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This Week in State Tax (TWIST)

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California: OTA finds that contemporaneous documentation is requirement for R&D credit

The California Office of Tax Appeals (OTA) ruled that a taxpayer was ineligible for California research and development (R&D) tax credits because it could not provide contemporaneous documentation regarding its research activities. The taxpayer was a consulting firm that specialized in testing hazardous materials (such as mold, asbestos, and lead). In 2022, the taxpayer engaged a third-party advisor to investigate its eligibility for R&D credits; the advisor determined that five of the taxpayer's activities in the 2019 and 2020 tax years qualified for credits. The study concluded that the taxpayer's activities satisfied the qualified research test and stated that "contemporaneous documentation and corroborating evidence exists to substantiate" the taxpayer's qualifying R&D activities, which the taxpayer's CEO could provide in the event of an audit. The taxpayer subsequently filed amended returns for 2019 and 2020 claiming credits for both years. After the Franchise Tax Board (FTB) requested documentation substantiating the eligibility of the activities, the taxpayer provided the 2022 study prepared by the third-party advisor; the FTB denied the credits due to insufficient documentation, and the taxpayer appealed to the OTA.

California conforms to federal rules concerning research credits, which require that "[a] taxpayer claiming a credit … must retain records in sufficiently usable form and detail to substantiate that the expenditures claimed are eligible for the credit." The taxpayer argued that, although it did not submit contemporaneous documentation, federal case law did not require it to do so, providing that "[a] taxpayer is not required to keep records in a particular manner so long as the records maintained substantiate [its] entitlement to the credit." The OTA disagreed with the taxpayer's reliance on the case law because eligibility for the credits was not an issue there; rather, the dispute concerned the *amount* of the credit. In the OTA's view, the taxpayer in this case had not "retain[ed] records … to substantiate that the expenditures claimed are *eligible* for the credit" as required under the federal rule. Finally, although the taxpayer argued that the IRS had accepted its R&D credits by issuing federal refunds for 2019 and 2020, the OTA found no evidence that the IRS had audited or accepted the credits and noted that the FTB was not bound by IRS determinations it considered erroneous.

Contact with Candance Axline or Geoffrey Way with questions about *In the Matter of Advanced American Laboratories*.