OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of: **ADVANCED AMERICAN LABORATORIES, INC.**	OTA Case No. 240917392

OPINION

Representing the Parties:

For Appellant:	Frank Sekula, CPA Patrick Michaels, CEO
For Respondent:	Sophie Kuehl, Attorney Nathan Hall, Attorney Supervisor
For Office of Tax Appeals:	Thomas Marlo, Attorney

A. KLETTER, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19324, Advanced American Laboratories, Inc. (appellant) appeals actions by respondent Franchise Tax Board (FTB) denying appellant's claims for refund of $11,022 for the 2019 tax year, and $10,518 for the 2020 tax year.

Office of Tax Appeals (OTA) Panel Members Asaf Kletter, Veronica I. Long, and Hans Famularo held a virtual oral hearing for this matter on March 12, 2026. 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).

ISSUE

Whether appellant has demonstrated that it engaged in "qualified research" under R&TC section 23609, and if so, whether appellant has substantiated its "qualified research expenses."[1]

[1] "Qualified research" and "qualified research expenses" are defined under Internal Revenue Code (IRC) section 41 and the regulations thereunder. As applicable here, California conforms to IRC section 41 pursuant to R&TC section 23609, subject to modifications. As discussed below, OTA concludes that appellant has not established that it engaged in "qualified research," and therefore, OTA need not determine whether appellant has substantiated its "qualified research expenses."

FACTUAL FINDINGS

1. Appellant is a California C corporation formed in 2003. Appellant is a consulting firm specializing in testing hazardous materials such as mold, asbestos, and lead. Appellant provided environmental testing for private and public institutions. Appellant's principal business activity during the tax years at issue was providing analytical testing services.
2. Appellant retained a CPA for a Research and Development (R&D) Tax Credit Study (Study) for the 2019 and 2020 tax years. Appellant's CEO completed a questionnaire and the CPA interviewed the CEO. The CPA completed the Study on May 13, 2022.
3. The Study identified five R&D projects and determined that appellant performed qualified research activities, as described below.
   a. Transmission Electron Microscopy (TEM) Large-Scale Dust Sampling. The Study states that appellant undertook this project to furnish in-depth data on dust composition, characteristics, and sources, which was "instrumental in risk assessment and regulatory compliance, all while cementing our standing as a technology leader in the industry, expanding our service portfolio, and bolstering profitability." The Study claims that the approach shifted from traditional numerical thresholds to a comparative method for characterizing potential contamination within interior spaces. Although TEM itself was not novel, the Study asserts that appellant "introduced new procedures and interpretations."
   b. Artificial Intelligence (AI)-based System for Microbiological Sample Analysis. The Study states that appellant initiated this project to facilitate efficient and accurate microbiological sample analysis through real-time training of an AI Microscope. The project had "the ultimate focus of achieving automatic microscopic analysis of biological entities," and "[w]hile this capability was not yet proven, it held the potential to free up resources for more complex tasks. . . ."
   c. xRapid Group Hands-Free Microscope Platforms.[2] The Study states that the purpose of the project was to introduce and automate the xRapid Group hands-free microscope platforms, which would reduce contamination risks and enhance accuracy environmental sample analysis and efficiency of appellant's operations.

[2] The xRapid Group appears to be the developer of the hands-free microscope platforms. The questionnaire appears to indicate that the microscope was already automatic.

d. Forward-Looking Infrared (FLIR) Technology for Analysis. The Study states that the project's core purpose was to leverage FLIR technology's capability to identify energy inefficiencies, insulation problems, water leaks, and conduct thermal surveys of buildings and infrastructure, all in support of energy efficiency and environmental assessment. The Study claims that appellant applied FLIR technology to assess the extent of water damage in real-world scenarios. The Study states that incorporating FLIR technology was "a strategic move aimed at expanding our service offerings to attract and retain more customers" and that FLIR technology "not only significantly enhanced our productivity but also contributed to improving profitability."

e. Polymerase Chain Reaction (PCR) Technology for DNA Analysis. The Study states that the project's primary purpose was to use PCR to detect and identify specific genetic markers or organisms in environmental samples, which significantly enhanced appellant's capacity to evaluate the biological composition of environmental samples, identify potential risks, and support effective environmental management and public health protection. The Study claims that appellant used PCR analysis of dust to determine microbial contamination within a structure, link it to occupant health concerns, and accurately characterize sites for microbial contamination.

