Louis A. Ambrose
Tax Counsel IV
Board of Equalization, Appeals Division
450 N Street, MIC: 85
PO Box 942879
Sacramento CA 95814
Tel: (916) 261-3016
Fax: (916) 324-2618

Attorney for the Appeals Division

BOARD OF EQUALIZATION

STATE OF CALIFORNIA

In the Matter of the Appeal of:

THOMAS A. LEONARDINI AND

KAREN M. LEONARDINI[1]

HEARING SUMMARY

PERSONAL INCOME TAX APPEAL

Case No. 449478

Years	Claims For Refund
2001	$32,541
2002	$51,940
2003	$30,705
2004	$27,759

Representing the Parties:

For Appellant: Jeremy Fingeret, Managing Director

For Franchise Tax Board: Jason Riley, Tax Counsel

QUESTION: (1) Whether appellants have presented evidence sufficient to demonstrate that their activities constituted "qualified research" as defined in Internal Revenue Code (IRC) section 41.

(2) Whether appellants have met their burden of proving qualified expenses for purposes of the research and development tax credit under Revenue and Taxation Code (R&TC)

[1] Appellant's mailing address is in Hillsborough, San Mateo County, CA.

section 23609 for the tax years at issue.

(3) Whether appellant-husband's wages were "unreasonable under the circumstances", so as to disqualify them as expenses under IRC section 174.

HEARING SUMMARY

Factual and Procedural Background

Appellants own Whitehall Lane Winery (WLW) which manufactures and sells wine. Appellants grow most of their wine grapes on 110 acres in the Napa Valley and also purchase wine grapes from other growers in Napa and the Carneros district. On their original returns, appellants did not claim any research and development (R&D) credits. Respondent accepted those returns as filed. (App. Opening Br., p.1.)

Appellants subsequently filed amended returns for 2001, on April 15, 2005, for 2002 and 2003 on May 15, 2005, and for 2004 on August 1, 2005. On the amended returns for each of the following taxable years, appellants claimed the following amounts of R&D credits: taxable year ending December 31, 2001, $32,541; taxable year ending December 31, 2002, $51,940; taxable year ending December 31, 2003, $30,705; taxable year ending December 31, 2004, $27,759. (Resp. Opening Br., p.1.)

Respondent audited these returns and appellants provided a research and development tax credit study (the "R&D Study"), prepared by alliantgroup, llc (alliantgroup) an outside consultant, to substantiate the R&D credit claims. (Resp. Opening Br., p.2.) The R&D study states that alliantgroup was engaged by WLW "to assist in analyzing, substantiating, and documenting the Company's various research and development activities in accordance with the guidelines provided in Internal Revenue Code… sections 41 and 174… , Treasury Regulations, and legal precedence." (Resp. Opening Br., exhibit J, p.4.)

The R&D Study states that "WLW commits a significant amount of time and resources in designing new wine products/manufacturing processes and improvements to existing wine products/manufacturing processes." (Resp. Opening Br., exhibit J, p.14.) The R&D Study also states that "WLW has implemented a project development management process for project identification" and presents a descriptive overview of that process. (Resp. Opening Br., exhibit J, pp.19-20.) The R&D

Study presents descriptions of the WLW's "process of experimentation" in the development of a vineyard project, a bottle closure project, and winemaking experimentation. (Resp. Opening Br., exhibit J, pp.30-40.)

In correspondence dated June 21, 2006, respondent made multiple information document requests (IDRs) for substantiation that WLW was engaged in qualified research. Respondent also scheduled a field examination at WLW's manufacturing facilities in Saint Helena on July 28, 2006, and requested that information listed in the IDRs previously issued by respondent be available for review, and that appellant-husband and various employees attend the field examination for interview. At the meeting, appellants provided respondent with additional documents which appellants' representative stated further substantiated the "qualified research". Appellants also directed respondent to the R&D Study in response to other questions from respondent. (Resp. Opening Br., p.3.)

Respondent also made another request, designated as IDR-4, dated January 17, 2007, requesting that appellants explain how each of the R & D projects met the qualified purpose requirements under Treasury Regulation section 1.41-4(a)(5), relating to "style, taste, cosmetic, or seasonal design factors." In reply, appellants submitted a memo dated February 12, 2007, taking issue with respondent's interpretation of "taste" within the meaning of the regulation. (Resp. Opening Br., p.3 and exhibit L.) In a letter dated February 19, 2008, respondent denied appellants' claims for refund for the 2001, 2002 and 2003 taxable years and the credit attributed to appellants' sole proprietorship for 2004. Appellants filed this timely appeal. (Resp. Opening Br., p.3.)

ISSUE (1): Whether appellants have presented evidence sufficient to demonstrate that their activities constituted "qualified research" as defined in IRC section 41.

Contentions

Appellants' Contentions

Appellants contend that WLW is "exactly the type of home-grown company California intended to assist when it created a State Research and Development tax credit incentive." Appellants assert that WLW conducted qualified research as defined in IRC section 41 and the qualified research expense amounts claimed were correct and appropriately substantiated. Appellants further assert that respondent provided no explanation with its denial of the claims for refund. (Appeal Letter, pp. 2-3.)

STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

In their reply brief, appellants repeat the assertion that respondent, in violation of R&TC section 19323, subdivision (a), provided no written explanation for the denial of the claims for refund. Appellants argue that respondent first set forth its reasons for the denial in its opening brief and, as a consequence, appellants had only 30 days to present their position, rather than 90 days as they would have if respondent had complied with section 19323, subdivision (a). For that reason, appellants state that they will file a supplement to their reply brief.[2] (App. Reply Br., p.1.)

Appellants cite tax court decisions in which, they assert, the court allowed taxpayers to prove expenses through the taxpayers' own testimony which, in some instances, was found to be "unconvincing and unsatisfactory." Appellants also cite "FSA 5488" issued by "IRS District Counsel" as stating that the *Cohan* case (*Cohan v. Commissioner* (2d Cir. 1930) 39 F.2d 540 (*Cohan*) may apply "for purposes of estimating the qualified research expenses and does not recommend blanket disallowance of the claim due to lack of records." Appellants call attention to *Fudim v. Commissioner*, T.C. Memo 1994-245, in which, appellants assert, the tax court applied the *Cohan* "two-step" analysis as follows: (1) determine whether the taxpayer engaged in research and development activity for which the credit under IRC section 41 is allowed and (2) determine whether there is a basis upon which to estimate qualified expenses. Appellants highlight the court's statement that "we must rely on [the taxpayer's] testimony and other evidence in the record." Appellants assert that "the court focused its analysis on the creditability of all evidence submitted" and conclude that, in this appeal, all available testimonial and documentary evidence must be examined. Appellants also contend that respondent relies on a reasonableness standard that does not apply to IRC section 41. (App. Reply Br., p.2.) Finally, appellants take issue with respondent's reliance on *U.S. v. McFerrin*, 2008 U.S. Dist. LEXIS 64327, which, appellants contend, the court "improperly decided", based on the "discovery rule", an incorrect definition of "uncertainty" under IRC section 41 and a substantiation standard inconsistent with Congress' intent. (App. Reply Br., pp.9-11.)

///

---

[2] By letter dated, December 3, 2009, the Board Proceedings Division notified appellants that the deadline to file a supplemental brief in reply to respondent's reply brief was January 2, 2010. However, appellants did not file a supplemental brief.

