



MULTISTATE INCOME/FRANCHISE TAX

California OTA – Activities related to deductible income permitted in apportionment factor Tax Alert

Overview

On March 17, 2023, the California Office of Tax Appeals (“OTA”), in a pending precedential [opinion](#), concluded, among others, that for the taxable years at issue (2008 through 2011), the taxpayer properly included in its combined reporting group’s apportionment percentage, its property, payroll, and sales attributable to income deducted under California Revenue and Taxation Code (“CRTC”) section 24404, disagreeing with the California Franchise Tax Board’s (“FTB”) long-standing position under FTB Legal Ruling 2006-01 (“LR 2006-01”) that factors related to deducted income are not includible in the apportionment percentage. On June 26, 2023, the OTA issued an [opinion](#) denying FTB’s petition for rehearing.

This Tax Alert summarizes the decision and provides taxpayer considerations.

Background

In California, cooperative associations are not exempt from tax under the Corporation Tax Laws, but they are permitted a deduction under CRTC section 24404 for all income arising from business done for or with members and nonmembers when done on a nonprofit basis (collectively, “Member Income”). However, cooperative associations cannot deduct, and therefore are taxable on, their for-profit nonmember income.

Southern Minnesota Beet Sugar Cooperative (“Taxpayer”), headquartered in Minnesota, is an agricultural cooperative corporation owned by its members (farmer shareholders). Prior to the years at issue, Taxpayer acquired Spreckels Sugar Company (“Spreckels”), a for-profit corporation based in California, that manufactures refined sugar and other products from sugar beets. For the taxable years at issue, Taxpayer and Spreckels filed a two-member unitary combined report and deducted all its Member Income under CRTC section 24404. For the taxable years at issue, Taxpayer apportioned its combined business income using a three-factor formula comprised of a property factor, payroll factor, and double-weighted sales factor, and therefore included the

property, payroll, and sales attributable to its deductible Member Income, a position of which the FTB denied.

Summary of OTA's analysis

The primary issue in this case involved the Taxpayer including in the California apportionment percentage its factors attributable to deductible Member Income. Relying on *Chase Brass & Copper Co., Inc. v. Franchise Tax Bd.* (1977) 70 Cal.App.3d 457 ("*Chase Brass*") and LR 2006-01, the FTB contended, among others, that the apportionment formula only reflects activities giving rise to positive business income and therefore activities that result in income that is exempted, excluded, deducted, or not recognized are not included in the apportionment formula, such as those related to income deducted under CRTC section 24404.

However, the OTA disagreed, reasoning in part that:

- Nothing in the plain language of the UDITPA and underlying regulations provide that the factors used to generate deductible Member Income under CRTC section 24404 are excluded from the apportionment formula. In fact, the California Supreme Court in *Microsoft Corp. v. Franchise Tax Board*, 39 Cal. 4th 750 (2006), stated that "[g]ross] implies the whole amount received, not just the amount received in excess of the purchase price[,]" and California subsequently added a definition for "gross receipts" under CRTC section 25120 to explicitly provide that this term means "the gross amounts realized."
- *Chase Brass* did not support the FTB's position, because that case involved income generated from intercompany transactions, whereas the present case involved income generated from outside parties. Moreover, *Chase Brass* was decided prior to California's enactment of UDITPA, whereas current law mandates the use of UDITPA in calculating the apportionment formula – meaning, the FTB no longer has the power to use any "fairly calculated" apportionment formula.
- Contrary to LR 2006-01, Member Income that is "deducted" under CRTC section 24404 should not be equated with income that has been "exempted," "excluded," or "not recognized." These terms are terms of art that have specific meaning in the context and structure of the CRTC and UDITPA. Notably, the latter terms do not enter into the gross income computation, whereas the former term does. Although the OTA noted that the FTB's interpretation may be entitled to a degree of deference due to its expertise in multistate taxation, the OTA must apply its own independent judgment and disagrees with the FTB's interpretation.

The OTA also noted that although the FTB did not attempt to assert that the standard apportionment formula did not fairly reflect Taxpayer's business activities in California pursuant to CRTC section 25137, if it had made this assertion, the FTB, not the taxpayer, would have the burden of proving distortion.

Although not the central issue in this case, the OTA also considered whether Taxpayer's interest expense incurred to acquire Spreckels and depreciation expense incurred from assets used to produce deductible income were deductible under CRTC section 24425. CRTC section 24425 prohibits a deduction for amounts allocable to one or more classes of income that is not included in the measure of the tax imposed under the Corporation Tax Laws. The OTA ultimately denied the Taxpayer's interest and depreciation deductions for the reasons stated in the opinion.

Considerations

Although the OTA's decision is specific to the Taxpayer in question, it does provide some indication of the OTA's position on these issues. Importantly, the OTA's analysis surrounding *Chase Brass* and LR 2006-01 may have broader implications with respect to the inclusion in the apportionment formula of factors attributable to deductible income, such as California's 75 percent foreign dividend deduction under CRTC section 24411 applicable to California combined reporting groups that file on a water's edge basis. The FTB's historical position under LR 2006-01 excluded from the sales factor the 75 percent dividends that were deducted under CRTC section 24411. Taxpayers should consult their tax advisors to evaluate the impact that this decision may have on their California tax liabilities.

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