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09.11.12

Chief Counsel Ruling 2012-04

Subject: Chief Counsel Ruling Request for TAXPAYER.

Dear *****:

You requested on behalf of your client, *****TAXPAYER*****
*****, a Chief Counsel Ruling concerning whether the production of PRODUCT 1,
PRODUCT 2, PRODUCT 3 and PRODUCT 4 meet the definition of "agricultural business
activities" within the meaning of California Revenue and Taxation Code (CRTC) section
25128(d)(2), such that the revenue from the sale of these products constitutes gross
business receipts derived from a qualified business activity, specifically an agricultural
business activity under CRTC section 25128(b) and (c)(1).

ISSUE

Whether TAXPAYER’S revenue from the sale of PRODUCT 1, PRODUCT 2, PRODUCT 3 and
PRODUCT 4 constitutes revenue from agricultural business activity under CRTC section
25128(d)(2).

FACTS

TAXPAYER leases farmlands¹ on which it grows and harvests vegetables, primarily *****.
Additionally, TAXPAYER runs a facility in California in which it processes **** into PRODUCT
1, PRODUCT 2, PRODUCT 3 and PRODUCT 4. In order to produce a “PRODUCT 1,”
TAXPAYER processes whole ***** by *****.
TAXPAYER produces PRODUCT 2, PRODUCT 3 and PRODUCT 4 through similar processes.

TAXPAYER is incorporated in STATE X, headquartered in CITY, California, and is a C
corporation, taxed as such for U.S. federal and California income tax purposes.

¹ All of the farmland on which TAXPAYER grows ***** is leased from others. TAXPAYER also has agreements
with other farmers. These farmers are contracted to grow ***** on TAXPAYER’S behalf.

HOLDING

TAXPAYER'S processing of PRODUCT 1, PRODUCT 2, PRODUCT 3 and PRODUCT 4 do not constitute agricultural business activities under CRTC section 25128(d)(2). Consequently, the gross receipts from the sale of those products are not derived from qualified agricultural business activities as set forth in CRTC section 25128(b), (c)(1).

APPLICABLE LAW

Taxpayers with income from business activities that are taxable both within and without the state must allocate and apportion their net income as provided in the Uniform Division of Income for Tax Purposes Act (UDITPA) contained in CRTC sections 25120-25139. (CRTC § 25121.) Under California's modified UDITPA formula generally, absent an effective single sales factor election,² the taxpayer's business income must be apportioned by using a four-factor formula composed of a property factor, a payroll factor, and a double-weighted sales factor. (CRTC § 25128(a).) The numerators of the respective factors represent the taxpayer's property, payroll, and sales in California, while the denominators represent the taxpayer's property, payroll, and sales everywhere.³ However, California requires businesses that derive more than 50 percent of their gross business receipts from conducting one or more qualified business activities (such as agricultural business activities) to apportion their business income to California using an evenly-weighted three-factor apportionment formula. (CRTC § 25128(b), (c)(1).)

CRTC section 25128(d)(2) and California Code of Regulations (Cal. Code Regs.) title 18, section 25128-2(c)(6) define agricultural business activities as including those activities relating to harvesting any agricultural commodity, including, but not limited to, handling, drying, packing, grading, or storing on a farm any agricultural commodity in its unmanufactured state, but only if the owner, tenant, or operator of the farm regularly produces more than one-half of the commodity handled, dried, packed, graded, or stored.

18 CCR section 25128-2(c)(1) further states that agricultural business activities also include the "production" of certain agricultural products including vegetables. Production is defined under 18 CCR section 25128-2(b)(3) to include planting and growing of one's own agricultural commodity and includes processing activities which are normally incident to the growing, raising, or planting of agricultural products. Production activities which are incident to the harvesting of agricultural products

² CRTC § 25128.5, effective for tax years beginning on or after January 1, 2011.

³ CRTC §§ 25129, 25132, 25134.

include picking, washing, inspecting, and packaging vegetables for sale. (18 CCR § 25128-2(b)(3).)

The regulation also states, however, that production does not include "the processing of agricultural products beyond those activities which are normally incident to the production of such products according to industry practice." (18 CCR § 25128-2(b)(3).) The regulation provides several examples in illustration of this limitation, among which are Examples 1 and 3. In Example 1, a company has grown and harvested grain in order to produce flour, breads, cereals, and other similar food products. The example concludes that the sale of the processed products do not constitute agricultural business activity. In Example 3, the activity of processing nuts by shelling and the sale of such processed nuts do not constitute an agricultural business activity.

DISCUSSION

TAXPAYER operates a facility in which it produces PRODUCT 1, PRODUCT 2, PRODUCT 3 and PRODUCT 4. As discussed above, to process PRODUCT 1 whole ***** are ***** that are used to produce PRODUCT 2, PRODUCT 3 and PRODUCT 4 are similarly processed beyond the picking and packaging activities that are normally considered agricultural business activities. Instead, these activities performed by TAXPAYER are similar to those in Examples 1 and 3 in CCR section 25128-2(b)(3), relating to processing of grains into flour and processing of nuts by shelling.

Like the production of flour or the shelling and processing of nuts, a mechanical process is applied to the whole ***** to transform it into a different form for consumption. Thus, the activities performed by TAXPAYER to the ***** in producing PRODUCT 1, PRODUCT 2, PRODUCT 3 and PRODUCT 4 are not normally incident to growing and raising *****. Therefore, the processing of PRODUCT 1, PRODUCT 2, PRODUCT 3 and PRODUCT 4 are not considered agricultural business activities under CRTS section 25128(d)(2). As a result, the revenue from the sale of PRODUCT 1, PRODUCT 2, PRODUCT 3 and PRODUCT 4 does not constitute revenue from agricultural business activities under CRTS section 25128(b) and (c)(1).⁴

Please be advised that the tax consequences expressed in this Chief Counsel Ruling are applicable only to the named taxpayer and are based upon and limited to the facts you have submitted. In the event of a change in relevant legislation, or judicial or administrative case

⁴ There is nothing in the facts to indicate that TAXPAYER receives service revenues from handling, drying, packing, grading, or storing produce on a farm; therefore, a discussion of 18 CCR section 25128-2(c)(6)(C) is beyond the scope of this Ruling. That regulation provides that the definition of agricultural business activity under CRTS section 25128, subdivision (d)(2), includes the "[h]andling, drying, packing, grading, or storing on a farm [of] any agricultural or horticultural commodity in its unmanufactured state, but only if the owner, tenant, or operator of the farm regularly produces more than one-half of the commodity handled, dried, packed, graded, or stored."

law, a change in federal interpretation of federal law in cases where our opinion is based upon such an interpretation, or a change in the material facts or circumstances relating to your request upon which this opinion is based, this opinion may no longer be applicable. It is your responsibility to be aware of these changes, should they occur.

This letter is a legal ruling by the Franchise Tax Board's Chief Counsel within the meaning of CRTC section 21012(a)(1). Please attach a copy of this letter and your request to the appropriate return(s) (if any) when filed or in response to any notices or inquiries which might be issued.

Very truly yours,

Anjali Balasingham
Tax Counsel