4. The Study determined that the taxpayer qualified for the R&D credit.[3] The Study states that "the IRS's Four-Part Test was documented on a contemporaneous basis when the work was performed," that "[a]ccording to [appellant's CEO], sufficient contemporaneous documentation and corroborating evidence exists to substantiate that each of [appellant's] R&D activities met all four requisites of the Four-Part Test," and that, "[i]n the event of an audit, [appellant's CEO] will produce any documentation that is available to support the claims for refund. . . ."[4]

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[3] It is unclear what information the CPA relied on. The Study states that the CPA "was not able to sample documents for himself due to reasons that preclude him from traveling, but found from an analytical perspective, it would be difficult to deny that a significant amount of time was spent performing R&D work for the benefit of each project." The Study then states that "[r]elying on the data and other documents he was provided, [the CPA] was able to satisfy himself that each listed activity of [appellant's] R&D . . . did in fact pass each part of the Four-Part Test."

[4] The Study also states that "[d]ue to cost constraints, [appellant] had not implemented a formal system to gather research activity information; rather [it] relied on estimated [QREs]. [Appellant's CEO] estimated [appellant's] R&D costs to be 30% of the total of certain direct costs during an in-depth interview. [Appellant's CEO] assured that this estimate is at least supported by 'some factual basis', to include contemporaneous documentation and corroborating evidence."

5. On June 6, 2022, appellant filed Amended Corporation Franchise of Income Tax Returns (amended returns) for the 2019 and 2020 tax years claiming R&D credits of $12,495 and $11,924, respectively, and requesting refunds of $11,022 for the 2019 tax year, and $10,518 for the 2020 tax year.
6. FTB subsequently audited the amended returns and issued information document requests (IDRs) to appellant seeking explanations of appellant's research activities and it calculated the R&D credit. At audit, appellant provided the Study to FTB, along with worksheets supporting the calculation of qualified research expenses (QREs).
7. On August 20, 2024, FTB denied the claimed R&D credits because appellant "failed to provide information in support of the claims" as requested in the IDRs, and as a result, FTB denied appellant's claims for refund.[5]
8. Appellant timely appealed. At the hearing, appellant's CEO provided testimony concerning the five projects and appellant's research activities regarding each project.

DISCUSSION

Tax credits are a matter of legislative grace and statutes allowing tax credits must be strictly construed against a taxpayer, with any doubts resolved in favor of FTB. (*Appeal of Pino*, 2020-OTA-375P, citing *Dicon Fiberoptics, Inc. v. Franchise Tax Bd.* (2012) 53 Cal.4th 1227, 1235; *General Motors Corp. v. Franchise Tax Bd.* (2006) 39 Cal.4th 773, 790.) A taxpayer has the burden of establishing that it is entitled to an R&D tax credit. (*Appeal of Pino*, *supra*.)

California allows a tax credit for amounts paid or incurred for qualified research conducted in California. (R&TC, § 23609.) Eligibility for and the amount of the credit are determined in accordance with Internal Revenue Code (IRC) section 41, as modified by R&TC section 23609. A taxpayer must satisfy four tests to establish that it engaged in qualified research:

> *1. IRC section 174 Test:* the research expenses qualify for treatment as expenses under IRC section 174 (IRC, § 41(d)(1)(A));
>
> *2. Technological in Nature Test:* the research was undertaken for the purpose of discovering information that is technological in nature (IRC, § 41(d)(1)(B)(i));
>
> *3. Business Component Test:* the discovered information was intended to be useful in the development of a new or improved business component (e.g. a product or process) of the taxpayer (IRC, § 41(d)(1)(B)(ii)); and

[5] FTB determined that appellant had zero R&D credit carryovers to the 2021 tax years. As only the 2019 and 2020 tax years are on appeal, R&D credit carryovers are not discussed further.

> *4. Process of Experimentation Test:* substantially all of the taxpayer's activities constituted elements of a process of experimentation related to a new or improved function, performance, reliability, or quality. (IRC, § 41(d)(1)(C), (d)(3).)

(*Appeal of Pino*, *supra*.)

Appellant conceded at the hearing that it has not submitted contemporaneous documentation but argues that contemporaneous documentation is not required.[6] Appellant is incorrect. "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." (Treas. Reg. § 1.41-4(d);[7] *Appeal of Pino*, *supra*.) "A taxpayer is not required to keep records in a particular manner so long as the records maintained substantiate [its] entitlement to the credit." (*Appeal of Pino*, *supra*, citing *Suder v. Commissioner*, T.C. Memo. 2014-201, at p. *21, and *Shami v. Commissioner* (5th Cir. 2014) 741 F.3d 560, 567.)

