STATE OF CALIFORNIA
FRANCHISE TAX BOARD
Legal Division
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BEFORE THE THREE-MEMBER FRANCHISE TAX BOARD
OF THE STATE OF CALIFORNIA

In the Matter of Revenue and Taxation Code
Section 25137 Petition of:

JACK IN THE BOX INC. & SUBSIDIARIES

Taxable Year	Claimed Refund[1]
2014	$ 547,967
2015	$ 1,129,085
2016	$ 956,415
2017	$ 4,128,222
2018	$ 2,764,632
2019	$ 1,422,182
2020	$ 2,660,928

FTB STAFF'S OPENING BRIEF

[1] Claimed refund amounts are estimates and will be finalized if the Board grants Taxpayer's request for alternative apportionment.

INTRODUCTION

In its petition to the Franchise Tax Board dated December 6, 2024 ("Taxpayer's Petition"), Jack in the Box, Inc. and Subsidiaries ("Taxpayer") requests the Franchise Tax Board ("the Board") disregard relevant case law, statutory provisions, and instructive regulations, as it claims an income tax refund in the amount of approximately $13.6 million.

Taxpayer is in the business of both operating and franchising Jack in the Box quick service restaurants in California and throughout the United States. These two business lines, while outwardly similar in restaurant activity and brand equity, generate two types of revenue streams for Taxpayer: (1) gross receipts from the operations of company-operated restaurants and (2) gross receipts from the rents, royalties, and franchise fees from franchisee-operated restaurants.[2] These gross receipts generated from Taxpayer's own activities are properly included in Taxpayer's standard apportionment formula. Despite this, however, Taxpayer seeks the use of an alternative apportionment formula that would include unrelated third-party gross receipts in its own apportionment factor.[3] In support of its position, Taxpayer primarily asserts that because the underlying activities of Taxpayer (i.e. burger sales) and its third-party franchisees (i.e. burger sales) are the same, that those third-party franchisee gross receipts (which are reported on the third-party franchisee's tax return) should somehow also be attributed to and reported as activities of Taxpayer on Taxpayer's own tax return. Taxpayer's assertion is erroneous and improper.

Under California law, Taxpayer cannot include an unrelated third-party's gross receipts in its own apportionment formula just as it does not include the income generated by that third-party (or deduct the third-party's expenses or costs of goods sold or claim

[2] There is no dispute between the parties that these two revenue streams form Taxpayer's unitary business.
[3] The unrelated third-party franchisees are not part of Taxpayer's unitary business and are not included as part of Taxpayer's combined report.

credits).[4] Despite the similar ways in which the company-operated and franchisee-operated restaurants are conducted, the third-party franchisee activities (i.e. burger sales) are not the activities of Taxpayer and as such, the gross receipts from the third-party franchisee activities cannot be included in Taxpayer's apportionment formula. In addition, while the amounts of the third-party franchisee's payments to Taxpayer for rent or royalties may use a calculation that takes a third-party franchisee's operational gross receipts into account, the third-party franchisee's operational gross receipts are its own, and they may not be included in Taxpayer's apportionment formula.[5] Furthermore, neither Taxpayer's proffered numerical comparisons of third-party franchisees' activities to Taxpayer's activities nor Taxpayer's analysis of restaurant locations within and without the state demonstrate that Taxpayer's own business activities within the state are not being fairly reflected in the standard apportionment formula.

Taxpayer's proposed alternative apportionment formulas, which are based on (1) the number of total restaurants (consisting of both Taxpayer's company-owned restaurants and franchisee-operated restaurants) and (2) the inclusion of third-party gross receipts, improperly conflate the activities of Taxpayer with the activities of the third-party franchisees and, therefore, fail to demonstrate that the standard apportionment unfairly reflects Taxpayer's own business activities in California.

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[4] Revenue and Taxation Code section 25134(a)(1) states the term "sales" means "all gross receipts ***of the taxpayer*** not allocated . . ." and "the term 'sales' means all gross receipts derived ***by the taxpayer*** from transactions and activity in the regular course of such trade or business." (*Ibid.*, emphasis added.) R&TC § 23037 [" 'Taxpayer' means any person subject to the tax imposed under Chapter 2 (commencing with Section 23101), Chapter 2.5 (commencing with Section 23400), or Chapter 3 (commencing with Section 23501)."] CCR § 23037 [" 'Person' includes any association, corporation, business trust, or organization of any kind. . ."]
[5] As discussed further below, royalty and certain rent fees are calculated as a percentage of the franchisee's monthly gross sales.

