2023 – OTA – 342P
Precedential

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

Representing the Parties

For Appellants: Derick J. Brannan, Representative
Erin F. Eakes, Representative
Ian O'Connell, V.P. of Finance and CFO

For Respondent: Anthony S. Epolite, Tax Counsel IV
Irina Iskander Krasavtseva, Tax Counsel IV

For Office of Tax Appeals: Grant S. Thompson, Tax Counsel V

K. GAST, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19045, Southern Minnesota Beet Sugar Cooperative (appellant) and its sole subsidiary Spreckels Sugar Company (Spreckels) (collectively, appellants)[1] appeal actions by respondent Franchise Tax Board (FTB) proposing additional tax of $59,952, $779,503, $1,920,273, and $1,945,119, plus applicable interest, for the 2008, 2009, 2010, and the 2011 tax years, respectively.[2]

Office of Tax Appeals (OTA) Administrative Law Judges Kenneth Gast, Cheryl L. Akin, and Eddy Y.H. Lam held an oral hearing for this matter in Sacramento, California, on January 24, 2023. At the conclusion of the hearing, the record was closed and this matter was submitted for an opinion.

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[1] Since the issues largely relate to Southern Minnesota Beet Sugar Cooperative, this Opinion will refer to that entity in the singular as "appellant," even though Spreckels is the other appellant.

[2] Appellants' 2008, 2009, 2010, and 2011 tax years correspond to their fiscal tax years ending August 31, 2009, August 31, 2010, August 31, 2011, and August 31, 2012, respectively.

ISSUES

1. Whether 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.
2. Whether appellant may deduct interest expense—incurred to acquire Spreckels, a unitary entity—against its taxable nonmember income.
3. Whether appellant may deduct depreciation expense—incurred from assets used to produce deductible income under R&TC section 24404—against its taxable nonmember income.

FACTUAL FINDINGS

General Background

1. Appellant is an agricultural cooperative corporation headquartered in Minnesota. It is owned by farmer shareholders (its members) and manufactures sugar and sugar by-products from sugar beets produced by its members.
2. During the tax years at issue, most of appellant's income 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.
3. Prior to the disputed tax years, appellant acquired Spreckels, a for-profit general corporation based in California. Like appellant, Spreckels manufactures refined sugar and other products from sugar beets. But, unlike appellant, Spreckels is not entitled to the R&TC section 24404 deduction. Spreckels earned substantial amounts of net income subject to California tax during the years at issue.
4. Appellant generally funded the Spreckels acquisition with third-party debt. By acquiring Spreckels, appellant obtained additional sugar production and distribution rights that

allowed appellant to sell more beet sugar produced by its members, increasing appellant's profitability and deductible member income.

Appellants' California Combined Report

5. For each year at issue, appellant and its wholly owned subsidiary, Spreckels, were engaged in a unitary business of manufacturing sugar and sugar by-products and were required to (and did in fact) file a two-member California combined report. (See R&TC, §§ 25101, 25106.5; Cal. Code Regs., tit. 18, § 25106.5 et seq.)

6. In determining the combined reporting group's California source business income, FTB's regulation required appellant and Spreckels to follow a number of sequential steps. As relevant here, they were each required to compute their separate net income before allocation and apportionment. (Cal. Code Regs., tit. 18, § 25106.5(c)(1), (b)(18).) To calculate its separate net income, appellant deducted from its gross income all of its member income (as permitted under R&TC sections 24401 and 24404), as well as interest expense incurred on debt used to acquire Spreckels and depreciation expense from assets used to produce its deductible member income.[3]

7. After aggregating their separate net incomes to derive their total group combined report business income, appellant and Spreckels were essentially required to multiply that combined amount by the group's California apportionment percentage. (Cal. Code Regs., tit. 18, § 25106.5(c)(7)(A) [applicable to appellants' 2011 tax year], (c)(7)(B) [applicable to appellants' other tax years on appeal].) For the tax years at issue, the group's California apportionment percentage 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.[4] (*Ibid*.)[5] Critically, when computing the group's

[3] Because appellant deducted all of its member income, its interest and depreciation expense deductions reduced its taxable nonmember income (and/or Spreckels's separate net income after appellant and Spreckels aggregated their pre-apportioned separate net incomes).

[4] For the 2011 tax year, the combined reporting group did not elect to use a single-sales factor formula (see former R&TC, § 25128.5), and for each disputed tax year, it did not conduct a qualifying agricultural business activity requiring it to use a three-factor (evenly-weighted sales factor) formula (see R&TC, § 25128(b), (c)(1)).

[5] Each of these factors is a fraction, where the numerator is generally the total California property, payroll, and sales of the taxpayer members of the group, and the denominator is the total property, payroll, and sales of the group everywhere. (Cal. Code Regs., tit. 18, § 25106.5(c)(7)(A)1.b.i.-iii & (c)(7)(B)2.a.-c.)

California apportionment percentage, appellant included all of its property, payroll, and sales attributable to its deductible member income. Since all of its property and payroll was located outside of California, and a relatively small portion of its sales was located in California for two of the tax years at issue, appellant's inclusion of activities attributable to its member income substantially diluted the group's denominators, thus reducing the group's California apportionment percentages, California source income, and resulting taxes reported as due.[6]

Procedural History

8. FTB examined appellants' tax returns for the disputed years and proposed the following three adjustments.

   a. First, FTB excluded all of appellant's property, payroll, and sales attributable to its deductible member income from the group's California apportionment percentage. FTB reasoned that only activities giving rise to net business income are appropriately included in the apportionment formula. Since, as noted above, all of appellant's property and payroll was located outside of California, and a relatively small portion of its sales was located in California for two of the tax years at issue, this had the effect of removing substantial out-of-state amounts from the group's denominators, resulting in higher California apportionment percentages, California source income, and additional taxes due. By doing so, FTB effectively required the combined reporting group to apportion its business income—which, except for one tax year, consisted mostly of Spreckels's net income—using a California apportionment percentage largely comprised of Spreckels's property, payroll, and sales factors, which were almost exclusively

[6] For the contested tax years, appellant claimed it was protected by Public Law 86-272, a federal statute, from California's franchise tax based on net income. Consequently, Spreckels was essentially attributed, and paid tax on, all of the group's California source (i.e., post-apportioned) combined report business income, including appellant's taxable nonmember income. (See Cal. Code Regs., tit. 18, § 25106.5(c)(7)(A)2. [involving a procedure known as "intrastate apportionment" applicable to appellants' 2011 tax year], (c)(7)(B)4. [applicable to appellants' other tax years on appeal].)

located in California.[7] For each tax year at issue, the group's California apportionment percentages significantly increased from about 29 to 30 percent, as reported, to about 94 to 96 percent, as adjusted by FTB.

b. Second, FTB determined appellant's interest expenses from the Spreckels acquisition could not be deducted from its gross income because it was related to appellant's deductible member income.

c. Third, for the same reason as its interest expense determination, FTB disallowed appellant's depreciation expense deductions.

9. After FTB issued Notices of Action affirming its Notices of Proposed Assessment for each tax year at issue, appellants filed this timely appeal.

DISCUSSION

Issue 1: Whether 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.

