OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:

MOTIVO ENGINEERING, LLC

OTA Case No. 220510300

OPINION

Representing the Parties:

For Appellant: Ruben Vardanyan, EA
Sanjay Bansal, Attorney
Kevin Shih, Representative

For Respondent: Jason Riley, Attorney
Nathan H. Hall, Attorney Supervisor

For Office of Tax Appeals: Andrew Jacobson, Attorney

A. KLETTER, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19045, Motivo Engineering, LLC (appellant) appeals actions by respondent Franchise Tax Board (FTB) proposing to assess additional tax of $27,715 and applicable interest for the 2015 tax year, additional tax of $59,329 and applicable interest for the 2016 tax year, and additional tax of $42,047 and applicable interest for the 2017 tax year.

Office of Tax Appeals (OTA) Administrative Law Judges (ALJs) Asaf Kletter, Josh Aldrich[1] and Sheriene Anne Ridenour held an oral hearing for this matter in Cerritos, California on July 17, 2024. At the conclusion of the hearing, the record was closed and this matter was submitted for an Opinion pursuant to California Code of Regulations, title 18, section 30209(b).

[1] ALJ Aldrich was assigned to this panel and attended the hearing but was later replaced by ALJ Huy "Mike" Le. (Cal. Code Regs., tit. 18, § 30436(b).) ALJ Le thoroughly reviewed the record, hearing, and hearing transcript before participating in this Opinion. OTA notified the parties of the substitution, and the parties were given the opportunity to object to the panel or to request a new hearing prior to the issuance of the Opinion. The parties declined to do so.

ISSUE

Whether appellant made a valid, binding election to claim the California Alternative Incremental Credit (AIC) for the 2013 tax year,[2] and if so, whether appellant revoked its California AIC election for the 2015, 2016 and 2017 tax years (Years at Issue).

FACTUAL FINDINGS

1. Appellant is a California corporation formed in 2010. During the Years at Issue, appellant was a product design and engineering firm that focused on integrated electro-mechanical systems. Appellant provided engineering services to an array of different industries and project types including automotive, defense, robotics, and clean energy. Appellant's services included the design and fabrication of prototypes and transitioning prototypes to production. Appellant claimed California research credits (research credits) for the 2013 through 2017 tax years.
2. On March 1, 2012, FTB issued Legal Division Guidance 2012-03-01 (LDG 2012-03-01). As relevant to this appeal, LDG 2012-03-01 states that California law modifies the federal definition of "gross receipts" with respect to California service receipts, to exclude all gross receipts other than those that are "sales of property held by the taxpayer primarily for sale to customers in the ordinary course of the taxpayer's trade or business that is delivered or shipped to a purchaser within this state."
3. Appellant timely filed a 2013 Form 100, California Corporation Franchise or Income Tax Return (return). Appellant attached to the 2013 return a 2013 California Form 3523, Research Credit (research credit form), which claimed an AIC under section B of the research credit form. Appellant reported wages for qualified services of $38,087, cost of supplies of $11,461, total qualified research expenses of $49,548, and blank or zero average annual gross receipts (AAGRs). Appellant determined a total available research credit of $1,120 using the AIC method. Appellant claimed zero research credit on the 2013 return and reported a credit carryover of $1,120.
4. Appellant filed timely returns for the 2014, 2015, 2016, and 2017 tax years. Appellant attached to its return for each respective tax year a research credit form which used the regular credit method of determining the research credit. Appellant determined that it generated research credits under the regular credit method of $60,123 for the 2014 tax

[2] Although the 2013 tax year is not at issue in this appeal, appellant contests the California AIC election because that election was the basis for FTB's adjustments for the Years at Issue. Therefore, whether appellant had a valid California AIC election is relevant to this Opinion, and OTA addresses it.

year, $82,268 for the 2015 tax year, $80,077 for the 2016 tax year, and $136,125 for the 2017 tax year. Appellant used the research credit to offset its tax liabilities for each respective tax year,[3] and reported a minimum franchise tax liability of $800 for each of the 2014 through 2017 tax years.