Finally, Taxpayer disregards the important fact that, for the taxable years at issue, Taxpayer implemented a "refranchising strategy," whereby Taxpayer sold its company-operated restaurants to its franchisees resulting in a significant change in its business activities during those years. As discussed in further detail below, the resulting apportionment change over the taxable years at issue reflects that the change in Taxpayer's business activities and is a strong indication that the standard apportionment formula is working as intended. Thus, the standard apportionment formula does not "punish" Taxpayer for being a "homegrown" business but is simply a reflection of a change in Taxpayer's business activities in the state.

Accordingly, and for the reasons set forth below, Taxpayer's request for alternative apportionment should be denied.

ISSUE

Whether Taxpayer has met its burden of proving by clear and convincing evidence that (1) the standard apportionment formula is not a fair representation of the extent of the Taxpayer's business activity in California, and (2) its proposed alternative is reasonable.

FACTS

Founded in 1951, Taxpayer operates and franchises Jack in the Box quick-service restaurants.[6] For the tax years at issue, Taxpayer's revenue was primarily derived from: (1) retail sales at company-operated restaurants and (2) rent, royalties, and franchise fees received from franchisee-operated restaurants.[7]

[6] Exhibit A - Jack in the Box (FYE 2020) Annual Report 10-K, p. 3.
[7] Taxpayer has other revenue which are either excluded from gross receipts or immaterial for purposes of this petition. Exhibit A - Jack in the Box (FYE 2020) Annual Report 10-K, pp. 3 and 29.

1) Company-Operated Restaurant Activities

For company-operated restaurants, Taxpayer's receipts were generated from the retail sales of food and beverages (i.e. burger sales).[8] Taxpayer operated the restaurants and was directly responsible for the operations of the restaurants, including product quality, service, food safety, cleanliness, inventory, cash control and the conduct and appearance of employees.[9]

2) Franchisor Activities

In contrast, franchisee-operated restaurants were operated by third-party franchisees that managed their businesses independently and, therefore, were responsible for the day-to-day operations of their restaurants.[10] Taxpayer did not operate these restaurants. Rather, Taxpayer's receipts from these third-party franchisees were generated from the following activities:

a) ***Rent*** - Taxpayer owned or leased the real properties on which most of its restaurants were located. A majority of Taxpayer's owned or leased sites were leased or subleased to franchisees.[11] For its leases of real property to franchisees, Taxpayer received fixed rental payments plus real estate taxes, insurance, and other expenses.[12] In addition, approximately 14 percent of Taxpayer's leases provided for contingent rental payments between 1 percent and 12 percent of the restaurant's gross sales once certain thresholds were met.[13]

[8] Exhibit A - Jack in the Box (FYE 2020) Annual Report 10-K, p. 29 and F-11.
[9] Exhibit A - Jack in the Box (FYE 2020) Annual Report 10-K, p. 5.
[10] *Id.* at p. 14.
[11] *Id.* at pp. 14 and F-19.
[12] *Id.* at p. 22.
[13] *Ibid.*

a) ***Royalties*** – Taxpayer received royalty fees from franchisees for a right to use Taxpayer's Marks[14] and the System[15].[16] The royalty fees were calculated as a percentage of the franchisee's monthly gross sales.[17] Royalty rates were typically 5 percent of gross sales but could range as high as 10 percent of gross sales.[18]

b) ***Franchise Fees*** - Pursuant to the franchise agreement between Taxpayer and a franchisee, Taxpayer also received an initial franchise fee of $50,000 in consideration of Taxpayer granting to a franchisee a limited license to use the Marks and the System.[19]

As part of its long-term strategic plan, Taxpayer implemented its "refranchising initiative" during the years at issue. Taxpayer's "refranchising initiative focused on increasing franchise ownership in the Jack in the Box system through the sale of company-operated restaurants to new and existing franchisees."[20] In 2014, Taxpayer sold 37 company-operated restaurants to franchisees, thereby increasing the franchise ownership to 81 percent at the end of fiscal year 2014 from 79 percent at the end of fiscal year 2013.[21] As of the end of fiscal year 2018, there were 2,237 restaurants, of which 137 were