I. Introduction

FTB's determination of tax is presumed to be correct, and a taxpayer has the burden of proving error. (*Appeal of GEF Operating, Inc.*, 2020-OTA-057P.) Appellant asserts it properly included in the denominator (and numerator, as applicable) of the group's California apportionment percentage its (largely out-of-state) property, payroll, and sales related to its deductible member income. It maintains such income is simply deducted from gross income and cannot be considered "exempt" or "excluded" from the tax base. FTB disagrees, asserting appellant's member income did not generate apportionable business income and therefore the related property, payroll, and sales must be excluded altogether from both the numerator and denominator of the group's apportionment formula. For reasons discussed below, OTA finds in favor of appellant.

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[7] FTB determined appellant also generated taxable nonmember income (i.e., income that did not qualify for the R&TC section 24404 deduction), which consisted of dividends, interest, gross rents and royalties, and other income. FTB thus allowed appellant to include in the group's California apportionment percentages (specifically, only the sales factor denominators) sales related to its taxable nonmember income because, unlike its deductible member income, this income was ultimately subject to California tax. Appellant's taxable nonmember sales were significantly smaller than Spreckels's total sales for purposes of computing the group's sales factor denominators. Appellant apparently had no property or payroll related to its taxable nonmember income.

II. Applicable Law – In General

Under California's Corporation Tax Law (CTL), corporations doing business in California are subject to a franchise tax according to or measured by their "net income" (or, if greater, a minimum tax). (R&TC, § 23151(a).) Similarly, in the combined report context, members are first required to compute their "total separate net income" from all sources before allocation and apportionment. (Cal. Code Regs., tit. 18, § 25106.5(c)(1), (b)(18).) R&TC section 24341 provides "'[n]et income' means the gross income, computed under Chapter 6 (commencing with [R&TC] [s]ection 24271), less the deductions allowed under this article [i.e., Article 1] and Article 2 (commencing with [R&TC] [s]ection 24401)." "[G]ross income" means "all income from whatever source derived . . . ." (R&TC, § 24271(a) [incorporating by reference and generally conforming to Internal Revenue Code (IRC) section 61(a)].) Thus, the starting point for determining net income is the taxpayer's gross income from all sources.

Once gross income from all sources is determined, allowable deductions from all sources are applied to calculate net income. (R&TC, § 24341.) These deductions are set forth in Articles 1 and 2 of Chapter 7 of the CTL. (*Ibid.*) Article 1 includes a variety of deductions, such as deductions for trade or business expenses, interest, and depreciation. (R&TC, § 24343 et seq.) Article 2 contains various "special deductions." (See R&TC, § 24401 ["In addition to the deductions provided in Article 1 . . ., there shall be allowed as deductions in computing taxable income the items specified in [Article 2]"].) These include deductions for net operating losses, organizational expenditures, and, as relevant here, a deduction for certain agricultural cooperative income under R&TC section 24404. (R&TC, § 24401 et seq.)

R&TC section 24404 essentially provides that agricultural cooperatives are permitted to deduct "all income resulting from or arising out of such business activities for or with their members carried on by them or their agents; or when done on a nonprofit basis for or with nonmembers."[8] California Code of Regulations, title 18, (Regulation) section 24404 explains that "[c]ooperative associations are not exempt from tax under [the CTL], but are permitted a deduction for all income arising from business done for or with members, and for or with

[8] The term "cooperative" is not defined in the R&TC or its administrative regulations, but one case, interpreting a statute similar to R&TC section 24404, defined it generally as "an enterprise or organization owned by and operated for the benefit of those using its services." (*California State Auto. Assn. v. Franchise Tax Bd.* (1987) 191 Cal.App.3d 1253, 1257 [involving R&TC section 24405, which, like R&TC section 24404, permits a deduction for cooperative income under certain circumstances].)

nonmembers when done on a nonprofit basis." "[A]ll cooperatives are subject to tax on or measured by income derived from business done with nonmembers on a profit basis but not less than the minimum tax." (Cal. Code Regs., tit. 18, § 24404.) Thus, under California's tax scheme, agricultural cooperatives can deduct certain income related to members and certain nonprofit income related to nonmembers (referred to above as "member income"). But they cannot deduct, and therefore are taxable on, their for-profit nonmember income (referred to above as "taxable nonmember income").

After multistate taxpayers compute their net income from all sources, they must allocate and apportion such income under California's version of the Uniform Division of Income for Tax Purposes Act (UDITPA)[9] (R&TC sections 25120 through 25141) to derive their net income attributed to sources within this state.[10] (See R&TC, §§ 25101, 25121; see also Cal. Code Regs., tit. 18, § 25106.5(b)(18), (c)(1)-(7).) "Under the [UDITPA]—adopted by California and certain other states and which seeks to establish uniform rules for the attribution of corporate income—a unitary enterprise's 'business income' is apportioned among the tax jurisdictions according to a formula."[11] (*Appeal of Robert Half International Inc. & Subs*., 2019-OTA-330 (*Robert Half*), citing *Microsoft Corp. v. Franchise Tax Bd.* (2006) 39 Cal.4th 750, 755-756 (*Microsoft*).) For the years at issue, California required appellants' combined report business income to be "apportioned to this state by multiplying the business income by a fraction, the numerator of

[9] References to UDITPA in this Opinion refer to the UDITPA as codified by California in 1966 and in effect for the tax years at issue. (See *The Gillette Co. et al. v. Franchise Tax Bd.* (2015) 62 Cal.4th 468, 473.) This act is based upon, and similar to, the model UDITPA drafted by the National Conference of Commissioners on Uniform State Laws. (*Ibid*.) The UDITPA was intended to provide a uniform guide for state laws and practices regarding multistate business taxation and to prevent taxation in multiple jurisdictions based on more than a business's net income. (*Ibid*.)

[10] As background, "[t]he United States Constitution bars taxation of extraterritorial income." (*Microsoft v. Franchise Tax Bd.* (2006) 39 Cal.4th 750, 755, citations omitted.) "However, it permits taxation of 'an apportionable share of the multistate business carried on in part in the taxing [s]tate' and grants states some leeway in separating out their respective shares of this multistate income, not mandating they use any particular formula." (*Ibid*.) One constitutional method of apportionment is the unitary business/formula apportionment method, which the UDITPA is generally based on. (*Id*. at pp. 755-756.) This method "calculates the local tax base by first defining the scope of the 'unitary business' of which the taxed enterprise's activities in the taxing jurisdiction form one part, and then apportioning the total income of that 'unitary business' between the taxing jurisdiction and the rest of the world on the basis of a formula taking into account objective measures of the corporation's activities within and without the jurisdiction." (*Container Corp. v. Franchise Tax Bd.* (1983) 463 U.S. 159, 165.)

[11] The UDITPA divides a unitary enterprise's income into "business income" and "nonbusiness income." Nonbusiness income, which is not apportioned by formula but instead generally allocated directly to a single state, is not at issue here. (See R&TC, §§ 25120(d), 25123-25127.) To avoid confusion, and unless otherwise specified, this Opinion uses the terms "business income" and "net income" interchangeably.

which is the property factor plus the payroll factor plus twice the sales factor, and the denominator of which is four." (R&TC, § 25128(a); see also Cal. Code Regs., tit. 18, § 25106.5(c)(7)(A)-(B).) Each factor is a fraction where the numerator measures activity or assets within California, and the denominator includes all activities or assets anywhere (including California). (R&TC, §§ 25129, 25132, 25134; see also Cal. Code Regs., tit. 18, § 25106.5(c)(7)(A)1.b.i.-iii & (c)(7)(B) 2.a.-c.)

