OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of: **C. R. PINO AND** **C. PINO**	) OTA Case No. 19054825)))))

OPINION

Representing the Parties:

For Appellants: Michel Millien, Senior Associate, alliantgroup

For Respondent: Carolyn Kuduk, Tax Counsel III

For Office of Tax Appeals: Linda Frenklak, Tax Counsel V

J. LAMBERT, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19324, C. R. Pino and C. Pino (appellants) appeal the actions of respondent Franchise Tax Board (FTB) denying appellants' claims for refund of $53,472 for the 2013 tax year and $69,466 for the 2014 tax year. FTB's actions were based on its determination that Fair Haven Distributing, LLC (Fair Haven) was not entitled to California research credits for the tax years at issue and therefore appellants, as the sole partners of Fair Haven, were also not entitled to the claimed research credits.

Appellants waived their right to an oral hearing; therefore, the matter is being decided based on the written record.

ISSUE[1]

Whether appellants have established that Fair Haven conducted qualified research for purposes of the California research credit.[2]

FACTUAL FINDINGS

1. Appellants are the sole members of Fair Haven, dba Sonoma Produce Marketing, a limited liability company based in California that is classified as a partnership for federal and California income tax purposes. According to a research credit study (the Study) discussed below, Fair Haven is "a fresh produce and brokerage company" that "works directly with growers on the West Coast to supply the best possible end-product to consumers on the East Coast." Additionally, in this appeal, Fair Haven describes its "regular business" as the "buying and transporting of produce from [California] and [Arizona] to east coast wholesale and retail customers." Fair Haven did not grow any of the produce at issue.
2. Fair Haven filed amended Limited Liability Company Returns of Income (Forms 568) for 2013 and 2014, which included research credit forms (Forms 3523) and amended Schedules K-1 (568) issued to appellants that included their distributive shares of the credits. On its amended returns, Fair Haven claimed California research credits of $53,472 for 2013 and $69,466 for 2014. The California research credits were based on claimed qualified research expenses consisting solely of wages paid for claimed qualified services.
3. For 2013, Fair Haven claimed $712,958 as qualified research expenses, which is 100 percent of appellant-husband's wages of $701,886 and 15 percent of appellant-wife's wages of $73,815. For 2014, Fair Haven claimed $926,214 as qualified research

[1] As discussed below, we conclude that appellants have not established that the activities of Fair Haven constituted "qualified research." Therefore, we do not need to determine the issues of whether appellants established that Fair Haven's claimed "qualified research expenses" and "base amount" for the 2013 and 2014 tax years were properly computed.

[2] "Qualified research" is defined under IRC (Internal Revenue Code) section 41 and the regulations thereunder. California conforms to IRC section 41 pursuant to R&TC sections 17052.12 and 23609, subject to some modifications.

expenses, which is 100 percent of appellant-husband's wages of $911,859 and 15 percent of appellant-wife's wages of $95,699.[3]

4. Appellants filed a joint amended individual income tax return (Form 540X) for 2013, claiming a pass-through California research credit of $53,472 and a refund of $47,429. Appellants also filed a joint Form 540X for 2014, claiming a pass-through California research credit of $69,466 and a refund of $60,753.

5. FTB audited Fair Haven's and appellants' 2013 and 2014 amended returns and examined the claimed research credits. In response to requests for information from FTB, Fair Haven stated that its activities included "consulting and advising farmers to improve grow and harvest processes, as well as collaborating with packaging and transport distributors, to ensure high-quality products upon delivery."

6. Fair Haven explained that it did not receive compensation from farmers with respect to its alleged research activities. Fair Haven stated that appellant-husband acted "as an agent for customers with NO formal contract …."[4] (Emphasis in original). Fair Haven stated that it " 'owned' nothing – once products were a 'go', [Fair Haven] risked the grower selling these items … to other customers." Fair Haven also stated it was "NOT granted any proprietary or patented business from any of this." (Emphasis in original.)

7. Fair Haven provided the Study prepared by alliantgroup.[5] The Study asserts that four research projects conducted partly or wholly during 2013 and 2014 involved Fair Haven working with the following companies that grew the produce at issue: (1) Family Tree Farms; (2) Colorful Harvest; (3) Access Organics; and (4) Maywood Farms. The Study states that "alliantgroup reviewed contemporaneous documents and conducted interviews

[3] According to the Study, Fair Haven claimed 100 percent of appellant-husband's salary as wages for qualified research because, as the Study asserts, he spent 80 percent of his time performing qualified research activities, meeting the "substantially all" threshold pursuant to IRC section 41(b)(2)(B). (See Treas. Reg. § 1.41-2(d)(2).) With regard to appellant-wife, appellants assert that she was an office manager, whose qualified research activities included documenting orders and obtaining customer product requirements, and therefore only 15 percent of her time was spent on such activities.

