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OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of: **J. HENDERSON AND** **D. HENDERSON**	)	OTA Case No. 241017718

OPINION

Representing the Parties:

For Appellants: Frank Sekula, CPA

For Respondent: Jason Riley, Attorney

For Office of Tax Appeals: Andrew Jacobson, Attorney

G. TURNER, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19324, J. Henderson (Mr. Henderson) and D. Henderson (Mrs. Henderson) (collectively, appellants) appeal actions by respondent Franchise Tax Board (FTB) denying appellants' claims for refund of $10,353 for the 2018 tax year and $22,509 for the 2019 tax year.

Appellants waived the right to an oral hearing; therefore, the matter was submitted to the Office of Tax Appeals (OTA) on the written record pursuant to California Code of Regulations, title 18, section 30209(a).

ISSUE

Whether appellants have demonstrated error in FTB's denial of their claimed California research and development (R&D) credits for the 2018 or 2019 tax years.

FACTUAL FINDINGS

1. Appellants are both dentists, who each held 50-percent shareholder interests in Henderson & Henderson Palo Alto (H&H), an S Corporation, during the tax years at issue.
2. H&H issued amended 2018 Schedules K-1, Shareholder's Share of Income, Deductions, Credits, etc., to appellants showing credits of $6,903 passed through to Mr. Henderson and $6,902 passed through to Mrs. Henderson. H&H issued amended 2019 Schedule

K-1s to appellants, showing credits of $7,306 passed through to Mr. Henderson and $7,306 passed through to Mrs. Henderson.

3. On February 14, 2022, appellants filed joint amended 2018 and 2019 California Resident Income Tax Returns (Forms 540) and California Schedules X, California Explanation of Amended Return Changes, on which they claimed passthrough R&D credits of $10,353 for the 2018 tax year and $22,509 for the 2019 tax year.
4. FTB initiated an audit of H&H's California returns for the 2018 and 2019 tax years regarding the R&D credit.
5. FTB issued seven Information Document Requests (IDRs) to H&H dated May 21, 2024, and reissued them on June 27, 2024, to seek information concerning the claimed R&D credits. However, H&H did not respond to any of the IDRs.
6. On September 5, 2024, FTB denied appellants' refund claims of $10,353 and $22,509 for the 2018 and 2019 tax years, respectively.
7. Appellants timely filed this appeal.

DISCUSSION

Burden of Proof

Tax credits are a matter of legislative grace, and statutes allowing tax credits must be strictly construed against a taxpayer, with any doubts to be resolved in favor of FTB. (*Appeal of First Solar, Inc.*, 2023-OTA-532P, citing *Dicon Fiberoptics, Inc. v. Franchise Tax Bd.* (2012) 53 Cal.4th 1227, 1235.) The taxpayer has the burden of showing that the requirements for the R&D credit are satisfied. (*Appeals of Swat-Fame, Inc., et. al.,* 2020-OTA-046P; *Appeal of Pino*, 2020-OTA-375P.)

S Corporation Reporting

California has adopted federal tax law regarding the treatment of S corporations and their shareholders, except as otherwise provided under the R&TC. (R&TC, § 17087.5; *Appeal of Smith*, 2023-OTA-069P.) For both federal and California tax purposes, an S corporation's income and losses are passed through on a pro rata basis to the corporation's shareholders, who must report them on their individual returns. (Internal Revenue Code (IRC), §§ 1363(b), 1366; R&TC, §§ 17087.5, 23800; *Appeal of Johnson*, 2022-OTA-166P.) An S corporation uses California Schedule K-1 to report the shareholder's pro rata share of the S corporation's income, deductions, credits, etc., and the shareholder uses the information from the California Schedule K-1 to file his or her return and is liable for the income tax on his or her pro rata share of the

S corporation's income. (*Appeal of Johnson*, *supra*.) When an S corporation computes its taxable income, items described in IRC section 1366(a)(1)(A) must be separately stated. (IRC, § 1363(b)(1).) As relevant herein, separately stated items of the S corporation include each of the corporation's separate items involved in the determination of credits against tax allowable under part IV of subchapter A of the IRC, which includes the R&D credit authorized by IRC section 41. (Treas. Reg. § 1.1366-1(a)(2)(v).)

Qualified Research

With certain noted exceptions, California adopts federal provisions relating to the R&D credit under IRC section 41 pursuant to R&TC section 23609. As relevant to this appeal, IRC section 41(a)(1) provides that a qualifying taxpayer may generally claim an R&D credit for the taxable year equal to 20 percent of the excess (if any) of: (A) the qualified research expenses (QREs) for the taxable year, over (B) the base amount. QREs mean the sum of: (A) in-house research expenses, and (B) contract research expenses paid or incurred by the taxpayer during the taxable year in carrying on any trade or business of the taxpayer. (IRC, § 41(b)(1).) To be eligible for an R&D tax credit under IRC section 41(a)(1), as modified by R&TC section 23609, appellants must prove that H&H performed qualified research, or paid someone else to perform qualified research, during the tax years at issue. Qualified research is research that satisfies four tests:[1]

> *1. Section 174 Test*: expenditures connected with the research must be eligible for treatment as expenses under IRC section 174 (IRC, § 41(d)(1)(A));
>
> *2. Technological in Nature Test*: research must be undertaken for the purpose of discovering technological information (IRC, § 41(d)(1)(B)(i));
>
> *3. Business Component Test*: the taxpayer must intend that the information to be discovered be useful in the development of a new or improved business component (e.g. product) of the taxpayer (IRC, § 41(d)(1)(B)(ii)); and
>
> *4. Process of Experimentation Test*: substantially all of the research activities must constitute elements of a process of experimentation for a purpose relating to a new or improved function, performance, reliability, or quality. (IRC, § 41(d)(1)(C), (d)(3).)