In general, multiplying business income by the fraction produced by the apportionment formula derives the taxpayer's net income for state purposes (i.e., California source income) to which the tax rate is applied. (See R&TC, §§ 25108(c), 23151(a); see also Cal. Code Regs., tit. 18, § 25106.5(c)(7)(A)1., (B), (f).) Business income may not always result in a positive number (i.e., gross income exceeds the allowable deductions for the tax year). Instead, it could result in a current year net operating loss (i.e., the allowable deductions exceed gross income for the tax year), or theoretically result in neither net income or loss if the business merely breaks even for the year. (See R&TC, §§ 24416, 25108(a), (c); see also Cal. Code Regs., tit. 18, §§ 25121(b), 25106.5(b)(17), (e).)

There is no dispute that under R&TC section 24404, appellant was an agricultural cooperative that generated (and properly deducted) its member income for the tax years at issue. The parties also agree that during these same years, appellants were engaged in a unitary business,[12] were required to determine their portion of net income attributed to California using the UDITPA, and derived business income subject to the standard three-factor (double-weighted sales) apportionment formula. In addition, neither party asserts a deviation from the standard apportionment formula is required to achieve an equitable result. (See R&TC, § 25137.) Rather, their dispute is over how, if at all, R&TC section 24404 impacts the standard apportionment formula under the UDITPA; namely, whether property, payroll, and sales amounts used to generate deductible member income are includible in that formula (i.e., the denominators and, as applicable, numerators of the three fractions).[13]

[12] "A unitary business is generally defined as two or more business entities that are commonly owned and integrated in a way that transfers value among the affiliated entities." (*Citicorp North America, Inc., et al. v. Franchise Tax Bd.* (2000) 83 Cal.App.4th 1403, 1411, fn. 5.)

[13] There is also no dispute that if the property, payroll, and sales related to deductible member income are properly included in the apportionment formula, appellant correctly computed its denominators and, as applicable, numerators with respect to such amounts for the tax years at issue.

III. Analysis

1. The UDITPA Does Not Exclude Factors Related to Deductible Member Income Under R&TC Section 24404

"As with any issue of statutory [or regulatory] interpretation, [OTA] begin[s] with the text of the relevant provisions. If the text is unambiguous and provides a clear answer, [OTA] need go no further. If the language supports multiple readings, [OTA] may consult extrinsic sources, including but not limited to the legislative history and administrative interpretations of the language. Where, as here, the Legislature has adopted a uniform act [i.e., the UDITPA], the history behind the creation and adoption of that act is also relevant." (*Microsoft*, *supra*, 39 Cal.4th at p. 758; see also *Butts v. Board of Trustees of California State University* (2014) 225 Cal.App.4th 825, 835 [statutory construction rules also govern interpretation of regulations].)

Nothing in the plain language of the UDITPA, including its accompanying regulations,[14] provides that the factors used to generate deductible member income under R&TC section 24404 are excluded from the apportionment formula. A review of the UDITPA's provisions supports this determination. UDITPA contains various rules for, among other purposes, describing taxpayers subject to its scheme (R&TC, §§ 25121, 25122), defining specific terms, such as business income (R&TC, § 25120(a)), detailing the composition of the formula used to apportion business income (R&TC, § 25128), and explaining how to compute the factors (R&TC, §§ 25129-25136). But none of these provisions, or their underlying regulations, provide that the standard formula is altered to exclude unitary activities that generate deductible member income. In fact, Regulation section 25121(b) clarifies a net loss arising from unitary business activities occurring within and without California must, like positive net income, be apportioned under the UDITPA and its regulations. (See also Cal. Code Regs., tit. 18, § 25106.5(b)(17) [in the combined reporting regulations, the term "income" generally includes "loss"].) Thus, contrary to FTB's position that the apportionment formula only reflects activities giving rise to positive business income, apportionment is still required if such activities produce a net loss.

R&TC sections 24401 and 24404, which allow appellant to deduct member income, are not located in the UDITPA, and they do not address how an agricultural cooperative's business

[14] Many of FTB's regulations under the UDITPA are based on the Multistate Tax Commission's model regulations interpreting the UDITPA. (See *Robert Half*, *supra*.)

income is apportioned. Indeed, the only explicit reference to R&TC section 24404 in the UDITPA (both statutes and its regulations) is Regulation section 25128-2. That regulation provides rules for what constitutes a qualified agricultural business activity for purposes of requiring use of a three-factor (evenly-weighted sales factor) formula, as opposed to the standard three-factor (double-weighted sales factor) formula for most businesses for the tax years at issue. (Cal. Code Regs., tit. 18, § 25128-2(f), (g).) Specifically, Regulation section 25128-2(f)(1) provides agricultural cooperatives under R&TC section 24404 are not engaged in qualified agricultural business activities, subsection (f)(2) provides certain sales to non-unitary cooperatives can constitute receipts from a qualified business activity for the non-cooperative seller, and subsection (g) provides patronage dividends under R&TC section 24404 from cooperatives are not included in the non-cooperative producer's (i.e., dividend recipient's) receipts from an agricultural business activity. However, there is no mention that the standard three-factor (double-weighted sales factor) formula (or the evenly-weighted formula for certain agricultural businesses) is somehow altered when applied to agricultural cooperatives permitted to use the R&TC section 24404 deduction.[15]

The UDITPA's statutory provisions defining the property and payroll factors used in the standard apportionment formula do not contain any general exclusion of activities that produce deductible income. R&TC section 25129 provides the property factor reflects "real and tangible personal property owned or rented and used" by the taxpayer, R&TC section 25132 provides the payroll factor reflects "total amount paid . . . by the taxpayer for compensation," and R&TC section 25120(c) defines "compensation" as "wages, salaries, commissions and any other form of remuneration paid to employees for personal services." There is thus no mention that the property and payroll factors must exclude values related to deductible income.

The sales factor likewise contains no such general exclusion. "The sales factor is a fraction, the numerator of which is the total sales of the taxpayer in this state during the taxable year, and the denominator of which is the total sales of the taxpayer everywhere during the taxable year." (R&TC, § 25134.) For the 2008 through 2010 tax years at issue, R&TC section 25120(e) provided the term "sales" meant "all gross receipts of the taxpayer [not

[15] The UDITPA's sole explicit reference by regulation to R&TC section 24404 for one apportionment purpose (the composition of the formula) but not for the purpose here (i.e., what values are included in the formula once its composition is determined) arguably supports appellant's position. (Cal. Code Regs., tit. 18, § 25128-2(f)(1).)

allocated as nonbusiness income].” Although the term “gross receipts” was not defined by statute or regulation, in *Microsoft*, the California Supreme Court noted “‘[g]ross’ implies the whole amount received, not just the amount received in excess of the purchase price.” (*Microsoft*, *supra*, 39 Cal.4th at p. 759.) As support, the Court cited a dictionary definition of “gross receipts,” which was defined as the “total amount of money or other consideration received by a business taxpayer for goods sold or services performed in a year, *before deductions*[.]” (*Ibid.*, fn. 7, italics added.) 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.” (*General Mills v. Franchise Tax Bd.* (2009) 172 Cal.App.4th 1535, 1547, citations omitted (*General Mills*).) Therefore, for the 2008 through 2010 tax years, gross receipts related to deductible member income under R&TC section 24404 are includible in the sales factor.

