

IN THE MATTER OF THE APPEAL OF:)
)
SOUTHERN MINNESOTA BEET SUGAR) CASE NO. 19034447
COOPERATIVE,)
)
) APPELLANT.)
)

TRANSCRIPT OF PROCEEDINGS
Sacramento, California
Tuesday, January 24, 2023

Job No. :
40044 OTA(B)REV

BEFORE THE OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

IN THE MATTER OF THE APPEAL OF:)
)
SOUTHERN MINNESOTA BEET SUGAR) CASE NO. 19034447
COOPERATIVE,)
)
) APPELLANT.)
)
_____)

TRANSCRIPT OF PROCEEDINGS, taken at
400 R Street, Sacramento, California,
commencing at 1:03 p.m. and concluding
at 2:16 p.m. on Tuesday, January 24, 2023,
reported by Maria Esquivel-Parkinson,
CSR No. 10621, RPR, a Certified Shorthand
Reporter in and for the State of California.

1 APPEARANCES:

2
3 PANEL MEMBERS:

4
5 Kenny Gast

6 Cheryl Akin

7 Eddy Lam

8
9 FOR THE APPELLANT:

10
11 Derick Brannan, Representative

12 Erin Eakes, Representative

13 Ian O'Connell, Representative

14
15 FOR THE FRANCHISE TAX BOARD:

16
17 Anthony Epolite, Tax Counsel

18 Irina Iskander Krasavtseva, Tax Counsel

I N D E X

E X H I B I T S

(Appellant's Exhibit 1 through 5 were admitted on page 6)

(FTB's Exhibits A through D were admitted on page 7)

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1 Sacramento, California; Tuesday, January 24, 2023

2 1:03 p.m.

3
4
5 ALJ GAST: This is Appeal of Southern Minnesota
6 Beet Sugar Cooperative, OTA Case No. 19034447. Today's
7 Tuesday, January 24th, 2023, and the time is approximately
8 1:03 p.m. My name is Kenny Gast. I'm the lead
9 administrative law judge. And with me today are Judges
10 Cheryl Akin and Eddy Lam.

11 At this point I'm going to ask the parties to
12 please identify yourself by stating your first and last
13 name for the record, beginning with Appellant.

14 MR. BRANNAN: My name is Derick Brannan. I'm with
15 PricewaterhouseCoopers.

16 MS. EAKES: Erin Eakes, PricewaterhouseCoopers.

17 ALJ GAST: May I ask you please speak in the
18 microphone. Thank you.

19 MR. O'CONNELL: Ian O'Connell with Southern
20 Minnesota Beet Sugar Cooperative.

21 ALJ GAST: And for the Franchise Tax Board?

22 MR. BRANNAN: Anthony Epolite with the Franchise
23 Tax Board.

24 MS. ISKANDER: Irina Iskander, Franchise Tax
25 Board.

1 ALJ GAST: Thank you.

2 Okay. I'm going to restate the issues, the three
3 issues that we have for this appeal. Sorry, they're a
4 little bit lengthy.

5 The first issue is whether Appellant properly
6 included in the combined reporting groups California
7 apportionment percentage, its property payroll and sales
8 related to business activities that permitted it to deduct
9 certain farmer's cooperative income under Revenue and
10 Taxation Code Section 24404.

11 The second issue is whether Appellant may deduct
12 interest expense incurred to acquire Spreckels Sugars
13 Company, a unitary entity, against its taxable nonmember
14 income.

15 And the third issue is whether Appellant may
16 deduct appreciation expense incurred from assets used to
17 produce deductible income under Revenue and Taxation Code
18 Section 24404 against its taxable nonmember income.

19 Now, to go over the exhibits, with respect to the
20 evidentiary record, Appellant has provided Exhibits 1
21 through 5. And FTB did not object to the admissibility of
22 these exhibits; therefore, these exhibits are entered into
23 the record.

24 (Appellant's Exhibit Nos. 1 through 5 were
25 admitted into evidence.)

1 ALJ GAST: And FTB provided Exhibits A through D.
2 Appellant has not objected to the admissibility of these
3 exhibits; therefore, these exhibits are entered into the
4 record.

5 (FTB's Exhibits A through D were admitted into
6 evidence.)

7 ALJ GAST: All right. With that we can now go to
8 the parties' presentations, and I'll start with Appellant.
9 You will have 30 minutes. If you need a little bit more
10 time, you can use that; or if you'd feel free not to use
11 the full 30 minutes, it's up to you. I have not, I'm just
12 throwing it out there.

13 MR. BRANNAN: Fair enough.

14 ALJ GAST: Thank you.

15 MR. BRANNAN: Good afternoon, everybody, Judge
16 Gast --

17 (Court reporter interrupts)

18 MR. BRANNAN: I will do my best. I move around a
19 lot. Yes. How's that? Is that better? Okay.

20 ALJ GAST: Mr. Brannan, it bends. Yeah.

21 MR. BRANNAN: Yes.

22 ALJ GAST: There you go.

23 MR. BRANNAN: We'll do that. It's going to be
24 hard because I need to look at my notes, otherwise it will
25 be even less organized than normal. So thank you very

1 much. Good afternoon, everybody, Judge Gast, Judge Akin,
2 and Judge Lam, for your time this afternoon. And also my
3 apologies. I did send in some I call them visual aids to
4 help kind of guide my presentation. They look like this.
5 I didn't get them in until yesterday, but I just want to
6 make sure you all have them before I start because I will
7 reference them throughout the presentation.

8 Okay. So to begin with, this case is about, you
9 know, from our perspective, it's about holding the FTB
10 accountable to the law. As you'll see, our case rests on
11 what's in the statutes and what's in the regulations and
12 not some contrived theory about what the FTB wants the
13 answer to be. We want the FTB to follow the statutes
14 passed by the Legislature as well as the FTB's own
15 regulations.

16 Rather than follow the law, what the FTB does is
17 advocate a the solution of convenience -- for them, not for
18 the taxpayer -- and reliance on outdated case authorities
19 and inconsistent agency positions which lack any persuasive
20 legal support.

21 So I've realized that the issues may have been a
22 little shorthand manner on Slide 2. And really, the
23 determination of income and factors for a unitary business
24 is the issue that we're going to spend most of our time on
25 today. In addition to the allocation of interest expense

1 and the treatment of depreciation expense for a
2 cooperative, I think it's also important to note what's not
3 at issue today. I may be stating the obvious, but these
4 points play a role in how, you know, we suggest that the
5 matter should be resolved today.

6 First of all, there's no questions as to
7 Appellants SMBSC or Southern Minnesota Beet Sugar
8 Cooperatives's qualifications as a cooperative under
9 California law. Second, there is no issue. The FTB's
10 already determined that Spreckels -- we'll refer to
11 sometimes as the for-profit operation in California -- and
12 SMBSC are part of the same unitary business. And it's that
13 unitary determination that carries with it a certain, you
14 know, conclusion that we are advocating as part of this
15 appeal. And honestly, it's that unitary determination that
16 the FTB really seeks to reject by carving out or rejecting
17 use of the factors that are attributable to the
18 cooperative's operations.

19 So just a brief factual overview. SMBSC is a --
20 it's a Minnesota cooperative cooperation headquartered in
21 Renville, Minnesota. SMBSC manufactures products derived
22 from sugar beets, including such things as refined sugar,
23 liquid sugar, pulp pellets, and molasses. SMBSC only
24 processes the sugar beets. Every member shareholder of
25 that cooperative is actually a sugar beet grower. So you

1 have the members that grow it and then you have the
2 cooperative that processes.

