

OFFICE OF TAX APPEALS
STATE OF CALIFORNIA

In the Matter of the Appeal of:) OTA Case No. 21068042
D. BERNSTEIN AND)
K. BERNSTEIN)
_____)

OPINION ON PETITION FOR REHEARING

Representing the Parties:

For Appellants: Russell G. Garza, Associate Director
For Respondent: Pamela W. Bertani, Attorney

A. VASSIGH, Administrative Law Judge: On June 4, 2024, the Office of Tax Appeals (OTA) issued an Opinion sustaining the action of respondent Franchise Tax Board (FTB) denying appellants’ claim for refund for the 2007 tax year. In the Opinion, OTA held that appellants did not demonstrate that they were entitled to research and development credits under Internal Revenue Code (IRC) section 41(d)(1). OTA reviewed six sample projects and determined that appellants failed to demonstrate that substantially all of the activities related to each of the sample projects constituted a process of experimentation for a qualified purpose.

Appellants timely filed a petition for rehearing (petition) with OTA on July 5, 2024, under Revenue and Taxation Code (R&TC) section 19334 on the basis that OTA’s Opinion is contrary to law. Upon consideration of appellants’ petition, OTA concludes that the ground set forth in appellants’ petition does not constitute a basis for granting a new hearing.

OTA will grant a rehearing where one of the following grounds for a rehearing exists and materially affects the substantial rights of the party seeking a rehearing: (1) an irregularity in the appeal proceedings which occurred prior to issuance of the Opinion and prevented fair consideration of the appeal; (2) an accident or surprise, occurring during the appeal proceedings and prior to the issuance of the Opinion, which ordinary caution could not have prevented; (3) newly discovered evidence, material to the appeal, which the party could not have reasonably discovered and provided prior to issuance of the Opinion; (4) insufficient evidence to justify the Opinion; (5) the Opinion is contrary to law; or (6) an error in law in the

OTA appeals hearing or proceeding. (Cal. Code Regs., tit. 18, § 30604(a)(1)-(6); *Appeal of Shanahan*, 2024-OTA-040P.)

The question of whether a decision is contrary to law is not one that involves a weighing of the evidence, but instead requires a finding that the decision is “unsupported by any substantial evidence.” (*Appeal of Swat-Fame, Inc. et al.*, 2020-OTA-045P.) This requires a review of the opinion to indulge “in all legitimate and reasonable inferences” to uphold the opinion. (*Sanchez-Corea v. Bank of America* (1985) 38 Cal.3d 892, 907.) The relevant question is not over the quality or nature of the reasoning behind the opinion, but whether the opinion can or cannot be valid according to the law. (*Appeal of Swat-Fame, Inc. et al.*, *supra.*) In our review, we consider the evidence in the light most favorable to the prevailing party (in this case, FTB). (*Ibid.*)

The Legal Standard for Determining Whether Research Activities Constitute Elements of a Process of Experimentation.

The process of experimentation test has three elements: (A) substantially all of the research activities for each business component must constitute (B) elements of a process of experimentation (C) for a qualified purpose. (IRC, § 41(d)(1)(C).) The “substantially all” element means that 80 percent or more of the taxpayer’s research activities for each business component, measured on a cost or other consistently applied reasonable basis, must constitute a process of experimentation for a qualified purpose. (Treas. Reg. § 1.41-4(a)(6).) If a business component fails the process of experimentation test because of the “substantially all” requirement, a court may apply the shrinking-back rule until an element that satisfies the test is reached. (*Suder v. Commissioner*, T.C. Memo 2014-201 (*Suder*).)

In regard to the six sample projects, OTA considered whether appellants showed that at least 80 percent of Processes Unlimited International, Inc.’s (Processes Unlimited’s) claimed activities constituted a process of experimentation. OTA also gave such consideration with respect to various *subsets* of each project. In their petition for rehearing, appellants contend that the Opinion “misapplies the legal standard for determining whether research activities constitute elements of a process of experimentation (‘POE’),” arguing that “engineering activity is synonymous with research activity in the experimental or laboratory sense to resolve uncertainty that constitutes elements of a POE.” Appellants argue that “standard engineering” activities necessarily constitute elements of a process of experimentation, such that “[a]s standard engineering constitutes POE, and the Opinion acknowledges that [Processes

Unlimited] performed standard engineering, it follows that the evidence shows [Processes Unlimited] performed research that constitutes elements of a POE.”

Appellants erroneously interpret the Opinion, claiming that the Opinion “relies on a purported distinction between engineering and POE that decades of consistent authority . . . show does not exist.” In actuality, OTA did not make a distinction between engineering and a process of experimentation, but rather pointed out that while appellants may have shown that engineering services were performed, they failed to establish “what portion, if any, of those activities constituted a scientific process of experimentation.” (Opinion, p. 13.)