Bottle Closure Project

With respect to the bottle closure project, appellants contend that respondent "improperly weighed" their research activities against the "discovery rule" developed in the cases of *United Stationers, Inc. v. U.S.* (7th Cir. 1998) 163 F.3d 440 and *Norwest Corp. v. Commissioner* (1998) 110 T.C. 454. Appellants assert that Congress provided guidance to interpret the IRC section 41 standard that research be "undertaken for the purpose of discovering information which is technological in nature." As an example of such guidance, appellants state the Conference Report to the Taxpayer Relief Act of 1986 (TRA 86) shows that "Congress intended only that information sought by taxpayers be discovered through a process of experimentation rooted in the application of technical scientific principles." Appellants assert that the IRS expanded a footnote in TRA 86 to a rule of general application "requiring all taxpayers undertake to discover information that exceeds existing knowledge in the industry" which the IRS successfully argued as the standard in *United Stationers* and *Norwest*. According to appellants, based on those decisions, the IRS "injected its version of the Discovery Test into proposed regulations issued in 1998". (App. Reply Br., pp. 12-13.)

As a result of concern over those regulations, appellants contend, Congress attempted to clarify the meaning of the "discovering information" requirement in the Conference Report by urging the IRS to carefully consider comments received in response to the proposed regulations. However, appellants contend, the IRS issued Treasury Decision 8930 (TD 8930) adopting the proposed regulations with minor changes and stating affirmatively that "research is undertaken for the purpose of discovering information only if it is undertaken to obtain knowledge that exceeds, expands, or refines the common knowledge of skilled professionals in a particular field of science or engineering." Appellants state that TD 8930 was superseded by proposed regulations issued in December of 2001 which expressly provided that a determination that research is undertaken for the purpose of discovering information that is technological in nature does not require the taxpayer be seeking to obtain "information that exceeds, expands or refines the common knowledge of skilled professionals in the particular field of science or engineering in which the taxpayer is performing the research." Appellants state that the Treasury Department assured taxpayers that they could rely on the proposed regulations until the final regulations were published and that the Treasury Department would not challenge return positions for taxable years ending before December 31, 2003, that are consistent with these final regulations. (App. Reply Br., pp. 14-15.)

Despite the foregoing, appellants contend that respondent argues in its opening brief that WLW did not undertake qualified research with respect to the bottle closure project because it did not "invent" the bottle closure eventually used. Specifically, appellants contend that respondent's review held WLW to "a standard of revolutionary advancement and universal newness never intended by Congress". Additionally, appellants contend that WLW's calculation of the research credit did not "anticipate maintenance of documentation showing that research conducted resulted in the discovery of information that expanded or refined the existing principles of chemistry, had a broad effect, or was new to the world." The standard applied by respondent, appellants contend, would have required WLW, in addition to conducting scientific research, "(a) to conduct an investigation into the deep recesses of its competitors' trade secrets to determine that none of them had achieved the product and/or process improvements developed; (b) publish any findings to ensure it made it into the common knowledge of the industry; and (3) then assess after the passage of time whether the research conducted was highly innovative and had a broad effect." Appellants contend that neither WLW nor any other company has the resources or ability to undertake those tasks. For those reasons, appellants assert that respondent should be required to reexamine WLW's research under the proper standard for qualified research. (App. Reply Br., pp. 16-17.)

Winemaking Project

With respect to the winemaking project, appellants contend that respondent grossly mischaracterizes WLW's activities in its description of the research. Appellants state that the project was undertaken to improve WLW's wine production operation by conducting numerous experiments which are briefly described. Appellants contend that WLW's "numerous testing and sampling techniques allowed it to produce an enhanced wine product." With respect to the vineyard project, appellants contend that respondent applied the incorrect substantiation standard and refers to the discussion above. (App. Reply Br., p.18.)

Vineyard Project

Appellants contend that respondent again applied the incorrect standard for substantiation, as discussed above, to the Vineyard Project. Appellants contend that the Vineyard Project involved the development of the principles of viticulture sciences and appellant there conducted "numerous testing and sampling techniques [which] allowed it to produce an enhanced wine product."

Respondent's Contentions

In reply to appellants' argument that the denial letter failed to provide a written explanation, respondent states the letter was legally sufficient because it informed appellants that the claims for refund of R&D credit amounts were denied, and it stated that appellants had 90 days in which to file an appeal with this Board. Respondent also asserts that "the ongoing conversation between respondent and appellants' representatives explained the reasoning behind the claim denial." Furthermore, respondent states that its opening brief sets forth an explanation of respondent's disallowance and the legal arguments to support that disallowance. Based on the foregoing, respondent maintains that appellants received explanations of the denial that satisfy the requirement of R&TC section 19323, subdivision (a). (Resp. Reply Br., pp. 3-4.)

Respondent notes appellants' R&D study itself states that it is merely a summary and an overview and does not include a complete description of all the facts relating to the qualified research activities performed. However, in response to the IDRs, respondent states that appellants referred respondent's auditor to the study which respondent determined did not support appellants' R&D credit claim. Respondent asserts that appellants have failed to provide any contemporaneous documentation to support their contention that appellant-husband engaged in qualified activities and received qualified wages. Respondent further asserts that the R&D study claims different amounts of "qualified research expenses" than appellants' amended returns and that there is no indication of the amount of time appellant-husband spent on each of appellants' projects. (Resp. Opening Br., pp.10-11.)

Respondent contends that appellants are not entitled to the R&D credit because they have not substantiated that any "qualified research" was performed. Specifically, respondent contends that appellants have not met the requirements of IRC section 41 by their failures (1) to sufficiently identify the business components for which R&D credit is claimed, (2) to show that the identified components are truly business components of WLW, (3) to demonstrate that WLW engaged in a process of experimentation and (4) to prove the existence of a qualified purpose. Respondent characterizes the definition of “qualified research” under IRC section 41(d)(1) as a “four-part test” by which Congress intended to limit a tax credit availability to taxpayers engaged in true research, “rather than routine product development, routine manufacturing, developments after commercial production, or market research.” Respondent contends that the research projects presented by appellants are not eligible for the R&D credit because they do not satisfy the four-part test. (Resp. Opening Br., pp. 12-13.)

<u>Bottle Closure Project</u>

Respondent argues that WLW did not invent a glass bottle closure. Rather, it was invented by a German physician who contracted with Alcoa to produce it based on patent application records. Because WLW did not invent the bottle closure, respondent argues that the project does not involve a business component of WLW as required by IRC section 41(d)(1)(B)(ii), but rather involves WLW’s commercial use of another company’s business component. Respondent further argues that the evidence shows that WLW adapted the bottle closure but has not proven that it has an ownership right in the product or that it has any substantial right to Alcoa’s business component. For that reason, respondent concludes that appellants are not entitled to R&D credit for their design of the bottle closure. (Resp. Opening Br., pp. 14-15.)

Respondent further argues that appellants’ activities constituted “funded research” as defined by IRC section 41(d)(4)(H) – activities involving the business component of another- rather than “qualified research” that would be entitled to R&D credit. Respondent cites Treasury Regulation section 1.41-4A(d)(1) which provides that “[a]ll agreements . . . between the taxpayer performing the research and other persons shall be considered in determining the extent to which the research is funded.” Based on that provision, respondent argues that WLW’s agreement must show that it held a substantial right in Alcoa’s business component. Respondent also cites Treasury Regulation section 1.41-4A(d)(2) which provides, in part, that qualified research expenses do not include expenses paid or incurred by a taxpayer in performing research for another person and in which the taxpayer retains no substantial rights under the research agreement. Respondent states that appellants failed to comply with respondent’s request for copies of research and similar agreements, and instead replied by stating that “the issue of funded research did not come into play” with the R&D study and, thus, the study “did not include any expenditure that was associated with funded research as part of the Qualified Research

Expenditures." Based on appellants' reply, respondent contends that appellants failed to provide any evidence demonstrating WLW had substantial rights in the bottle closure or showing WLW developed the bottle closure. (Resp. Opening Br., pp.16-17, exhibit I.)

