OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	OTA Case No. 21047529
NOVO NORDISK INC.	

OPINION

Representing the Parties:

For Appellant:	Kyle O. Sollie, Attorney Timothy Lee, Attorney Rich Moore, Attorney
For Respondent:	Brian Miller, Attorney Nathan Hall, Attorney Supervisor
For Office of Tax Appeals:	Nguyen Dang, Attorney

A. KLETTER, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19045, Novo Nordisk Inc. (appellant) appeals actions by the Franchise Tax Board (respondent) proposing to assess additional tax of $582,481 for the 2012 tax year and $87,673 for the 2013 tax year, plus applicable interest. Respondent's proposed assessments are based on its reduction of appellant's claimed California research credits (research credits) for the 2012 and 2013 tax years.

Office of Tax Appeals (OTA) Administrative Law Judges Asaf Kletter, Amanda Vassigh, and Kenneth Gast held an oral hearing for this matter in Cerritos, California, on June 12, 2024. At the conclusion of the hearing, the record was closed, and this matter was submitted for an opinion.

ISSUE

Whether appellant must include the qualified research expenses (QREs) of a former member, Novo Nordisk Delivery Technologies, Inc. (Affiliate), which were incurred in the

2008 tax year, in computing appellant's fixed-based percentage for purposes of the research credit.

FACTUAL FINDINGS

1. Appellant was a pharmaceutical company engaged in the development of treatments for diabetes and other serious chronic diseases.
2. Aradigm Corporation (Aradigm), an unrelated entity, was an emerging specialty pharmaceutical company focused on the development and commercialization of drugs delivered by inhalation for the treatment of severe respiratory diseases. Aradigm developed a proprietary pulmonary drug delivery platform that it trademarked as AERx.
3. Pursuant to a Second Amended and Restated License Agreement (Licensing Agreement) between Aradigm and appellant's ultimate parent company, Novo Nordisk A/S (Parent), based in Denmark, Parent acquired from Aradigm the worldwide and exclusive right to develop, manufacture, and sell an inhaled insulin product using AERx. Parent also purchased from Aradigm various inhaled insulin-related patents.
4. In 2004, Parent formed Affiliate for the specific purpose of developing an inhaled insulin product utilizing the intellectual property Parent licensed and/or acquired from Aradigm.
5. In 2008, Parent, and several other major pharmaceutical companies, announced that they would be abandoning research and development of an inhaled insulin product due to faltering expectations regarding its commercial viability.
6. Also in 2008, Affiliate ceased all research and business activity, terminated the leases on its facility in Hayward, California, laid off all its 358 employees, except one employee who was retained solely for purposes of winding up the business, and sold its fixed assets, including laboratory equipment, to appellant's other affiliates and the public.
7. Pursuant to Article 10 of the Licensing Agreement, Parent could terminate the agreement at its sole discretion with prior written notice to Aradigm, but the parties retained certain rights and obligations. In 2008, Parent terminated the agreement and assigned to Aradigm, at no cost, the patents Parent had previously purchased from Aradigm, the intellectual property developed by Affiliate, and provided Aradigm the preclinical and clinical research, including a preclinical safety database and other related data, gathered by Affiliate during its development of an inhaled insulin product.

8. Shortly thereafter, Aradigm stated in its 2008 Securities and Exchange Commission (SEC) Form 10-K, Annual Report, (Form 10-K) that it did not intend to complete the development of an AERx-based inhaled insulin product on its own, but instead, would attempt to out-license or sell the intangible assets that Parent and/or Affiliate had assigned to it, associated with inhaled insulin.
9. On December 6, 2010, Affiliate merged with its direct parent company, Novo Nordisk U.S. Holdings, Inc. (NNUSHI), a wholly-owned subsidiary of Parent, with NNUSHI as the surviving corporation.
10. For the 2011, 2012, and 2013 tax years, because Affiliate had been merged out of existence and was no longer a member of appellant's "controlled group of corporations,"[1] only appellant claimed QREs for the research credit. Appellant's 2012 research credit included a carryover from the 2011 tax year.
11. For the 2011, 2012, and 2013 tax years, appellant was respectively in its eighth, ninth, and 10th years as a "startup company."[2]
12. On audit, respondent determined, as relevant here,[3] that appellant failed to include Affiliate's QREs which were incurred in the 2008 tax year in computing appellant's "fixed-base percentage."[4] Affiliate had QREs but no gross receipts for the 2008 tax year.
13. Accordingly, respondent increased appellant's fixed-base percentage for the 2011, 2012, and 2013 tax years, which decreased appellant's research credit carryover from the 2011 tax year to the 2012 tax year and reduced the research credit amounts generated for the 2012 and 2013 tax years.
14. Respondent thereafter issued appellant Notices of Proposed Assessment (NPAs) for the 2012 and 2013 tax years reflecting these adjustments.[5]

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[1] The discussion below defines a "controlled group of corporations."