Appellants also point to Congressional reports and the legislative history of the research credit in support of their argument. In 1986, Congress amended the R&D credit due to the government’s finding that taxpayers were interpreting it too broadly. (*Union Carbide Corp. and Subsidiaries v. Commissioner*, T.C. Memo. 2009-50 (*Union Carbide*) citing to S. Rept. 99–313, at 694 (1986), and H. Rept. 99–426, at 178 (1986).) Congress therefore provided a definition of “qualified research” in the Tax Reform Act of 1986. (Tax Reform Act of 1986, Pub.L. 99–514, sec. 231(b), 100 Stat. 2173.) In doing so, Congress added the process of experimentation test to IRC section 41, thus *narrowing* the scope of eligibility for the R&D credit. OTA has not found any basis in the law for appellants’ contention that the legislative history supports their argument that the process of experimentation test is satisfied simply by establishing the existence of engineering services. In fact, the legislative history indicates otherwise.

As stated in the Opinion, the taxpayer has the burden of showing that the requirements for the research credit are satisfied. (See, e.g., *Trinity Industries, Inc. v. U.S.* (N.D.Tex. 2010) 691 F.Supp.2d 688, 696, *aff’d*. in part & *revd.* in part (5th Cir. 2014) 757 F.3d 400 (Trinity II).) Furthermore, Treasury Regulation section 1.41-4(d) underscores the evidentiary requirement, providing that “[a] taxpayer claiming a credit under [IRC] section 41 must retain records in sufficiently usable form and detail to substantiate that the expenditures claimed are eligible for the credit.” In keeping with the relevant law, the Opinion centered on whether appellants had provided evidence to demonstrate that substantially all of Processes Unlimited’s activities for

any of the sample projects (or for any subset of a project) constituted elements of a process of experimentation for a qualified purpose.¹

Appellants contend that in *Union Carbide*, the Tax Court “held that POE is generally synonymous with the scientific method (a ‘standard’ or ‘typical’ engineering framework) . . .” However, the *Union Carbide* court emphasized the extensive evidentiary record, which substantiated Union Carbide Corp.’s research credit eligibility. Indeed, the evidentiary record in *Union Carbide* is replete with evidence to corroborate witness testimony regarding petitioner’s research credit claims – contrary to Appellants’ argument for an evidentiary presumption that “standard engineering” constitutes a cognizable process of experimentation. The Court provides, as the basis for its decision, a comprehensive description of the documentation and methodologies upon which testimony was based, including (but not limited to) product cost detail reports and material accounting summary reports to calculate the supply costs of identified runs and claimed QREs. (*Union Carbide, supra.*)

Appellants also contend that in *Suder*, the Tax Court held that the company’s “routine” engineering constituted POE, stating that “the engineering was so ‘routine’ (or ‘standard’) that the Court provided a single recitation of [the taxpayer’s] development process and said [the taxpayer] followed the ‘same, or a substantially similar product development process’ for all twelve of the sampled projects.” Here, too, appellants argue that routine or standard engineering activities automatically constitute a cognizable process of experimentation. Yet again, the key element upon which the Court based its decision is the extensive evidentiary record in the case. The Tax Court found that demonstrable, contemporaneous evidence in the record clearly established that 11 of the 12 projects at issue satisfied the four-part test for establishing qualified research activities. (*Suder, supra*, at p. 53.) The Court concluded that appellant persuasively established that the company engaged in a cognizable process of experimentation, and established research credit eligibility based on a vast record of extensive

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contemporaneous documentation, testing and substantiation of the company's systematic trial-and-error processes. (*Suder, supra*, at p. 54.)

In *Little Sandy Coal Company, Inc. v. Commissioner*, the Tax Court concluded that the petitioner failed to establish, "on the basis of the record before [the Court], that substantially all of the research [petitioner] conducted in developing the Apex tanker constituted elements of a process of experimentation." (*Little Sandy Coal Company, Inc. v. Commissioner*, T.C. Memo 2021-14.) Once again, the Court made clear that in order to prevail in these cases, taxpayers must meet an evidentiary burden beyond simply showing that engineering activity took place.

Courts have consistently required taxpayers to substantiate their claims of eligibility for the R&D credit. The law is clear that engineering activity does not automatically constitute a process of experimentation for a qualified purpose. Neither the case law nor the legislative history indicates that the taxpayers' burden of proof has been diminished. OTA thus applied the legal standard explained above to each of the six sample projects. With respect to various subsets of each project, OTA considered whether appellants showed that at least 80 percent of Processes Unlimited's claimed research activities constituted a process of experimentation. In each case, OTA came to the same conclusion: appellants had failed to demonstrate that at least 80 percent of the claimed research activities, or any subset of the projects, constituted a process of experimentation.

