledge to improve or perfect a design, determining alternative design features and implementations, determining or improving the processes for manufacture of the design, and testing to design failure. (Cal. Code Regs., tit. 18, § 1501.1(a)(7).)

Appellant argues that the FIB/CE Services are exempt because the invoices and purchase orders constitute nontaxable qualified R&D contracts, and appellant argues that the requirement of Regulation section 1501.1(a)(1)b is met because appellant conveyed information to its customers via email, phone call, or return of the item. To this end, appellant argues that the true object of the contracts was the transfer of information which is technological in nature or which is intended to be useful in the development of a new or improved product.

At the outset, OTA notes that a qualified R&D contract is one that calls for delivery of a report detailing information developed by the contractor or other TPP incidental to the true object of the contract. (Cal. Code Regs., tit. 18, § 1501.1(a)(1)b.) However, appellant has not

produced any qualified R&D contracts.[7] Appellant's alleged "contracts" primarily consist of sales and purchase invoices, which do not call for delivery of a report detailing information developed by appellant or other TPP incidental to the true object of the contract. Appellant claims that it is unable produce reports based on its nondisclosure agreements.[8] However, the nondisclosure agreements that bind appellant do not obviate appellant's obligation to maintain and make available records. (See R&TC, §§ 7053, 7054; Cal. Code Regs., tit. 18, § 1698(b)1).)

In the M&O's, the parties were placed on notice to discuss whether the requirements of Regulation section 1501.1(a)(1)b have been met. In the decision, CDTFA found that the requirements set forth in Regulation section 1501.1(a)(1)b have been met, despite the fact that there are no descriptive contracts to analyze in this appeal. The decision indicates that Regulation section 1501.1(a)(1)b is just intended to help determine whether the requirements of 1501.1(a)(1)a have been met, and if the requirements of 1501.1(a)(1)a have been met then of course the requirements of 1501.1(a)(1)b have been met. This circular reasoning dispenses with the conjunction that binds subsections (a)(1)a *and* (a)(1)b of Regulation section 1501.1, and in doing so, effectively expands the deduction for nontaxable labor or the exclusion from sales tax by treating these subdivisions as disjunctive requirements. Regulation section 1501.1 operates similar to an exemption;[9] that is, transactions that include the sales of services together with the transfer of TPP are treated as nontaxable provided those transactions meet the criteria of Regulation section 1501.1. The expansion of an exemption or the liberal interpretation of Regulation section 1501.1 is contrary to established precedent because courts have consistently concluded that statutes granting exemption from taxation must be reasonably, but nevertheless strictly, construed against the taxpayer to avoid enlarging or extending the concession beyond the plain meaning of the language used in granting it. (*Standard Oil Co. v. State Bd. Of Equalization* (1974) 39 Cal.App.3d 766, 769-770; *Appeal of Snowflake Factory LLC*, *supra*; and *Appeal of Thomas Conglomerate*, *supra*.) Further, any doubt must be resolved against the right to an

[7] Here, OTA notes that the authorizing and reference statutes for Regulation section 1501.1 (that is, R&TC sections 7051, 6006, 6009, 6010, 6011, and 6012) do not impart much clarity. Based on the language, the drafters of Regulation section 1501.1 appear to have adopted language from Internal Revenue Code (IRC) section 41. "Qualified research" is a term of art more thoroughly developed in IRC section 41.

[8] OTA has tools available to protect information, subject to certain conditions. (See Cal. Code Regs., tit. 18, §§ 30430.5, 30431, and 30432.)

[9] Exemptions are typically found between R&TC sections 6351 through 6423.

exemption. (*Associated Beverage Co. v. State Bd. of Equalization*, *supra*.) Based on the foregoing, OTA declines to adopt or incorporate CDTFA's finding for the items still in dispute.

During the hearing, appellant conceded that its contracts did not meet the requirements of Regulation section 1501.1. Specifically, appellant stated: "It is not like there's a contract that says, we are here joined together to create. You know, it's not going to follow the [Regulation] is what we're saying. It's not going to follow the [Regulation]." (Transcript, p. 50, lines 22-25.) Appellant then stated that the contract is not going to "formally follow the [Regulation]. It's not going to say, oh, we are hiring you to undertake a service to discover information that's technological in nature. It's not going to say that." (Transcript, p. 51, lines 2-5.) In addition, there is insufficient evidence to show that there was a meeting of the minds to engage in qualified R&D since the purchase orders and invoices are transactional in nature with little information to interpret the intent of appellant and its customers. Therefore, OTA concludes the transactions at issue do not constitute qualified R&D contracts.

In sum, OTA need not analyze the purpose of these transactions because the form of appellant's contracts does not meet the requirement of Regulation section 1501.1(a)(1)b. With respect to appellant's argument that the requirement of Regulation section 1501.1(a)(1)b is met because appellant conveyed information to its customers via email, phone call, or return of the item, OTA finds this argument unpersuasive because the regulation explicitly requires the parties to contract for the delivery of a report (as discussed above) or a transfer of other TPP, and appellant failed to meets its burden to show that this legal requirement was met. The mere fact that information was conveyed to appellant's customers does not alter the fact that the "contracts" at issue do not call for conveyance of this information or other TPP, which is what Regulation section 1501.1(a)(1)b requires.