Respondent states that, in response to respondent's IDR-3, appellants asserted that the bottle closure project research resulted in WLW bottling some of its white wines with screw top caps which have a number of advantages over cork. Respondent contends that it uncovered evidence indicating the research described by appellants is actually market research which is specifically disqualified by IRC section 41(d)(4)(D) and does not serve a qualified purpose as required by IRC section 41(d)(1)(C) and (d)(3). Respondent notes that WLW's general manager was quoted in 2004 as stating that the release of wines with screw top caps was a test to see how the market would respond as well as to see how the caps would perform. Respondent contends that this statement demonstrates that WLW was "researching" whether consumers would accept a wine bottled without a cork. In addition, respondent contends that appellants purchased caps and capping machines but did not engage in development of the cap. Finally, respondent cites statements made by appellant-husband and the general manager to the effect that the non-cork closure was being used "in a format that consumers will enjoy" and that WLW adopted the glass stopper, which customers gave "rave reviews", as an "elegant" alternative to cork. Because the purpose of the research was to determine consumer preference or "taste", which is not a qualified purpose pursuant to IRC section 41(d)(4)(D), respondent contends that it properly denied the R&D credit. (Resp. Opening Br., pp. 18-20.)

Respondent further contends that WLW did not develop either closure (Stelven screw cap or glass stopper), and that there is no evidence that WLW has substantial rights in either product, which might allow WLW to claim R&D credit. Instead, any qualified research resulting in the invention of the glass stopper should be attributed to Alcoa. Finally, the screw cap and glass stopper are not business components of WLW, and therefore, appellants cannot claim R&D credit for those products. (Resp. Opening Br., pp. 21-22.)

<u>Winemaking Project</u>

Respondent contends that the winemaking project does not meet the "process of experimentation" requirement of IRC section 41(d)(1)(C), which is "a process designed to evaluate one or more alternatives to achieve a result where the capability or the method of achieving that result, is uncertain as of the beginning of the taxpayer's research activities." Respondent contends that WLW's winemaking has not changed from year to year and appellants have not provided documentation to substantiate that appellant-husband was involved in winemaking. In support of the first point, respondent quotes WLW's marketing material from 2001 through 2007, which states that: "The wine and winemaking techniques remain constant from vintage to vintage because of the outstanding conditions in the vineyards every year." Respondent concludes that WLW created a distinctive style for its wines long ago and aims for continuity of character from year to year. For that reason, respondent argues that the process of experimentation requirement was not met because there was no uncertainty with respect to the "appropriate design" of the WLW wines as required by Treasury Regulation section 1.41-4(a)(5)(i). (Resp. Opening Br., pp. 22-23.)

Respondent adds that uncertainty alone does not establish that WLW performed qualified research activities. As an example, respondent notes that there is no uncertainty as to WLW's capability or method in the production of its classic Bordeaux-style blend, and the appropriate design is not uncertain because "it was laid down more than a century ago in Bordeaux, France." Respondent states that the court in *Eustace v. Commissioner,* T.C. Memo 2001-66, found that such activities amount to nothing more than "tinkering" which differs from experimentation and does not rely on the scientific method. In this regard, respondent contends that this activity is excluded as "duplication of an existing business component" under IRC section 41(d)(4)(C). (Resp. Opening Br., p. 24-25.)

<u>Vineyard Project</u>

Respondent contends that appellants provided no substantiation that the vineyard project comprised any activity other than routine commercial farming and is disqualified on that basis alone. Although appellants claim that the project "consisted of the development of principles of viticulture sciences", respondent states that WLW retained no written record of this development and it did not involve the process of experimentation. As support for its contention, respondent notes that the project only resulted in the installation of an irrigation system for commercial farming; the project did not evaluate alternatives or document findings and thus did not engage in the scientific method. In addition, respondent states that apart from three aerial photos showing canopy density or canopy vigor, appellants provided no other substantiation for the claimed experimentation and, thus, did not meet the recordkeeping requirement of IRC section 41 and Treasury Regulation section 1.41-4(d). Respondent contends that WLW's use of computerized soil moisture probes for its irrigation system is "routine data collection" for that system rather than a qualified research activity. Respondent further contends that the fact that the probes transmit data every 15 minutes by means of computer does not establish that qualified research activity occurred. (Resp. Opening Br., pp. 25-27.)

Respondent contends that appellants' answers to the IDRs are circular in logic and not germane to the audit. As an example, respondent points to appellants' reply to the following from IDR-3: "Discuss, in general, the various alternatives to be explored in the research project." Appellants reply describes "the various alternatives for exploring this project" which is titled "Grape Leaf Components and Soil Moisture Measurements" as "the process of testing the various vineyards to determine the optimal period for the harvesting of grapes was accomplished through a series of tests that were conducted on grape leaf components and soil moisture measurements." Respondent contends that the response has no probative value in determining whether the activity constituted qualified research and the activity was not supported by substantiating documentation. (Resp. Opening Br., pp. 27-28.)

Finally, respondent states that appellants incorrectly allege that respondent applied the "discovery rule" to appellants' R&D credit claim. In this regard, respondent states that both *Eustace* and *McFerrin* both involved taxable years in which the "discovery rule" was the applicable standard. However, respondent notes that the courts in both cases applied both the "discovery rule" and the "process of experimentation" standard and, therefore, those decisions remain valid law with respect to the latter. Respondent contends that it applied the "process of experimentation" standard and the other three requirements of IRC section 41(d)(1) to determine that appellants were not engaged in qualified research but did not apply the "discovery rule." (Resp. Reply Br., pp. 9-10.)

<u>Applicable Law</u>

R&TC section 23609 provides a tax credit for "qualified research expenses" determined in accordance with IRC section 41. Generally, the credit is determined based on the amount by which the taxpayer's qualified research expenditures (QREs) exceed a "base amount." Insofar as is relevant to this appeal, R&TC section 23609 substantially conforms to IRC section 41.

IRC section 41(b)((2)(A) defines, in relevant part, "in-house research expenses" as "any wages paid or incurred to an employee for qualified service performed by such employee." IRC section 41(b)((2)(B) defines "qualified services" as "services consisting of (i) engaging in qualifying research or (ii) engaging in the direct supervision or direct support of research activities which constitute qualified research."

Under IRC section 41(d)(1), the term "qualified research" is defined as "research":

> (A) with respect to which expenditures may be treated as expenses under section 174,
> (B) which is undertaken for the purpose of discovering information –
> (i) which is technological in nature, and
> (ii) the application of which is intended to be useful in the development of a new or improved business component of the taxpayer, and
> (C) substantially all of the activities of which constitute elements of a process of experimentation for a purpose described in paragraph (3) [which lists qualified purposes as "(i) a new or improved function, (ii) performance, or (iii) reliability or quality"]."