3 The majority of SMBSC's income is considered
4 income for or on behalf of its members, also known as
5 patronage income, and it is allocable or deductible under
6 24404, you know, as part of the cooperative deduction rules
7 in California.

8 In 2005, SMBSC acquired Spreckels. Spreckels'
9 primary operations are in Brawley, California, Southern
10 California. And like SMBSC, Spreckels is in the business
11 of refining sugar, pulp, and molasses from sugar beets.
12 Spreckels obtains 100 percent of its raw materials from
13 local growers in California. In contrast to SMBSC, none of
14 the Spreckels Sugar Company's income is patronage income.
15 SMBSC generally funded the Spreckels acquisition with
16 third-party debt, and the allocation of the interest from
17 that debt is one of the issues in this case.

18 In addition to generating additional income of
19 anywhere from five to \$30 million a year for the years
20 under consideration, the Spreckels acquisition enabled
21 SMBSC to obtain additional sugar production allotments from
22 the federal regulatory authorities. That -- those
23 distribution rights actually were estimated to provide up
24 to \$9 million worth of benefit to the cooperative. As
25 determined by Respondent, SMBSC and Spreckels are part of

1 the same unitary business.

2 So focusing on the first issue, in spite of the
3 FTB determination that there's a unitary business here,
4 what the FTB wants to do without citation to any meaningful
5 legal support is to exclude the factors attributable to the
6 cooperative operations in Minnesota. And you can
7 appreciate, you know, from the review of the briefs that
8 including those procedures reduces the apportionment
9 percentage in California, whereas excluding the procedures,
10 as the FTB would want to do in this case, increases the
11 apportionment percentage in California and obviously
12 increases the income subject to tax.

13 The problem for the FTB, regardless of the theory
14 that they want to put forward today, is that they don't
15 have any legal support in their own statutes or
16 regulations. But the key starting point is really at
17 Slide 4 and it's the unitary method. That unitary
18 determination carries with it certain consequences that the
19 FTB seeks to ignore.

20 And there's a little quote here. It's from Chase
21 Brass. There's any number of cases that basically hold the
22 same thing with regard to the unitary method. "Unitary
23 income is derived from the functioning of the business as a
24 whole, to which the activities in the various states
25 contribute; and by reason of such interrelated activities

1 and the integrated overall enterprise, the business done
2 within the state is not truly separate and distinct from
3 the business done without the state." Well, why don't we
4 start with that because it's really the background and the
5 premise for everything that is supposed to go forward once
6 we have that unitary determination.

7 The way that California sets up the determination
8 of income and determination of the apportionment factors
9 for a unitary business is set forth in its code, in the
10 statutes, and in the regulations. The best description,
11 also ironically cited by the FTB in this case, is from
12 William Pearce, who's one of the drafters of the original
13 version of UDITPA, and that's also cited on Slide 4.

14 As described, the Uniform Act assumes that the
15 existing state legislation has defined the base of the tax
16 and that the only remaining problem is the amount of the
17 base that should be assigned to the particular taxing
18 jurisdiction. Thus UDITPA does not deal with the problem
19 of ascertaining the items used in computing income or the
20 allowable items that expense.

21 So what's going on here? Mr. Pearce and the Code
22 are setting up a two-step process. First, we establish the
23 income. Second, under UDITPA we establish how that income
24 is to be apportioned. There's a sequence to it, and it's
25 established by the combined report regulations.

1 Also on Slide 5, what you see is consistent with
2 Mr. Pearce's comment, consistent with the theory -- excuse
3 me, total separate net income is the total net income from
4 all sources of a member of a combined reporting group from
5 its separate books of account as determined under the
6 Revenue and Taxation Code -- emphasized in bold face --
7 before allocation and apportionment. So again, there's a
8 two-step process. By design and by law, we first determine
9 the income and then determine the manner in which the
10 income shall be apportioned.

11 I appreciate that some of the references to the
12 details of the statutes and the regs might be a bit
13 tedious, but there's a point to this. The point to this is
14 there is law in place that governs the outcome. And we
15 want to follow the law. We want to follow the statutes.
16 We want to follow UDITPA as far as the conclusion in this
17 case. So we're going to walk through it because we think
18 it's important and it's how this case ought to be resolved.

19 So looking at Slide 6. Referring to the statutes
20 and the laws applicable to the case, Slide 6. The first
21 entry: Combined reporting in general. Each taxpayer whose
22 income and apportionment factor data are permitted or
23 required to be included in a combined report shall --
24 mandatory language there -- shall report income in the
25 manner provided by this regulation and, to the extent

1 applicable, other regulations adopted under
2 Section 25106.5. Specifically, the combined report
3 regulations. The key here is that neither the taxpayer nor
4 the agency in this case has discretion about how they move
5 forward under these rules.

6 Also on Slide 6, net income means the gross income
7 computed under Chapter 6 less the deductions allowed under
8 this Article and Article 2, Article 2 commencing with
9 Section 24401. The determination of net income for a
10 cooperative is really no different from any other
11 corporation such that net income equals gross income less
12 allowed deductions.

13 On Slide 7, you see the key -- the relevant
14 language. "Associations organized in whole or in part on a
15 cooperative basis" -- like Southern Minnesota Beet Sugar
16 Cooperative -- "shall be allowed deductions in computing
17 taxable income for all member resulting from or arising out
18 of activities for or with their members." It's a pretty
19 straightforward statute.

20 Importantly for this case potentially is what's in
21 the FTB's own regulation. "Cooperative associations are
22 not exempt from tax under this part but are permitted a
23 deduction." And the words matter here. This is, in fact,
24 a legal proceeding. The words of the statutes, the words
25 of the regulations matter. There is a difference between

1 an exempt entity or exempt income and what is deductible
2 income in this case that we're talking about under 24404.

3 So now we pause. In accordance with the
4 applicable statutes and regulations, we have determined the
5 income. This is what taxpayer did in this case. Followed
6 the rules, determined their income. They deducted
7 patronage dividends or income that was allocable to its
8 members in SMBSC consistent with the rules. I don't
9 believe there's any debate about whether that was proper or
10 not.

11 So now what we have is we have the separate net
12 income for Spreckels and we have the separate net income
13 number for SMBSC. And we combine them, and that becomes
14 the income base subject to apportionment. It's all in the
15 rules. There's a recipe here. This is very
16 straightforward.

17 Once we have the net income for that unitary
18 business, the income must be allocated or apportioned in
19 accordance with UDITPA as adopted by the California State
20 Legislature. Neither the taxpayer nor the State has much
21 choice in how this is done. The rules give us the answer.
22 There's a recurring theme here. And again, there's a
23 reason for this. We're relying on the book. We're relying
24 on the code book.

25 So turning to Slide 8. Taxpayers earning income

1 derived from or attributable sources both within and
2 without the state shall determine California tax in
3 accordance with UDITPA as codified beginning with
4 California Revenue and Taxation Code Section 25120. The
5 first step under UDITPA is to separate income into either
6 business income or nonbusiness income. Once you've done
7 that, nonbusiness income is allocable to the commercial
8 domicile of the company. There is no nonbusiness income,
9 but it's convenient as a reference point.

10 Business income is what's subject to apportion in
11 accordance with the factors. Business income means income
12 arising from transactions and activity in the regular
13 course of the taxpayer's trade or business. In this
14 matter, both parties agree, at least I think we do, that
15 all of the income is business income subject to
16 apportionment.

17 For taxable years beginning before January 1,
18 2013, all business income shall -- there's that word again,
19 it's directive, it's mandatory -- shall be apportioned to
20 the state by multiplying the business income by a fraction:
21 The numerator, which is the property factor, plus the
22 payroll factor, plus twice the sales factor and the
23 denominator which is four for a factor apportionment. It's
24 in the statute. That's what we're applying here.