[2] The discussion below defines a "startup company."

[3] Respondent made adjustments related to appellant's reported wage expenses, which are not at issue here.

[4] The term "fixed-base percentage," discussed below, generally represents the historical ratio between a taxpayer's aggregate QRE to its aggregate gross receipts. (See Internal Revenue Code (IRC), § 41(c)(3)(A).)

[5] Respondent did not issue appellant an NPA for the 2011 tax year because its reduction of appellant's research credit for that tax year did not result in a proposed tax deficiency.

15. Appellant protested the NPAs. Respondent issued appellant Notices of Action affirming the NPAs.
16. This timely appeal followed.

DISCUSSION

I. Legal Background

a. Burden of Proof

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

b. Statutory Construction Principles

In construing a statute, "our fundamental task is to determine the Legislature's intent so as to effectuate the law's purpose." (*People v. Superior Court of Riverside County* (2022) 81 Cal.App.5th 851, 862.) The words of a statute are generally the most reliable indicator of legislative intent. (*Ibid*.) However, "if the words are ambiguous or uncertain, [OTA] may resort to extrinsic sources to ascertain their meaning, including the statute's legislative history and ostensible objects to be achieved." (*Ibid*.) In such circumstances, "[OTA] must select the construction that comports most closely with the apparent intent of the Legislature, with a view to promoting rather than defeating the general purpose of the statute, and avoid an interpretation that would lead to absurd consequences." (*People v. Jenkins* (1995) 10 Cal.4th 234, 246.)

c. California Research Credit

The research credit is generally determined in accordance with Internal Revenue Code (IRC) section 41.[6] (R&TC, § 23609.)[7] The research credit was designed to incentivize taxpayers

[6] For the 2011 through 2013 tax years, R&TC sections 23051.5(a)(1) and 17024.5(a)(1)(O) provide that California conforms to the January 1, 2009 version of the IRC. Thus, references to the IRC contained in this Opinion are to the IRC as in effect on January 1, 2009.

[7] Notably, however, California substantially modifies the federal definitions of gross receipts and qualified research and does not permit taxpayers to elect the federal alternative simplified credit. (R&TC, § 23609(c)(2), (h)(3), (4).) In addition, the percentage of the excess of QREs over the base amount for which the research credit is provided is different (i.e., lower) for California tax purposes. (R&TC, § 23609(a)(1), (b)(1)(A), (2)(A), (3)(A).)

to increase their research expenditures as a percentage of gross receipts and is therefore allowed only to the extent the taxpayer's QREs for the credit year exceed a historical "base amount." (IRC, § 41(a)(1); *Hewlett-Packard Co. and Consol. Subsidiaries v. Commissioner* (2012) 139 T.C. 255, 260, citing H.R. Rep. No. 101-247, pp. 1199-1200 (1989).) The "base amount" for the taxable year for which the research credit is being determined (the credit year) is computed by multiplying the "fixed-base percentage" and the average annual gross receipts of the taxpayer for the four taxable years preceding the credit year. (IRC, § 41(c)(1).) In the case of "start-up companies,"[8] the "fixed-base percentage" is 3 percent for the first five taxable years in which the taxpayer has QREs. (IRC, § 41(c)(3)(B)(ii).) For the sixth through 10th taxable years, the "fixed-base percentage" is a specified fraction of the percentage which the taxpayer's aggregate QREs for specified years is of the taxpayer's aggregate gross receipts for such years. (IRC, § 41(c)(3)(B)(ii)(II-VII).) It is undisputed that for the tax years at issue, appellant was a startup company in its eighth, ninth, and 10th credit years.[9]

In determining the amount of the research credit, all members of the same "controlled group of corporations"[10] shall be treated as a single taxpayer. (IRC, § 41(f)(1)(A)(i).) The taxpayer is required to compute the allowable "group credit"[11] by applying all IRC section 41

[8] A "startup company" is one which did not have gross receipts and QREs prior to 1984, or which had both gross receipts and QREs for fewer than three taxable years beginning after December 31, 1983, and before January 1, 1989. (IRC, § 41(c)(3)(B)(i).)