5. FTB audited appellant's returns for the 2015, 2016 and 2017 tax years. FTB determined that appellant claimed the AIC for the 2013 tax year by completing section B of the research credit form but claimed the regular research credit for the 2014 through 2017 tax years. FTB asserted that because appellant claimed the AIC for the 2013 tax year, appellant was required to claim the AIC for the subsequent tax years, including the 2015 through 2017 tax years, unless it obtained FTB's consent to revoke its AIC election.
6. Because FTB had not granted consent for appellant to revoke the AIC election, FTB recalculated appellant's research credits, and determined that, under the California AIC, appellant was only entitled to research credits of $27,203, $26,479, and $45,012 for the 2015, 2016, and 2017 tax years, respectively. FTB reduced appellant's allowable research credits accordingly.
7. On or around October 1, 2019, appellant sent FTB a letter requesting permission to revoke its AIC election and use the regular credit method for the 2018 tax year and subsequent tax years. In an October 11, 2019 letter, FTB acknowledged receipt of appellant's letter and granted permission to use the regular credit method. FTB instructed appellant to attach a copy of the October 11, 2019 letter to the first return filed under the new method.
8. On July 11, 2019, FTB issued appellant three separate Notices of Proposed Assessment (NPAs) proposing to assess additional tax of $27,515 for the 2015 tax year, $59,329 for the 2016 tax year, and $42,047 for the 2017 tax year, based on its disallowance of appellant's research credits which appellant claimed under the regular credit method.
9. Appellant protested the NPAs for the 2015, 2016, and 2017 tax years.
10. FTB denied appellant's protest because it determined that appellant failed to request FTB's consent to revoke its California AIC election before appellant changed the method it used to calculate its research credit. On March 16, 2022, FTB issued Notices of Action affirming its NPAs for the 2015, 2016 and 2017 tax years.
11. This timely appeal followed.

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[3] Appellant claimed research credits of $28,236 for the 2014 tax year, $54,918 for the 2015 tax year, $85,808 in the 2016 tax year, and $87,059 for the 2017 tax year.

DISCUSSION

I. Applicable Law

a. Burden of Proof

Tax credits are a matter of legislative grace, and the taxpayer bears the burden of proving that the taxpayer is 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 FTB's favor. (*Ibid.*) The taxpayer has the burden of showing that the requirements for the research credit are satisfied. (*Ibid.*)

The burden of proof is generally on the taxpayer as to all issues of fact and requires proof by a preponderance of the evidence. (Cal. Code Regs., tit. 18, § 30219(a), (b).) To meet this evidentiary standard, a party must establish by documentation or other evidence that the circumstances it asserts are more likely than not to be correct. (*Appeal of Smith*, 2023-OTA-069P.) FTB's proposed assessment of additional tax is presumed correct, and the taxpayer bears the burden of proving it to be incorrect. (*Ibid.*) Unsupported assertions are insufficient to satisfy a taxpayer's burden of proof. (*Ibid.*) In the absence of credible, competent, and relevant evidence showing error in FTB's determination, the determination must be upheld. (*Ibid.*)

b. California Research Credit

The research credit is generally determined in accordance with Internal Revenue Code (IRC) section 41.[4, 5] (R&TC, § 23609.) The research credit is allowed only to the extent that the taxpayer's qualified research expenses (QREs) exceed a historical "base amount." (IRC, § 41(a)(1).) QREs are defined as the sum of in-house research expenses and contract research expenses that are paid or incurred by the taxpayer during the tax year in carrying on any trade or business. (IRC, § 41(b)(1).)

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[4] Notably, however, California substantially modifies the federal definitions of gross receipts and qualified research and does not permit a taxpayer to elect the federal alternative simplified credit. (R&TC, § 23609(c)(2), (h)(3), (4).) In addition, the percentage of the excess of qualified research expenses 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).)