[4] Appellants assert that written contracts were not executed because Fair Haven's "industry is a 'hand-shake' [*sic*] type of industry, where relationships are forged through honoring agreements and collaborating in order to reach an agreement."

[5] alliantgroup is also representing appellants in this appeal.

regarding … the projects with [appellant-husband]."[6] The Study indicates that the contemporaneous documentation reviewed included purchase orders, invoices, email correspondence, and photographs.[7]

8. For the years and projects at issue, appellants provided one piece of email correspondence from December 2014 between appellants and Colorful Harvest, which includes a confirmation of orders for 738 cases of cauliflower for Blue Apron.

9. The only other contemporaneous documentation in the record for the years and projects at issue, besides the above-mentioned email,[8] are the following invoices:

   (1) An invoice with ship date of January 29, 2013, from Fair Haven for "Qty Shipped" of 228 of "Cauliflower, Green 12Ct" and 114 of "Cauliflower, Purple 12Ct" from Colorful Harvest to a customer in New York;

   (2) An invoice with ship date of June 25, 2014, from Fair Haven for "Qty Shipped" of 1,176 of "Org. Melon, Cantaloupes 9CT" from Access Organics to a customer in New Jersey; and

   (3) An invoice with ship date of June 24, 2014, from Fair Haven for "Qty Shipped" of 280 of "Org. Cantaloupes 9CT" from Access Organics to a customer in New York.[9]

10. The Study includes a qualified research analysis of four research projects, as described below.

   a. Family Tree Farms. The Study states that Fair Haven undertook this project in 2010 and 2013 to improve the quality and growth performance of blueberries and

[6] Other than the Study and the information provided therein, the record does not include additional evidence or documentation of the interviews, such as interview notes or transcripts.

[7] The Study indicates that purchase orders were reviewed. Evidence in the record of orders include invoices and a 2014 email, which are further discussed below. There is one other invoice provided that is similar to the other invoices, but which will not be discussed further, as it is for a year not at issue in this appeal.

[8] One other email correspondence from 2016 is provided, as well as a questionnaire, both of which relate to a project, customer, and year not at issue in this appeal. In the email, a customer states it will need a "couple of plant trials to refine some of the [requested] data points" and asks appellant-husband questions about cost, delivery, taste profile, etc. Appellant-husband responds that Fair Haven is "in the process of doing some very unscientific tests at farm level." As noted above, the record also includes a questionnaire created by the same customer from the 2016 email, and which is signed by appellant-husband and dated April 5, 2016. The questionnaire requests that Fair Haven answer questions regarding the "nature of the ingredient supplied." Fair Haven states: "No Added Ingredients."

[9] The invoices also indicate shipments of produce other than those related to the projects at issue.

other fruit. The Study asserts that Fair Haven was uncertain of the appropriate growth method, given environmental and soil conditions. The Study states that, after evaluating types of blueberries and existing farm conditions, appellant-husband selected the most appropriate variety to plant. According to the Study, appellant-husband also planted different varieties in "test pots to determine the most appropriate time to pick the blueberries." In addition, the Study states that he "evaluated soil conditions" and "took into consideration the water table." The Study states that he also developed a sorting method that allowed only larger blueberries to be harvested. The Study asserts that appellant-husband utilized principles of: (1) "hard sciences" to determine the appropriate growth method; and (2) "biology" to investigate fruit properties in relation to existing soil and environmental conditions. The Study includes a photograph of the Family Tree Farms logo and a photograph of a cluster of blueberries.

b. Colorful Harvest. The Study states that Fair Haven undertook this project in 2013 and 2014 to develop a growth method for cauliflowers and potatoes, given a customer's need for specific sizes and types to conform to Blue Apron recipes. The Study states that Blue Apron provides customers with meal ingredients proportioned to the amount required for recipes in home delivery meal kits. According to the Study, appellant-husband was uncertain of the appropriate growth method, given environmental and soil conditions and customer specifications. The Study asserts that he evaluated the growth process of cauliflower to help grow the correct size for the customer recipes. The Study asserts that appellant-husband helped grow smaller cauliflower, which removed an extra step in the process that involved cutting the cauliflower in half to fit inside the packaging. In addition, the Study asserts that appellant-husband worked to provide the types and sizes of potatoes required for various Blue Apron recipes and developed the appropriate growth process and packaging.[10] The Study states that he also evaluated alternative packaging types to meet customer