[9] IRC section 41(c)(3)(B)(ii)(IV-VI) provides the following fixed-based percentages applicable for the tax years at issue: (IV) For the taxpayer's eighth such taxable year (i.e., appellant's 2011 tax year), one-half of the percentage which the aggregate QREs of the taxpayer for the fifth, sixth, and seventh such taxable years is of the aggregate gross receipts of the taxpayer for such years; (V) For the taxpayer's ninth such taxable year (i.e., appellant's 2012 tax year), two-thirds of the percentage which the aggregate QREs of the taxpayer for the fifth, sixth, seventh, and eighth such taxable years is of the aggregate gross receipts of the taxpayer for such years; (VI) For the taxpayer's 10th such taxable year (i.e., appellant's 2013 tax year), five-sixths of the percentage which the aggregate QREs of the taxpayer for the fifth, sixth, seventh, eighth, and ninth such taxable years is of the aggregate gross receipts of the taxpayer for such years.

[10] As used in IRC section 41, the term "controlled group of corporations" has the same meaning given to such term by section 1563(a), as modified, to refer to two or more corporations connected through stock ownership of more than 50 percent. (IRC, § 41(f)(5).) As relevant here, a parent-subsidiary controlled group consists of one or more chains of corporations connected through stock ownership of at least 50 percent with a common parent corporation. (*Ibid.*; see also IRC, § 1563(a)(1)(A), (B).)

[11] "Group credit" means the research credit (if any) allowable to a controlled group. (Treas. Reg. § 1.41-6(a)(3)(iv).)

computational rules on an aggregate basis. (Treas. Reg. § 1.41-6(b).)[12] The group credit is allocated to each member based on the member's proportionate share of the aggregate QREs and other amounts giving rise to the group credit. (IRC, § 41(f)(1)(A)(ii); Treas. Reg. § 1.41-6(c).) IRC section 41(f)(1), referred to as the Aggregation Rule, was enacted to ensure that the research credit will be allowed only for actual increases in research wage expenditures by preventing taxpayers from shifting expenses amongst commonly controlled or otherwise related persons.[13] (Sen. Rep. No. 97-44, 1st Sess., p. 83, 1981 WL 21359.)

QREs required to be included in the fixed-base percentage computation shall be determined on a basis consistent with the determination of QREs for the credit year. (IRC, § 41(c)(6)(A) & (B); see also Treas. Reg. § 1.41-3(d).) IRC section 41(c)(6), referred to as the Consistency Rule, ensures that increases in the taxpayer's QREs for the credit year is not merely due to differences in how those expenses are accounted for between the credit year and prior years. For instance, where the statutory definition of QREs has changed between the credit year and a prior year which is required to be included in computing the fixed-base percentage, the taxpayer must apply the credit year definition of QREs in determining the amount of its QREs for the prior year. (Treas. Reg. § 1.41-3(d)(2), Example 1.)[14]

It is undisputed that prior to Affiliate's merger with NNUSHI in 2010, Parent directly or indirectly owned a controlling interest in both appellant and Affiliate, and therefore these corporations constituted a parent-subsidiary controlled group (Group) which was required to compute the Group's fixed-base percentage on an aggregate basis. (See Treas. Reg. § 1.1563-1(a)(2)(ii), Example 2.) It is also undisputed that after the merger with its parent, Affiliate ceased to exist and was no longer a Group member. The computational rules required the Group, for each respective credit year, to include the Group's QREs for its fifth such taxable

[12] When applying the IRC, California incorporates final or temporary Treasury Regulations to the extent that they do not conflict with California corporation tax law or regulations promulgated by respondent. (R&TC, § 23051.5(d).)

[13] Because California's statute for the research credit is based on a federal statute, it is presumed that the Legislature was aware of the legislative history behind the enactment of the federal statute, and therefore, the federal legislative history may be used to interpret the state statute. (*Clayworth v. Pfizer, Inc.* (2010) 49 Cal.4th 758, 778.)

[14] The Consistency Rule also applies where a taxpayer has claimed a certain type of expenditure as a QRE for the credit year which had not previously been claimed as a QRE. (Treas. Reg. § 1.41-3(d)(2), Example 2.) In this situation, the taxpayer must adjust its QREs in computing the fixed-base percentage to include any similar expenditures, regardless of whether the period for filing a refund or claim for the research credit has expired for any year taken into account in computing the fixed-base percentage. (*Ibid*.)

year (i.e., 2008) on an aggregate basis, unless an exclusion applies. (IRC, § 41(c)(3)(B)(ii)(IV)-(VI).)

As will be described in the next section, there are special rules for changes in business ownership, under which the QREs are increased or decreased for the credit year when there is an acquisition or disposition. (IRC, § 41(f)(3)(A), (B).) In this appeal, the parties disagree on whether the Group is required to include Affiliate's 2008 QREs in the group's aggregate QREs in computing appellant's fixed-base percentage for its eighth, ninth, and 10th years. Excluding Affiliate's 2008 QREs from the fixed-base percentage reduces the base amount,[15] and therefore increases the taxpayer's QREs that exceed that base amount, which increases the research credit for the tax years at issue.