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[14] "Marks" means the name Jack in the Box® and certain other service marks, trademarks, names, logos and commercial symbols that are authorized for use in connection with the Jack in the Box restaurants. (Taxpayer's Petition, Exhibit 4 - Franchise Agreement, p. 1)
[15] "System" means Taxpayer's distinctive restaurant format and operating system which utilizes specialized and unique techniques, knowledge, expertise, skill and proprietary information. The restaurant format and operating system includes but is not limited to: operating and management systems and standards; specifications and procedures for the purchase, preparation and sale of food, beverages and other products; and a distinctive building design, decor and color scheme. (Taxpayer's Petition, Exhibit 4 - Franchise Agreement, p. 1)
[16] Taxpayer's Petition, Exhibit 4 - Franchise Agreement, p. 2.
[17] Taxpayer's Petition, Exhibit 4 - Franchise Agreement, p. 15.
[18] Exhibit A - Jack in the Box (FYE 2020) Annual Report 10-K, p. 4.
[19] Exhibit A - Jack in the Box (FYE 2020) Annual Report 10-K, p. 4.
[20] Exhibit B - Jack in the Box (FYE 2014) Annual Report 10-K, p. 2.
[21] *Ibid.*

company-operated and 2,100 were franchisee-operated.[22] Through the execution of Taxpayer's refranchising strategy over these five years, Taxpayer increased its franchise ownership from 79 percent at the end of fiscal year 2013 to 94 percent at the end of fiscal year 2018.[23] Taxpayer's franchise ownership percentage remained approximately the same at 94 percent at the end of fiscal years 2019 and 2020.[24] Taxpayer expects the majority of Jack in the Box new unit growth will be through franchise restaurants.[25]

LEGAL ANALYSIS

I. TAXPAYER'S REQUEST FOR ALTERNATIVE APPORTIONMENT UNDER SECTION 25137 SHOULD BE DENIED BECAUSE TAXPAYER HAS NOT SHOWN, BY CLEAR AND CONVINCING EVIDENCE, THAT THE STANDARD APPORTIONMENT FORMULA IS AN UNFAIR REFLECTION OF THE EXTENT OF TAXPAYER'S BUSINESS ACTIVITIES IN CALIFORNIA.

A. Burden of Proof

As the party invoking Section 25137, 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 of the extent of the Taxpayer's business activity in California, and (2) its proposed alternative is reasonable.[26]

The standard apportionment provisions under the Uniform Division of Income for Tax Purposes Act ("UDITPA") "provide a rough but constitutionally sufficient approximation of the income attributable to business activity in each state."[27] If the standard apportionment provisions do not fairly represent the extent of a taxpayer's business activity in the state (i.e., the formula is "distortive"), Section 25137, a "relief provision," allows the taxpayer to seek,

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[22] Exhibit C - Jack in the Box (FYE 2018) Annual Report 10-K, p. 2.
[23] *Ibid.*
[24] Taxpayer's Petition, Exhibit 1; Exhibit A - Jack in the Box (FYE 2020) Annual Report 10-K, p. 2.
[25] Exhibit C - Jack in the Box (FYE 2018) Annual Report 10-K, p. 2.
[26] *Microsoft Corp. v. Franchise Tax Board ("Microsoft")* (Aug. 17, 2006) 39 Cal.4th 750, 756.
[27] *Ibid*.

or the FTB to impose, "an alternate method of calculation to achieve an equitable result."[28]

Section 25137 provides:

> If the allocation and apportionment provisions of this act do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition for or the Franchise Tax Board may require, in respect to all or any part of the taxpayer's business activity, if reasonable: (a) Separate accounting; (b) The exclusion of any one or more of the factors; (c) The inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this state; or (d) The employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

For purposes of Section 25137, a simple comparison of the varying levels of taxation from differing apportionment methods, by itself, does not demonstrate that the standard apportionment formula unfairly reflects the extent of a taxpayer's activity in this state.[29] Nor does Section 25137 authorize deviation from standard UDITPA provisions merely because a purportedly better approach exists.[30] Allegations that the standard apportionment formula is not precise also do not justify proposed deviations.[31] Rough approximation is sufficient in the formula apportionment of income from a unitary business.[32] As long as the standard apportionment methods fairly represent the extent of the taxpayer's business activity in this state, its use will be upheld.[33]

For the reasons discussed below, Taxpayer has not met its burden of showing by clear and convincing evidence that the standard apportionment formula does not fairly reflect Taxpayer's business activity in California. Therefore, Taxpayer's request for alternative apportionment must be denied.

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[28] *Microsoft, supra*, 39 Cal.4th 750, p. 757.
[29] *Appeal of Merrill, Lynch, Pierce, Fenner & Smith, Inc. (Merrill Lynch)* (June 2, 1989) 89-SBE-017.
[30] *Appeal of Kikkoman International, Inc*. ("*Kikkoman*") (June 29, 1982) 82-SBE-098.
[31] *Ibid.*
[32] *Appeal of Crisa Corporation* (June 20, 2002) 02-SBE-004.
[33] *Kikkoman, supra,* 82-SBE-098.