[10] The Study often provides information related to growing the type of produce involved in each project. For instance, with regard to Colorful Harvest, the Study notes that "[p]otatoes require well-drained, loose soil conditions, and constant moisture." The Study then states that appellant-husband "evaluated these existing soil conditions and worked with the growers to develop the best method."

needs. The Study asserts that appellant-husband utilized principles of: (1) "hard sciences" to determine the appropriate growth method; and (2) "biology" to investigate vegetable properties in relation to existing soil and environmental conditions. The Study includes a photograph of purple cauliflower and a photograph of eight potatoes divided into two groups, labeled by the Study as "Potato Sizes for Blue Apron Receipts."

c. Access Organics. The Study states that, in 2014 and 2015, Fair Haven undertook this project to develop a growth method to improve the quality of cantaloupes. The Study asserts that appellant-husband was uncertain of the appropriate growth method, given environmental and soil conditions. The Study asserts that appellant-husband evaluated "two alternative methods of growth"[11] to determine the "most appropriate method to improve the product." According to the Study, appellant-husband determined the "most appropriate combination of growth time" for the best quality and highest sugar levels. The Study asserts that he also evaluated alternative transportation methods, such as whether to pack the truck with one or more types of fruit and what type of packaging to use, such as boxes or crates. The Study asserts that appellant-husband utilized principles of:
(1) "hard sciences" to determine the appropriate growth method; and
(2) "biology" to investigate cantaloupe properties in relation to existing soil and environmental conditions. The Study does not include any photographs with its discussion of this project.

d. Maywood Farms. The Study asserts that this project was conducted in 2013 to develop a growth method to provide an improved fig product with a longer shelf life. The Study asserts that appellant-husband was uncertain of the appropriate growth method, given environmental and soil conditions. The Study states that he evaluated growth conditions and determined the figs should be picked earlier to develop a longer shelf life. The Study notes that figs grow best in "well-drained soil" that has a "pH level between 6 and 6.5." According to the Study, appellant-

[11] The Study states the two growth methods for cantaloupes are "planting in soil amended with four to six inches of compost or by utilizing a nine inch [*sic*] layer of manure covered with three inches of compost to create a bed thick of nitrogen soils that is naturally warm."

husband "evaluated alternative methods" and undertook a "systematic trial and error process" to determine the appropriate sugar level and timing of harvest. The Study asserts that appellant-husband "evaluated the soil and site conditions," chose to pick the figs riper to extend shelf life, and determined that picking the figs later corrected sugar levels previously reduced by additional water. The Study states that he also evaluated alternative packaging methods, such as a clamshell or box. The Study asserts that appellant-husband utilized principles of: (1) "hard sciences" to determine the appropriate growth method; and (2) "biology" to investigate fig properties in relation to existing soil and environmental conditions. The Study includes a photograph of figs, a photograph of a tractor in a field hitched to a wagon filled with empty crates, and a photograph of figs inside a crate.

12. FTB disallowed the research credits claimed by Fair Haven for 2013 and 2014. As a result, FTB denied appellants' claims for refund based on Fair Haven's disallowed research credits. This timely appeal followed.

DISCUSSION

I. Burden of Proof

Tax credits are a matter of legislative grace, and taxpayers bear the burden of proving they are entitled to claimed tax credits. (*INDOPCO, Inc. v. Commissioner* (1992) 503 U.S. 79, 84.) Statutes granting tax credits are to be construed strictly against the taxpayer with any doubts resolved in FTB's favor. (*Dicon Fiberoptics, Inc. v. Franchise Tax Bd*. (2012) 53 Cal.4th 1227, 1235.)

II. Qualified Research

A. Applicable Law

To be eligible for a research credit under IRC section 41(a)(1), as modified by R&TC sections 17052.12 and 23609, appellants must prove that Fair Haven performed qualified research, or paid someone else to perform qualified research, during the tax years at issue.[12] The

[12] For purpose of the California research credit, qualified research only includes research conducted in California, pursuant to R&TC sections 17052.12(b)(3)(d) and 23609(c)(2).

research credit is generally determined based on the amount by which the taxpayer's qualified research expenses exceed a base amount.[13] (IRC, § 41(a).)