Appellant primarily argues that it disposed of Affiliate under IRC section 41(f)(3)(B), and therefore, the Group was not required to include Affiliate's 2008 QREs in the fixed-based percentage for the 2011 through 2013 credit years. Appellant also references various authorities to support its interpretation, such as the Aggregation Rule and the Consistency Rule, but agrees that those rules are not in dispute in this appeal. Appellant also asserts that respondent must follow the outcome of the IRS's examination of appellant's 2007 through 2012 federal income tax returns. OTA addresses each of appellant's arguments in turn below.

II. Rules for Changes in Business Ownership

For the tax years at issue, IRC section 41(f)(3)(A) provided that if a taxpayer acquires the major portion of a trade or business or the major portion of a separate unit of a trade or business (hereinafter referred to as the "acquired business") of another person (hereinafter referred to as the "predecessor"), the taxpayer will increase its QREs and gross receipts for purposes of applying IRC section 41 for any taxable year after the acquisition.[16] For purposes of determining the acquiring taxpayer's research credits, the QREs and gross receipts of the taxpayer during periods before such acquisition shall be increased by the respective amounts attributable to the acquired business. (IRC, § 41(f)(3)(A).)

[15] As described above, Affiliate did not have any gross receipts for the 2008 tax year.

[16] As described above, for the tax years at issue, California conformed to the IRC as effective on January 1, 2009. IRC section 41 was modified effective December 17, 2010, and January 2, 2013, which added clarifying provisions relating to the rules for changes in business ownership. However, those changes were not incorporated into California law. The amendments do not affect this appeal and the parties do not argue otherwise.

For the tax years at issue, IRC section 41(f)(3)(B) provided that, if the taxpayer disposes of the major portion of any trade or business or the major portion of a separate unit of a trade or business in a transaction to which subparagraph (A) (concerning acquisitions) applies, and the taxpayer furnished to the acquiring person such information as is necessary for the application of subparagraph (A), then, for purposes of applying this section (concerning dispositions) for any taxable year ending after such disposition, the QREs and gross receipts of the taxpayer shall be decreased by the respective amounts attributable to the acquired business. (IRC, § 41(f)(3)(B).)

"These rules are intended to facilitate an accurate computation of base period expenditures and the credit by attributing research expenditures to the appropriate taxpayer." (Staff of the Joint Comm. on Taxation, 97th Cong., 1st Sess., General Explanation of the Economic Recovery Tax Act of 1981 (1981) p. 135.)[17] "If the [statutory scheme] did not include rules for changes in ownership of a business, a taxpayer who begins business by buying and operating an existing company might be entitled to a credit even if the amount of qualified research expenditures did not increase. Also, the sale of a unit of a business could cause the seller to lose any credit even though qualified research expenditures increased in the part of the business that was retained." (*Ibid.*)

A Treasury Regulation promulgated under IRC section 41 points to Treasury Regulation section 1.52-2(b) for the meaning of "acquisition," "separate unit," and "major portion."[18] (Treas. Reg. § 1.41-7(b).)[19] However, Treasury Regulation section 1.41-7(b) adds that an "acquisition" includes an incorporation or a liquidation. Concerning an acquisition, the Treasury Regulation promulgated under IRC section 52 provides that an acquisition must transfer a viable trade or business, and not merely acquire physical assets. (Treas. Reg. § 1.52-2(b)(1)(ii).) That regulation provides that an acquisition occurs where a restaurant (predecessor) transfers to S. Co (acquiror) its building, all its restaurant equipment, its name and goodwill; ceases to operate a

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[17] Available at: https://www.jct.gov/CMSPages/GetFile.aspx?guid=d44df064-f7c8-444a-9c57-68d03522feed.

[18] As discussed below, respondent does not contest that Affiliate was a separate unit, and the definition of "major portion" is not at issue. In determining what constitutes the "major portion" of a business (or separate unit), all facts and circumstances surrounding the transaction shall be taken into account. (Treas. Reg. § 1.52-2(b)(3).) The regulation sets forth the factors to be considered. (*Ibid*.)