B. Standard Apportionment is Not in Dispute

Taxpayer does not dispute that Section 25128.7 is the applicable apportionment formula methodology for the years at issue. Section 25128.7 requires the use of a single sales factor apportionment formula for taxable years beginning on or after January 1, 2013.[34]

Taxpayer also does not dispute that Sections 25135, 25136, and 25137-3 provide the standard sourcing rules for Taxpayer's gross receipts. As discussed above, Taxpayer's gross receipts were derived from (1) its retail sales of food and beverages at its company-operated restaurants, and (2) rent, royalties, and franchise fees received from its franchisees. Under Section 25135, subdivision (a)(1), sales of tangible personal property (i.e. food and beverage sales to consumers at Taxpayer's company-operated restaurants) are assigned to this state if the property is delivered within this state. Under Section 25136, sales from the lease or rental of real property (i.e. franchise rental receipts) are assigned to this state if the property is located in this state. Under Section 25137-3, a special apportionment and allocation provision for franchisors, royalties and franchise fees are assigned to the state in which the franchisee's place of business is located.

Based on the methodology provided above, the standard apportionment percentage for the years at issue was determined at audit as follows:

STANDARD APPORTIONMENT (PER AUDIT)				
	09/2014	09/2015	10/2016	10/2017
California Sales	$676,110,348	$666,704,895	$713,321,788	$735,142,802
Everywhere Sales	$1,556,512,634	$1,555,716,759	$1,640,257,341	$1,680,869,428
Apportionment %	**43.4375%**	**42.8552%**	**43.4884%**	**43.7359%**

	09/2018	09/2019	09/2020
California Sales	$615,318,396	$501,573,818	$570,154,331
Everywhere Sales	$1,205,631,540	$812,376,446	$910,594,103
Apportionment %	**51.0370%**	**61.7416%**	**62.6134%**

[34] For the taxable years at issue, Taxpayer business activities did not meet the qualifications under Section 25128, subsection (b); therefore, Taxpayer is subject to the singles sales factor apportionment formula.

As illustrated above, Taxpayer's gross receipts generated from both of its revenue producing activities, the gross receipts from the operations of company-operated restaurants and the gross receipts from the rents, royalties, and franchise fees received from third-party franchisees, have properly been included in its standard apportionment formula. Despite this, Taxpayer requests the use of an alternative apportionment formula that includes the third-party franchisee's operational gross receipts in Taxpayer's apportionment factor. The use of an alternative apportionment formula under Section 25137, however, requires Taxpayer to prove by clear and convincing evidence that the standard apportionment formula does not fairly reflect the extent of its business activities in California, which Taxpayer has failed to demonstrate for the reasons provided below.

C. Taxpayer's Premise that its Business Activities that Generate its Income from Its Company-Operated and Franchise-Operated Restaurants Are the Same is Fundamentally Flawed

To support its position that the standard apportionment formula is distortive, Taxpayer asserts various arguments which are based on the premise that the "underlying business activity of both company-owned and franchised restaurants is the same."[35] This premise is fundamentally flawed and any analysis based on this flawed premise does not show that the standard apportionment formula does not fairly reflect the extent of Taxpayer's business activities in California.

Taxpayer's premise ignores the key distinction that the company-operated restaurants are operated by Taxpayer and that the franchisee-operated restaurants are operated by third-party franchisees. The law is clear that the relevant consideration under

[35] Taxpayer's Petition, p. 6.

Section 25137 is whether the extent of a ***taxpayer's*** business activities in the state is unfairly reflected in the standard apportionment formula. In other words, Section 25137 does not contemplate the consideration of unrelated third-party business activities in determining whether a ***taxpayer's*** standard apportionment formula is distortive.

When looking at Taxpayer's own business activities, it is clear that the activities that generated income from company-operated and franchisee-operated restaurants ***to Taxpayer*** are ***not the same***. Taxpayer's business activities which generated income from its company-operated restaurants were the sales of food and beverages (i.e burger sales). In contrast, Taxpayer's business activities which generated income from its franchisee-operated restaurants (i.e. rent, royalties, and franchise fees) were its leasing of real property and licensing of its Marks and the System. Taxpayer's two different revenue streams and the corresponding business activities that generated that revenue are clearly ***not the same***.