25 Following the rules as established by the

1 Legislature and the FTB's own regulations, we get to a
2 result. That's what the answer is here today. Based on
3 the arguments presented by the FTB, there are no exceptions
4 to this rule, or at least there's no authority for any
5 exceptions to this rule. But I haven't seen anything in
6 the statutes or in the code that says that the FTB or a
7 taxpayer -- and remember, these are mandatory for both
8 sides here -- can depart from that rule. Nonetheless,
9 that's what the FTB wants to do. Appellant's case is that
10 straightforward: Follow the rules, get to an answer,
11 include the factors, we're done.

12 Now, the FTB raises a couple of points. And I'll
13 try and get to them quickly, but the idea in their rebuttal
14 is that for some reason because income is deductible under
15 24404, that somehow gives the FTB an excuse not to include
16 factors that are attributable to the cooperative
17 operations. Well, as we started with, the purpose of a
18 unitary business or the recognition of a unitary business
19 means that all aspects of that business contribute to the
20 production of every dollar of income. So they can't just
21 do that. They can't just make up an answer because they
22 don't like it. And that's what's going on here. They
23 don't have any legal support.

24 What you see throughout the briefs is vague
25 reference to what the code says. Well, I've just walked

1 through the relevant code sections. Happy to talk about
2 them again. There's a reference to Chase Brass, an age-old
3 decision. Conceptually, Chase Brass is probably fine.
4 Transactions between members of the same unitary group do
5 not give rise to economic benefit; therefore, we do not
6 have factors attributable to that transaction. That's
7 fine.

8 Problems with Chase Brass: Those facts aren't the
9 facts of this case, one. Two, Chase Brass is a pre-UDITPA
10 case. Pre-UDITPA cases dealt with different law. At the
11 time the FTB had tremendous discretion. There's a list of
12 eight or ten different factors, including any other factors
13 that the agency wants to use to apportion income. That's
14 not the law today so that case doesn't work. Pre-UDITPA
15 cases don't matter. The concept may be fine on the facts
16 of that case, but pre-UDITPA cases don't matter.

17 If you look at -- there's a holding in the
18 New York Football Giant's case, and it specifically says
19 that we have to reject pre-UDITPA findings and reevaluate
20 the case under the new law. It's a unique case because it
21 had the same facts under early law and then the same facts
22 under the post-UDITPA law. And they reach different
23 conclusions for a good reason. The law was different. We
24 have to do the same thing here. We can't just blindly
25 follow whatever we believe the teaching to be under Chase

1 Brass.

2 Lastly, you know, most important for our position
3 is that the holding in Chase Brass is now embedded in the
4 intercompany transaction regulations at 25106.5-1. So the
5 FTB has already taken the piece of Chase Brass that they
6 like and they put it in the regulations, and now part of
7 the regulations don't apply to my client. They don't apply
8 to a cooperative.

9 So we go to the fundamental provisions that I've
10 just recited to you on income and apportionment factors.
11 The FTB counsel avoids or does not reference specifically
12 FTB Legal Ruling 2006-01. I feel kind of obligated to
13 present it or reference it here because it's all we heard
14 about through the audit was how 2006-01, which is entitled
15 "Treatment of Factors for an Exempt Organization," or
16 something like that. But what they do in 2006-01 is they
17 say, well, if you're exempt and it's an exempt
18 organization, we're not including any of that income in the
19 apportionable income pot. And then they say, well, because
20 of that, we're not going to include any factors. Well,
21 that's fine. There's actually a statute that supports that
22 outcome right now. (Telephone ringing)

23 Wow, that's poor form, isn't it? My apologies.
24 So -- yeah. Of course, I lost my spot here.

25 According to the FTB, the exclusion is the result

1 of the basic function of the UDITPA formula. And this is,
2 again, in 2006-01, which seeks to assign net business
3 income solely on the basis of those activities that gave
4 rise to the income. Again, conceptually that's fine, but
5 we need some law to support that. We need a statute. We
6 need a regulation to support that, and we don't have it and
7 the FTB doesn't have it.

8 The other interesting thing in 2006-01, the FTB
9 then tosses in a footnote to the legal ruling indicating
10 that the analysis, the same analysis, the exclusion of
11 factors related to income that is not included in the tax
12 base, the same analysis would apply regardless of whether
13 the statute uses the term exempted, excluded, deducted, not
14 recognized, et cetera. And what you have here is a really
15 interesting statement by the FTB. What they're saying is,
16 based on a theory without any legal support, they are going
17 to exclude factors.

18 I give them credit though. The next sentence in
19 the legal ruling says, "The conclusion is based upon the
20 fact that these income amounts are related to activities
21 excluded from net income subject to apportionment," but not
22 the language used in the actual statute. So I love the FTB
23 for that because what they're telling us is, yeah, we know
24 we're not following the statute. Well, we can't let them
25 do that.

1 Taxpayers open up their returns every year.
2 Taxpayers try and decide how to prepare their return. They
3 look to the rule book to do that. They get to an answer.
4 And then they're subject to audit and they're hanging up.
5 I mean, these years are ten years old. This is crazy. We
6 should be able to follow the statute and the regs.

7 What the FTB's position really comes down to is
8 they want to say, look, this amount goes into gross income
9 and then there's a deduction. And once we deduct it, we're
10 not going to treat it like income anymore. Well, if it's
11 exempt income, there's a statute that covers it. If it's
12 excludable income, there's a regulation or statute that
13 covers it.

14 There is a statute that covers the patronage
15 dividends deduction as well, and it's 24404. And there are
16 any number of authorities that say that even though it's
17 deductible, we still treat it as income. And once it's
18 treated as income, then it gets factor representation. And
19 that's really what this is -- you know, again, this is
20 where we end up.

21 If we look at the appeal of CTI Holdings, the
22 holding is very clear. Just because we're deducting
23 something doesn't mean it loses its character as income.
24 We can also look at any number of chief counsel rulings
25 that the FTB has put out over the years. They're cited in

1 the briefs. And the idea is once it's deducted -- most of
2 these focus on Section 24402, not 24404. But at the end of
3 the day, we're in the same Article 2 under "Special
4 Deductions" and the treatment is the same. And if somebody
5 can suggest why they should be treated differently, I'm all
6 ears, but really it's the same special deduction.

7 The most telling argument to identify the flaw in
8 the FTB's position is really a very simple one. The FTB
9 routinely and taxpayers routinely will have multiple
10 entities included in a combined report.

11 (Court reporter interrupts)

12 MR. BRANNAN: My apologies.

13 The FTB will routinely or a taxpayer will
14 routinely include multiple entities in a combined report.
15 What happens when one of these entities loses money or is
16 subject to a net operating loss carryover that reduces
17 income to zero? That's the same situation that we're
18 dealing with here today. And the FTB would never be heard,
19 nor could a taxpayer ever even think of prevailing on a
20 case where we would take out those factors from a combined
21 report. Yet the FTB wants to say because that income
22 somehow isn't subject to tax, which again is contrary to
23 all the authority that's out there, we should exclude the
24 factors.

25 So I challenge the FTB to explain the legal basis

1 for their ruling and I challenge this panel to hold the FTB
2 accountable to the law. So I'll stop there. I'd like to
3 cover the other two issues a little more quickly than I
4 went through the first one. And, you know, I'm available
5 for any questions that you may have on the first issue or I
6 can continue.