<u>Nontaxable Repair Labor</u>

Generally, a repairperson may either be a retailer or consumer. (Cal. Code Regs., tit. 18, § 1546(b).) When a repairperson is a retailer, tax applies to fair retail selling price of the property when the retail value of the parts and materials furnished in connection with repair work is more than 10 percent of the total charge, or if the repairperson makes a separate charge for the property. (Cal. Code Regs., tit. 18, § 1546(b)(1).)

On the other hand, tax applies to charges for producing, fabricating, or processing of TPP for a consideration for customers who directly or indirectly furnish the materials used in that

process. (Cal. Code Regs., tit. 18, §1526(a).) This includes any operation which results in the creation or production of TPP, or is a step in the process of creating or producing TPP. (Cal. Code Regs., tit. 18, § 1526(b).) For example, converting an existing car into a stretch limousine is taxable fabrication labor resulting in the sale of a stretch limousine (as opposed to nontaxable labor to repair the existing car). (Cal. Code Regs., tit. 18, § 1526(c).)

As an alternative approach, appellant argues that the FIB/CE Services do not constitute fabrication labor but were instead repair services. Appellant argues that the FIB/CE Services were performed to fix an item that did not work as intended, and that appellant did not convert the property into something else or with a new or changed purpose or function. In support, appellant submitted declarations signed by two of its engineers, and declarations of Thomas Byrd, VP of Finance and Administration.

Appellant also argues that with respect to FIB/CE Services, appellant has no TPP to convey based on the confidentiality or nondisclosure agreements between appellant and its customers. Instead, appellant argues that it merely performs services on its customer's property. In some instances where appellant renders services, the customer's property is destroyed, and thus there would be no transfer of TPP in those instances.

With respect to appellant's argument that it had no TPP to convey, OTA finds appellant's position unavailing because R&TC section 6006 defines a sale broadly to includes the fabrication of TPP furnished directly or indirectly by the customer, and transfers of title or possession of TPP that has been produced or fabricated for the customer. (R&TC, § 6006; Cal. Code Regs., tit. 18, § 1526.) Here there is no dispute that TPP was generally transferred between appellant and its customers pursuant to the transactions at issue. In other instances where the customer's property was destroyed as part of the service provided, appellant has not provided sufficient records to distinguish those transactions from the more typical scenario where property is transferred. Appellant claims the lack of records is based on nondisclosure agreements. Even so, appellant has the burden of proof to establish this fact, which it has not done; further, the Sales and Use Tax Law presumes that all gross receipts are subject to tax until the contrary is established, and appellant had the duty to maintain and make available records. (*Appeal of Talavera*, *supra*; R&TC, §§ 6091, 7053, 7054; Cal. Code Regs., tit. 18, § 1698(b)(1).)

Regarding appellant's argument that the charges at issue constitute nontaxable repair charges, this argument is contradicted by appellant's assertion that the purpose of circuit editing

is to make one-time modifications to a microchip based on customer specifications to improve the production and/or design process, and that the service is intended to reroute connections within a microchip as well as to create probe points for electrical testing. Given this description, it is apparent that in performing FIB/CE Services, appellant does not simply refit the property for the use for which it was originally intended (which would constitute repair labor), but instead alters the property in ways that allow appellant's customers to make design improvements, which indicates that these services are a step in a process or series of operations resulting in the creation or production of TPP.[10] (See Sales and Use Tax Annotations 435.0320 (11/17/54) [nontaxable repair labor versus taxable fabrication labor]; 435.1140 (03/24/55) [the initial application of high-vacuum optical coating, involving the evaporation of aluminum, fluoride, and other materials on glass and plastics is taxable fabrication labor]; and 435.0479.125 (10/10/89) [changes to a die used to produce cardboard boxes are taxable fabrication labor].)[11] In sum, OTA finds that appellant has not established that its FIB/CE Services constitute nontaxable repair labor.

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[10] Here, there are three initial declarations admitted into evidence. Two of the declarants are engineers employed by appellant as well as the declaration of Mr. Byrd, VP of Finance and Administration. There are also two supplemental declarations of Mr. Byrd, which generally cover contract formation or the FIB/CE process. Each of the initial declarations are formulaic. For example, the declarations collectively refer to FIB/CE Services and Sample Prep Services charges as the Services. Each of the three declarations use the same exact analogy to describe appellant's Services. That is, "A good analogy, [for the Services] would be a spark plug that did not function properly in an engine. In performing the Services, [appellant]was just, by analogy, trying to get the spark plug to perform as intended in an engine (the larger item)." The analogies tend to conflict with appellant's argument.

[11] Annotations are not binding authority and do not have the force or effect of law. (Cal. Code Regs., tit. 18, § 35101(a)(1); *Appeal of Martinez Steel Corporation*, 2020-OTA-074P.) However, OTA may give some consideration to annotations and will independently determine the appropriate weight to afford an annotation. (*Yamaha Corp. of America v. State Bd. of Equalization*, (1998) 19 Cal.4th 1, 15; *Appeal of Martinez Steel Corporation*, *supra*.)