[5] For the 2013 and 2014 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. For the 2015 through 2017 tax years, R&TC sections 23051.5(a)(1) and 17024.5(a)(1)(P) provide that California conforms to the January 1, 2015 version of the IRC. IRC section 41 was modified effective December 17, 2010, January 2, 2013, and December 19, 2014. However, the amendments do not affect the instant appeal, and the parties do not argue otherwise.

c. Election and Revocation of the Federal AIC

Former IRC section 41(c)(4)(A)[6] provided that a taxpayer may elect the federal AIC to determine its federal research credit.[7] If a taxpayer elected the federal AIC, the federal research credit was equal to the sum of: (1) 3 percent of so much of the QREs for the taxable year as exceeds 1 percent of the AAGRs of the taxpayer for the four taxable years preceding the taxable year (historical AAGR amount) for which the credit is being determined (credit year), but does not exceed 1.5 percent of the historical AAGR amount; (2) 4 percent of so much of the QREs for the taxable year as exceeds 1.5 percent of the historical AAGR amount but does not exceed 2 percent of the historical AAGR amount; and (3) 5 percent of so much of the QREs for the taxable year as exceeds 2 percent of the historical AAGR amount. (Former IRC, § 41(c)(4)(A).)

A taxpayer made the federal AIC election under IRC section 41(c)(4) by attaching federal Form 6765, Credit For Increasing Research Activities (federal research credit form), with the portion relating to the federal AIC election complete, to a taxpayer's timely-filed, original federal return for the taxable year to which the election applies. (Treas. Reg. § 1.41-8(b)(2).)

If a taxpayer made the federal AIC election, the election applied to the taxable year for which it was made and all succeeding taxable years, unless revoked in the prescribed manner. (Former IRC, § 41(c)(4)(B); Treas. Reg. § 1.41-8(b)(1).) Treasury Regulation section 1.41-8(b)(3) provides that a taxpayer is deemed to have requested, and to have been granted, the consent of the tax agency to revoke an election under IRC section 41(c)(4) if the taxpayer attaches the federal research credit form, with the portion relating to the federal regular credit method or alternative simplified credit method complete, to its federal original return for the year to which the revocation applies. A federal AIC election may not be revoked on an amended return. (Treas. Reg. § 1.41-8(b)(3).)

d. Election and Revocation of the California AIC

For tax years beginning on or after January 1, 2000, R&TC section 23609(h)(1) modifies former IRC section 41(c)(4)(A) to lower the percentage of the excess QREs over the historical

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[6] For the 2013 through 2014 tax years, "former IRC section 41" refers to section 41, as amended effective October 3, 2008, by Public Law (PL) 110-343 and repealed December 17, 2010, by PL 111-312. For the 2015 through 2017 tax years, "former IRC section 41" refers to section 41, as amended effective December 19, 2014, by PL 113-295 and repealed December 18, 1015, by PL 114-113. IRC section 41 (c)(4) reads identically in both versions. See footnote 5 above.

[7] Public Law 115-141 repealed the federal AIC election in 2018, after the Years at Issue in this appeal.

AAGR amount.[8] R&TC section 23609(h)(2) provides that former IRC section 41(c)(4)(B), concerning a federal AIC election, shall not apply. In lieu thereof, a taxpayer may elect the California AIC for any taxable year beginning on or after January 1, 2008. (*Ibid*.) That election shall apply to the taxable year for which made and all succeeding taxable years unless revoked with the consent of FTB. (*Ibid*.)

II. Analysis

a. California AIC Election

It is undisputed that appellant made a California AIC election on its 2013 return. However, appellant asserts that its California AIC election was invalid and not binding on the Years at Issue. Appellant argues that LDG 2012-03-01 defines gross receipts for purposes of the California research credit, and that the California research credit form instructions provide that if a company has no gross receipts under LDG 2012-03-01, it cannot elect the AIC method. Appellant asserts that because it provided engineering services to customers, and did not sell any tangible or intangible property, it had zero gross receipts for purposes of the California research credit. Appellant argues that it could not elect the AIC method for the 2013 tax year; therefore, FTB's determination that appellant was required to use the AIC method for the Years at Issue based on the AIC election for the 2013 tax year was erroneous.

