



This Week in State Tax (TWIST)

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California: Factors Related to Deductible Income Cannot be Excluded from Apportionment Formula

The California Office of Tax Appeals or OTA recently addressed whether property, payroll and sales associated with deductible income are excluded from the apportionment formula. The taxpayer, an agricultural cooperative corporation headquartered in Minnesota, manufactured sugar, and sugar by products from beets grown by its farmer members. The taxpayer owned a for-profit sugar manufacturer the acquisition of which was funded with third-party debt. The two entities were engaged in a unitary business and filed a combined California return. In computing its separate net income (the first step in determining the combined group's California liability), the taxpayer deducted member income under R&TC section 24404, as well as interest expense on debt used to acquire the sugar subsidiary, and depreciation expense related to assets that were used to produce deductible member income. On audit, the FTB excluded all the taxpayer's property, payroll, and sales attributable to its deductible member income on the basis that only activities giving rise to net business income were included in the apportionment formula. The FTB also disallowed the taxpayer's interest and depreciation deductions that were related to deductible member income. The taxpayer protested and the matter eventually came before the OTA.

Under California law, agricultural cooperatives are permitted to deduct all income (1) resulting from or arising out of business activities for or with their members and (2) from activities done on a nonprofit basis for or with nonmembers. The issue before the OTA was whether property, payroll, and sales associated with deductible member income were includible in the taxpayer's apportionment formula. The OTA concluded that there was no language in UDITPA or in California's statutes or regulations supporting the FTB's assertions that activities related to deductible income should be excluded from the apportionment formula. Further, the OTA declined the FTB's request to defer to Legal Ruling 2006-01, in which it concluded that activities related to income that is partially or completely excluded from the measure of tax should be excluded from both the numerator and denominator of the property, payroll, and sales factors. The OTA distinguished the situations addressed in Legal Ruling 2006-01, including one addressing the FTB's position that when 75 percent of a foreign dividend is excluded from the tax base only 25 percent of the dividend is includible in the U.S. dividend recipient's sales factor denominator. In the OTA's view, cooperative member income "deducted" under R&TC section 24404 should not be equated with income that has been "exempted," "excluded," or "not recognized," as such items generally do not enter into gross income to begin with and are not included in net income. The OTA next addressed and sustained the FTB's denial of the interest and depreciation deductions against the taxpayer's nonmember income. This decision is "pending precedential." Please contact [Oksana Jaffe](#) with questions on *Appeal of Southern Minnesota Beet Sugar Cooperative*.

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