7 ALJ GAST: Let me ask my panel members.

8 Are there any questions on the first issue? I'll
9 start with Judge Akin.

10 ALJ AKIN: I'm going to hold my questions at this
11 time.

12 ALJ GAST: Okay.

13 ALJ LAM: I don't have any questions for now.

14 ALJ GAST: Okay.

15 Yeah, why don't you finish your presentation --

16 MR. BRANNAN: Sure.

17 ALJ GAST: -- and then we'll see if we have any
18 questions.

19 MR. BRANNAN: Great. Thank you.

20 ALJ GAST: Thank you.

21 MR. BRANNAN: So the next issue has to do with the
22 allocation of interest expense incurred to acquire the
23 for-profit business. The issue presented is really easily
24 stated. It's just hard to solve, quite frankly. And the
25 question is how much, if any, of the interest expense

1 incurred to acquire Spreckels, a for-profit business, may
2 be offset against taxable income generated by Spreckels.

3 Taxpayer's position is that because I acquired a
4 for-profit enterprise, it was \$50 million is what we paid
5 for it give or take, that all of the interest expense ought
6 to be allocable to the Spreckels acquisition. The FTB's
7 position is, oh, wait, you've acknowledged in some of the
8 IDR responses that the reason that you really wanted it was
9 to get an increased allotment under the federal regulatory
10 scheme. In other words, basically these allotments are
11 based on consumption predictions by the federal government.
12 And depending on how much you're growing and how much
13 you're processing, you can get more of these allotments
14 that allow you to sell more on the marketplace.

15 That's a true statement. That is part of the
16 rationale for acquiring Spreckels. There's no question.
17 And as a result, and there's a number in the briefs, you
18 know, call it \$9 million of benefit attributable to the
19 increased allotment allowed to the cooperative based on the
20 acquisition of Spreckels. But it's helpful to provide --
21 you know, we think at the end of the day that the answer to
22 the case is going to revolve around the Zenith -- the
23 appeal of Zenith, which talks about how to allocate and
24 what evidentiary requirements we may have.

25 Context for Zenith is helpful, and that's what

1 we've provided in Slide 9. If you look at the statement of
2 the law under 24425, "No deduction shall be allowed for any
3 amount otherwise allowable as a deduction which is
4 allocable to one or more classes of income not included in
5 the measure of tax imposed by this part."

6 What they're saying is pretty simple. If income
7 is not included in the measure of tax, then any deduction
8 that is allowed for expenses related to that income would
9 constitute a double deduction. That's not what we're
10 advocating for, but that's the reason for the rule. And
11 although not referenced in the slide, Regulation 25120
12 basically says if there's a problem, let's come up with a
13 fair method of allocation.

14 In Zenith, the FTB argued that all interest
15 expense should be treated as an indirect expense -- and
16 we're talking about indirect cost versus direct cost in the
17 accounting terminology there -- but it's an indirect
18 expense because the nature of it is that it cannot be
19 allocated to a specific activity. That is kind of the
20 definition of an indirect expense.

21 As an indirect expense, the FTB argued that the
22 expense should be allocated between nondeductible and
23 deductible income in accordance with longstanding
24 precedent. And also on that slide, we get over into
25 Slide 10, what you see is the precedent was a basic

1 allocation formula consistent with the idea that we don't
2 know exactly how the income -- or excuse me -- the proceeds
3 of the loan are used because cash is fungible, money is
4 fungible, and, therefore, we're not going to presume to
5 know how the interest expense ought to be allocated.

6 So what they do is they come up with a method of
7 allocation based on, say, gross income, based on revenue,
8 some sort of equitable measure to split it up as opposed to
9 engaging in the debate that we're about to have. Simple
10 methodology.

11 But then Zenith talks about it, because this is a
12 couple kind of evidentiary standards. Unless a taxpayer
13 can establish its dominant purpose in a sufficiently direct
14 relationship between the expense and the income,
15 Respondent's allocation formula -- and again, what we're
16 talking about here is that allocation based on income, some
17 way to go between deductible and nondeductible --
18 Respondent's allocation formula will provide the best means
19 to allocate interest expense between taxable and nontaxable
20 activities. Okay. So we have the default mechanism, which
21 is this allocation rule, some sort of proration.

22 Further on the slide, it's direct evidence of a
23 purpose to purchase tax exempt obligations or -- the
24 bracketed language -- or taxable investments exists where
25 the proceeds of indebtedness are used for or are directly

1 traceable to the purchase. See, this was the key in Zenith
2 is that the taxpayer in that case didn't want to accept the
3 allocation method because the taxpayer knew as a matter of
4 certainty, or at least that's what the Zenith -- the board
5 held in Zenith, they knew what the loan proceeds were used
6 for. It wasn't a function where they dumped the cash into
7 one account. They knew what the proceeds were used for and
8 they knew that the loan was used to acquire a taxable
9 activity or to generate a taxable transaction. And so the
10 board concluded because of that connection that all of the
11 interest expense could be offset or fully deductible
12 against taxable income.

13 In this case, the same facts apply. There's no
14 debate that under the law or under the facts that all of
15 the loan proceeds in the related -- you know, were used to
16 acquire Spreckels, roughly \$50 million. They're still
17 paying interest on it today. Once we know that that's what
18 the money was used for, that really is the end of the
19 inquiry. That would be Appellant's position in this case.

20 The FTB takes the exact opposite position.
21 Because the purpose, according to the FTB, because a
22 purpose which we own was to benefit the cooperative, all of
23 that interest expense, the FTB suggests, needs to be
24 allocated to the cooperative and so none of it is
25 deductible against taxable income. In other words, no tax

1 benefit for the cooperative, no tax benefit for the
2 taxpayer in this case.

3 Well, that's -- that's fine. There's a couple of
4 problems with, you know, candidly, with the all-or-nothing
5 approach, even with the own approach that we're suggesting,
6 although I like ours better than the FTB's. But all or
7 nothing kind of ignores the fact that there can be multiple
8 reasons for acquiring a business like Spreckels. You don't
9 spend \$50 million for one reason. You don't spend
10 \$50 million to benefit a cooperative when what you're
11 acquiring, even for the years under consideration,
12 generates as much as \$30 million of income.

13 To ignore that is not being very realistic. It's
14 the elephant in the room. We have a business over here.
15 It's generating significant income for the unitary
16 business, and the FTB wants to pretend it doesn't exist.

17 You can't do that. It's not a single purpose. If it is,
18 we have to trace it, because that's what Zenith tells us to
19 do.

20 Here's the other problem with the FTB's theory.
21 If we assume that all of Spreckels, that the only reason we
22 acquired Spreckels was in order to gain these increased
23 federal allotments in the marketplace, what's embedded in
24 that statement is a conclusion that the only purpose of
25 Spreckels is for the benefit of the members of the

1 cooperative.

2 And what does that mean? That means that all of
3 the Spreckels income is deductible under 24404 as for or
4 for the benefit of the members of the cooperative. Because
5 the FTB's extreme position really does mean that. It means
6 that the only purpose of the acquisition was to gain the
7 allotment.

8 Now, we're not advocating that. We acknowledge
9 that's an unreasonable outcome here. The point is to
10 illustrate how unreasonable the FTB's position is. At
11 least we have direct tracing. I know where my money went.
12 The FTB's position that it only operated to benefit the
13 cooperative ignores the reality of a \$50 million business
14 sitting in California generating \$30 million of income.
15 You can't just pretend it doesn't exist.

16 Candidly, looking back at this, I think our
17 position is still better than the FTB's position if it's an
18 all-or-nothing approach. But given the multiple purposes,
19 some sort of allocation formula based on, say, comparative
20 revenues, comparative gross income -- we've actually
21 suggested it in one of the footnotes -- but some sort of
22 allocation method may be the better answer here. And I
23 don't want to say that's a concession because you still
24 like my answer better than the FTB's, but I think it kind
25 of makes sense given the evidence that it's in -- that's in

1 front of the panel today.