[19] Treasury Regulation section 1.41-7(b) references the definitions in Treasury Regulation section 1.52-2(b). The latter regulation apparently concerns special rules for an employment, wage or payroll tax credit.

restaurant business; and the acquiror operates predecessor's restaurant using the predecessor's old name. (Treas. Reg. § 1.52-2(b)(1)(iii), Example 2; see also Sen. Rep. No. 95-66, 1st Sess., p. 73 (1977) [Generally, transfer of goodwill is an indication that a trade or business has changed hands; however, a buyer's retention of employees is not a determinative factor].)[20]

Treasury Regulation 1.52-2(b)(2)(i) provides that a "separate unit" is a segment of a trade or business capable of operating as a self-sustaining enterprise with minor adjustments. It also provides that the allocation of a portion of the goodwill of a trade or business to one of its segments is a strong indication that that segment is a separate unit. (Treas. Reg. § 1.52-2(b)(2)(i).) Moreover, Treasury Regulation section 1.52-2(b)(2)(ii) provides examples to illustrate the acquisition of a separate unit of a trade or business. For example, P. Co, a chain of department stores, has eight divisions, each of which operates in different metropolitan areas of the country under a different name, and each of which operates independently on a day-to-day basis, although certain buying and merchandizing functions are centralized. An acquisition of a separate unit occurs where the Q. Corp. acquires all the physical and intangible assets of one division, including that division's name, and where other than making those minor adjustments necessary to give the division buying and merchandising departments, the division continues doing business in the same manner as it had been prior to acquisition. (Treas. Reg. § 1.52-2(b)(2)(ii), Example 2.)

III. Analysis

Appellant contends that the assignment of all intellectual property pertaining to Affiliate's inhaled insulin business to Aradigm, the surrender of Parent's exclusive AERx license to Aradigm, and the transfer of clinical data and other records pertaining to that business to Aradigm was a transaction that constitutes the disposition of a major portion of a separate unit of a business, which entitles the Group to exclude Affiliate's QREs from its base amount.

At the hearing, respondent stated that it did not dispute that Affiliate was a major portion of a separate unit of a trade or business under IRC section 41(f)(3)(B)(i). Its main contention appears to be that the transaction did not constitute the acquisition of a viable trade or business under Treasury Regulation 1.52-2(b)(1)(ii). Respondent appears to take the position that Aradigm did not acquire a major portion or a major portion of a separate unit of a trade or

[20] Available at: https://www.finance.senate.gov/download/1977/03/28/tax-reuction-and-simplification-act-of-1977-report-95-66 [*sic*].

business because that trade or business must be capable of operating a self-sustaining enterprise with minor adjustments.[21]

At the hearing, the parties agreed that for there to be a disposition, there must be an acquisition. IRC section 41(f)(3)(B), concerning dispositions, only applies "in a transaction to which subparagraph (A) [concerning acquisitions] applies." As described above, an acquisition must transfer a viable trade or business. (Treas. Reg. § 1.52-2(b)(1)(ii).) Therefore, the dispositive question in this appeal is whether, pursuant to the termination of the License Agreement, appellant transferred a viable trade or business to Aradigm.

Both parties rely on statements in Aradigm's Form 10-K which describe the termination of the License Agreement. The Form 10-K states that "[appellant] must enable [Aradigm] to continue to pursue commercialization of inhaled insulin." The annual report further states that appellant is required to "supply [Aradigm] with insulin for use in continuing development of inhaled insulin," and to "[p]rovide [Aradigm] full access to the data generated in the development of inhaled insulin . . . ." The Form 10-K also states that appellant "transferred to Aradigm, at no charge, a portfolio of U.S. and foreign patents related to inhaled insulin." Finally, the Form-10K states that Aradigm received U.S. and foreign patents pursuant to the termination of the License Agreement, and that:

> "[Aradigm] assume[s] the responsibility for the maintenance of this portfolio. [Appellant] is also providing [Aradigm] with the data from preclinical and clinical research generated during the collaboration. [Aradigm] do[es] not intend to complete the development of AERx . . . on our own. We are attempting to out-license or sell the assets associated with inhaled insulin."

Appellant urges, based on the above, that it transferred a viable trade or business to Aradigm, and everything Aradigm needed to have or continue the development of an inhaled insulin business. Respondent asserts that appellant's return of patents and intellectual property rights, preclinical and clinical data, and other related dated gathered by Affiliate in development

[21] At the hearing, in response to a question of whether IRC section 41(f)(3)(B)(i) applies in this appeal (about disposing of the major portion of any trade or business or major portion of a separate unit of a trade or business), respondent stated that the IRC provision only applies if there was an acquisition. Respondent stated that it did not disagree that Affiliate was a separate unit of a trade or business but asserted that Affiliate was not a viable trade or business when transferred to Aradigm because a viable trade or business must need only minor adjustments. Respondent asserted that to make the separate unit (transferred to Aradigm) a viable business, major (and not minor) adjustments were required. While respondent referred to the IRC, Treasury Regulation sections 1.41-7(b) and 1.52-2(b) set forth the requirements for a viable trade or business. Thus, OTA interprets respondent to contest the viability of the trade or business that was transferred to Aradigm, not the major portion or separate unit elements.

of an inhaled insulin product to Aradigm merely implemented the prearranged unwinding of the collaboration with Aradigm. Respondent further asserts that because appellant did not transfer employees, physical space, or other significant operating assets, it retained an interest in inhalable insulin. Appellant responds that respondent mischaracterizes appellant's obligations under the termination of the License Agreement as a mere transfer of intangible assets.