This sales factor conclusion appears to be the same for the 2011 tax year. The parties do not explicitly address that year, but OTA briefly discusses it because for tax years beginning on or after January 1, 2011, the Legislature, for the first time, added a definition of “gross receipts.” That term is now statutorily defined, in relevant part, as “*the gross amounts realized* (the sum of money and the fair market value of other property or services received) . . . in a transaction that produces business income, in which the income, gain, or loss is recognized . . . under the [IRC], as applicable for purposes of [the CTL]. Amounts realized on the sale or exchange of property *shall not be reduced by the cost of goods sold or the basis of property sold*.” (R&TC, § 25120(f)(2), italics added.) FTB does not appear to argue appellant’s member income itself (prior to the deduction) is not recognized under the IRC, as applicable for purposes of California’s CTL. Therefore, the gross receipts related to such income should count towards to the sales factor for 2011. (See Cal. Code Regs., tit. 18, § 24404 [“Cooperative associations are not exempt from tax [under the CTL] . . . but are permitted a deduction”]; see also R&TC, § 23701a(a) [not exempting from the CTL cooperative organizations described in R&TC section 24404].) Although the statute contains certain enumerated exclusions from the definition of “gross receipts,” none of them relate to deductible member income under R&TC section 24404 or imply such an exclusion was contemplated by the Legislature. (See R&TC, § 25120(f)(2)(A)-(L).)

Similarly, there is nothing in FTB's regulations interpreting the UDITPA that indicate activities related to deductible member income under R&TC section 24404 are excluded from the apportionment formula. Those regulations generally provide that to be included in the apportionment formula, a taxpayer's property, payroll, and sales must be used in, paid in, or derived from transactions and activity in the regular course of the taxpayer's trade or business. (See Cal. Code Regs., tit. 18, §§ 25129, 25132, 25134; see also Cal. Code Regs., tit. 18, § 25106.5(c)(7)(A)1.b.i.-iii & (c)(7)(B)2.a.-c. [involving combined reporting groups and referencing statutory rules for the property, payroll, and sales factors]). The regulations do indicate property and payroll used in connection with the production of nonbusiness income are excluded from the factors, and property previously used in the regular course of the taxpayer's trade or business is excluded from the property factor if that property is permanently withdrawn from the unitary business. (See Cal. Code Regs., tit. 18, §§ 25129(a) & (b), 25132(a).) But there is no suggestion that activities related to deductible member income generated from unitary business activities are likewise excluded.

This is also true for Regulation section 25134, which "provides inclusive rules for the types of gross receipts includible in the sales factor (without distinguishing between the numerator or denominator)." (*Robert Half*, *supra*.) It provides "the term 'sales' means all gross receipts derived by the taxpayer from transactions and activity in the regular course of such trade or business." (Cal. Code Regs., tit. 18, § 25134(a)(1).) It further provides rules for determining sales in various situations, but none of them indicate sales are excluded from the apportionment formula if they do not produce net income for the taxpayer conducting unitary business activities. (See, e.g., Cal. Code Regs., tit. 18, § 25134(a)(1)(A) [sales includes "all gross receipts" from sales of goods or products], (a)(1)(B) [sales includes "the entire reimbursed cost, plus the fee," for cost plus fixed fee contracts], (a)(1)(C) [sales includes "the gross receipts" from the performance of services, including fees, commissions, and similar items], & (a)(1)(F) [sales includes "gross receipts" from the sale of equipment used in the business].) Although it does remove from the sales factor denominator "receipts excluded under Regulation [section] 25137(c)," this provision excludes various types of sales, such as certain substantial and occasional sales, from the sales factor, but none of the exclusions apply here. (Cal. Code Regs., tit. 18, §§ 25134(b), 25137(c).) Accordingly, the property, payroll, and sales factor regulations limit the type of activities includible in the apportionment formula, but the limitation is based on whether the activities are a regular part of the taxpayer's trade or business, not on whether the activities relate to deductible member income or produce positive net income.[16]

To summarize, net income is determined by adding the taxpayer's gross income from all sources and subtracting all allowable deductions from all sources. That computation directly implicates R&TC sections 24401 and 24404, which allow appellant to deduct member income, and is performed *before* allocation and apportionment. R&TC sections 24401 and 24404 are not located in, and do not address how net income is apportioned under, the UDITPA once net income from all sources is determined. 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. Although R&TC section 25137 allows for the standard apportionment formula to be altered in some circumstances, FTB does not argue it applies here. Since OTA discerns no, and FTB has not pointed to, any ambiguity in the relevant UDITPA statutes and its regulations, the analysis need go no further. Appellant therefore properly included in the combined reporting group's California apportionment percentage its property, payroll, and sales related to its deductible member income under R&TC section 24404.

2. FTB's Contentions

a. *Chase Brass* Does Not Support FTB's Position

The only case cited by FTB to support its proposed adjustments is *Chase Brass & Copper Co., Inc. v. Franchise Tax Bd.* (1977) 70 Cal.App.3d 457 (*Chase Brass*). *Chase Brass* allowed FTB to exclude from the taxpayer's sales factor internal (i.e., intercompany) sales made to another member of the unitary combined group. FTB notes the court stated "[s]ince no net income is produced by the internal sales, it was not required that they be included in the computation." (*Chase Brass*, *supra*, 70 Cal.App.3d at p. 473.) FTB asserts *Chase Brass* supports its adjustments to the property, payroll, and sales factors because, like a taxpayer's intercompany sales within a unitary combined group, appellant's member activities do not generate net income.

[16] Nothing in FTB's special apportionment regulations under R&TC section 25137 changes this conclusion. (See Cal. Code Regs., tit. 18, § 25137 et seq.) In addition, Regulation section 25106.5 et seq., involving detailed steps to determine California source net income or loss for combined reporting groups such as appellants', does not alter the UDITPA or its regulations in the manner FTB advances here. (See, e.g., Cal. Code Regs., tit. 18, § 25106.5(c)(7)(A)-(B).)

Chase Brass does not support FTB's view and is distinguishable. Income or loss generated from intercompany transactions within a combined reporting group is not the same as gross income generated from outside the group and subsequently deducted. Indeed, the issue of intercompany transactions and their effect on the tax base and apportionment formula are now addressed by at least one statute and a regulation, which were not in effect for the tax years at issue in *Chase Brass*. (See R&TC, § 25106; Cal. Code Regs., tit. 18, § 25106.5-1.) The rules governing intercompany transactions do not apply here, and there are no statutes or regulations requiring taxpayers to exclude from the apportionment formula unitary activities related to deductible member income under R&TC section 24404.

The internal sales at issue in *Chase Brass* also did not have any real impact outside the unitary group. They shifted funds within the unitary group but did not change the overall net income of the group. In contrast, appellant's cooperative activities are an integral part of its unitary business. They have a real economic impact outside the unitary group because they produce sugar and sugar by-products that are sold outside the group. Thus, appellant's use of property, payroll, and sales to generate third-party revenue for the unitary business is materially different from the internal sales at issue in *Chase Brass*.