For the reasons stated above, OTA's Opinion correctly applied precedential legal standards to determine whether appellants have satisfied the process of experimentation test.

The Legal Standard for Determining Whether Substantially All of the Research Activities Constituted Elements of a Process of Experimentation.

Appellants argue that the Opinion "misapplies the legal standard for determining whether substantially all of the research activities constituted elements of a POE." Appellants again rely on the erroneous reasoning that "standard engineering" is automatically an element of a process of experimentation, claiming that *all* of Processes Unlimited's research met the process of experimentation test. As explained above, this reasoning is erroneous and does not comport with the law. Appellants then argue that Processes Unlimited's research activities "must be substantially all elements of a POE for a permitted purpose and, therefore, qualified research." Such circular reasoning is not supported by the law.

The courts have made it clear that taxpayers have the "burden to provide enough evidence for [the] court to calculate the 'substantially all' fraction 'on a cost or other consistently applied reasonable basis.'" (*Little Sandy Coal Company, Inc. v. Commissioner* (7th Cir. 2023) 62

F.4th 287; Treas. Reg. § 1.41-4(a)(6).) The court was unable to apply the shrinking-back rule on subcomponents for lack of documentation, and found that the taxpayer's research activities, including engineering calculations and design iterations, did not automatically establish a cognizable process of experimentation. (*Ibid.*) In *Little Sandy Coal Company*, the taxpayer asked the Court to take on faith that its employees engaged in sufficient “research activities that involved a process of experimentation. But, Section 41(d) requires [the Court] to walk by sight, not by faith.” (*Id.* at 308.)

Appellants have the burden to demonstrate that they are entitled to the R&D Credit. (*Trinity II, supra.*) As explained above, appellants failed to proffer sufficient evidence to establish that at least 80 percent of the claimed research activities constituted a process of experimentation. OTA finds that there is substantial evidence to support the opinion that appellants failed to satisfy the process of experimentation test, and appellants accordingly failed to show they are entitled to the credit. Therefore, a rehearing on the ground that the Opinion is against (or contrary to) law is not warranted.

OTA's Jurisdiction to Review FTB's Action Denying Appellants' Refund Claim.

Appellants contend that the Opinion's “determination that [Processes Unlimited] failed to substantiate whether its research in 2007 was qualified because the project did not end neatly within the calendar year is contrary to law.” The Opinion held, with respect to the Kuwait 120 MBOPD Project # 3748, that “[o]verall, appellants have not shown they are entitled to any research credits in relation to the Kuwait 120 MBOPD Project – or alternatively, any subset of the project. Further, according to a Master Services Agreement, this project commenced in March of 2008, which was after the applicable 2007 tax year.”

Appellants argue that in *Siemer Milling Co. v. Commissioner*, T.C. Memo 2019-37 (*Siemer Milling Co.*), the Tax Court “held that the fact that the taxpayer's research spanned multiple years was not indicative of whether it was qualified or not. There, the Government argued that Siemer Milling's research did not qualify because it spanned multiple years. The Court summarily rejected that argument and explained that not all uncertainties are neatly resolved within the confines of a single tax year.” More accurately, the Tax Court held that “there is no requirement under the statute or regulations that the taxpayer face different uncertainty each year, only that the taxpayer face uncertainty concerning the development or improvement of a product in the year for which he wishes to claim the credit.” (*Siemer Milling Co., supra* at 27.)

The Opinion states that the Master Services Agreement indicates that the Project commenced in March 2008 – after the 2007 taxable year at issue – not that the Project failed to “end neatly within” the taxable year at issue. The Master Services Agreement identifies the Effective Date as March 2008, and it appears to have been executed on May 19, 2008 – again, after the 2007 taxable year at issue. Thus, any purported uncertainties for the Kuwait 120 MBOPD Project #3748 would have been in 2008 (when the Project commenced) – but not in the year for which appellants wish to claim the research credit (taxable year 2007). As such, the Opinion is not in conflict with the Tax Court’s reasoning in *Siemer Milling Co.*

Appellants have not satisfied the requirements for granting a rehearing and as such, their petition is denied.

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Amanda Vassigh
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Amanda Vassigh
Administrative Law Judge

We concur:

DocuSigned by:
Tommy Leung
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Tommy Leung
Administrative Law Judge

DocuSigned by:
Erica Parker
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Erica Parker
Hearing Officer

Date Issued: 4/2/2025