Treasury Regulation 1.41-4(a)(3) provides in pertinent part that:

> (i) Research is undertaken for the purpose of discovering information if it is intended to eliminate uncertainty concerning the development or improvement of a business component. Uncertainty exists if the information available to the taxpayer does not establish the capability or method for developing or improving the business component, or the appropriate design of the business component.
>
> (ii) Application of the discovering information requirement. A determination that research is undertaken for the purpose of discovering information that is technological in nature does not require the taxpayer be seeking to obtain information that exceeds, expands or refines the common knowledge of skilled professionals in the particular field of science or engineering in which the taxpayer is performing the research. In addition, a determination that research is undertaken for the purpose of discovering information that is technological in nature does not require that the taxpayer succeed in developing a new or improved business component.[3]

Treasury Regulation 1.41-4(a)(5)(i) defines the "process of experimentation" in relevant part as "a process designed to evaluate one or more alternatives to achieve a result where the capability

---

[3] Although the current regulation provides that it is applicable to tax years after December 31, 2003, the regulation was adopted, in relevant part, as a proposed regulation on December 26, 2001, and the IRS then stated that it would not challenge return positions that were consistent with the proposed regulation. (66 Fed. Reg. 247, p. 66367 (Dec. 26, 2001).) The regulation discarded the IRS's prior formulation of the applicable rule, which required the taxpayer undertake to obtain knowledge that exceeds or refines the knowledge of skilled professionals in the field of science or engineering. Staff notes that *United Stationers, Inc. v. U.S.* (7th Cir. 1998) 163 F.3d 440, appeared to adopt a more stringent form of the "discovery" requirement than set forth in the current regulation by requiring that qualifying research "go beyond the current state of knowledge in [the] field [or] expand or refine its principles." (*United Stationers* v. U.S., *supra* at p.445.)

or the method of achieving that result, or the appropriate design of that result, is uncertain as of the beginning of the taxpayer's research activities." The Court of Appeals for the Fifth Circuit has described the "process of experimentation as involving three steps:

> (1) the identification of uncertainty concerning the development or improvement of a business component,
> (2) the identification of one or more alternatives intended to eliminate that uncertainty, and
> (3) the identification and the conduct of a process of evaluating the alternatives (through, for example, modeling, simulation, or a systematic trial and error methodology).
>
> (*U.S. v. McFerrin* (2009) 570 F.3d 672, 677.)

In addition, Treasury Regulation 1.41-4(a)(5)(ii) describes a "qualified purpose" of a process of experimentation as relating to "a new or improved function, performance, reliability or quality of the business component. Research will not be treated as conducted for a qualified purpose if it relates to style, taste, cosmetic, or seasonal design factors."

IRC section 41(d)(2) provides that the test for qualified research shall be applied separately with respect to each "business component" of the taxpayer, and defines "business component" as "any product, process, technique, formula, or invention which is to be held for sale, lease or license, or used by the taxpayer in a trade or business of the taxpayer."

IRC section 41(d)(4) excludes the following activities (among others) from the definition of "qualified research" (and thus provides that such activities will not be eligible for the credit):

> (D) Surveys, studies, etc.
> Any -
> (i) efficiency survey,
> (ii) activity relating to management function or technique,
> (iii) market research, testing, or development (including advertising or promotions),
> (iv) routine data collection, or
> (v) routine or ordinary testing or inspection for quality control. . . . "
> * * *
>
> (H) Funded research. Any research to the extent funded by any grant, contract, or otherwise by another person (or governmental entity).

For purposes of determining the extent to which an activity is considered "funded research", Treasury Regulation 1.41-4A(d) is applicable and provides in part that:

> (1) All agreements (not only research contracts) entered into between the taxpayer performing the research and other persons shall be considered in determining the extent to which the research is funded.

> (2) Research in which taxpayer retains no rights. If a taxpayer performing research for another person retains no substantial rights in research under the agreement providing for the research, the research is treated as fully funded for purposes of [IRC] section 41(d)(4)(H), and no expenses paid or incurred by the taxpayer in performing the research are qualified research expenses.
>
> Incidental benefits to the taxpayer from performance of the research (for example, increased experience in a field of research) do not constitute substantial rights in the research. If a taxpayer performing research for another person retains no substantial rights in the research and if the payments to the researcher are contingent upon the success of the research, neither the performer nor the person paying for the research is entitled to treat any portion of the expenditures as qualified research expenditures.

IRC section 41(d)(1)(A) provides that, in addition to meeting the requirements set forth in IRC section 41 itself, a taxpayer seeking the research credit must also comply with the requirements of IRC section 174, which provides a deduction for "research or experimental expenditures." Treasury Regulation section 1.174-2(a)(1) provides that, to fall within the definition of "research or experimental expenditures," expenses must represent "research and development costs in the experimental or laboratory sense." Treasury Regulation section 1.174-2(a)(1) further explains as follows:

> Expenditures represent research and development costs in the experimental or laboratory sense if they are for activities intended to discover information that would eliminate uncertainty concerning the development or improvement of a product. Uncertainty exists if the information available to the taxpayer does not establish the capability or method for developing or improving the product or the appropriate design of the product. Whether expenditures qualify as research or experimental expenditures depends on the nature of the activity to which the expenditures relate, not the nature of the product or improvement being developed or the level of technological advancement the product or improvement represents.

One scholarly commentator has noted that, for purposes of IRC section 174:

> The term "uncertainty" must be limited to technological or scientific uncertainty in that a taxpayer must be uncertain as to whether it will be able to develop or improve its product in the scientific or laboratory sense. Put differently, the taxpayer must be uncertain as to whether it will be able to achieve its product development objective through its research activities. Conversely, uncertainty attributable to business or market concerns is not determinative of the existence of research and experimentation for purposes of section 174. [4]

In this process, the taxpayer is required to "identify the uncertainty", "identify one or more alternatives" and "identity and conduct a process of evaluating the alternatives."[5] The IRS audit

---

[4] Cameron, *Research Tax Credit: Statutory Construction, Regulatory Interpretation and Policy Incoherence* (2004) 9 Comp. L. Rev. & Tech. J. 63.

[5] Respondent's Opening Brief, Exhibit O, page 22.

manual explains as follows:

> The key difference regarding 'uncertainty' in sections 41 and 174 is that, under section 41, uncertainty must relate to a qualified purpose, and must be resolved through a 3-element process of experimentation, fundamentally relying on the principles of the hard sciences, engineering, or computer science. The regulations clarify that merely demonstrating that uncertainty has been eliminated is insufficient…Focus on developing facts necessary to determine whether the taxpayer's activities meet these requirements and the core elements.[6]

Treasury Regulation section 1.174-2(a)(3) further provides that the term "research or experimental expenditures" does not include expenditures for, among other things, quality control testing, surveys or advertising.

In *U.S. v. McFerrin* 2008 U.S. Dist. LEXIS 64327 the taxpayers contracted with alliantgroup to conduct a R&D study and the results of this study were the basis of the claim for R&D credit by the taxpayers and their companies. The federal district court found that the IRS "proved convincingly that alliantgroup's work and resulting report were fundamentally flawed and unreliable" and "entitled to no weight." The court described alliantgroup's methods as "staff conducting superficial on-site meetings with personnel from [taxpayers' companies], and reviewing various records of the companies." The court noted that there was no evidence that alliantgroup had "anyone with meaningful scientific experience or training on staff, or that skilled or knowledgeable individuals conducted the study, did any investigation, or rendered conclusions." Finally, the court noted that alliantgroup did not define "research" for purposes of the R&D credit in its interviews with the employees so that each employee's answers reflected that employee's own interpretation of what qualified as "research."

The district court bifurcated the test for determining whether the activities constituted "qualified research" as meeting both the discovering information requirement and the process of experimentation requirement. The district court articulated the standard for "discovering information technological in nature [as] research undertaken to discover information that goes beyond the current state of knowledge in the field" and the court held that appellants failed to meet that standard. On appeal, the court of appeal held that the district court applied the wrong standard for discovering

---

[6] Respondent's Opening Brief, Exhibit O, page 22.

information. The court noted that even though the 2003 Treasury Regulations were not in effect when the amended returns were filed, the taxpayers had clearly been relying on the proposed regulations which defined the discovering information standard as “eliminating uncertainty”, and which was similar to the definition that was ultimately adopted. Additionally, the court noted that the IRS conceded the taxpayers could rely on the definitions from the 2003 regulations. Therefore, the court of appeal held that the district court erred by not reviewing the evidence under the definitions from the 2003 Treasury Regulations. (*U.S. v. McFerrin*, *supra,* 570 F.3d 672, 678.)