As emphasized in the regulation and legislative history, the transfer of goodwill is an important consideration in determining whether a viable business has been transferred. (Treas. Reg. § 1.52-2(b)(1)(iii), Example 2; see also Sen. Rep. No. 95-66, *supra*.) Goodwill is generally considered the continued patronage and competitive advantage of a business which may be represented by property rights or interests, trademarks, and secret formulas or processes. (*Philip Morris Inc. and Consol. Subsidiaries v. Commissioner* (1991) 96 T.C. 606, 634, affd. (2d Cir. 1992) 970 F.2d 897.)

Because Affiliate ceased business operations prior to commencing any sales activity, the goodwill associated with its business did not include the expectation of continued patronage, but rather was wholly attributable to those items which gave it a competitive advantage, such as its patent portfolio, exclusive AERx license and other proprietary data and technical expertise Affiliate had developed during its collaboration with Aradigm. In acquiring these intangible assets, Aradigm had also acquired the goodwill associated with Affiliate's business. Accordingly, the question that arises is whether the transfer of goodwill and intangibles without the fixed assets of the business and its employees is sufficient to constitute the acquisition of a viable trade or business.

An acquisition of a separate unit pursuant to the regulation requires that the separate unit be a trade or business "capable of operating as a self-sustaining enterprise with minor adjustments." (Treas. Reg. § 1.52-2(b)(2)(i).) The regulation illustrates that the transfer of a viable business occurs where the predecessor ceases business operations and the acquiring person operates a similar business using the assets and goodwill acquired from the predecessor. (Treas. Reg. § 1.52-2(b)(1)(iii), Example 2.) In contrast, where the predecessor continues to operate a similar business, no separate unit is acquired. (Treas. Reg. § 1.52-2(b)(2)(iii), Example 6.) Further contrasting the transfer of a viable business, where a manufacturer sells a business asset, but the acquiror cannot conduct a profitable business operation with the transferred asset alone, no separate unit is acquired. (*Id*., Example 7(b).)[22]

While it is undisputed that Affiliate ceased business operations, the evidence indicates that Aradigm did not operate a similar business to Affiliate's following the transfer of Affiliate's intangible assets and other assets. Affiliate's business involved the research, development and commercialization of an AERx-based inhaled insulin product. The operation of this business apparently required certain fixed assets, such as laboratory equipment and a facility located in Hayward, California. However, it appears Aradigm did not acquire these assets because it did not intend to operate a similar business. Rather, Aradigm intended to continue its own business of developing an AERx-based insulin product through third-party licensing agreements, which only required Affiliate's intangible assets. Therefore, because Aradigm did not acquire all the assets required to operate Affiliate's business (i.e., substantial changes were necessary to operate a similar business), OTA finds that Aradigm did not acquire a viable business from Affiliate.[23]

Considering all the facts and circumstances, OTA finds that appellant has not shown that the transaction pursuant to the termination of the License Agreement, which involved the cessation of Affiliate's business, and assignment of intangibles to Aradigm, constitutes an acquisition under IRC section 41(f)(3)(A), and consequently, no adjustment is warranted to exclude Affiliate's 2008 QREs from appellant's fixed-base percentage.[24]

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[22] Moreover, where substantial changes are required to operate the business after an acquisition of assets, the IRS has determined that no viable business has been transferred. (See IRS Private Letter Ruling 8051105 [viable business not transferred where it was necessary for the acquiring person to make substantial facility improvements and changes to the operations of the acquired business, including to overcome the poor reputation of the predecessor corporation]; IRS Technical Advice Memorandum 8108014 [acquisition of a viable business did not take place where, among other things, there is no evidence that the acquired business could have been operated as a viable business with only minor changes or adjustments].)

[23] Appellant advances a plain meaning definition of "viable;" however, the applicable regulation provides explanation and illustrative examples. The parties agree that viability does not require economic viability. Appellant also asserts that OTA should take caution in applying the rules and examples of Treasury Regulation section 1.52-2 because it concerns a payroll credit, while this appeal concerns a research credit. However, the applicable research credit regulation, section 1.41-7(b), directs OTA to apply these rules and examples, and it only modifies the research credit regulation to include a liquidation or incorporation within the meaning of "acquisition."