FTB asserts that the California research credit form instructions are not proclamations of law, and that appellant must follow the law and not the instructions. FTB further asserts that R&TC section 23609 and former IRC section 41(c)(4)(A) do not prohibit appellant from making an AIC election where it had zero gross receipts.

The authoritative sources of law are the statutes, regulations, and judicial decisions, not informal publications put out by the tax agency. (*Appeal of Dandridge*, 2019-OTA-458P.) Administrative guidance contained in tax agency publications is not binding on the Government, nor can it change the plain meaning of tax statutes. (*Ibid*; see also *Adler v. Commissioner* (9th Cir. 1964) 330 F.2d 91, 93.) Therefore, OTA finds that the 2013 California research credit form instructions statement that if a taxpayer has no (i.e., zero) California gross receipts under LDG 2012-03-01, it cannot use the AIC method and must use the regular credit method as a start-up, is not binding. The applicable statutes, R&TC section 23609(h)(2) and former IRC section 41(c)(4)(A), contain no prohibition from making the federal or California AIC election if a

[8] Specifically, the percentage of the QREs that exceeded 1, 1.5, and 2 percent of the historical AAGR amount was reduced to 1.49, 1.98, and 2.48, respectively (from 3, 4, and 5 percent, respectively). (R&TC, § 23609(h)(1).)

taxpayer has zero gross receipts. Because the applicable statutes did not prohibit appellant from making the California AIC election, OTA finds that appellant's election was valid.

Appellant also asserts that it mistakenly elected the AIC method for the 2013 tax year. Appellant relies on one line of the California research credit form for the 2013 tax year, which reports blank or zero AAGRs. Appellant claims that it does not sell any tangible or intangible property and does not have any gross receipts under R&TC section 23609(h)(3). Appellant also claims that the principal business activity code reported on its return is "engineering services" and that its product or service is "design and prototype" services. Therefore, appellant asserts it could not elect the AIC method.

Appellant also argues that its tax return preparer incorrectly completed the California research credit form because the preparer was unfamiliar with the determination of gross receipts under R&TC section 23609(h)(3), the preparer erroneously believed that the taxpayer had historically incurred gross receipts, and the preparer erroneously made an AIC election for the 2013 tax year.

However, as described above, even if the taxpayer had zero gross receipts, the applicable statutes did not prohibit appellant from electing the California AIC method. Moreover, appellant provides no authority that allows OTA to revoke an AIC election based on a mistake.[9] For the reasons described above, OTA finds that the AIC election for the 2013 tax year was valid and binding.

b. California AIC Revocation

It is likewise undisputed that appellant did not request that FTB revoke appellant's California AIC election prior to filing the returns for the Years at Issue. On October 11, 2019, appellant obtained FTB's consent to revoke its AIC election beginning with the 2018 tax year.

Appellant asserts that it revoked its California AIC election by claiming the regular research credit on its 2014 return in compliance with former IRC section 41(c)(4)(B) and Treasury Regulation section 1.41-8(b)(3), which are both related to the IRS's deemed consent to revoke the federal AIC election. While appellant concedes that consent from FTB was required by R&TC section 23609(h)(2), appellant claims that there was no published guidance at the time it filed its 2014 return to state how it could request consent from FTB. Moreover, appellant further claims that FTB failed to notify appellant that it had improperly claimed the regular research credit after appellant filed its 2014 return.

[9] Because OTA finds that appellant's AIC election for the 2013 tax year was valid and binding, it need not address the alternative argument raised by FTB concerning the duty of consistency.