STAFF COMMENTS

Bottle Closure Project

Appellant argues that respondent improperly relied on *McFerrin* and improperly applied the “discovery rule” per *United Stationers* and *Norwest Corp.* Appellants assert that Congress only intended that information should be obtained through the process of experimentation and did not intend, as TD 8930 states, that a taxpayer must “undertake to discover information that exceeds existing knowledge in the industry.” For that reason, according to appellants, Treasury Regulation 1.41-4 was adopted to clarify that “qualified research” must be undertaken to eliminate uncertainty i.e. must evaluate one or more alternatives to achieve a result where the capability or the method of achieving that result, or the appropriate design of that result, is uncertain as of the beginning of the taxpayer’s research activities.

Respondent counters that it did not apply the “discovery rule” as characterized by appellants and that *McFerrin* was cited only as authority for its application of the process of experimentation concept. Moreover, respondent argues that the glass stopper activities did not meet the business component part of the test because the product was a business component of Alcoa which held the patents. Respondent argues that WLW merely adapted the product to its uses but held no substantial right in that business component. In this regard, respondent argues that appellants’ activities constituted funded research and appellants did not provide evidence as requested by respondent to show appellants had a substantial right in that business component of Alcoa. Respondent also argues that WLW did not develop the screw-top cap, and any research conducted by WLW was for the purpose of determining consumer preference, which is not a qualified purpose.

Staff notes that the R&D Study does not provide a detailed explanation of how the bottle closure project is a business component of WLW. In the "technical analysis" section of the R&D Study, a "qualification analysis" states that "the development activities associated with the various patented projects satisfy the Business Component-Permitted Purpose Requirement because the purposes of the R&D activities were to develop business components with new or improved functionality, performance, reliability, quality or durability as identified in the following matrix." The matrix is a table with general types of business components, such as "product" and "process" and general purposes of activities such as "function" and "performance". (Resp. Opening Br., exhibit J, pp. 26-27.)

A brief description of the bottle closure project is stated as "the development of an innovative wine screw cap solution in order to improve the taste and life of still wine product." (Id. at p.29.) The fuller description of the project states that "WLW developed various innovative design techniques and fabrication processes to achieve a functional sealing product." The Study states that the "[t]he company's first attempt … utilized synthetic cork components" but it was determined that "synthetic corks were not able to form a complete seal" and caused "plastic taint" of the wine. The Study further states that "WLW developed a screw cap as a potential solution" and that "several of the initial experiment[s] with the screw cap closures were sensory in nature and consisted in evaluating wine sealed with natural cork versus wines sealed with screw caps." (Id. at 36-38.)

In the staff's view, it appears that the foregoing description is insufficient to demonstrate that either bottle closure product was a business component of WLW. First, the description does not even mention the glass stopper and, secondly, the performance of the screw cap seems to be testing after commercial production, adaptation of an existing business component and routine or ordinary testing or inspections for quality control, which are not qualified purposes under Treasury Regulation 1.41-4(c).

At the hearing, appellants should be prepared to explain how either closure constitutes a "business component" of WLW in view of the fact that third-parties hold the patents and WLW appears to have merely adapted those products to its own needs. Specifically, appellants should be prepared to present evidence to show that WLW had an agreement with any third-party that granted WLW substantial rights in the bottle closure so as to prove that, to the extent WLW was engaged in research, it was not funded research which does not qualify for the R&D credit. Appellants should also explain why the project does not involve non-qualified purposes described above.

In the event that the Board may find that WLW engaged in activities with a qualifying purpose and a non-qualifying purpose, such as a purpose relating to consumer preference, the Appeals staff is unclear as to whether the existence of such non-qualifying purpose would result in a finding that the entire project was not qualified research. At the hearing, the parties should be prepared to discuss and cite any authority in this regard.

Winemaking Project

Appellants state that the purpose of the project was to improve the wine production operation by conducting numerous experiments, such as "the selecting of harvest criteria to crushing and fermenting grapes to barrel selection and aging techniques; [and] bench trials with regards to alcohol reduction through processes utilizing reverse osmosis and spinning cone; experimentations with acidity levels and wine chemistry." Respondent contends that the process of experimentation standard has not been met because winemaking practices have not changed from year to year. As an example, respondent notes that there was no uncertainty with respect to WLW's capability or methods or with respect to the "appropriate design" of its classic Bordeaux-style blend. Respondent describes WLW's activities as "tinkering" and as the duplication of an existing business component which is excluded as qualified research under IRC section 41(d)(4)(C). In addition, respondent asserts that there is no documentary evidence to show that appellant-husband was involved in winemaking.

The duplication of an existing business component is defined as "[a]ctivities relating to reproducing an existing business component (in whole or in part) from a physical examination of the business component itself or from plans, blueprints, detailed specifications, or publicly available information about the business component . . ." (Treas. Reg., § 1.41-4(c)(4).) It appears that the project could be viewed as one that was intended to produce enhanced wine products and not merely reproduce WLW's existing wine products. At the hearing, respondent should be prepared to explain how WLW's winemaking project activities met the definition of the duplication of an existing business component. Appellants should be prepared to discuss how its activities differ from standard production practices and methods in the winemaking industry.

<u>Vineyard Project</u>

Appellants contend that the project involved the development of the principles of viticulture sciences and conducted “numerous testing and sampling techniques [which] allowed it to produce an enhanced wine product.” Respondent contends that appellants did not provide evidence of any activity other than routine commercial farming, that WLW retained no written record of this development, other than some aerial photographs, and the project did not involve the process of experimentation.

A brief description of the vineyard project is stated as “the development of the principles of viticulture sciences to improve grape quality in a vineyard” to improve the quality and flavor of WLW’s wines. (Id. at p.29.) The fuller description of the project states that “WLW utilized the principles of viticulture sciences . . . to improve grape quality and produce enhanced wine products.” The Study states that the “[t]he company re-planted vineyards with different rootstocks, irrigation regimes and nutrient needs . . . and integrated various devices and data gathering techniques during its testing process, including moisture probes, pressure bombs, plant samples, test pits, scientific thermometers and satellite photos.” The Study further states that “as a result of the successful completion of the project, [WLW] was able to significantly improve and modify its irrigation and fertilization regimes.” (Id. at 34-36.)

It appears to staff that the project in concept may meet the definition of the “process of experimentation” in that it appears to have been designed to evaluate alternatives to achieve a result – an improved wine product – where the capability or method of achieving that result was uncertain at the beginning of the project. At the hearing, respondent should be prepared to describe the types of documentation and other evidence that would be necessary to demonstrate that the project involved the process of experimentation. Appellants should be prepared to explain how the methods utilized in this project differ from ordinary viticulture practices and activities necessary to grow and harvest wine grapes.

(2) Whether appellants have met their burden of proving qualified expenses for purposes of the R & D tax credit under R&TC section 23609 for the tax years at issue.

Appellants' Contentions

Appellants dispute the authorities relied upon by respondent as (1) dicta from a Tax Court opinion (*Eustace v. Commissioner*, T.C. Memo 2001-66), (2) a federal district court opinion that has been expressly abrogated by applicable Treasury Regulations (citing *Cohan v. Commissioner, supra*, 39 F.2d 540), and (3) a reading of IRC section 6001 expressly prohibited by its drafters. (App. Reply Br., pp. 5-7.)

With respect to *Eustace*, appellants argue that case did not involve a "prepackage study" by a third-party consultant and, rather, the taxpayers' claim was based on "a calculation completed by a recently hired internal tax manager who after interviews with employees made his own determination as to what he believed qualified for the research credit." Moreover, appellants assert, "the focus" of *Eustace* was not substantiation but whether the taxpayers' company was performing qualified research pursuant to IRC section 41. The court found that the taxpayers did not present sufficient evidence to establish that the company's activities met statutory requirements for the research credit. Appellants contend that the court mentioned only in dicta that the methodology used by the tax manager was "unreliable, inaccurate, incomplete and wholly insufficient." Appellants conclude that respondent should have focused, not on the dicta, but on the legislative history concerning substantiation of the research credit and other cases that bear directly on that point which derive from *Cohan*. (App. Reply Br., pp. 5-6.)