2 The last point, depreciation expense for a
3 cooperative. The theory, you know, we -- we're on the last
4 slide here. And what you have is a quote from United
5 States vs. Lootie (phonetic). And the theory is sound.
6 The theory is very fundamental that depreciation of an
7 asset represents the gradual sale of that asset. And when
8 a cooperative like SMBSC sells an asset in this case, it's
9 going to generate by rule nonmember taxable income.

10 So if we accept the proposition that depreciation
11 represents this gradual sale, then we ought to, we ought to
12 get a deduction of that depreciation expense against
13 taxable income in order to the ensure kind of a fair
14 reflection of income from year to year. Taxpayers
15 shouldn't have to wait until they sell that asset. It
16 could be 10 or 20 years out or whenever they transition or
17 dispose of that asset before there's some sort of
18 recognition of that.

19 (Court reporter interrupts)

20 MR. BRANNAN: Taxpayers shouldn't have to wait
21 10 years or more for a recognition event to get the benefit
22 of that gradual sale under the theory articulated by
23 Lootie.

24 So that's all I have. If there are questions,
25 certainly happy to respond to any questions.

1 And apologize for the pace of my speaking when I
2 get a little carried away. Thank you.

3 ALJ GAST: Thank you, Mr. Brannan. I'm going to
4 turn it over to the panel for questions. I might
5 start because I have a few questions with the first issue.

6 MR. BRANNAN: Um-hum.

7 ALJ GAST: Just so I understand kind of the
8 background, as I'm, you know, looking at the return that
9 FTB provided for 2008, Southern Minnesota claims 86272
10 protection; is that correct?

11 MR. BRANNAN: I think we did. I'm not sure that's
12 an issue any longer.

13 ALJ GAST: Okay. So just understanding the
14 background that -- and I don't know if this is true for all
15 of the years, but Spreckels was intrastate apportioned all
16 of Southern Minnesota's taxable nonmember income and paid
17 tax on that. Is that a correct assessment for 2008, '9,
18 '10 and '11?

19 MR. BRANNAN: I think that the starting point for
20 the discussion ought to be the FTB's protest schedules.
21 And what the FTB did is they zeroed out member income and
22 included nonmember income in the sales factor of the
23 apportionment formula.

24 Now, I'm not sure if that's responding to your
25 question or not, but I think the framework for the question

1 may be helpful.

2 ALJ GAST: Yeah. I was just looking at the
3 returns, and I saw that Southern Minnesota only paid \$800
4 minimum tax for 2008 as a member of a two-member combined
5 report.

6 MR. BRANNAN: Right.

7 ALJ GAST: All of the income was apportioned
8 intrastated to Spreckels who paid tax.

9 MR. BRANNAN: Correct. I think --

10 ALJ GAST: Is that --

11 MR. BRANNAN: Yes.

12 ALJ GAST: Is that true for all the years?

13 MR. BRANNAN: Yes.

14 ALJ GAST: Okay. I just wanted to clarify that.

15 MR. BRANNAN: Yes.

16 ALJ GAST: My other question is, on the first
17 issue, which kind of doesn't spill into the second issue
18 but, you know, under the -- or second and third issues,
19 which deal with 24425, you can't deduct expenses related to
20 income not included in the measure of tax.

21 MR. BRANNAN: Um-hum.

22 ALJ GAST: And I think that means gross income.
23 From Anaheim Union Water Co. vs. FTB, some of these cases
24 that dealt with cooperatives. So if you agree with that
25 premise, isn't Southern Minnesota's income not gross

1 income? And if it's not gross income, why would it be
2 included in the apportionment formula?

3 MR. BRANNAN: There's two things at work here.

4 ALJ GAST: Okay.

5 MR. BRANNAN: One, 24425 very specifically, it
6 talks about -- I have to get to the terminology matter
7 because, as I indicated, words matter. But it's included
8 in the measure of tax as opposed to subject to tax. And
9 included in the measure, what 24425 is getting at, and the
10 authority speaks to this, is it's getting to a more
11 practical financial accounting exercise. And it's solving
12 a very difficult problem, which is: What do we do with
13 these indirect expenses, these indirect costs? Because we
14 don't know exactly where they went.

15 It's not engaged in kind of the semantics of
16 whether it is included in the gross income number or not.
17 It's a different exercise. Fair question. I mean, because
18 I get the point. But it's really not concerned with the
19 computation of gross or net income that is set forth in the
20 statutes and the regs.

21 If you look at it on the other side, there are
22 very, very precise definitions of what is gross income,
23 what is net income, and then you get into the regs and
24 there's all sorts of definitional provisions that deal with
25 apportionment, separate net income, combined separate net

1 income, et cetera, et cetera. But they really are dealing
2 with kind of -- you know, with the proper level of
3 extraction, if you will.

4 You're looking at it from different lenses. They
5 are different concepts. But I appreciate that they're
6 perilously close to kind of saying the same thing. But
7 because the goal of the statute in 24425 is different
8 financial accounting, more so than the apportionment rules,
9 they really go to different things. So if that's
10 responsive. They're just different.

11 ALJ GAST: Okay. Thank you. I'm going to turn it
12 over to my panel members, if they have any questions.

13 Judge Akin?

14 ALJ AKIN: Yes. Can you hear me?

15 MR. BRANNAN: Yes.

16 ALJ AKIN: Am I coming through? Okay. I did have
17 a question for you on the second issue, so the interest
18 expense issue. And if we were going to look at doing some
19 sort of allocation under Zenith, you know, I understand
20 that the -- I think there's no dispute -- I'll wait for
21 FTB's presentations before, you know, deciding this.

22 MR. BRANNAN: Um-hum.

23 ALJ AKIN: But I think there's no dispute that the
24 interest expense was incurred to acquire Spreckels. And,
25 you know, I do see that Spreckels generates taxable income,

1 you know, and then also had the benefit of, you know, the
2 increased allotments that increased the nontaxable income
3 for Southern Beet.

4 So if we were going to do some sort of allocation,
5 what would that allocation method be I guess?

6 MR. BRANNAN: The cases actually come up with some
7 slightly different answers to that question. I think
8 traditionally it would be gross income. We could suggest
9 any number of, you know, factors -- not to misuse that term
10 in this context -- but, you know, revenue. Relative
11 revenues might make sense. You know, gross income, net
12 income.

13 What's a little awkward about this business,
14 candidly, is a commodity business like sugar, sometimes
15 they make money and sometimes they don't. You know, the
16 years that are front of us, we made some money. But it
17 would be nice if there was a suggested formula to have
18 something that might be enslated from the longward
19 vicissitudes of the market, sorry, but -- right? I mean --
20 and revenue probably is a better measure at that point.
21 But I -- something like that, something that would be an
22 apples-to-apples comparison as between a cooperative and
23 a -- you know, Spreckels or the for-profit side of the
24 business. That's what we would suggest.

25 ALJ AKIN: Okay. Thank you. And just a note

1 that, Franchise Tax Board, I do plan on asking you similar
2 questions if you don't cover it in your presentation. I
3 don't want you to think that I'm not going to give you an
4 opportunity to be also respond, but I did want to hear
5 probably your presentation first.

6 ALJ GAST: Okay. Judge Lam, do you have any
7 questions?

8 ALJ LAM: I do not have any questions for now.

9 ALJ GAST: Okay. Why don't we turn it over to the
10 Franchise Tax Board for your presentation. You will have
11 30 minutes as well. Please begin whenever you're ready.