R&TC section 23609(h)(2) plainly provides that a California AIC election will apply to all succeeding taxable years "unless revoked with the consent of the Franchise Tax Board." Appellant concedes that it never took any steps to contact FTB by any means to obtain FTB's consent, or information on how to obtain such consent, to revoke its AIC election prior to its letter on or around October 1, 2019. Instead, appellant urges that it claimed the regular research credit on its 2014 return filed with FTB, which should count as deemed consent under federal authorities. However, R&TC section 23609(h)(2) plainly provides that "[former] IRC section 41(c)(4)(B) shall not apply." While the statute does not specify how to revoke the AIC election, the statute is not ambiguous. Further, where R&TC section 23609(h)(2) specifically decouples from former IRC section 41(c)(4)(B), it is inappropriate to look to federal guidance for that statutory section to interpret the revocation procedure for California purposes.

Moreover, while appellant used California forms, it nevertheless followed a federal revocation procedure, which is ineffective under California law. Because R&TC section 23609(h)(2) plainly states that former IRC section 41(c)(4)(B) shall not apply, it follows that California does not conform to the federal AIC election. Therefore, Treasury Regulation section 1.41-8, which provides rules for the time and manner and revocation of the federal AIC election under former IRC section 41(c)(4)(B), is inapplicable for California purposes. R&TC section 23051.5(e) provides that a proper election filed with the IRS in accordance with the IRC or treasury regulations "shall be deemed to be a proper election for purposes of this part, *unless otherwise expressly provided in this part or in regulations issued by the Franchise Tax Board.*" (Italics added.) Because R&TC section 23609(h)(2) plainly states that the federal AIC election under former IRC section 41(c)(4)(B) shall not apply, R&TC section 23051.5(e) does not support appellant's position.[10]

Appellant also asserts that FTB failed to provide any guidance for the Years at Issue to explain how to obtain FTB's consent to revoke its AIC election. However, FTB's September 2006 edition of *Tax News* explains the procedure to follow, the forms to complete, and the address to which a taxpayer should send a California AIC revocation, among other information. While FTB's guidance is not binding law, it does not excuse appellant's failure to take any steps to contact FTB to revoke its California AIC election, as R&TC section 23609(h)(2) plainly requires, nor does it validate appellant's erroneous revocation method, by submitting to California using the federal revocation procedure.

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[10] The parties argue over the applicability of R&TC section 23051.5(e)(3)(A), which concerns the procedure for a separate state election where the California tax treatment is different than the federal treatment. However, copies of the federal returns are not in the record, and therefore, OTA has no basis to determine whether that statute is applicable.

Appellant takes issue with the fact that when it filed its 2014 return, FTB did not notify appellant that FTB had not consented to revocation of the AIC election. Appellant has not cited any legal authority requiring FTB to notify appellant of a failed revocation, and OTA is not aware of any such authority.[11] Instead, FTB audits returns under its established audit procedures. (R&TC, § 19032 et seq.) It is undisputed that FTB did not audit the 2014 tax year because that tax year was beyond the statute of limitations for assessing additional tax. Because FTB did not audit appellant's 2014 return, it did not discover that appellant's 2014 return improperly claimed the regular credit method to determine its research credit when appellant failed to revoke the California AIC election it previously made for the 2013 tax year.

HOLDING

Appellant made a valid, binding election to claim the California AIC for the 2013 tax year, and appellant failed to revoke its California AIC election for the Years at Issue.

DISPOSITION

FTB's actions are sustained.

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Asaf Kletter
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Asaf Kletter
Administrative Law Judge

We concur:

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Huy "Mike" Le
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Huy "Mike" Le
Administrative Law Judge

DocuSigned by:
Sheriene Anne Ridenour
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Sheriene Anne Ridenour
Administrative Law Judge

Date Issued: 10/22/2024

[11] To the extent the parties raise other arguments OTA has not addressed, OTA considered them and found them not dispositive of the issue decided in this Opinion.