Additionally, *Chase Brass* reviewed a materially different apportionment statute. The court applied R&TC section 25101 as in effect during the 1950s, which was prior to California's enactment of the UDITPA. During those tax years, the court noted R&TC section 25101 essentially gave FTB "discretion" to choose an apportionment formula that was "fairly calculated" to determine a taxpayer's net income from sources within California, but it did not mandate the use of specific factors. (*Chase Brass*, *supra*, at pp. 466-468.) In contrast, R&TC section 25101 now provides the tax "*shall* be measured by the net income derived from or attributable to sources within [California] in accordance with [the UDITPA]." (Italics added; see also R&TC, § 25121 [net income "shall" be allocated and apportioned under the UDITPA].) Thus, current statutes no longer grant FTB the power to use any "fairly calculated" apportionment formula; rather, they require FTB to apply the UDITPA. (See *Appeal of New York Football Giants, Inc.* (77-SBE-014) 1977 WL 3825.) If FTB seeks to deviate from the standard apportionment formula, then under R&TC section 25137, FTB, not the taxpayer, "has the burden of proving by clear and convincing evidence that (1) the approximation provided by the standard formula is not a fair representation, and (2) its proposed alternative is reasonable."

(*Microsoft*, *supra*, 39 Cal.4th at p. 765.) FTB does not attempt to invoke R&TC section 25137 here.

Lastly, when FTB argues appellant's property, payroll, and sales related to member activities did not produce net income, it makes an error *Chase Brass* warns against: "treating [appellant] as a separate and independent entity with a separate accounting system[,]" when "separate accounting is not permitted for the unitary business of the corporations, and [in fact] the contention [] has been repeatedly rejected [by the California and U.S. Supreme Courts]." (*Chase Brass*, *supra*, at pp. 468-469.) FTB thus improperly focuses on appellant's cooperative activities in isolation when the focus should be in the context of its unitary business with Spreckels and whether appellant's activities contributed to the production of the unitary group's business income. Accordingly, *Chase Brass* does not support FTB's position.

b. FTB Is Not Entitled to Deference Under *Yamaha*

Citing in part to the California Supreme Court's decision in *Yamaha Corp. of America v. State Bd. of Equalization* (1998) 19 Cal.4th 1, 12 (*Yamaha*), FTB notes that while an agency's construction of a statute is reviewed independently, significant weight is given to long-standing agency constructions of a statute. FTB thus appears to seek deference in its interpretation of the apportionment statutes. OTA declines for reasons that follow.

In *Yamaha*, the Court explained the weight and persuasiveness of an agency interpretation may be influenced by factors such as the technical expertise of the agency, the complexity of the matter, whether the agency's interpretation has been consistent, and whether the interpretation has been formally adopted in regulations. (See *Yamaha*, *supra*, 19 Cal.4th at pp. 12-13.) Whether and to what extent an agency's view is entitled to deference is "fundamentally situational" and "turns on a legally informed, commonsense assessment of the[] contextual merit." (*Id.* at pp. 12, 14.) Thus, the weight afforded to the tax agency's judgment depends "'upon *the thoroughness evident in its consideration, the validity of its reasoning, its consistency with earlier and later pronouncements, and all those factors which give it power to persuade, if lacking power to control.*'" (*Id.* at pp. 14-15, italics added by *Yamaha*, quoting *Skidmore v. Swift & Co.* (1944) 323 U.S. 134, 140.)

OTA reviews FTB's interpretation with these factors in mind. As to the technical expertise of the agency and complexity of the matter, FTB has extensive expertise in the complex area of multistate taxation, including expertise in the day-to-day administration of the UDITPA. This factor weighs in favor of a degree of deference to its interpretation.

Regarding whether FTB's interpretation has been formally adopted in regulations, FTB has not provided evidence or argument to show that it has been. As previously discussed, FTB's apportionment regulations generally provide that activities related to property, payroll, and sales must be included in the apportionment formula if they are used or arise in the regular course of the trade or business. They do not provide that such activities are excluded if they do not produce net income.[17] This factor does not weigh in favor of deference.

In evaluating the degree of weight to give FTB's interpretation, OTA also considers the thoroughness evident in FTB's consideration, the validity of its reasoning, and its consistency with earlier and later pronouncements. In this appeal, FTB argues that under *Chase Brass*, its proposed adjustments properly interpret R&TC section 24404 and Regulation section 24404. However, as discussed previously, *Chase Brass* does not support FTB's adjustments. Also, FTB has not adequately explained what specific language in R&TC section 24404 or Regulation section 24404, or other provisions, can be interpreted as setting forth a specific rule that activities that generate deductible member income are excluded from apportionment factors or a general rule that activities that do not produce net income are excluded from apportionment factors. To reiterate, R&TC section 24404 and Regulation section 24404 are not in, and do not reference, the UDITPA.

At the oral hearing, FTB requested that OTA defer to its Legal Ruling 2006-01 (April 28, 2006), which has set forth its position for the past 17 years. In that ruling, FTB addresses the issue of how activities related to income that is partially or completely excluded from the measure of the income or franchise tax should be reflected for apportionment factor purposes. FTB essentially concludes such activities should be excluded from both the numerator and denominator of the property, payroll, and sales factors. FTB asserts its ruling fully supports its contentions here. OTA disagrees for several reasons.

[17] FTB's position appears to be that as apportionment factors are used to apportion net income, activities should be excluded from the apportionment factors if they do not generate net income. If this were the case, one might expect the converse to also be true: if activities generate net income, they must be included in the apportionment factor. But OTA does not see such a general rule in FTB's regulations. (See, e.g., Cal. Code Regs., tit. 18, § 25137(c)(1)(A) [excluding from the sales factor certain substantial and occasional sales regardless of whether they produce business income or loss].)

Legal Ruling 2006-01 does not squarely address deductible member income under R&TC section 24404. Rather, it addresses two hypothetical factual situations that are distinguishable from the issue here. The first situation involves an organization exempt from California's franchise or income tax that conducts activities generating both exempt and taxable income. FTB concludes only the non-exempt activities that are reflected in the tax base (i.e., the taxable unrelated business income) should be included in the apportionment formula. But appellant is not a tax-exempt entity, as FTB's Regulation section 24404 confirms.

The second situation involves a U.S. corporation that receives a dividend from a unitary foreign (non-U.S.) corporation excluded from the combined group's water's-edge election. The U.S. corporation "eliminate[s]" 75 percent of that dividend income from its tax base under R&TC section 24411. FTB concludes only 25 percent of the dividend is includible in the U.S. corporation's sales factor denominator because the remaining 75 percent was "excluded from the [U.S. corporation's] tax base." But, here, appellant deducted its member income under R&TC section 24404, not R&TC section 24411. Further, in the second situation, FTB adjusts the U.S. corporation's sales factor, but FTB does not address whether that corporation's property and payroll factors are similarly adjusted. In contrast, here, FTB completely eliminated appellant's property and payroll from the group's California apportionment percentage.[18]

Although the two situations addressed in Legal Ruling 2006-01 are not directly applicable, the ruling contains broad language that is similar to FTB's arguments here. Among other things, in the ruling, FTB argues activities that generate excluded income "are simply irrelevant in the UDITPA approach." It further argues "[t]his would be equally true for all activities that do not result in net business income, regardless of whether it is because the activity results in [nonbusiness income] or results in income that is excluded by operation of a statute." In footnote four, the legal ruling broadly asserts this same analysis "would apply regardless of whether the statute uses the term 'exempted,' 'excluded,' 'deducted,[']' 'not recognized,' etc." The footnote then disclaims any reliance on statutory language, stating that "[t]he conclusion is based upon the fact that these income amounts are related to activities excluded from net income subject to apportionment, not the language used in the statute to reach this conclusion."