12 MR. EPOLITE: Thank you. Good afternoon. My name
13 is -- my name is Anthony Epolite, along with Irina
14 Iskander. We represent the Franchise Tax Board in this
15 matter.

16 Today's appeal involves a California taxpayer that
17 is a combined group consisting of a Minnesota cooperative
18 and California for-profit corporation, a noncooperative.
19 Beet Sugar operates as a cooperative for the benefit of its
20 members who are Minnesota farmers with the cooperative's
21 primary purpose being cost reduction for its co-op members.
22 A cooperative, therefore, does not seek to generate
23 business profits and, for that reason, is treated very
24 differently under federal and California law from a
25 C corporation engaged in a for-profit business.

1 Under California law, all income produced for the
2 benefit of co-op members is not included in the measure of
3 tax. For California tax purposes, the measure of tax is
4 calculated by adding apportionable business income and
5 California allocable nonbusiness income. As such, a
6 cooperative is different from typical C corporation. And
7 the deduction allowed by Revenue and Taxation Code
8 Section 24404 is a means of excluding otherwise taxable
9 income from the tax base of the cooperative.

10 This is the distinct characteristic of
11 cooperatives and is at the heart of this appeal. Thus
12 income is eliminated from the tax base of the cooperative.
13 Thus because income is eliminated from the tax base of the
14 cooperative, it is appropriate to adjust the apportionment
15 factors to remove the property, payroll, and sales which
16 produce the income that was eliminated from the tax base.
17 This is the context of this appeal and what makes this
18 appeal different, a cooperative and a noncooperative in the
19 same unitary group.

20 The cooperative's only for-profit income was
21 dividend, interest, royalty, and other income for which
22 factor representation is appropriate and which the FTB has
23 allowed. As for Spreckels, this is a California
24 corporation, and most of its activity was in California
25 during each of these years. When a business operates in

1 interstate commerce, it determines its California state
2 income tax liability first by determining its apportionable
3 business income. The business then calculates the
4 appropriate apportionment formula to determine how much of
5 that business income is apportioned to California.

6 We will begin our presentation following this same
7 process. We will first discuss interest and depreciation
8 expense as those issues relate to the determination of what
9 is apportionable business income, and then we will address
10 the primary issue in this case: Whether it is appropriate
11 to provide factor representation for the property, payroll,
12 and sales factors of the cooperative when income from the
13 cooperative is not included in the tax base.

14 Regarding Appellant's claimed interest expense,
15 Revenue and Taxation Code Section 24425 disallows
16 deductions allocable to one or more classes of income not
17 included in the measure of the tax. Under Great Western
18 Financial, Section 24425 applies whenever income is
19 eliminated from the measure of the tax under any authority
20 or for any purpose to prevent a taxpayer from receiving a
21 double benefit in deducting expenses incurred in the
22 production of nontaxable income.

23 In 2005, the cooperative acquired Spreckels,
24 incurring substantial debt for that acquisition. The
25 cooperative acquired Spreckels to obtain the unused sugar

1 allocations that Spreckels possessed. Sugar is a regulated
2 commodity, and sugar allocations -- excuse me. The
3 cooperative acquired Spreckels to obtain the unused sugar
4 allocations that Spreckels possessed. Sugar is a regulated
5 commodity, and sugar producers are limited in the amount
6 that can be sold on the open market. Prior to 2005, the
7 cooperative's allocations were fully maximized while
8 Spreckels were not.

9 According to the federal agricultural code, sugar
10 producers could utilize the unused allocations from another
11 producer if the other producer was acquired. Primarily,
12 all of the cooperative's activities related to the
13 production of sugar which is sold on the open market.
14 Accordingly, Spreckels was an attractive acquisition for
15 the cooperative as acquiring Spreckels gave the cooperative
16 the ability to sell additional sugar on the open market.
17 As such, the interest expense incurred by the cooperative
18 to acquire Spreckels is properly attributed to the
19 activities of the cooperative to sell more sugar and make a
20 profit for its members. This increased the amount of the
21 cooperative's profit, all of which is removed from the tax
22 base by Section 24404.

23 Appellant has admitted that the purchase of
24 Spreckels was for the direct benefit of the cooperative.
25 This was the dominant purpose of the acquisition under the

1 Zenith appeal. Because the cooperative's income is
2 deducted pursuant to the operation of Revenue and Taxation
3 Code Sections 24401 and 24404 and not included in the tax
4 base, the interest expense is attributable to the deducted
5 income. Necessarily, the purchase of Spreckels was to
6 increase the market allocation of the cooperative leading
7 to an increase in the cooperative's net income, which was
8 not included in the measure of the tax.

9 Section 24425 denies a deduction of any amount
10 otherwise allowable as a deduction if it is allocable to
11 income not included in the measure of tax. Here the
12 members' income relates to the processing and selling of
13 sugar on the open market and was not included in the tax
14 base. It therefore follows that the interest expense
15 directly related to the members' income would be
16 nondeductible. Moreover, to provide Appellant with a
17 deduction for interest expense in this instance would
18 result in a double benefit.

19 Regarding Appellant's claimed depreciation
20 expense, Section 24425 is also applicable. All of the
21 cooperative's depreciable assets were used in the business
22 activity of the cooperative to generate member income which
23 was eliminated from the tax base. At audit Appellant
24 confirmed that its manufacturing assets were used
25 exclusively at its Minnesota facility for the production of

1 sugar and various byproducts.

2 Consistent with our discussion of interest
3 expense, Section 24425 is operative whenever an expense is
4 directly attributable to income eliminated from the tax
5 base. The depreciation expense at issue is directly
6 related to income of the cooperative, and that income was
7 eliminated from the tax base. Therefore, as with the
8 interest expense, this depreciation expense would also be
9 nondeductible. As you can see, the nature of the
10 cooperative's activities is critical in determining whether
11 items of income and items of deduction are included in the
12 tax base.

13 We now turn to our determination of the
14 appropriate apportionment formula to decide how much of the
15 taxpayer's business income is apportioned to California and
16 included in the California tax base.

17 This appeal is rooted in Revenue and Taxation Code
18 Section 24404, which provides a deduction for patronage
19 dividends. After net income as defined by state law has
20 been computed, UDITPA determines what portion of that net
21 income is business income subject to apportionment and what
22 portion is allocable to a specific state or states as
23 nonbusiness income.

24 Once business income has been determined, UDITPA
25 apportions it using only those factors that represent the

1 activities that gave rise to the income that is being
2 apportioned. Put another way, only the components of
3 property, payroll, and sales that produced the business
4 income subject to apportionment are properly included in
5 the apportionment formula. Property, payroll, and sales
6 related to activities that did not give rise to business
7 income subject to apportionment are not included in the
8 apportionment formula.

9 Under California law, all income produced for the
10 benefit of co-op members is not included in the measure of
11 tax. For California purposes, the measure of tax is
12 calculated by adding apportionable business income and
13 California allocable nonbusiness income. Thus because the
14 cooperative's income is not included in the tax base, it is
15 also not included in the apportionable business income of
16 the combined group. For this reason, the apportionment
17 formula calculated to apportion the group's business income
18 should also not include the cooperative's receipts.

19 Matching income to factor representation is not a
20 new position by the FTB. In fact, this logical approach
21 has been utilized by the FTB and taxpayers for over
22 16 years. In 2006, the FTB issued Legal Ruling 2006-01,
23 which clearly explains why factors should include gross
24 receipts from only those activities which generate taxable
25 income. While legal rulings issued are not equivalent to a

1 statute or a regulation, the California Legislature has
2 agreed with the underlying principle of Legal Ruling
3 2006-01 by extending the legal rulings expressly in
4 underlying principle of legal ruling -- the California
5 Legislature has agreed with the underlying principle of
6 Legal Ruling 2006-01.