Qualified research is research that satisfies four tests:

1. *The IRC 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 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).)

The four tests summarized above are applied separately to each business component. (IRC, § 41(d)(2)(A).) If a business component as a whole fails the qualified research tests, the "shrinking-back rule" allows for application of the qualified research tests to a subset of the business component if doing so will allow the subset to satisfy those tests. (Treas. Reg. § 1.41-4(b)(2).) For these purposes, a "business component" is defined as a product, process, computer software, technique, formula, or invention that is to be held for sale, lease, or license or used by the taxpayer in a trade or business of the taxpayer.[14] (IRC, § 41(d)(2)(B).)

1. The IRC Section 174 Test

This test requires that expenditures connected with the research activities qualify under IRC section 174. IRC section 174 provides alternative methods of accounting for "research or

[13] IRC section 41(b)(1) defines the term "qualified research expenses" as the sum of in-house research expenses and contract research expenses that are paid or incurred by the taxpayer during the tax year in carrying on any trade or business of the taxpayer. IRC section 41(b)(2)(A) defines the term "in-house research expenses" to mean, in relevant part, any wages paid or incurred to an employee for qualified services performed by such employee.

[14] Certain types of research are specifically excluded from the definition of qualified research, including research conducted after the beginning of the commercial production of a business component, research related to the adaption of an existing business component to a particular customer's requirement or need, efficiency surveys, market research, routine data collection, and routine or ordinary testing or inspection for quality control. (IRC, § 41(d)(4).)

experimental expenditures" that taxpayers would otherwise capitalize. (Treas. Reg. § 1.174-1.) The Treasury Regulations define "research or experimental expenditures" as "expenditures incurred in connection with the taxpayer's trade or business which represent research and development costs in the experimental or laboratory sense." (Treas. Reg. § 1.174-2(a)(1).) An activity generally constitutes "research and development" in the "experimental or laboratory sense" if: (1) the information available to the taxpayer does not establish the capability or method for developing or improving a product or process or the appropriate design of a product or process (i.e., an uncertainty exists); and (2) the activity is intended to discover information that would eliminate that uncertainty. (Treas. Reg. § 1.174-2(a)(1) & (2).)

2. The Technological in Nature Test

The technological in nature test requires that the research is undertaken for the purpose of discovering information that is "technological in nature." (IRC, § 41(d)(1)(B).) Information is technological in nature if "the process of experimentation used to discover such information fundamentally relies on principles of the physical or biological sciences, engineering, or computer science." (Treas. Reg. § 1.41-4(a)(4).)

In holding the taxpayer did not meet the technological in nature test with regard to a project, the tax court in *Siemer Milling Company v. Commissioner*, T.C. Memo. 2019-37 at p. *13 (*Siemer*), stated the following:

> Siemer failed to establish that the Littleford Day project met the technological information test. Siemer again makes a conclusory statement that it meets the technological information test because it "relied on principles of engineering and the physical and biological sciences." It says an example is that it "analyzed the effects of adjustments to heat, blending speed and hold time in the machine on the flavor, moisture and color of the resulting flour products." Siemer alleges it relied on principles of biochemistry, food science, and engineering, but without more in the record to establish how Siemer relied on principles in these fields, the Littleford Day project fails the technological information test.

3. The Business Component Test

The business component test requires that the research is intended for the purpose of discovering information that is useful in the development of a new or improved business component of the taxpayer. (IRC, § 41(d)(1)(B)(ii).) A "business component" is defined as "any product, process, computer software, 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."[15] (IRC, § 41(d)(2)(B).)

If the requirements of IRC section 41(d) are not met at the level of the discrete business component, the requirements are then applied "at the most significant subset of elements of the product, process, computer software, technique, formula, or invention to be held for sale, lease, or license" (shrinking-back rule). (Treas. Reg. § 1.41-4(b)(2).) The shrinking-back continues "until either a subset of elements of the product that satisfies the requirements is reached, or the most basic element of the product is reached and such element fails to satisfy the test."[16] (Treas. Reg. § 1.41-4(b)(2).)