Appellants contend that IRC section 41 has no separate requirement for documenting expenses for R&D credit and that R&TC section 23609, which conforms to IRC section 41, also has no documentation requirement. Appellants also assert that "Congress eliminated a specific documentation requirement in Treasury Decision 9104 (TD 9104)" which states that "the Treasury and the IRS decided against a specific research credit documentation requirement." Appellants further state the "preamble" states "taxpayers must be provided with reasonable flexibility in how they substantiate research credits and observes that Congress made clear through legislative history that the credit should not impose unreasonable recordkeeping burdens." Appellants also cite a "Conference Report to the Tax Relief Extension Act of 1999" (Conference Report) where the conferees expressed their concerns and reaffirmed that eligibility for the credit should not turn on such requirements." Finally, appellants state that TD 9104 further clarifies that the 2001 proposed regulations to IRC section 41 do not provide for a separate recordkeeping requirement beyond the requirements set out in IRC section 6001 and the regulations thereunder. (App. Reply Br., p.7.)

Appellants contend that IRC section 6001 provides the only recordkeeping requirement for the R&D credit and that section generally requires every taxpayer to maintain accounting records to enable them to file a correct return of his or her taxable income each year. Appellants further contend that IRC section 6001 and the regulations thereunder provide very little guidance as to the type of documentation that meets the general recordkeeping requirement but that case law, and, specifically *Cohan*, provides further guidance regarding substantiation for a R&D credit claim. Appellants state that in *Cohan* the court held the taxpayer was allowed to estimate "a substantial amount of entertainment and travel expenses" because, the court reasoned, "absolute certainty in such matters is usually impossible and is not necessary." Under the *Cohan* rule, appellants assert, a taxpayer may establish his or her right to deduct such expenses "through virtually any form of admissible evidence, including self-serving statements." Additionally, according to appellants, even if the taxpayer does not have complete documentation, he or she merely needs to show that he or she incurred "some amount of deductible expenses" in order to establish entitlement to the deduction. (App. Reply Br., pp. 7-8.)

Appellants maintain that despite the fact that Congress legislatively overruled the *Cohan* rule for certain types of expenses, the rule is still applicable for other "non-specifically excluded expenses". Because IRC sections 41 and 174 do not impose strict substantiation requirements, appellants contend, a taxpayer is allowed to estimate expenses under the *Cohan* rule and, thereby, comply with the substantiation requirement under IRC section 6001. Appellants repeat their assertion that the *Cohan* rule requires only that the taxpayer establish that some qualifying R&D expenses were incurred and provide some basis for estimating total deductible expenses. A taxpayer is not required to produce "adequate records" or "sufficient evidence" to corroborate the taxpayer's statement of those expenses.

Respondent's Contentions

Respondent contends that appellants have not provided enough evidence to substantiate the research credits as required by IRC section 41, which requires that "a taxpayer must maintain records in sufficiently useable form and detail to substantiate that the expenditures claimed are eligible for the credit." Respondent cites Treasury Regulation section 1.41-4 as requiring mandatory recordkeeping for taxpayers claiming R&D credit. Respondent contends that appellants' R&D Study is a "prepackage credit study" created "years after the alleged research occurred" and does not satisfy the recordkeeping requirement. Additionally, appellants assert that the IRS has viewed such studies as "a major problem for years", has litigated the issue and has issued guidance for treatment of such studies to its auditors. Respondent states that the IRS determined that the studies generally fail to substantiate qualified research expenses and include information not germane to the audit. Respondent further states the courts upheld the IRS's determinations. Finally, respondent asserts that prepackage credit studies are deficient because they make vague generalizations about a taxpayer's activity which are insufficient to support an R&D credit claim and they fail to show the connection between an expense and qualified activity because (1) they often have no contemporaneous documentation and (2) taxpayers' estimates of personnel time spent on qualified activity often are without a reliable basis. (Resp. Opening Br., pp. 4-6.)

Respondent states that it rejected appellants' R&D Study based on flawed methodology and insufficient content because it failed to demonstrate any nexus between appellants' wages and activity that constituted qualified research under IRC section 41 and it failed to substantiate that WLW engaged in qualified research. Respondent cites IRC section 41 and the applicable Treasury Regulation for the proposition that employee wages constitute in-house research expenses only to the extent the wages were paid or incurred for qualified services the employee performed. The failure by appellants to establish a nexus between the wages claimed and any activity constituting qualified research, respondent argues, is grounds for denying the claims. Respondent cites *Eustace*, in which the court found a taxpayer's reconstruction of qualified expenses - a pro-forma list of salaries supplemented by testimony - to be "unreliable, inaccurate, incomplete, and wholly insufficient" to meet the taxpayer's burden of proof. Respondent contends that appellants have not presented sufficient evidence to prove the amounts claimed as "qualified research expenses" were paid for "qualified research activities." (Resp. Opening Br., pp. 6-7.)

Respondent argues that the R&D Study was prepared in 2006, after the original and amended returns were filed, and after the alleged research was performed, makes its methodology and accuracy immediately suspect and of little probative value. Respondent further argues that the R&D Study did not tie employees' wages to any specific business component as required by IRC section 41(d)(2) and by the court in *Eustace*. Respondent also argues that the methodology of the R&D Study is flawed because it is based on a combination of a cost center approach and a project-by-project approach, the same methodology used by the same consultant, alliantgroup, llc, which was rejected by a federal district court in *McFerrin* because it "lacks meaningful factual foundation and is unreliable." Respondent adds that the court also found that the taxpayer's prepackage credit study was "based on inadequate investigation and limited information, and as a result, has no probative value." Thus, respondent contends, this method does not establish the required nexus between qualified research expenses and qualified research activities. (Resp. Opening Br., pp. 8-9.)

Respondent disputes appellants' reliance on *Cohan* and *Fudim* to support "their allegation that there is no documentation requirement, and to assert their alleged 'qualified research expenses' should be estimated." Respondent asserts that *Cohan* is sometimes cited for the general proposition that the amount of qualified expenses may be estimated, if the taxpayer first establishes entitlement to the deduction. Respondent contends that a court can estimate only when it is clear that qualifying expenses were incurred in the relevant tax year. In this regard, respondent contends that appellants have not substantiated their activities rise to the level of qualified research under IRC section 41(d). (Resp. Reply Br., pp.4-5.)

Respondent asserts that the *Cohan* rule only applies if the taxpayer provides some rational basis on which an estimate may be made and this Board has held that claimed business expenses may not be allowed based on "mere speculation, unsupported allegations or mere inference." While respondent agrees with appellants' statement that Congress intended that the recordkeeping requirements not be overly burdensome, respondent asserts that some recordkeeping is necessary and that employee interviews to reconstruct activities believed to qualify is an "unreliable, inaccurate, incomplete and wholly insufficient" method. Respondent notes that the court in *Eustace* declined to apply the *Cohan* rule because the taxpayers in that case failed to present sufficient evidence to establish their activities met the IRC section 41 requirements for the qualified research. (Resp. Reply Br., p.5.)

Respondent distinguishes the facts in *Fudim* from those present here by arguing that the taxpayer in *Fudim* had documentary evidence proving “qualified research”, which included “contemporaneous letters, U.S. patents, and peer-reviewed scientific articles acknowledging and describing the petitioner’s newly developed process for which the petitioner was awarded two patents.” Based on that evidence, respondent asserts that the court then developed a method to estimate the time spent by Mr. Fudim and Mrs. Fudim as a percentage of their wages for qualified research but the court disallowed claimed expenses for the Fudim’s daughter due to insufficient evidence. In addition, respondent quotes *McFerrin*, in which the court held that “when a taxpayer fails to maintain adequate records, the court may estimate the allowable credit only when it is clear that qualifying expenses were actually incurred in the relevant tax year.” (Resp. Reply Br., pp. 5-6.)