In briefing, appellant cites *U.S. v. McFerrin* (5th.Cir. 2009) 570 F.3d 672 (*McFerrin*), arguing that a business is not required to submit contemporaneous documents to justify R&D expenses for tax credit purposes. Appellant's reliance on *McFerrin* is misplaced. *McFerrin* does not stand for the proposition that no contemporaneous documentation is required to claim R&D expenses. Rather, in *McFerrin*, *supra*, the government conceded that some of the taxpayer's activities constituted qualified research. (*McFerrin*, *supra*, 570 F.3d at p. 678.) The government argued that even if qualified research occurred, the taxpayer failed to provide adequate documentation to substantiate the costs associated with that research. (*Id*. at p. 679.) However, the court held that *if* a taxpayer can show that activities were "qualified research," then the court should estimate the expenses associated with those activities. (*Ibid*; see *Little Sandy Coal v. Commissioner* (7th Cir. 2023) 62 F.4th 287, 301 (*Little Sandy Coal*) [*only after* a taxpayer that establishes qualified research has occurred may the court estimate, if needed, the amount of QREs].) Thus, even under *McFerrrin*, taxpayers are required to maintain records to show qualified research. Furthermore, as discussed below, because OTA concludes that appellant has not established that it engaged in "qualified research," there is no basis for OTA to estimate the amount of appellant's alleged QREs. (See *Little Sandy Coal*, *supra*.)

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[6] Appellant's CEO testified that due to a document retention policy, records are only kept for three years and it would be overly burdensome to produce the information on appeal. Appellant's CEO testified that he provided some reports to appellant's representative to show the type of work he was describing in 2019 and 2020. Those reports are not in the record.

[7] 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 FTB. (R&TC, § 23051.5(d).)

The only evidence in the record is the Study, which contains no contemporaneous documentation (e.g., email communications, lab data, notes, and monthly reports to substantiate the occurrence of the research projects).[8] At the hearing, appellant's CEO testified regarding the uncertainty in each of the five projects.[9] While appellant's CEO's testimony was credible, his testimony, either alone or together with the Study, did not provide sufficient detail to establish that the IRC section 174 Test, the Business Component Test, or the Process of Experimentation Test were met.

Concerning the IRC section 174 Test, without evidence establishing appellant's activities concerning the development or improvement or products or processes, appellant has not established that the claimed expenditures were for activities intended to discover information that would eliminate uncertainty. (*Appeal of Pino*, *supra*.) Regarding the Business Component Test, the record does not establish that the claimed processes were held either for sale, lease, or license, or used by appellant in its trade or business. (*Ibid*.) Finally, without evidence, appellant fails to establish that "substantially all" of appellant's research activities constituted a process of experimentation for a qualified purpose. (See *ibid* ["merely stating the existence of an evaluative process does not show that [the company] actually engaged in that process, or that, if the process occurred, it was a qualified process of experimentation under the law"]; see also *Union Carbide Corp. and Subsidiaries v. Commissioner*, T.C. Memo. 2009-50 at pp. *80-*81 [discussing requirements the Process of Experimentation Test].)[10] Based on the foregoing, appellant has not shown that it meets the four tests for qualified research.

Lastly, appellant contends that the IRS accepted appellant's R&D credit because appellant received a refund from the IRS for the 2019 and 2020 tax years. However, there is no evidence in the record that the IRS audited or accepted appellant's federal R&D credit, and moreover, FTB is not bound to follow IRS decisions which it believes to be erroneous. (See *Appeal of Der Wienerschnitzel International, Inc.* (79-SBE-063) 1979 WL 4104.)

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[8] As described above in footnotes 3 and 4, the Study is based on a questionnaire completed by appellant's CEO and an interview with the CEO which is not in the record. Appellant's worksheets support the calculation of QREs through a high-level estimate but do not corroborate the research activity.

[9] Appellant's CEO testified that the projects addressed uncertainties as follows: (1) TEM dust sampling was used to differentiate contamination that occurs from mechanical means, such as cars, from contamination in a house; (2) A sample analysis was trained to take out differentiation in analysis of mold spores; (3) the microscope platforms were used to eliminate uncertainty in lab analysis; (4) FLIR technology was used to determine the source of intrusion of moisture or fungus; (5) PCR was used to identify the type of mold inside and outside of a house.

[10] The record shows that the projects involved adaptation of pre-existing technology or techniques into appellant's practices, procedures, or methods, which is not qualified research. (IRC, § 41(d)(4).)

Accordingly, appellant has not established that it engaged in "qualified research" under R&TC section 23609.

HOLDING

Appellant has not demonstrated that it engaged in "qualified research" under R&TC section 23609.

DISPOSITION

FTB's actions denying appellant's claims for refund are sustained.

DocuSigned by:
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Asaf Kletter
Administrative Law Judge

We concur:

Signed by:
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Veronica I. Long
Administrative Law Judge

Signed by:
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Hans Famularo
Administrative Law Judge

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