4. The Process of Experimentation Test

A process of experimentation is "a process designed to 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." (Treas. Reg. § 1.41-4(a)(5)(i).) A process of experimentation "involves [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)." (*Ibid.*) "Uncertainty concerning the development or improvement of the business component (e.g., its appropriate design) does not establish that all activities undertaken to achieve that new or improved business component constitute a process of experimentation." (*Ibid.*)

The process of experimentation test has three elements: (A) substantially all of the research activities for each business component must constitute; (B) elements of a process of experimentation; (C) for a qualified purpose. (IRC, § 41(d)(2) & (d)(1)(C).)

[15] Any plant process, machinery, or technique for commercial production of a business component shall be treated as a separate business component (and not as part of the business component being produced). (IRC, § 41(d)(2)(C).)

[16] Two projects extend to years not at issue (i.e., Family Tree Farms: 2010, 2013; Access Organics: 2014, 2015). However, we note that "the development or improvement of a business component can span more than one tax year." (*Siemer, supra*, at p. *10.)

A. Substantially All

The "substantially all" element means that 80 percent or more of the taxpayer's research activities for each business component, measured on a cost or other consistently applied reasonable basis, must constitute a process of experimentation for a qualified purpose. (Treas. Reg. § 1.41-4(a)(6).) If a business component fails the process of experimentation test because of the "substantially all" requirement, the shrinking-back rule may be applied, discussed above, until an element that satisfies the test is reached. (*Suder v. Commissioner*, T.C. Memo. 2014-201 at p. *17.)

B. Process of Experimentation

This test requires a "structured method of discovering information." (*Union Carbide Corp. and Subsidiaries v. Commissioner*, T.C. Memo. 2009-50 at p. *80 (*Union Carbide*), affd. (2d Cir. 2012) 697 F.3d. 104.) The process of experimentation "requires the use of the scientific method." (*Union Carbide, supra*, at p. *81; *Appeals of Swat-Fame, Inc., et al*., 2020-OTA-046P at p. *12 (*Swat-Fame*).) Whereas a simple trial and error method is not sufficient, a "systematic trial and error methodology can be a process of experimentation" (Treas. Reg. § 1.41-4(a)(5)(i)), which suggests a methodical plan involving an iterative testing process in which a hypothesis is tested, data analyzed, and the hypothesis refined and re-tested "so that it constitutes experimentation in the scientific sense." (*Union Carbide, supra*, at p. *81.)

In holding the taxpayer did not meet the process of experimentation test with regard to a project, the tax court in *Siemer*, *supra*, at p. *13, stated the following:

> Siemer failed to establish that the Littleford Day project met the process of experimentation test. Siemer put forth as evidence the steps in its process, but narrating the steps of its process does not establish that it engaged in testing of a hypothesis "so that it constitutes experimentation in the scientific sense." Without more in the record to establish that Siemer had a methodical plan that constituted a process of experimentation, the Littleford Day project fails the process of experimentation test.

C. Qualified Purpose

A purpose is qualified "if it relates to a new or improved function, performance, reliability or quality of the business component." (Treas. Reg. § 1.41-4(a)(5)(ii).) However,

research is not qualified if it is conducted for a purpose that "relates to style, taste, cosmetic, or seasonal design factors." (IRC, § 41(d)(3)(B).)

III. Recordkeeping

Taxpayers shall keep records sufficient to establish a claimed credit. (Treas. Reg. § 1.6001-1(a); see *Suder*, *supra*, at p. *21.) "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."[17] (Treas. Reg. § 1.41-4(d).) "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*, *supra*, at p. *21; *Shami v. Commissioner* (5th Cir. 2014) 741 F.3d 560, 567, aff'g in part, vacating in part, and remanding T.C. Memo. 2012-78; see also T.D. 9104, 69 FR 22-01 [the "regulations do not contain a specific recordkeeping requirement beyond the requirements set out in [IRC] section 6001 and the regulations thereunder]".)[18]

IV. Analysis

A. Discussion of Evidence

The Study states that the qualified research analysis of each project was based on interviews conducted with appellant-husband for purposes of the Study, together with a review of contemporaneous evidence, such as invoices, email correspondence, and photographs. For instance, the Study includes a photograph of two types of potatoes that is captioned by the Study as "Potato Sizes for Blue Apron Receipts." However, like the other photographs in the Study, such as those of figs and blueberries, this photograph does not display or provide any information showing that Fair Haven engaged in qualified research.