In contradiction to appellants’ characterization of legal recordkeeping requirements, respondent contends that IRC section 6001, Treasury Regulation section 1.6001-1(a) and case law requires taxpayers to keep records and Treasury Regulation section 1.41-4(d) has a clear recordkeeping mandate titled “recordkeeping requirement for the research credit”. Respondent concludes that the language of Treasury Regulation 1.6001-1 makes clear that taxpayers are required to establish entitlement to the R&D credit with substantiating evidence, and may not “simply identify the costs associated with that credit.” Respondent contends that appellants have failed to present evidence to support and substantiate the R&D credit claimed. (Resp. Reply Br., pp. 7-8.)

<u>Applicable Law</u>

Treasury Regulation 1.41-4(d), expressly effective for 2003 and 2004 and stated by the IRS to govern the tax years in issue as well,[7] sets forth the following substantiation requirement for IRC section 41 credit claims:

> (d) Recordkeeping for the research credit. A taxpayer claiming a credit under section 41 must retain records in sufficiently usable form and detail to substantiate that the expenditures claimed are eligible for the credit. For the rules governing record retention, see Sec. 1.6001-1. To facilitate compliance and administration, the IRS and taxpayers may agree to guidelines for the keeping of specific records for purposes of substantiating research credits.

---

[7] 66 Federal Register 66,367 (2001 proposed regulation); T.D. 9104, 69 Federal Register 22, 26 (in final regulation issued in 2003, IRS states: "[f]or taxable years ending before December 31, 2003, the IRS will not challenge return positions that are consistent with these final regulations.").

Treasury Regulation 1.6001-1(a) provides that:

> (a) In general. Except as provided in paragraph (b) of this section, any person subject to tax under subtitle A of the Code . . . or any person required to file a return of information with respect to income, 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.

Other than Treasury Regulation 1.41-4(d) and its cross-reference to these general recordkeeping requirements, there is no specific recordkeeping requirement under IRC section 41. In enacting the federal Tax Relief Extension Act of 1999 that renewed the IRC section 41 credit, Congress in a conference report expressly rejected the IRS proposed regulation that included a specific recordkeeping requirement.[8] Hence, the federal Treasury Department in 2001 stated that "the 2001 proposed regulations do not contain a specific recordkeeping requirement beyond the requirements set out in [IRC] section 6001 and the regulations thereunder." (Treasury Decision (T.D.) 9104, 2004-1 Cumulative Bulletin (C.B.) 406.) Thus, when the IRS issued the current regulation as a proposed regulation in 2001, it stated:

> Taxpayers must be provided reasonable flexibility in the manner in which they substantiate their research credits. Accordingly… the failure to keep records in a particular manner (so long as such records are in sufficiently usable form and detail to substantiate that the expenditures claimed are eligible for the credit) cannot serve as a basis for denying the credit.[9]

In *Cohan v. Commissioner supra*, 39 F.2d 540, 543-544, the court held that the former Board of Tax Appeals (which was the equivalent of the current United States Tax Court) could not completely disallow travel and entertainment expenses in view of the fact that the Board found the taxpayer incurred such expenses and such expenses were allowable for deduction. While the court recognized the taxpayer had not kept expense records, the court nonetheless held that "[a]bsolute

---

[8] In 1998, the IRS issued proposed regulations containing a requirement that the credit be allowed only where the taxpayer recorded the results of the claimed credit qualifying experiments. See REG-105170-97, at 63 Federal Register 66,503, Document 98-34970 (also available at 1998 Tax Notes Today (TNT) 234-84). However, when Congress renewed the IRC section 41 credit in 1999, it included conference report language that rejected the proposed experiment-specific substantiation requirement: "The conferees … are concerned about unnecessary and costly recordkeeping burdens and reaffirm that eligibility for the credit is not intended to be contingent on meeting unreasonable recordkeeping requirements." H.R. Rep. No. 106-478, page 132 (1999), Document 1999-36730 (also available at 1999 TNT 223-7).

[9] Treasury Proposed Regulation REG-112991-01, 66 Federal Register at 66,366.

certainty in such matters is usually impossible and is not necessary; the Board should make as close an approximation as it can, bearing heavily if it chooses upon the taxpayer whose inexactitude is of his own making."

Congress in 1962 amended the IRC to require substantiation of any claimed travel and entertainment expense,[10] but did not overrule the application of *Cohan* to other areas. Thus, in *Fudim v. Commissioner, supra*, the tax court held that a taxpayer could claim the R&D credit even without substantiation of specific amounts claimed if the evidence shows the taxpayer engaged in qualified research as defined in IRC section 41 and where there was some basis for estimating the amount of such research. Because the taxpayer had two income sources – consulting and the patented research described above – the tax court "estimated the time spent on R & D under the principles set forth in *Cohan v. Commissioner*"[11] and determined that 80 percent of the taxpayer's income came from research that qualified for the credit.

However, *Eustace v. Commissioner, supra*, the tax court sustained the IRS denial of amended return claims of the R&D credit where the credit was not claimed on the 1990, 1991, and 1992 federal returns for the subchapter S corporation in which the taxpayers were shareholders. On December 30, 1993, the S corporation hired a new tax manager, who determined that the S corporation should claim research credits for the 1990, 1991, and 1992 tax years. The tax manager interviewed employees and delineated the employees and activities he believed qualified for the research credit. The tax court held the taxpayers' reconstruction of qualifying expenses was "unreliable, inaccurate, incomplete, and wholly insufficient to establish what various workers did and whether such expenses qualify for the research credit." While the court also held the taxpayers had not presented sufficient evidence to establish the claimed activities met the requirements for qualified research, the court suggested the research credit might be applicable to the subcomponents of those activities. The taxpayers acknowledged that they did not have the substantiation necessary to tie salaries to activities at the subcomponent level, but argued under *Cohan* the court would be required to make a reasonable

---

[10] IRC section 274(d).

[11] *Fudim, supra*, page 12.

allocation of salaries to functionality. However, the court disagreed holding that *Cohan* did not require it to make such an allocation.

In short, the taxpayer must demonstrate some "rational basis on which an estimate can be made"[12] that goes beyond mere speculation, unsupported allegations, or mere inference.[13] Such a rational basis does not require project-specific documentation. In *Union Carbide Corporation v. Commissioner*, T.C. Memo 2009-50, the tax court found that two of the taxpayer's five claimed projects involving conversion of raw hydrocarbon feedstocks into olefins were substantiated based on estimated base period wages, forecasts of material costs, and estimated project costs where no accounting records were available, and employee testimony regarding claimed wage expenses. Specifically, the court stated that;

> the documents that petitioner produced were sufficient to substantiate its claim that the MATRIC team identified all of the scientific research projects that occurred during the base period and were sufficiently detailed to allow the MATRIC team to make reasonable determinations as to the duration and production quantities of its intended runs.

On that basis, the court held that the taxpayer complied with the substantiation standard of Treasury Regulation 1.41-4(d), which requires that the taxpayer "retain records in sufficiently usable form and detail to substantiate that the expenditures claimed are eligible for the credit."

In 2005 and 2008, the IRS issued public website[14] audit manuals for auditing IRC section 41 claims, including claims predicated on prepackaged credit studies. Since R&TC section 23609 expressly incorporates IRC section 41 except for the express modifications not relevant to this appeal, the analysis of IRC section 41 in these IRS audit manuals is relevant to interpreting the California R&D credits claimed by appellants. The 2008 IRS Audit Techniques Guide to IRC section 41 states as follows:

> It is strongly recommended that examiners resist relying *exclusively* on these prepackaged submissions. Instead, the examiner should *independently determine the documents and other information necessary*, *including testimony*, to substantiate the taxpayer's claim for the research credit….Determine whether the activities constitute

[12] *Vanicek v. Commissioner* (1985) 85 T.C. 731, 742-43.