Recordkeeping

"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."

[1] For purposes of the California research credit, "qualified research" only includes research conducted in California. (R&TC, § 23609(c)(2).)

(Treas. Reg. § 1.41-4(d); *Appeal of Pino*, *supra*.) Treasury Regulation section 1.41-4(d) incorporates the rules governing record retention of Treasury Regulation section 1.6001-1. Taxpayers "shall keep such permanent books of account or records, including inventories, as are sufficient to establish the amount of gross income, deductions, credits, or other matters required to be shown by such person in any return of such tax or information." (Treas. Reg. § 1.6001-1(a); see also *Appeal of Pino*, *supra*.) "A taxpayer is not required to keep records in a particular manner so long as the records maintained substantiate his or her entitlement to the credit." (*Suder v. Commissioner*, T.C. Memo. 2014-201 at p. *21; *Appeal of Pino*, *supra*.)

Analysis

On appeal, appellants assert that many qualified research projects do not generate documents, that FTB does not ask any questions on research projects, and that FTB makes no "good faith" effort to review research credits claimed or review information provided to them but simply denies almost all credit claims. A taxpayer, appellants assert, should reasonably expect that when significant information is provided, that it be considered on its own merits.

Appellants cite *U.S. v. McFerrin* (2009) 570 F.3d 672 (*McFerrin*), for the proposition that "a business is not required to submit contemporaneous documents to justify R&D expenses for tax credit purposes." Appellants' reliance on *McFerrin* is misplaced. *McFerrin* concerned a suit brought by the United States against a taxpayer seeking to recover R&D credits allegedly paid by the IRS in error. The United States argued, among other things, that the taxpayer was not entitled to the claimed credit because they failed to provide adequate documentation substantiating the *costs* of qualified research. The Court simply found that substantiating the amount of the expense of an otherwise qualified research expense did not require contemporaneous documentation:

> "If McFerrin can show activities that were 'qualified research,' then the court should estimate the expenses associated with those activities. The district court need not credit McFerrin's reconstruction of expenses from years after the fact [citations omitted]. But the court should look to testimony and other evidence . . . in determining a fair estimate." (*Id*. at p. 679.)

McFerrin, therefore, does not represent authority for a taxpayer having *no* records to substantiate the amount of the claims. The more fundamental question here concerns whether appellants have presented documentation substantiating whether *activities* of the taxpayer qualified for the credit at all.

In support of their claim, appellants submit an undated Detailed Project Information and Credit Study under the letterhead of Business Incentive Solutions, designated Version 7/2024

(the Report). The Report identifies five projects, and describes in narrative form for each project, the qualified business component, the process of experimentation, what each project sought to discover, and the technological nature of the project. The Report was provided for the first time during this appeal with appellants' reply brief dated January 13, 2025.

The Report is the only substantive evidence that appellants have provided to substantiate their claimed R&D credits. Beyond the rudimentary assertions contained in the Report, there is nothing to indicate the Report was derived from evidence provided by appellants, such as invoices, email correspondence, employee interviews, reports, employment records, contract research agreements, invoices for purchased supplies, or other documents of appellants tending to establish what the qualified activities were, corroborate that the activities were conducted, and provide some connection between each activity claimed as "qualified research" and the corresponding amount of the credits claimed. Here, no evidence corroborates that the assertion made in the Report of five project listings are based on the kinds of minimal records necessary to prove entitlement to the credit. (See Treas. Reg. § 1.6001-1(a); *Appeal of Pino*, *supra.*)

While appellants are free to keep records in a variety of forms, some documentation is still required. (*Appeal of Pino*, *supra.*) Appellants cannot simply rely on unsupported assertions to satisfy their burden of proof. (*Appeal of GEF Operating, Inc*., 2020-OTA-057P.)

Based on appellants' failure to provide any records produced by H&H to document its purported qualified research, OTA finds that they do not satisfy the recordkeeping requirement for claiming R&D credits for the 2018 or 2019 tax years. Therefore, appellants have failed to establish their entitlement to claim R&D credits for the 2018 or 2019 tax years.

HOLDING

Appellants have failed to demonstrate error in FTB's denial of their claimed R&D credit for the 2018 or 2019 tax years.

DISPOSITION

FTB's actions denying appellants' claims for refund for the 2018 and 2019 tax years is sustained.

Signed by:
Greg Turner
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Greg Turner
Administrative Law Judge

We concur:

Signed by:
Veronica I. Long
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Veronica I. Long
Administrative Law Judge

DocuSigned by:
Amanda Vassigh
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Amanda Vassigh
Administrative Law Judge

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