The invoices from Fair Haven indicate that produce was shipped from farms and sold to customers on the east coast. A 2014 email between appellants and Colorful Harvest provides

[17] Treasury Regulation section 1.41-4(d) states: "For the rules governing record retention, see [Treas. Reg.] § 1.6001-1. To facilitate compliance and administration, the [Internal Revenue Service (IRS)] and taxpayers may agree to guidelines for the keeping of specific records for purposes of substantiating research credits."

[18] The IRS and the United States Department of Treasury "concluded that the high degree of variability in the objectives and conduct of research activities" means "taxpayers must be provided reasonable flexibility in the manner in which they substantiate their research credits." (Notice of Proposed Rulemaking, 66 Fed. Reg. 66362 (Dec. 26, 2001).)

confirmation of an order for cauliflower to be purchased by Blue Apron.[19] The invoices and email demonstrate Fair Haven's activities involving, as appellants describe, the "buying and transporting of produce from [California] … to east coast wholesale and retail customers."[20] The documents do not, however, provide any information from which we can conclude that Fair Haven conducted qualified research, such as information evidencing a process of experimentation with regard to developing an improved growth process.

The record also includes a non-contemporaneous document titled "Calendar Events" that summarizes appellant-husband's travel from 2012 to 2015, including a short description of each trip. For example, the calendar indicates that appellant-husband was "[r]esearching possible transportation alternittves [*sic*] to get new items to market" in 2013, and that he travelled a few times to New York City for "[c]ustomer presentations of new items" and to determine "package requirements." However, the calendar does not specify any alleged correlating projects or items and, in addition, the supporting evidence, including the profit and loss statements for 2013 and 2014 indicating travel expenses for "lodging" and "transportation," are insufficient to verify the activities indicated on the calendar. While the calendar states that appellant-husband visited Colorful Harvest in 2013, and then again in 2014 for "field trials," a general reference to "field trials" does not suffice to show that the requirements for qualified research have been satisfied. Nothing in the record explains the nature or extent of these "field trials" or shows that such trials constituted processes of experimentation comprising substantially all of the research activities for any business components.

B. Section 174 test

The record, including the invoices and email, is insufficient to corroborate the alleged "environmental conditions," "growth methods," or "customer specifications," which the Study asserts resulted in uncertainties allegedly intended to be addressed by the research activities. In addition, appellants do not provide evidence establishing their asserted participation in claimed

[19] We note that, while the 2016 email mentions "plant trials" and "tests," the use of the phrase "very unscientific tests" in the email suggests that the tests may not "constitute experimentation in the scientific sense." (See *Union Carbide*, *supra*, at p. *81.) We do not address this email further because it is for a year and project not at issue.

[20] While the two invoices evidence Fair Haven's involvement in the "buying and transporting" of such cantaloupes and cauliflower "from [California] … to east coast wholesale and retail customers," no further evidence is provided as to the two other projects at issue, Maywood Farms or Family Tree Farms, including evidence substantiating the "buying and transporting" of figs and blueberries, for the tax years at issue.

activities concerning the development or improvement of products or processes, which are activities distinct from the "buying and transporting of produce," as indicated by the submitted invoices and email. Accordingly, appellants have not established the claimed expenditures were for activities intended to discover information that would eliminate uncertainty concerning the development or improvement of a product or process. (Treas. Reg. § 1.174-2(a)(1) & (a)(3).) Therefore, appellants have not established that the claimed expenditures would be eligible for treatment as expenses under IRC section 174.

C. Technological in Nature Test

The Study states the technological in nature test is satisfied for each project because appellant-husband "utilized the principles of hard science" and "biology." Similar to the situation in *Siemer*, *supra*, however, the Study only makes "a conclusory statement that [appellant-husband] … relied on principles of … biological sciences." (*Siemer*, at p. *13.) The Study simply recounts the statutory requirements without explaining how Fair Haven's activities satisfy such requirements. While the Study provides generic growing information with respect to, for example, soil pH or nitrogen levels, the record does not establish how such information was relied upon or utilized in the described activities, such as those relating to the timing of the harvest, irrigation, and sugar levels. In some cases, the Study provides growing information, but then merely states that appellant-husband determined the "most appropriate method to improve the product." As stated in *Siemer*, "the record does not establish what principles … [appellant-husband] relied on or how [he] relied on any particular principle …." (*Id.* at p. *12.) Therefore, appellants have not shown that the technological in nature test has been satisfied.

