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2023 – OTA – 343
Nonprecedential

**OFFICE OF TAX APPEALS**

**STATE OF CALIFORNIA**

In the Matter of the Appeal of:

**SOUTHERN MINNESOTA BEET SUGAR COOPERATIVE AND SUBSIDIARY**

OTA Case No. 19034447

**OPINION ON PETITION FOR REHEARING**

Representing the Parties:

For Appellants: Derick J. Brannan, Representative

For Respondent: Anthony S. Epolite, Tax Counsel IV

K. GAST, Administrative Law Judge: On March 17, 2023, the Office of Tax Appeals (OTA) issued an Opinion reversing respondent Franchise Tax Board's (FTB's) actions on the first of three issues for the 2008 through 2011 tax years. Specifically, on the first issue, OTA held that Southern Minnesota Beet Sugar Cooperative (appellant) properly included in the combined reporting group's California apportionment percentage its property, payroll, and sales related to business activities that permitted it to deduct certain agricultural cooperative income under Revenue and Taxation Code (R&TC) section 24404.[1] FTB disagrees with this conclusion and timely filed a petition for rehearing (petition) under R&TC section 19048.[2] Upon consideration of FTB's petition, OTA concludes FTB has not established a basis for a rehearing.

A rehearing may be granted where one of the following six grounds exists, and the substantial rights of the party seeking a rehearing (here, FTB) are materially affected: (1) an irregularity in the appeal proceedings which occurred prior to issuance of the Opinion and prevented fair consideration of the appeal; (2) an accident or surprise which occurred during the

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[1] For each tax year at issue, appellant filed a two-member California combined report with its wholly owned subsidiary, Spreckels Sugar Company (Spreckels). Since the issues on appeal largely relate to Southern Minnesota Beet Sugar Cooperative, OTA, as it did in the underlying Opinion, will refer to that entity here in the singular as "appellant," even though Spreckels is the other appellant.

[2] FTB filed a petition in this appeal only for the first issue. Appellant did not file a petition for the other two issues where OTA found in favor of FTB concerning whether appellant may deduct certain interest and depreciation expenses against its taxable nonmember income.

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appeal proceedings and prior to the issuance of the Opinion, which ordinary caution could not have prevented; (3) newly discovered, relevant evidence, which the party could not have reasonably discovered and provided prior to issuance of the Opinion; (4) insufficient evidence to justify the Opinion; (5) the Opinion is contrary to law; or (6) an error in law in the appeals hearing or proceeding. (Cal. Code Regs., tit. 18, § 30604(a)(1)-(6).)

Here, FTB solely contends the Opinion is contrary to law. "[T]he 'contrary to law' standard of review shall involve a review of the Opinion for consistency with the law." (Cal. Code Regs., tit. 18, § 30604(b).) To find that the Opinion is contrary to law, OTA must determine whether the Opinion is unsupported by any substantial evidence. (*Appeals of Swat-Fame, Inc., et al.*, 2020-OTA-045P.) This requires a review of the Opinion to indulge in all legitimate and reasonable inferences to uphold it. (*Ibid.*) The relevant question is not over the quality or nature of the reasoning behind the Opinion, but whether the Opinion can or cannot be valid according to the law. (*Ibid.*) In its review, OTA considers the evidence in the light most favorable to the prevailing party (here, appellant). (*Ibid.*)

As background, most of appellant's income during the tax years at issue arose from business activities for or with its member shareholders (member income). Under R&TC section 24404, appellant was permitted to deduct the entirety of its member income, which greatly reduced its gross income and resulting net income subject to California tax. Appellant also earned, to a much lesser extent, income that did not qualify for the R&TC section 24404 deduction (taxable nonmember income), which essentially comprised its net income subject to California tax. In determining the combined reporting group's California source business income, the group was required to multiply its combined business income by its California apportionment percentage, which was computed using a three-factor formula comprised of the sum of a property factor, a payroll factor, and a double-weighted sales factor, with that sum divided by four. (Cal. Code Regs., tit. 18, § 25106.5(c)(7)(A), (c)(7)(B).) Critically, when computing the group's California apportionment percentage, appellant included all of its (largely out-of-state) property, payroll, and sales attributable to its deductible member income, which substantially diluted the group's denominators, thus reducing the group's California apportionment percentages, California source income, and taxes reported as due.

FTB examined appellant's returns and excluded all of appellant's property, payroll, and sales attributable to its deductible member income from the group's California apportionment

percentage. In FTB's view, only activities giving rise to net business income are appropriately included in the apportionment formula. On appeal, OTA reversed FTB on this issue, concluding appellant properly included in the combined reporting group's California apportionment percentage its property, payroll, and sales related to business activities that permitted it to deduct certain agricultural cooperative income under R&TC section 24404. OTA explained that net income is determined by adding the taxpayer's gross income from all sources (which includes the gross member income) and then subtracting all allowable deductions from all sources (which includes the deductible member income). OTA determined this computation directly implicates R&TC sections 24401[3] and 24404, which allow appellant to deduct member income, and is performed *before* allocation and apportionment. OTA reasoned R&TC sections 24401 and 24404 are not located within, and do not address how net income is apportioned under, California's version of the Uniform Division of Income for Tax Purposes Act (UDITPA) (R&TC, §§ 25120 through 25141). OTA further reasoned there is no language in the UDITPA to support FTB's position that unitary business activities are excluded from the apportionment formula if they relate to deductible income, and FTB did not argue the standard apportionment formula should be altered under R&TC section 25137.

