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This Week in State Tax (TWIST)

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California: Pesticide manufacturer does not qualify for agricultural company apportionment

The California Office of Tax Appeals (OTA) affirmed a Franchise Tax Board (FTB) determination that a company was not entitled to use the three-factor apportionment formula available to businesses with more than 50 percent of their gross receipts from agricultural business activities. The taxpayer, which transitioned from a C-corporation to an S-corporation during the tax years at issue (2013–2015), reported its principal business activity as wholesale sales of agricultural chemicals and related services. Sales of these products made up over 95 percent of the company's total sales in the years at issue. It filed California returns using the three-factor apportionment formula applicable to qualifying agricultural business activities. Following an audit, the FTB determined that the business did not qualify for use of the three-factor exception and was instead required to use the standard single-sales factor apportionment methodology. The company and its shareholders appealed.

The taxpayer argued it qualified for the three-factor method because it sold products used in agricultural operations and therefore engaged in activities “relating to” agriculture. According to the taxpayer, the statutory language was broad enough to include businesses that support agricultural production, even if they do not themselves cultivate crops or raise livestock. The FTB disagreed, arguing that the statute requires examination of the taxpayer's own activities, not the activities of its customers, and that the taxpayer's business consisted primarily of selling and marketing agricultural chemicals rather than conducting agricultural operations.

The OTA agreed with the FTB, concluding that the taxpayer's activities did not fall within the statutory definition of agricultural business activity. While the OTA agreed that the phrase “relating to” should be read broadly, it concluded that, in the context of the statute, it refers only to the activities of the taxpayer claiming the exception — not the activities of, or end use by, its customers. The OTA determined that the taxpayer's own operations did not involve stock, dairy, poultry, fruit, or truck farming, or the cultivation, raising, or harvesting of agricultural commodities. Instead, it found the taxpayer made and sold products that aided such agricultural activities. In reviewing the legislative history of the agricultural apportionment exception, the OTA noted it was intended to protect businesses whose operations have no choice as to their manufacturing or production location due to the location of agricultural resources. The taxpayer's sales and distribution activities were not similarly bound and extending the exception to the company would be inconsistent with that purpose.

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