[13] *Appeal of Albert Hakim*, 90-SBE-005 (Aug. 1, 1990).

[14] The manuals are available at www.irs.gov and copies are attached as Exhibits N and O to Respondent's Opening Brief.

> qualified research under section 41(d)…determine whether the taxpayer conducted interviews of current (and former) employees and contractors in order to formulate their determination. Advise the taxpayer that this information may need to be corroborated through supporting documentation, and additional interview procedures may be implemented for the examination. A tour of all relevant company operations, including research facilities, should also be considered and arranged. (Emphasis added).[15]

With respect to estimates, the 2005 IRS audit manual states as follows:

> Estimation methods are permitted only in cases where the sole issue is the exact amount paid or incurred in the qualified research activity. Accordingly, taxpayers must have factual support for every assumption underlying their estimates to meet their burden of proof. (Footnote omitted).[16]

STAFF COMMENTS

Staff notes the R&D study includes a schedule titled "R&D Qualifying Wage" which lists employee gross salaries for each of the tax years in issue and assigns a percentage for each year for certain employees as qualified research expenses. (Resp. Opening Br., exhibit J, pp. 44-45.) In a memorandum dated July 28, 2006, from alliantgroup to respondent, appellants list the employees who worked on each of the projects but does not identify the tasks that each of them performed. (Resp. Opening Br., exhibit Q.)

Respondent argues that the evidence relied upon by appellants does not substantiate the wages claimed are qualified research expenses because the activities did not constitute qualified research. At the hearing, respondent should be prepared to explain whether the evidence submitted by appellants is sufficient at least as a rational basis for estimating qualified research expenses assuming that one or more of the projects is found to be a qualified research activity. Respondent also argues the R&D Study fails to show any nexus between the wage amounts claimed and the activities that are claimed as qualified research. At the hearing, respondent should be prepared to explain and give examples of a sufficient nexus to justify the wages amounts as qualified research expenses.

The R&D Study does not provide any support for its methodology of determining the amount of time that each employee spent on the R&D projects. The R&D Study simply states that

---

[15] Respondent's Opening Brief, Exhibit O, pages 5 and 8.

[16] Respondent's Opening Brief, Exhibit O, page 29.

employees were interviewed and “the employees’ roles, responsibilities and R&D activities” were confirmed. From that information, each employee’s “total wages were multiplied by [the] qualified R&D percentage to come up with a total qualified wage expense” which was “confirmed during interviews.” (Resp. Opening Br., exhibit J, p.24.) At the hearing, appellants should be prepared to provide any supporting documentation, including notes of those employee interviews, and discuss the manner in which the qualified R&D percentage was determined.

(3) Whether appellant-husband’s wages were “unreasonable under the circumstances”, so as to disqualify them as expenses under IRC section 174.

Appellants’ Contentions

Finally, appellants dispute the standard applied by respondent in its disallowance determination that the amounts paid to appellant-husband and included in the credit calculation were unreasonable. Appellants contend that the plain language of IRC sections 41 and 3401(a) and Treasury Regulation section 31.3401(a)(1-3) do not prescribe a reasonableness requirement similar to the requirement of IRC section 174 for “balancing” appellant-husband’s salary. Rather, according to appellants, a plain reading of IRC section 41 in conjunction with IRC section 3401(a) and the Treasury Regulation section compels the conclusion that in-house research expenditures include all remuneration received by an individual in the performance of qualified research with no limitation based on a reasonableness standard. (App. Reply Br., pp. 18-20.)

Appellants contend that respondent has erroneously interpreted the reasonableness requirement of IRC section 174 as though it were part of IRC section 41. Appellants state that subdivision (e) of IRC section 174 limits eligible research and experimental expenditures to those which are “reasonable under the circumstances.” Appellants quote the Treasury Department’s interpretation of “reasonable under the circumstances” as, generally, the amount that “would ordinarily be paid for like activities by like enterprises under like circumstances.” Appellants further state that Congress amended IRC section 174 to add the reasonableness requirement in response to a 1989 federal district court decision holding that IRC section174 imposed no reasonableness standard. Appellants contend that a committee report for the Act that included that amendment indicates that Congress intended to impose that requirement for only IRC section 174 expenditures and not IRC section 41 expenditures. As further evidence of that intent, appellants point out that IRC section 41 was amended by the same legislation but no reasonableness requirement was added to that section. (App. Reply Brl, pp.20-22.)

Respondent's Contentions

With respect to the amounts of appellant-husband's wages claimed as "qualified research expenditures", respondent states that he has no science background and admitted at respondent's field examination that he spent very little time at the winery. Respondent surmises that appellant-husband may have spent only weekends at the winery and his time is not accounted for on these weekends. According to respondent, there is no documentation to substantiate his work to support allowance of approximately $2 million in "qualified research expenditures". In addition, respondent contends that appellant-husband's wages are not allowable as "qualified research expenditures" because they are not reasonable under the circumstances as required by IRC section 174. In making this argument, respondent cites Treasury Regulation section 1.41-2(d)(1) which provides that employee wages constitute in-house research expenses "only to the extent the wages were paid or incurred for qualified services performed by the employee." Respondent asserts that such wages must be deductible under IRC section 174, which applies to research or experimental expenditures, according to subdivision (e) of that section, "only to the extent that the amount thereof is reasonable under the circumstances." Respondent contends that appellant-husband's wages are not reasonable under the circumstances because they far exceed the salary of WLW's winemaker and appellant-husband was allegedly "working in conjunction" with the winemaker. Secondly, there is no documentary evidence to establish a nexus between appellant-husband's high level of compensation and any activity that constitutes "qualified research" and no evidence that appellant-husband's services were worth on average 17 times more than the winemaker's. (Resp. Opening Br., pp. 28-30.)

Applicable Law

Treasury Regulation 1.41-2(d)(1) provides in relevant part that:

> Wages paid to or incurred for an employee constitute in-house research expenses only to the extent the wages were paid or incurred for qualified services performed by the employee. If an employee has performed both qualified services and nonqualified services, only the amount of wages allocated to the performance of qualified services constitutes an in-house research expense. In the absence of another method of allocation that the taxpayer can demonstrate to be more appropriate, the amount of in-house research expense shall be determined by multiplying the total amount of wages paid to or incurred for the employee during the taxable year by the ratio of the total time actually

spent by the employee in the performance of qualified services for the taxpayer to the total time spent by the employee in the performance of all services for the taxpayer during the taxable year.

IRC section 3401 provides, for purposes relevant to this discussion, that "wages" means "all remuneration (other than fees paid to a public official) for services performed by an employee for his employer, including the cash value of all remuneration (including benefits) paid in any medium other than cash."

IRC section 41(d)(1)(A) defines "qualified research", in relevant part, as research "with respect to which expenditures may be treated as expenses under section 174." IRC section 174(e) provides that section 174 "shall apply to a research or experimental expenditure only to the extent that the amount thereof is reasonable under the circumstances."

STAFF COMMENTS

Because IRC section 41(d)(1)(A) incorporates IRC section 174 by reference, it appears that all provisions of IRC section 174 are applicable, including, under subdivision (e), whether an expenditure is "reasonable under the circumstances". At the hearing, appellants should be prepared to cite any authority in support of their position that the provision applies only to IRC section 174 expenditures. Both parties should be prepared to discuss whether the wage amounts claimed for appellant-husband comport with the Treasury Department's interpretation of "reasonable under the circumstances" as, generally, the amount that "would ordinarily be paid for like activities by like enterprises under like circumstances."

///

///

///

Leonardini_la