In its petition, FTB asserts OTA's Opinion "fails to fully address the principles of cooperative income taxation and its understanding of [appellant's] business activity. As a result, the Opinion erroneously concluded that [a]ppellant contributed factors towards the [California combined] group's apportionment formula." FTB argues that cooperatives exist to effect transactions with and for the benefit of their members. FTB further argues all benefits and costs from a cooperative's business activities with or for its members flow through the cooperative to its patrons (i.e., the cooperative's shareholders/members), leaving no income to be retained as profit by the cooperative and ensuring all income is taxed only once at the member, not cooperative, level.

As support, FTB quotes *Woodland Production Credit Assn. v. Franchise Tax Bd.* (1964) 225 Cal.App.2d 293, 298-299 (*Woodland Production*), which states in relevant part: "The tax exclusion or deduction of cooperatives' earnings rests on the theory that such earnings are not profits, but rather savings produced for patrons through a pooled effort. [Citations.] Although

[3] R&TC section 24401 authorizes "special deductions" in computing a C corporation's taxable income and is located in Article 2 of Chapter 7 of California's Corporation Tax Law, which is where R&TC section 24404, the provision at issue, is found.

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these savings are usually distributed as patronage dividends, they constitute in theory a downward adjustment in the price of the product the cooperative sells or the service it furnishes to its patrons; or in an upward adjustment in the price of the product it markets for them." Relying on this language, FTB contends appellant's cooperative business activities created "savings" for its member shareholders and therefore these activities "neither increase nor decrease [a]ppellant's California taxable income." Citing *Microsoft Corp. v. Franchise Tax Bd.* (2006) 39 Cal.4th 750, 760 (*Microsoft*), and *General Motors v. Franchise Tax Bd.* (2006) 39 Cal.4th 773, 787-788, FTB asserts the "economic reality" of the cooperative's transactions with or for its members, which includes a consideration of why money is being received, shows the cooperative's business activities do not constitute "taxed transactions" at the cooperative level because these transactions never create income or loss for the cooperative. Rather, FTB concludes, savings for the cooperative's members is the sole reason why the cooperative receives money. Thus, FTB argues, "if a business activity never intends to, and actually does not contribute to a calculation of an apportionable tax base because the activity is set up by the taxpayer not to produce income or loss for the entity, then the business activity also should not contribute to the factors that apportion the tax base."

However, OTA carefully and thoroughly considered the essence of FTB's contentions in rendering its detailed Opinion and found they were unpersuasive. After citing to and discussing the above language from *Woodland Production* that FTB now cites for the first time in its petition, OTA concluded "even though these [cooperative] savings may not generate profit for appellant's unitary group, such transactions can nevertheless be included in 'sales' under the UDITPA, and this should be equally true of the property and payroll factors." As support, OTA cited *General Mills v. Franchise Tax Bd.* (2009) 172 Cal.App.4th 1535 (*General Mills*), which concluded sales from hedging futures were includible in the sales factor because they are made for the ultimate purpose of obtaining gains or profit, even if there is no profit motive from the future trades alone. Elsewhere in its Opinion, OTA quoted *General Mills*, at p. 1547, in finding: "The Court of Appeal also broadly concluded '*many transactions that do not generate profit are nevertheless included in "sales" for UDITPA purposes*, such as sales to consumers at cost or at a loss that are designed to bring customers into a store or promote the company's products and thus ultimately generate profit for the company.'" (Italics added.) And contrary to FTB's assertion, the economic reality of appellant's cooperative business is appellant did receive third

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party receipts in exchange for a product or service, even if the main purpose of its cooperative business was to create savings, not profit, for its member shareholders through a pooled effort. (*Microsoft*, *supra*, 39 Cal.4th at p. 760 [looking to the economic reality of the taxed transaction].)

OTA also noted California law specifically provides that cooperative associations are not exempt from tax under California's Corporation Tax Law (CTL), but rather are permitted a deduction for all income arising from business done for or with members, and for or with nonmembers when done on a nonprofit basis. (Cal. Code Regs., tit. 18, § 24404.) Therefore, appellant is not a tax-exempt entity under the CTL and does generate member income that is first considered gross income under the CTL at the cooperative level and then deducted under R&TC section 24404. This supports the conclusion that cooperatives are not generating income that is "exempt," "excluded," or "not recognized" for purposes of the CTL, which are tax terms of art that might have supported FTB's theory that related activities and receipts should be excluded altogether from the apportionment formula.

Lastly, in its Opinion, OTA rejected a similar argument that FTB advances in its petition; namely, FTB is seeking to treat appellant as a separate and independent entity with a separate accounting system when such accounting is not permitted for a unitary business. (See *Chase Brass & Copper Co., Inc. v. Franchise Tax Bd.* (1977) 70 Cal.App.3d 457, 468-469.) Instead, for purposes of analyzing the apportionment issue here, OTA concluded the proper focus should be in the context of appellant's unitary business with Spreckels Sugar Company and whether appellant's activities contributed to the production of the unitary group's business income. In short, FTB's dissatisfaction with the Opinion and attempt to reargue the same issue does not constitute grounds for a rehearing. (*Appeal of Graham and Smith*, 2018-OTA-154P.) Consequently, OTA denies FTB's petition.

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Kenneth Gast
Administrative Law Judge

We concur:

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Amanda Vassigh
Administrative Law Judge

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Administrative Law Judge

Date Issued: 6/26/2023