7 In 2015 the Legislature expressly endorsed Legal
8 Ruling 2006-01 by extending the legal ruling's application
9 to apportionment factors attributable to the income of
10 qualified health care service plans excluded by Revenue and
11 Taxation Code Section 24330. Section 1 of the related Act
12 states, "It is the intent of the Legislature that Franchise
13 Tax Board Legal Ruling 2006-01 (April 28, 2006) regarding
14 the treatment of apportionment factors attributable to
15 income exempt from income tax shall apply to apportionment
16 factors attributable to the income of qualified health care
17 service plans excluded by Section 24330 of the Revenue and
18 Taxation Code as added by Section 4 of this Act."

19 By applying the FTB's position, the California
20 Legislature reinforces Respondent's position presented
21 today that it is not appropriate to provide factor
22 representation for activities that do not generate taxable
23 income.

24 In conclusion, for the many reasons discussed
25 today, the OTA must deny the interest expense and

1 depreciation deductions as well as reject Appellant's
2 argument that it is -- that its apportionment factors
3 should include activities that did not contribute to the
4 calculation of apportionable business income. Thank you.

5 ALJ GAST: Thank you. Okay. With that I'm going
6 to turn it over to my panel members to see if they have any
7 questions. I'll start with Judge Akin.

8 ALJ AKIN: Thank you. I did want to give you the
9 same opportunity to answer a similar question that I posed
10 to Appellant. First, you know, I would like to ask whether
11 there's any question or dispute that the interest expense
12 at issue was used to acquire Spreckels.

13 MR. EPOLITE: Well, yes, it was used to acquire
14 Spreckels, but for the benefit of the co-op members. So
15 there was dominant purpose to that acquisition so there
16 would be no purpose for the use of an allocation formula
17 and the application of a formula because there was a
18 dominant purpose. So there would be no reason to apply
19 that formula in the Zenith appeal.

20 ALJ AKIN: Okay. Thank you. That actually
21 answered my next question as well, which was going to be,
22 you know, FTB's position on why an allocation like what was
23 done in Zenith would not be appropriate here.

24 If I'm understanding you correctly, FTB's position
25 is it's not applicable here because there was a dominant

1 purpose and FTB's position is that that dominant purpose
2 was to benefit the cooperative members by that increased
3 allotment.

4 MR. EPOLITE: That's correct.

5 ALJ AKIN: Okay. Thank you.

6 MS. ISKANDER: If I may add to that?

7 ALJ AKIN: Yes.

8 MS. ISKANDER: I think the understanding -- we
9 understand that the dominant purpose was in order to
10 increase income that is excluded from apportionable
11 business income. Just what we said, right? Of course, if
12 facts come up that there is some portion of income that the
13 debt generated that was included in apportionable business
14 income -- which we don't have. We don't have those facts.
15 So far the only facts that Appellants told us is that Hayes
16 Packos (phonetic) is a profitable business. But the debt
17 was not acquired in order to support Spreckels' business.

18 That income that Spreckels generated would have been
19 generated with or without the debt.

20 So if Appellant have showed us or can show us
21 that, indeed, some of the debt was also incurred in order
22 to increase Spreckels' income, for example if somehow
23 Spreckels also got a greater allotment and could have sold
24 more sugar because of some Minnesota allotments in
25 California for example, then it would be reasonable to

1 allocate the expense among activities that produce income
2 that is included in apportionable business income and that
3 is excluded from the apportionable business income.

4 ALJ AKIN: Understood. Okay. Thank you. That
5 does answer my question on the interest issue. Thank you.

6 ALJ GAST: Okay. I'm going to turn it over to
7 Judge Lam for questions.

8 ALJ LAM: Yeah. I have -- hello? Sorry.

9 I have a question for Appellant. What would you
10 say is the dominant purpose in making the acquisition to
11 acquire Spreckels?

12 MR. BRANNAN: I would say that the dominant
13 purpose, as evidenced by the direct tracing, is the use of
14 the funds. And we used the funds to acquire a for-profit
15 business. So --

16 ALJ LAM: And --

17 MR. BRANNAN: Go ahead, please. I'm sorry.

18 ALJ LAM: And for that for-profit, did it produce
19 any taxable income?

20 MR. BRANNAN: Spreckels did, yes, for the unitary
21 business. Spreckels produced for these four years taxable
22 income ranging from -- I have it here, but it's somewhere
23 like 4 all the way up to like \$29 and a half million for
24 the last year under consideration.

25 (Court reporter interrupts)

1 MR. BRANNAN: \$29 and a half million in the last
2 year under consideration. So Spreckels generated income
3 subject to tax. I mean, the -- the irony here is that what
4 we're here to discuss is how to tax the income attributable
5 to Spreckels. And, I mean, that's -- kind of speaks for
6 itself I think.

7 ALJ LAM: True.

8 FTB, would you want to -- do you have any
9 questions or did you -- I saw like a --

10 MR. EPOLITE: I was just going to further chime in
11 regarding your question, to read from the financing
12 document --

13 ALJ LAM: Okay.

14 MR. EPOLITE: -- regarding the motivation for --

15 ALJ LAM: Oh, yes. Please go ahead.

16 MR. EPOLITE: "Transaction summary: In order to
17 obtain additional marketing allocation, enhance the overall
18 profitability of the company, SMBSC is purchasing Imperial
19 Sugar Company's California beet operations known as Holly
20 Sugar Corporation for \$15 million plus the value of the
21 tangible working capital at closing. The Holly operations
22 include sugar beet plants in Brawley; in Mendota,
23 California; a distribution center in Tracy; sugar facility
24 in Hamilton City; and seed operation known as Holly
25 Hybrids. SMBSC plans to rationalize production or possibly

1 close the Mendota plant transferring its marketing
2 allocation of approximately 2.7 million CWTs for benefit of
3 the" --

4 (Court reporter interrupts)

5 MR. EPOLITE: Sure.

6 -- "the Renville Minnesota plant. SMBSC plans to
7 operate the more profitable Brawley plant just as it is.
8 However, if the local growers or another company offer an
9 attractive price, management will be a willing seller."

10 So as much as the plan to continue to operate that
11 Brawley plant, they would have been willing to have sold
12 that California plant. So the primary purpose was for the
13 market allocation.

14 ALJ LAM: Thank you for that.

15 I do not have any further questions.

16 ALJ GAST: I have a quick -- a few questions.

17 Number one, that financing document you're
18 referring to, that's not in the record.

19 MR. EPOLITE: No, it's not.

20 ALJ GAST: That was never provided. So I think
21 the panel will consider those statements as argument and
22 not evidence. So that's one point of clarification on
23 that.

24 Number two, going back to Legal Ruling 2006-01
25 that you were talking about that you said the California

1 Legislature endorsed in 2015, do you have the Bill for
2 that? Because that --

3 MR. EPOLITE: Yes.

4 ALJ GAST: I think it's Senate Bill 2, Medi-Cal.
5 Is that correct?

6 MR. EPOLITE: Yes. It was during extraordinary
7 session in 2016.

8 ALJ GAST: Okay. And specifically, you're
9 referring to, when you were reading it, Section 1 talking
10 about it's the intent of the Legislature that the Franchise
11 Tax Board Legal Ruling 2006-01 regarding the treatment of
12 apportionable factors, its one sentence, is that what you
13 were referring to?