[24] Both appellant and respondent provide numerous arguments concerning whether the termination of the License Agreement resulted in a disposition. Because the parties agree that there must be both an acquisition and a disposition, and OTA has determined that the termination of the License Agreement, and appellant's transfer of Affiliate's intangible assets to Aradigm was not an acquisition within the meaning of the applicable authorities, it is unnecessary to decide whether appellant disposed of Affiliate within the meaning of the applicable authorities.

IV. Whether IRC section 41(b)(1), the Aggregation Rule, and the Consistency Rule require a different statutory construction.

As described above, OTA's fundamental task is to determine the Legislature's intent so as to effectuate the law's purpose, and the words of a statute are generally the most reliable indicator of legislative intent. (*People v. Superior Court of Riverside County*, *supra*, 81 Cal.App.5th at 862.) Appellants points to various features of the research credit which it asserts gives interpretative guidance that would allow it to exclude Affiliate's 2008 QREs from appellant's fixed-base percentage for the 2011 through 2013 credit years.

First, appellant asserts IRC section 41(b)(4) supports that it transferred a viable trade or business. IRC section 41(b)(4) provides that, for in-house research expenses, a taxpayer shall be treated as meeting the trade or business requirement if, at the time the expenses were paid or incurred, the taxpayer's principal purpose in making the research expenditures was to use the results of the research in the active conduct of a future trade or business. IRC section 41(b)(4) allows a taxpayer to claim research expenditures when it does not yet have a trade or business. Appellant asserts that the statutory section supports that it disposed of a "future trade or business," and therefore, may exclude Affiliate's 2008 QREs when Affiliate was disposed of. However, as described above, IRC section 41(f)(3) requires an acquisition of a *viable* trade or business by Aradigm. Section 41(b)(4) has no application to whether an acquisition or to whether a trade or business was viable under the applicable regulations.

Second, appellant argues that the Aggregation Rule supports appellant's interpretation that IRC section 41(f)(3)(B) did not require the Group to include Affiliate's 2008 QREs in computing its fixed-base percentage for the 2011 through 2013 credit years because Affiliate was not a member of the Group at the end of the respective credit years. As described above, the Aggregation Rule provides that the taxpayer computes the allowable group credit by applying the IRC section 41 rules on an aggregate basis, and then allocates the group credit to each member based on the member's proportionate share of the aggregate QREs. (IRC, § 41(f)(1); Treas. Reg. § 1.41-6.) By its own terms, the Aggregation Rule applies to the credit year and does not address removal of prior year QREs. Appellant agrees that the Aggregation Rule does not directly apply because this appeal is governed by IRC section 41(f)(3), which concerns the acquisition or disposition of a trade or business.

The research credit is based on incremental expenditures, and to function as intended, it is evident that QREs which generate a research credit for the taxpayer must also increase the taxpayer's base amount in subsequent years. There is no provision in IRC section 41 or the applicable regulations which directly addresses how the Aggregation Rule should be applied following a corporate reorganization, the liquidation of a member of a controlled group of corporations, or the cessation of a line of business or research by the taxpayer. However, the legislative history indicates that the Aggregation Rule was enacted to prevent taxpayers from obtaining the research credit without having to incur additional research wage expenditures by shifting expenses amongst commonly controlled or otherwise related persons or entities with a lower base amount, which would create the illusion of an increase in research activity. (Sen. Rep. No. 97-44, *supra*.) The Aggregation Rule ensures that the research credit will be allowed only where the taxpayer has actually increased its research expenditures as a percentage of gross receipts for the credit year.

The Aggregation Rule does not support appellant's exclusion of Affiliate's 2008 QREs from the fixed-based percentage for the 2011 through 2013 credit years, after Affiliate ceased to exist as a trade or business and merged into its parent corporation. The Aggregation Rule was intended to avoid shifting of expenses between related entities and therefore, does not support removal of QREs on the subsequent liquidation or merger of controlled group member, nor does it help interpret whether a taxpayer transferred a viable trade or business. Allowing appellant to exclude Affiliate's 2008 QREs from the Group's fixed-base percentage for the credit years would allow an artificial research credit based on a reduction of the Group's base amount, rather than an actual increase in credit year expenditures. Moreover, allowing the Group to reduce its fixed-base percentage due to the termination of its inhaled insulin business would, in effect, lead to the absurd result of providing the Group with a research credit for decreasing its research activity which contradicts the stated purpose of the research credit.