[18] Legal Ruling 2006-01 should also be viewed with caution when considering its application to different factual situations. FTB's website states its legal rulings represent its conclusion "regarding the application of law to the entire statement of facts specified[,]" and taxpayers and others are therefore "cautioned against reaching the same conclusion in other cases unless the facts and circumstances are *the same*." (https://www.ftb.ca.gov/tax-pros/law/legal-rulings/index.html, italics added.)

As OTA is evaluating the consistency of FTB's position, the ruling's broad statements appear to be consistent with FTB's arguments here. But when also evaluating the thoroughness evident in FTB's consideration and the validity of its reasoning, OTA finds member income "deducted" under R&TC section 24404 should not be equated with income that has been "exempted," "excluded," or "not recognized." These terms and others are terms of art that have specific meaning in the context and structure of the R&TC. (See *Beamer v. Franchise Tax Bd.* (1977) 19 Cal.3d 467, 478-479.) They also can have unique meaning for purposes of the UDITPA. (See *Microsoft*, *supra*, 39 Cal.4th at pp. 759-760 [gross receipts differs from gross income in that the latter subtracts the cost of goods sold, and "sales" for sales factor purposes encompasses more than just gross income]; *General Motors v. Franchise Tax Bd.* (2006) 39 Cal.4th 773, 787-788 (*General Motors*) [for tax purposes, return of loan principal is not a gross receipt under the UDITPA]; R&TC, § 25120(f)(2) [for tax years 2011 and forward, the definition of gross receipts is tied to the IRC, as applicable for purposes of the CTL].)[19]

Critically, items that are "exempted," "excluded," or "not recognized" generally do not enter into gross income (or gross receipts) to begin with and are not included in net income. This appears to support FTB's position the related activities should not be included in the apportionment formula. (See R&TC, § 23701 et seq. [involving organizations exempt from all taxes imposed under the CTL]; R&TC, § 24301 ["In computing the tax imposed under [the CTL], 'gross income' does not include any of the items specified in [Article 2 of Chapter 6]"]; R&TC, § 24320 et seq. [involving other exclusions from gross income under Article 3 of Chapter 6]; Treas. Reg. § 1.61-6(b)[20] ["Certain realized gains or losses on the sale or exchange of property are not 'recognized,' that is, are not included in or deducted from gross income at the time the transaction occurs [such as IRC sections 351, 721, and 1031]"].) However, the deduction for certain agricultural cooperative income is not found in the R&TC provisions dealing with exempt entities (R&TC, § 23701 et seq.), gross income (Article 1 of Chapter 6 of

[19] When interpreting the UDITPA, California courts "strive to achieve uniformity with sister states when possible." (*General Motors*, *supra*, 39 Cal.4th at p. 788; see also R&TC, § 25138 [the UDITPA "shall be so construed as to effectuate its general purpose to make uniform the law of those states which enact it"].) At least one other state that follows the UDITPA has issued a recent opinion acknowledging these principles. (*Oracle Corp. and Subs. v. Dept. of Revenue* (2021) TC 5340, 2021 WL 9848297 at p. *10 [the Oregon Tax Court, Regular Division, concluded there is a link between "gross receipts" for income tax accounting purposes and for apportionment purposes].)

[20] Since, under R&TC section 24271(a), California generally conforms to IRC section 61, it likewise conforms to this federal Treasury Regulation. (R&TC, § 23051.5(d).)

the CTL), exclusions from gross income (Articles 2 and 3 of Chapter 6 of the CTL), or nonrecognition transactions (e.g., IRC sections 351, 721, and 1031). Rather, it is found in Article 2 of Chapter 7 of the CTL as an item that is specifically deducted from gross income, which at that point has already been computed and includes gross member income itself. Under the CTL, member income is thus first considered gross income and then deducted under R&TC section 24404 to determine net income subject to tax. Indeed, if member income were not gross income, there would arguably be no need for the R&TC section 24404 deduction.

At the oral hearing, FTB also argued that in 2016, the California Legislature endorsed Legal Ruling 2006-01 when it enacted Senate Bill No. 2. (Stats. 2015-2016, 2nd Ex. Sess., ch. 2, § 1.) In that bill, the Legislature stated "[i]t is the intent of the Legislature that [FTB] Legal Ruling 2006-01 . . . regarding the treatment of apportionment factors attributable to income exempt from income tax shall apply to apportionment factors attributable to the income of qualified health care service plans excluded by Section 24330 of the [R&TC], as added by . . . this act." (*Ibid*.) However, R&TC section 24330, which has since been repealed by its own terms, specifically operated to exclude certain gross income of a qualified health care service plan. (Former R&TC, § 24330.) It was found in Article 3 of Chapter 6 of the CTL, which contains other exclusions from gross income and, as discussed above, should not be considered the same as a deduction from gross income. If anything, the Legislature's statement—"income exempt from income"—appears to endorse Legal Ruling 2006-01's conclusion related to organizations exempt from the CTL, but should not be broadly interpreted as applying to the deductible member income at issue here.

One might argue the R&TC section 24404 deduction effectively "eliminates" member income from gross income and is similar to an exclusion or exemption of income from the tax base such that the related activities should likewise be excluded from the apportionment formula. (See generally *Anaheim Union Water Co. v. Franchise Tax Bd.* (1972) 26 Cal.App.3d 95, 103- 104 [noting R&TC section 24425 prevents taxpayers from deducting expenses related to "gross income" not included in the measure of tax and is applicable to member income deductible under R&TC section 24405].) However, there is no authority in the UDITPA or its regulations that indicates activities related to the deduction under R&TC section 24404 are excluded from the apportionment formula. (Cf. R&TC, § 25106 [intercompany unitary dividends are "eliminated from the income of the recipient" and generally are not considered "in any other manner" in determining the tax]; Cal. Code Regs., tit. 18, § 25106.5-1(f) [several examples eliminate intercompany unitary dividends from the sales factor].)

Indeed, the purpose of cooperative income deductions "rests on the theory that such earnings are not profits, but rather savings produced for patrons through a pooled effort." (*Woodland Production Credit Assn. v. Franchise Tax Bd.* (1964) 225 Cal.App.2d 293, 298 [involving R&TC section 24405].) The savings "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." (*Id.* at p. 299.) Thus, even though these 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. (See *General Mills*, *supra*, 172 Cal.App.4th at p. 1547 [sales from hedging futures 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]; see also *Microsoft*, *supra*, 39 Cal.4th at p. 760 [looking to the economic reality of the taxed transaction].)[21]

Lastly, in its brief and in Legal Ruling 2006-01, FTB refers to a quote from Professor William Pierce, the principal drafter of the model act reflected in California's UDITPA, to bolster its position. In the quote, Professor Pierce states the following: "[T]he uniform act assumes that the existing state legislation has defined the base of tax and that the only remaining problem is the amount of the base that should be assigned to the particular taxing jurisdiction. Thus, the statute does not deal with the problem of ascertaining the items used in computing income or the allowable items of expense." (Pierce, *The Uniform Division of Income for State Tax Purposes* (1957) 35 Taxes 747, italics omitted (*Pierce*).)