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HOLDING

Appellant has not established that the transactions at issue were performed pursuant to qualified R&D contracts, and appellant has not established that the transactions at issue constitute nontaxable repair labor.

DISPOSITION

Sustain CDTFA's decision to reduce the total taxable measure from $2,417,080 to $1,644,699, as set forth in the fifth reaudit.

DocuSigned by:
Josh Aldrich
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Josh Aldrich
Administrative Law Judge

I concur:

DocuSigned by:
Sheriene Anne Ridenour
67F043D83EF547C...
Sheriene Anne Ridenour
Administrative Law Judge

M. GEARY, Administrative Law Judge, concurring:

I agree with the majority's disposition, sustaining the California Department of Tax and Fee Administration's (CDTFA's) decision to reduce the total taxable measure from $2,417,080 to $1,644,699, as set forth in the fifth reaudit. However, I respectfully disagree with the grounds upon which the majority relies, at least insofar as the majority implies that a qualified research and development (R&D) contract must specifically and expressly call for the delivery of a report detailing information developed by the contractor, or the delivery of other tangible personal property (TPP) incidental to the true object of the contract.

There are two reasons for my disagreement. The first is my interpretation of California Code of Regulations, title 18, (Regulation) section 1501.1 to allow CDTFA to consider the totality of the circumstances to determine whether the requirements of that regulation have been met.[1] When the evidence shows that a contractor: (1) was hired to use its technical expertise to determine why a microchip (chip) was not functioning as intended and report its findings to the customer;[2] (2) used its expertise to analyze and determine the cause of the failure, and; (3) reported the results of its analysis to the customer, either by providing a report or by returning to the customer the chip that the contractor modified to perform as the customer expected it to perform and that the customer could then use to duplicate a properly functioning chip, I would conclude that such evidence is sufficient to establish an R&D contract under Regulation section 1501.1.

The second reason I decline to join in the majority opinion is that CDTFA agrees with my first reason. (See Factual Finding 10, above.) I disagree with the majority's conclusion that this interpretation is inconsistent with the law. To allow a deduction from gross receipts for the

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[1] Regulation section 1501.1(a)(1) describes the following two requirements for a qualified R&D contract: the service provided under the contract is undertaken for the purpose of discovering information that is technological in nature, the results of which are intended to be useful in the development of a new or improved product, process, technique, or invention; and the contract calls for the delivery of a report detailing information developed by the contractor or other TPP incidental to the true object of the contract, as defined in Regulation section 1501. (Cal. Code Regs., tit. 18, § 1501.1(a)(1)a, b.) Regulation section 1501 recognizes that when ideas, information, or artistic expressions are contained in or on TPP and the true object of a transfer of such property from one person to another for a consideration is not for value of the TPP but to communicate the content – Regulation section 1501 uses an original manuscript sold to a publisher as an example of TPP transferred for its content – there is no taxable sale.

[2] I cannot imagine a circumstance where the customer would hire the contractor to conduct a failure analysis but not expect to be informed regarding the results of that analysis.

revenue from services performed pursuant to a qualified R&D contract, CDTFA (or the Office of Tax Appeals) must find that both requirements of Regulation section 1501.1 have been met.

My agreement with the majority's disposition is based on my conclusion that there has been a failure of proof.[3] CDTFA's conclusion during the fifth reaudit that the disallowed transactions involved taxable sales of TPP was reasonable and rational. The burden of proving otherwise rests with Nanolab Technologies, Incorporated (appellant). (*Appeal of Owens-Brockway Glass Container, Inc.*, 2019-OTA-158P.) The evidence does not prove that any of the sample items that remain in dispute were incorrectly disallowed.[4] The declarations submitted by appellant are inconsistent with the evidence that indicates that every service did not include an effort by appellant to determine why a chip did not function as the customer intended it to perform. Some of the evidence indicates that appellant's customers summarized the failures they experienced and the design changes they wanted to test, and there is insufficient evidence to show that appellant did anything in connection with the disputed transactions to discover information that was technological in nature. To the extent appellant merely executed its customer's instructions to modify the TPP and returned it to the customer for testing, the services would have been more in the nature of fabrication labor. According to the evidence, there were only 109 sample transactions at issue when this appeal went to hearing. It was incumbent upon appellant to show why those transactions should have been allowed. It did not do that.[5]

Michael F. Geary
Administrative Law Judge

Date Issued: 7/30/2024

[3] I also agree with the majority's conclusion that the services performed by appellant (the ones that remain at issue) were not repair labor.

[4] Like the majority, I have difficulty understanding why CDTFA allowed some of the transactions that are no longer at issue.

[5] I am aware that in appeals like this one, there is a tension between the evidence required to satisfy a taxpayer's burden of proof and the need to protect confidential and proprietary information. However, there is nothing in the evidence that would lead me to conclude that appellant could not maintain and provide business records sufficient to support its claimed deductions.