Third, appellant contends that the Consistency Rule supports its interpretation that the Group was required to exclude Affiliate's 2008 QREs in computing the Group's fixed-based percentage. However, for a controlled group, the consistency rule is applied on a per member basis. (*Union Carbide Corp. and Subsidiaries v. Commissioner* T.C. Memo. 2009-50 at pp. 100-101, affd. (2d Cir. 2012) 697 F.3d 104.) In other words, each member of the group (as opposed to the group as a whole) must determine its QREs in a consistent manner, meaning that an adjustment to prior year expenses need only be made for the member incurring the QREs for which the research credit is being claimed. (*Ibid*.)

It is undisputed that Affiliate did not incur any research expenses for any of the credit years. Accordingly, OTA finds that no prior-year expense adjustment is necessary to prevent the Group from claiming the research credit based on an inconsistent reporting of Affiliate's expenses in the credit years. As the Consistency Rule requires the consistent determination of research expenditures between tax years, it is not relevant to the acquisition of a business.

For the above reasons, OTA finds that appellant's cited authorities, including IRC section 41(b)(4), the Aggregation Rule, and the Consistency Rule do not support appellant's exclusion of Affiliate's 2008 QREs from the fixed-base percentage for the 2011 through 2013 credit years.

V. Federal Determination

Finally, appellant contends that an IRS determination is controlling in this matter. Appellant asserts that the IRS examined appellant's 2007 through 2012 federal income tax returns and concurred with appellant's decision to exclude Affiliate's 2008 QREs from the Group's group credit calculations for the years under examination, which include the tax years at issue. Appellant claims that respondent's audit policy is to follow an IRS determination regarding the research credits, and therefore, this determination is dispositive.

Respondent emphasizes that this policy applies only where the federal determination is on point and there are no differences between federal and state law, which is not the case here because the Group elected to compute the research credit for federal tax purposes using a different method than it had for state purposes (i.e., the alternative simplified credit). Respondent asserts that California does not conform to this method of computing the research credit. Respondent further asserts that any IRS determination regarding the research credit calculation using this method is irrelevant because the alternative simplified credit does not require a determination that the Group was required to include Affiliate's 2008 QREs.

The alternative simplified credit is equal to 14 percent of the QREs for the credit year as exceeds 50 percent of the average QRE for the three preceding taxable years. (IRC, § 41(c)(4)(A).) Respondent is correct that California does not conform to this method of computing the research credit. (R&TC, § 23609(h)(4).) Respondent is also correct that the alternative simplified credit method does not require the Group to account for its 2008 research expenses when calculating its research credit for the 2012 and 2013 tax years. However, the

Group was required to account for these expenses in computing its research credit for the 2011 tax year. Therefore, an IRS determination that the Group was not required to account for Affiliate's 2008 expenses in computing its prior year expenses might also indicate that those expenses could be excluded for purposes of determining the fixed-base percentage under the regular method.

OTA's role in the appeals process is to determine the correct amount of the taxpayer's California income tax liability. (*Appeal of Robinson*, 2018-OTA-059P, citing *Appeals of Dauberger, et al.* (82-SBE-082) 1982 WL 11759.) In making this determination, it is well established although FTB may base its proposed assessment on a final federal determination to the extent applicable under California law, it is not bound to do so and can conduct an independent investigation. (*Appeal of Black*, 2023-OTA-023P; *Appeal of Der Wienerschnitzel, Inc*. (79-SBE-063) 1979 WL 4104.) While such a determination may be helpful in deciding an issue on appeal, it is of no persuasive value where, as here, the reasoning behind that determination is not in the record, and we are unable to ascertain whether it was based on a thorough and sound analysis of appellant's research credit calculation and the applicable law. Moreover, the news releases cited by appellant do not change the California statutory requirements for calculating the research credit. (*Appeal of Electronic Data Systems & Subs.*, 2023-OTA-539P.)

For these reasons, OTA finds that the IRS determination regarding appellant's research credit calculation has no bearing on the disposition of this issue.[25]

[25] The record in this case was voluminous. To the extent appellant and respondent raise additional arguments, or variations on the arguments described above, that OTA has not specifically addressed, it has considered them and found the resolution of these arguments to be immaterial to the outcome.

HOLDING

Appellant must include the QREs of a former member, Affiliate, which were incurred in the 2008 tax year, in computing appellant's fixed-based percentage for purposes of the research credit.

DISPOSITION

Respondent's actions are sustained.

DocuSigned by:
Asaf Kletter
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Asaf Kletter
Administrative Law Judge

We concur:

DocuSigned by:
Amanda Vassigh
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Amanda Vassigh
Administrative Law Judge

DocuSigned by:
Kenneth Gast
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Kenneth Gast
Administrative Law Judge

Date Issued: 9/16/2024