But Professor Pierce's statement does not support FTB's position because it does not suggest deductions that reduce the tax base also require alterations to the apportionment formula. Rather, if any inference can be drawn from the statement, it is the computation of net income, including the application of deductions such as R&TC section 24404, is determined *before and separate from* the UDITPA. Indeed, Professor Pierce's discussion of the apportionment

[21] *Microsoft* and *General Motors* were companion cases issued by the California Supreme Court on August 17, 2006. *General Mills* was issued by the California Court of Appeal on April 15, 2009. Therefore, these cases were issued after FTB issued Legal Ruling 2006-01 on April 28, 2006, they are not addressed in that ruling, they provide important guidance on what is a gross receipt includible in the sales factor, and they have bearing on the issues in this appeal.

formula's composition tends to support that activities related to appellant's cooperative business should be included in the group's apportionment formula since they contribute to the overall production of the group's (including Spreckels's) business income. (See *Pierce*, *supra*; see also *Appeal of Merrill, Lynch, Pierce, Fenner & Smith, Inc.* (89-SBE-017) 1989 WL 95886 [the property, payroll, and sales factors reflect capital, labor, and consumer markets, respectively, that contribute to the production of business income]; Hellerstein, Hellerstein, & Appleby, State Taxation (3d ed. 2001) Division of the Tax Base, ¶ 8.06.)

In short, FTB's expertise in multistate taxation counsels in favor of a degree of deference to its interpretation. However, FTB's position does not persuasively explain how the relevant statutes or regulations might be interpreted in the manner it proposes, which would result in excluding unitary business activities that contribute to the production of apportionable business income from the apportionment formula without support in the UDITPA and its regulations and without a showing of distortion.[22] In these circumstances, OTA gives due deference and careful consideration to FTB's position, but in the end, OTA must apply its own independent judgment. Accordingly, OTA reverses FTB's decision on this issue.

<u>Issue 2: Whether appellant may deduct interest expense—incurred to acquire Spreckels, a unitary entity—against its taxable nonmember income.</u>

Income tax deductions are a matter of legislative grace, and a taxpayer that claims a deduction has the burden of proving by competent evidence it is entitled to that deduction. (*Appeal of Vardell*, 2020-OTA-190P.) In computing a taxpayer's net income (here, appellant's pre-apportioned net income), certain specified items are nondeductible. (R&TC, § 24421.) One such nondeductible item is set forth in R&TC section 24425(a), which provides, in full, that "[n]o deduction shall be allowed for any amount otherwise allowable as a deduction which is allocable to one or more classes of income not included in the measure of the tax imposed by

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[22] FTB's position would effectively remove a corporation from a unitary group if the corporation's activities did not produce net income. For example, this could occur when a unitary corporation produces a net loss for the year or utilizes a net operating loss carryover to fully offset its post-apportioned taxable income. In this respect, the consequence of FTB's interpretation would appear to be in tension with the general unitary business principle that taxation of a unitary business should be determined by examining all the activities of that business as a whole, rather than by viewing the business activities of one corporate member of the unitary group in isolation. (See, e.g., *Butler Bros. v. McColgan* (1941) 315 U.S. 501, 508-509; *Mobil Oil Corp. v. Comr. of Taxes of Vermont* (1980) 445 U.S. 425, 438.) In addition, depreciation on fixed assets and payroll expenses are deductible in determining unitary business income, but the related property and payroll values are, of course, included in the apportionment formula, as long as they are used or paid in the regular course of the trade or business. (See Cal. Code Regs., tit. 18, §§ 25129, 25132.)

[the CTL], regardless of whether that income was received or accrued during the taxable year." This rule "applies whenever income is eliminated from tax under any authority or for any purpose, thus preventing a taxpayer from receiving a double benefit in deducting interest expenses incurred in the production of nontaxable income." (*Apple, Inc. v. Franchise Tax Bd.* (2011) 199 Cal.App.4th 1, 23, citation and quotation marks omitted (*Apple*).)

There is no dispute R&TC section 24425(a) operates, among other purposes, to deny deductions related to income deductible under R&TC section 24404. (See *Appeal of Imperial Hay Growers' Association* (70-SBE-031) 1970 WL 2464.) The question here is whether appellant's interest expense deductions are in fact allocable to its deductible member income. Appellant argues its interest expense is directly traceable to debt used to acquire an asset (i.e., Spreckels) that generated taxable income. FTB counters the acquisition allowed appellant to generate more deductible member income under R&TC section 24404.

To support their respective positions, both parties cite to the Board of Equalization's (BOE's) precedential decision in *Appeal of Zenith National Insurance Corp.* (98-SBE-001) 1998 WL 15204 (*Zenith*). The issue there was whether interest expense incurred in connection with the issuance of corporate debentures should be allocated to taxable or nontaxable income for purposes of determining the deductibility of that expense under R&TC section 24425. (*Zenith*, *supra*.) The taxpayer received nontaxable dividends from an insurance subsidiary over several tax years. (*Ibid.*) During those same years, the taxpayer incurred interest expense in connection with the issuance of corporate debentures used to develop a portfolio of preferred stock paying taxable dividends. (*Ibid.*) The taxpayer deducted all of its debenture-related interest expense, but on audit, FTB used a formula to reallocate the interest expense deductions between the taxpayer's income from taxable preferred stock dividends and its income from nontaxable insurance dividends. (*Ibid.*)

In deciding the case, BOE discussed the proper analysis for these issues. (*Zenith*, *supra*; see also *Apple*, *supra*, 199 Cal.App.4th at pp. 22-26 [applying the *Zenith* analysis].) It held "[i]n the absence of direct evidence linking indebtedness with a particular purchase, [BOE] will determine whether the totality of the facts and circumstances establish a sufficiently direct relationship between the borrowing and the investment to allow for a direct allocation between those two items." (*Zenith*, *supra*, citing IRS Rev. Proc. 72-18, 1972-1 C.B. 740.) BOE further held "[u]nless the taxpayer can establish its dominant purpose and a sufficiently direct relationship between the expense and the income, [FTB's] allocation formula will provide the best means to allocate interest expense between taxable and nontaxable activities." (*Ibid.*) BOE then concluded "*due to the factual nature of the inquiries presented by this analysis*, it is also clear that the taxpayer must carry the general burden of proving its *dominant purpose* for incurring and/or continuing the subject obligations (and the related interest expense), as well as the burden of demonstrating *the actual use* of the subject funds, by tracing or some other method." (*Ibid.*, italics added.)

On the facts before it, BOE found that for three of the four tax years, the taxpayer established a dominant purpose sufficient to allow for a direct allocation of its interest expense. (*Zenith*, *supra*.) However, for the last year, BOE concluded the taxpayer failed to keep its original dominant purpose and required the use of FTB's allocation formula. (*Ibid.*) That formula consisted of a ratio of the taxpayer's insurance-related income (income excluded from California's bank and corporation tax) to its gross income (all income whether excluded or not). (*Ibid.*)

Applying this analysis here, OTA first notes the term "dominant" is not defined in *Zenith* or the authorities it cites, but one dictionary definition states the term means "exercising the most power, control, or influence."[23] Therefore, "dominant purpose" appears to mean the most important purpose if there is more than one purpose. Here, appellant argues since FTB agrees the interest expense is directly traceable to debt used to purchase Spreckels, that expense is deductible because it relates to a class of income included in the measure of tax (i.e., Spreckels's net income that was taxed by California). FTB contends the dominant purpose of appellant's acquisition debt was to allow it to sell more sugar and increase its deductible member income. As support, FTB provides an audit information request sent to appellant relating to the Spreckels acquisition and its impact on appellant's sugar distribution rights.[24] Appellant responded, in part, "the purchase of Spreckels along with its unused allocations immediately allowed [appellant] to sell more sugar." Appellant further responded that due to the acquisition, it "estimated that it would reap an annual benefit of approximately $9 [million] by being able to sell all of its refined sugar at market prices."