14 MS. ISKANDER: Yes. It is Section 1 that you just
15 read.

16 ALJ GAST: Okay. It doesn't refer to the Legal
17 Ruling anywhere else; correct?

18 MS. ISKANDER: I don't think so.

19 ALJ GAST: Okay.

20 MS. ISKANDER: That's the only way.

21 ALJ GAST: Okay. Okay. I don't think I have
22 anymore questions at this time. I'm going to turn it over
23 to Mr. Brannan for rebuttal. You have 20 minutes.

24 MR. BRANNAN: Thank you.

25 I guess a couple of points, and I'm trying to

1 order them in my head before I speak. I think we'll start
2 with the factor questions. That's the first one that we
3 raised.

4 The reference to qualified health care service
5 providers, the Bill, I haven't seen that. That's okay. It
6 seems very clear to me that it's speaking directly to
7 exempt income. We don't have exempt income here. In fact,
8 exempt income has its own statute that we've already
9 referenced. It's -- 23038 specifically excludes exempt
10 entities, for example, from the combined report.

11 We don't -- we don't have any specific laws that
12 say we're not going to give factor representation to
13 deductible income under 24404 or any of those special
14 deduction provisions. So I would characterize that as kind
15 of a last gas. We don't have an issue with the treatment
16 of exempt income or excludable income, which is, by
17 statute, specifically carved out from gross income
18 under 24301.

19 That's our whole point. There are statutes and
20 regulations in place that govern the outcome of this case.
21 The best the FTB's come to argue with is, well, it's kind
22 of like exempt, it's kind of like excluded, it's kind of
23 like nonbusiness, it's kind of like something. We just
24 know that we don't want factors.

25 They really have provided zero, and I mean zero,

1 authority to support it except for a presentation on
2 unitary theory, which, by the way, ignores the fundamental
3 premise for unitary theory, which is that all aspects of
4 the business contribute equally to each of the dollar
5 generated and subject to tax. They don't like that part.
6 So that's why we're sticking with the law and we hope that
7 you do as well in connection with that first issue.

8 So we'll talk a little bit more about the proper
9 allocation of the interest expense. I guess I had assumed,
10 and I think it's still true but always good to talk about
11 these things, that there is no issue that we used the loan
12 proceeds to acquire Spreckels. I hope that's not an issue.
13 If it is, it would be news to me.

14 Yes, one of the purposes of acquiring Spreckels
15 was to get the increased allotment in the market. We're
16 not running from that. We're not ignoring that. It is an
17 admission. It's in the record. That is true. But you
18 can't take all of the acquisition and ignore the
19 freestanding business that generates taxable income.
20 That's just not a reasonable outcome. It's not a
21 reasonable allocation under the regulation.

22 And the obvious point, and I think this is why
23 it's always good to have your client with you here at
24 table, is we didn't use all of the allotment attributable
25 to Spreckels, you know, for the benefit of the cooperative.

1 We only used a portion of it. So it did, indeed, expand
2 what the cooperative was able to put in the market, but we
3 didn't use 100 percent of it. We used -- it varied from
4 year to year, and it would be 30 or 40 percent or whatever.
5 But so some of that allotment is still being used for
6 Spreckels, their for-profit operations to sell into the
7 marketplace.

8 So again, we have another reason why it's not a
9 reasonable result to assume that the only benefit of the
10 allocation -- or excuse me -- of the acquisition enured or
11 accrued to the cooperative business. That's just not what
12 happened. So I'm not denying the statement that one of the
13 reasons that we acquired them was for that additional
14 allotment and that the cooperative business sitting in
15 Minnesota took advantage of that, but it doesn't mean that
16 everything ought to be allocated that way. It's not a
17 reasonable result under the reg.

18 So a little bit on -- I'll be brief. A little bit
19 on the, you know, the usage of the money. The Zenith case
20 says evidence of dominant purpose can be shown through
21 direct tracing and use of the funds. We used the funds to
22 acquire Spreckels. Taxable operations. I think that's
23 easy.

24 We come here today -- and you can hear it in the
25 original presentation -- we, by virtue of the position

1 relying on the statutes and the regs, we do not want to be
2 an unreasonable party here. We do not want to take an
3 extreme position. I can put together the arguments that I
4 used it to buy Spreckels and, therefore, it should all
5 be -- any interest expense should be attributed or
6 allocable to those for-profit operations. But I want to
7 take an honest look at the facts and come up with a
8 reasonable answer, and that's why I'm, you know, very
9 clearly suggesting here some sort of allocation that makes
10 sense. Because I think that's consistent with the rule.
11 It's consistent with the purpose of the statute. And it
12 makes sense for everybody. We've suggested that to the FTB
13 as -- at the early parts of the audit, and it has never --
14 they've never been receptive to it, and that forces us to
15 take a little more an extreme position.

16 So I think the right answer at the end of the day
17 is some sort of allocation. But I think our answer, if
18 you're going to go all or nothing, I think our answer is
19 still far better than the FTB's because of the direct
20 tracing language that's in the Zenith case.

21 I think that's it. Certainly, if there are any
22 questions, happy to respond.

23 ALJ GAST: Thank you. I'm going to turn it over
24 to my panel to see if they have any final questions. I'll
25 start with Judge Akin.

1 ALJ AKIN: I don't think I have any additional
2 questions. I do want to thank both parties for their
3 presentations today.

4 ALJ GAST: And Judge Lam?

5 ALJ LAM: I do not have any further questions.
6 Thank you.

7 ALJ GAST: I, as well, do not have any further
8 questions. I think both parties did a great job presenting
9 today. With that I'm going to ask the parties if there's
10 anything else they'd like to tell us before I close the
11 record. Any comments?

12 MR. BRANNAN: If I may just consult for just a
13 second to make sure I'm not missing anything? My client is
14 actually more important than I am.

15 ALJ GAST: Okay.

16 MR. BRANNAN: Thank you very much. It's a little
17 harder to do that when everything is so visible. So thank
18 you for the time.

19 ALJ GAST: So, Mr. Brannan, there's nothing else?

20 MR. BRANNAN: That's correct.

21 ALJ GAST: Okay.

22 MR. BRANNAN: My apologies. Nothing else.

23 ALJ GAST: Okay. And Franchise Tax Board?

24 MR. EPOLITE: We're good. Thank you.

25 ALJ GAST: Okay. Thank you.

1 Okay. With that this concludes the hearing. And
2 I want to thank the parties, like I said, for their
3 presentations.

4 This appeal will be decided based on the arguments
5 and evidence presented. Our written opinion will be issued
6 no later than 100 days from today. This case is
7 submitted. The record is closed. And this concludes the
8 hearing for today. And I believe we will start again
9 tomorrow at 9:30 a.m. Thank you.

10 (Conclusion of the proceedings at 2:16 p.m.)

11 ---o0o---

REPORTER'S CERTIFICATE

STATE OF CALIFORNIA)
COUNTY OF SACRAMENTO) ss.

I, MARIA ESQUIVEL-PARKINSON, do hereby certify
that I am a Certified Shorthand Reporter, and that at the
times and places shown I recorded verbatim in shorthand
writing all the proceedings in the following described
action completely and correctly to the best of my ability:

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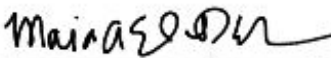
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DATE: Tuesday, January 24, 2023

I further certify that my said shorthand notes have
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pages 1 through 55 constitute an accurate and complete
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matter specified.

I further certify that I have complied with CCP
237(a)(2) in that all personal juror identifying
information has been redacted if applicable.

IN WITNESS WHEREOF, I have subscribed this
certificate at Sacramento, California, on this 10th day of
February, 2023.



Maria Esquivel-Parkinson
CSR No. 10621, RPR

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