D. Business Component Test

The record does not establish that the claimed processes were either held for sale, lease, or license, or used by Fair Haven in its trade or business. (See IRC, § 41(d)(2)(B).) While the claimed processes, such as the growth processes, would be used by the farmers in the farmers' trade or business, appellants have not provided evidence sufficient to establish that those

processes were used by Fair Haven in its trade or business.[21] In addition, the evidence does not indicate that Fair Haven held any claimed process for sale, lease, or license. However, as discussed above, the invoices indicate that cantaloupe and cauliflower products were held for sale by Fair Haven,[22] which shows that such products were business components of Fair Haven. (See IRC, § 41(d)(2)(B)(i).) There is no evidence, however, proving that any products from Maywood Farms or Family Tree Farms, such as figs or blueberries, were either held for sale, lease, or license, or used by Fair Haven in its trade or business, for the years at issue; therefore, appellants have not established that products from those projects were business components of Fair Haven.

E. Process of Experimentation Test

With regard to the process of experimentation test, the Study states that appellant-husband "evaluated alternative methods" and "undertook a systematic trial and error process," which is similar to what occurred in *Siemer*, *supra*, where the court noted the taxpayer stated that it "ran tests" but did "not explain how those tests were part of a scientific process where a hypothesis was formed, tested, and retested." (*Siemer*, at p. *14.) Also similar to *Siemer*, where the court stated the taxpayer "put forth as evidence the steps in its process," the Study states, for example, that appellant-husband "evaluated these two alternative methods of growth [for cantaloupes] and determined the most appropriate method to improve the product." (*Id.* at p. *13.) These overbroad and conclusory statements do not establish that Fair Haven engaged in a process of experimentation. In other words, merely stating the existence of an evaluative process does not show that Fair Haven actually engaged in that process, or that, if the process occurred, it was a qualified process of experimentation under the law. As described above, there is insufficient evidence in the record to establish a "methodical plan involving an iterative testing process in which a hypothesis is tested, data analyzed, and the hypothesis refined and re-tested 'so that it constitutes experimentation in the scientific sense.'" (See *Siemer*, *supra*, at p. *8;

[21] In appellants' briefing, they contend that Fair Haven satisfies the business component test with regard to "work done … by Fair Haven to create an improved growing *technique* or packaging *process*." (Emphasis in original.) We note that some of the activities described in the Study also appear to be related to improving a product, such as developing an "improved fig product" (Maywood Farms) and a "custom bag" (Colorful Harvest).

[22] FTB asserts that Fair Haven "resold" the produce, and that the invoices show "Fair Haven as the seller" of the cantaloupes and cauliflower.

Swat-Fame, *supra*, at p. *12.) Accordingly, appellants have not shown that substantially all of Fair Haven's alleged research activities for any business component constituted a process of experimentation.[23] (Treas. Reg. § 1.41-4(a)(6).)

F. Conclusion

While the Study states that the basis of the qualified research analysis for each project included a review of contemporaneous evidence, the contemporaneous evidence in the record, including the invoices, 2014 email correspondence, as well as the other evidence in the record, including the non-contemporaneous "Calendar Events," do not corroborate the assertions in the Study that Fair Haven engaged in qualified research.[24] Therefore, we find that appellants have not provided sufficient evidence to establish that Fair Haven engaged in qualified research.

[23] The process of experimentation test requires that substantially all of the research activities for each business component must constitute elements of a process of experimentation for a qualified purpose. (IRC, § 41(d)(2) & (d)(1)(C).) The Study states that, for most of the produce evaluated, the "core qualities" sought to be improved include "[t]aste and flavor profile." Similar to the conclusion provided in a non-precedential IRS memo, we interpret "taste" under IRC section 41(d)(3)(B) in this case to mean "individual and consumer preference," rather than "flavor and sensory taste" of a food product. (See Technical Advice Memorandum 9522001, June 2, 1995.)

[24] Appellants have not provided sufficient evidence to apply the "shrinking-back" rule, such that the IRC section 41 tests are satisfied, pursuant to Treasury Regulation section 1.41-4(b)(2).

HOLDING

Appellants have not established that Fair Haven conducted qualified research for purposes of the California research credit.

DISPOSITION

FTB's actions denying appellants' claims for refund for 2013 and 2014 are sustained.

DocuSigned by:
Josh Lambert
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Josh Lambert
Administrative Law Judge

We concur:

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

DocuSigned by:
715CE19AD48041B...
Andrew J. Kwee
Administrative Law Judge

Date Issued: 10/28/2020