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[23] https://www.ahdictionary.com/word/search.html?q=dominant. *Microsoft* cited, in part, to a version of the American Heritage Dictionary when defining "gross receipts." (*Microsoft*, *supra*, 39 Cal.4th at p. 759, fn. 7.)

[24] It is unclear if the purpose of FTB's information request specifically related to this interest expense issue and/or whether it was related to the unitary audit of appellant and Spreckels.

Although both parties present a credible reason why appellant incurred and/or continued the debt used to acquire Spreckels, OTA finds neither has established appellant's *dominant purpose*. On the one hand, appellant incurred the debt to acquire a unitary asset (i.e., Spreckels) that did in fact generate significant net income for the combined group that was subject to tax during the disputed years.[25] (See *Zenith*, *supra* [direct evidence of a purpose to purchase assets producing taxable or nontaxable income exists where the proceeds of indebtedness are used for, and are directly traceable to, the purchase]; *Appeal of Mission Equities Corp.* (75-SBE-002) 1975 WL 3263 ["the question is what income did the expenses in controversy help to produce"].) On the other hand, appellant admitted Spreckels helped appellant sell more sugar and therefore generate more deductible member income. (See *Zenith*, *supra* [BOE referenced taxpayer's declarations, as well as its president's live testimony, to discern its dominant purpose].)

Since OTA is unable to discern appellant's dominant purpose, and the acquisition produced both taxable and nontaxable income for the combined group, *Zenith* instructs an allocation formula must be employed. (*Zenith*, *supra* [allocation formula used when dominant purpose not shown].) However, appellant, which carries the general burden of proof, has not shown what allocation formula should be used. In its briefing, appellant indicates, without further explanation or support, its interest expense should be allocated between Spreckels's taxable income and the increased benefit appellant enjoyed as a result of the acquisition (i.e., $9 million).[26] At the oral hearing, appellant then suggested a different formula—one taking into account other factors, such as gross revenue or income—might be more appropriate, but did not provide anything more specific. Because appellant did not clearly set forth a reasonable allocation formula supported by evidence, it is not entitled to deduct its interest expense at issue.[27]

[25] At the oral hearing, FTB argued the interest expense should not be allocated to taxable income because appellant did not show the Spreckels acquisition increased the amount of *Spreckels's* taxable income. However, FTB's argument seems misplaced because the acquisition did in fact increase the *combined reporting group's* taxable income, whereas prior to the acquisition, Spreckels's taxable income was not included in a combined report filed with appellant.

[26] It is unclear if the $9 million is a gross or net amount (before application of the deduction permitted by R&TC section 24404).

[27] OTA notes it does not have sufficient evidence in the record to allow it to compute an allocation formula (e.g., using appellant's gross or net income before application of R&TC section 24404 for the tax years at issue versus Spreckels's gross or net income for those same years).

Issue 3: Whether appellant may deduct depreciation expense—incurred from assets used to produce deductible income under R&TC section 24404—against its taxable nonmember income.

This final issue also involves R&TC section 24425(a), which generally prevents taxpayers from deducting expenses that enable them to earn income that is not included in the measure of tax. There is no dispute R&TC section 24425(a) denies depreciation deductions related to deductible income. (See *Appeal of Redwood Mutual Water Co.* (80-SBE-84) 1980 WL 5016 (*Redwood*).) There is also no dispute, and indeed appellant concedes, R&TC section 24425(a) disallows its claimed depreciation because it is wholly allocable to assets used to produce deductible member income under R&TC section 24404. Appellant nonetheless contends it is still entitled to deduct depreciation.

Appellant argues "depreciation represents a loss to the going concern," and it should be allowed "to deduct a loss for the declining value of its assets on an annual basis in order to allow [its combined reporting group] to properly reflect its income for tax purposes." Quoting *U.S. v. Ludey* (1927) 247 U.S. 295, 301, appellant asserts the theory underlying depreciation is that by using property and subjecting it to wear and tear, the taxpayer makes a "gradual sale" of the property. Appellant believes it is "inconsistent" to deny depreciation deductions when cooperative property is used to generate deductible income, yet if that property is sold, treat the sale proceeds as a taxable event (because such sales to third parties do not give rise to deductible income). On this ground, it argues FTB should, under R&TC section 24651, make an adjustment to reflect the annual loss suffered by its for-profit activities due to the "gradual sale" of a piece of property.

R&TC section 24651, however, provides no assistance to appellant. It generally requires income to be computed under the method of accounting the taxpayer regularly uses to compute its income in keeping its books. (R&TC, § 24651(a).) R&TC section 24651(b) provides that, if no method of accounting has been regularly used by the taxpayer, or the method used "does not clearly reflect income," income shall be computed "under such method as, in the opinion of [FTB], does clearly reflect income." Appellant has not shown its method of accounting failed to clearly reflect income, or it proposed an alternative computation that "in the opinion of [FTB]" clearly does so.

Appellant does not explain, or provide support for, why R&TC section 24425's denial of its depreciation deductions does not clearly reflect its income on a yearly basis. Simultaneously deducting depreciation expenses as well as deducting the income those assets produce arguably also leads to yearly income distortion. The result appellant advocates would essentially allow cooperatives to use otherwise nondeductible expenses to offset taxable income those expenses did not produce, which can only exacerbate the problem. (See *Anaheim Union*, *supra*, 26 Cal.App.3d 95 at p. 106 [it would be an "absurd result" to allow cooperatives "to offset their expenses incurred in producing [deductible] income [] against their nonmember profit business," and "there is nothing to indicate the Legislature intended to confer double benefits"].) In addition, as appellant acknowledges, cooperative businesses ultimately benefit from an upward basis adjustment in the amount of the disallowed depreciation deductions, which may reduce (or entirely eliminate) taxable gain when the property is sold. (See *Redwood*, *supra*.) Accordingly, appellant is not entitled to deduct its depreciation expense at issue.

HOLDINGS

1. 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.
2. Appellant may not deduct interest expense—incurred to acquire Spreckels, a unitary entity—against its taxable nonmember income.
3. Appellant may not deduct depreciation expense—incurred from assets used to produce deductible income under R&TC section 24404—against its taxable nonmember income.

DISPOSITION

FTB's actions, proposing to exclude from the combined reporting group's California apportionment percentage appellant's property, payroll, and sales related to business activities that permitted it to deduct certain agricultural cooperative income under R&TC section 24404, are reversed. In all other respects, FTB's actions are sustained.

DocuSigned by:
Kenneth Gast
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Kenneth Gast
Administrative Law Judge

We concur:

DocuSigned by:
Cheryl L. Akin
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Cheryl L. Akin
Administrative Law Judge

DocuSigned by:
Eddy Y.H. Lam
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Eddy Y.H. Lam
Administrative Law Judge

Date Issued: 3/17/2023