On the other hand, the food and beverage sales (i.e. burger sales) activities of the franchisee-operated restaurants generated income to the third-party franchisees. The activities that generated that income to the third-party franchisees were the business activities of the third-party franchisees, ***not*** the business activities of Taxpayer. Thus, to the extent Taxpayer's arguments and proposed alternatives conflate the "burger sales" activities of Taxpayer's company-operated restaurants and the third-party franchisee-operated restaurants, they are inappropriate. The fact that the company-operated restaurants and the franchisee-operated restaurants were conducted in similar ways, used the "same point-of-sale system" or that the "customer experience is identical" is irrelevant for Section 25137 purposes.[36] The relevant consideration, again, is ***Taxpayer's*** business activities. The third-

[36] Taxpayer's Petition, p. 2.

party franchisee's business activities are simply ***not*** the business activities of Taxpayer and cannot be considered in determining whether the extent of Taxpayer's business activities is unfairly reflected in the ***Taxpayer's*** standard apportionment formula.

In fact, as shown above, Taxpayer's standard apportionment formula properly reflects the underlying business activities that generated income ***to Taxpayer.*** Taxpayer's income from its company-operated restaurants (i.e. burger sales) was properly included in Taxpayer's taxable income and its associated gross receipts were properly included in Taxpayer's apportionment formula. Similarly, Taxpayer's income received from its franchisees (i.e. rents, royalties, franchise fees) was included in Taxpayer's taxable income and its gross receipts from those activities (i.e. rental and licensing activities) were included in Taxpayer's apportionment formula. On the other hand, a third-party franchisee doing business in California reports income generated from the food and beverage sales (i.e. burger sales) at its own franchise restaurant as taxable income and its corresponding gross receipts would have been properly included in the third-party franchisee's apportionment formula ***on its own separate tax return***. The "burger sales" activities of Taxpayer are separate and distinct from the "burger sales" activities of the third-party franchisees and, as such, each entity's sales are properly reported on each entity's tax returns.

Accordingly, since it is clear that Taxpayer's business activities which generated income from company-operated and franchisee-operated restaurants ***to Taxpayer*** are ***not*** the same, any argument ignores this distinction does not demonstrate distortion ***as to Taxpayer's business activities*** under Section 25137.

D. Taxpayer's Various Arguments Which Are Based on Its Erroneous Reliance on a Flawed Premise Do Not Demonstrate Distortion

1. *Fees received by Taxpayer based on a percentage of a third-party franchisee's gross sales does not change the underlying business activities of Taxpayer.*

Taxpayer argues that because certain fees derived from Taxpayer's franchise agreement with its franchisees (i.e. rent and royalties) are based on a percentage of the franchisee's gross sales, that the "franchised restaurants gross receipts generate income for [Taxpayer]" or that they somehow "directly contribute to [Taxpayer's] profits."[37] However, this argument relies on Taxpayer's flawed premise that ignores the distinction between Taxpayer's business activities of "burger sales" at its company-operated restaurants and its franchisor activities (i.e. leasing real property and licensing its Marks and the System) at the franchisee-operated restaurants and conflates Taxpayer's activities with the activities of the third-party franchisees.

Here, Taxpayer's underlying business activity that generates its rent and royalty income is Taxpayer's leasing and licensing activity, respectively. A fee structure, even if it is calculated based on a third-party's gross sales, does not change the underlying activity that generated that income. Therefore, Taxpayer's characterization of third-party franchisee activities as being the activities that generate income to Taxpayer, based on how the fee is calculated, is incorrect.

Section 25137 requires consideration of ***Taxpayer's business activities*** and does not permit looking to non-taxpayer business activities to determine whether the standard apportionment formula is distortive. Here, the third-party franchisee activities of "burger sales" are not the activities of Taxpayer and, therefore, the third-party franchisee activities

[37] Taxpayer's Petition, p. 9.

neither generate income for Taxpayer nor directly contribute to Taxpayer's profits for tax purposes. Accordingly, the inclusion of the third-party franchisee's gross receipts generated by the third-party franchisees' activities in Taxpayer's apportionment formula is improper.

2. *Numerical comparisons of third-party franchisees' activities to Taxpayer's activities do nothing to show that Taxpayer's own business activities within the state are not being fairly reflected in the standard apportionment formula.*

Taxpayer argues that "[n]early 80 percent of Taxpayer's operating income is not fairly represented in the standard apportionment formula, which is distortive."[38] To support this argument, Taxpayer relies on figures from its fiscal year 2019 Annual Report (Form 10-K) and states:

> franchised restaurants account for 90 percent of [Jack in the Box's ("JIB's")] sales and over 79 percent of JIB's total net operating income. Despite this, franchised restaurant gross receipts are not fully or fairly reflected in the formula. Conversely, 137 company-owned restaurants have nearly the same amount of receipts in the standard formula as the other 2,100 franchised restaurants. Those 137 restaurants are greatly exaggerated in the standard formula.[39]

This argument fails because Taxpayer's numerical calculations are all derived from an erroneous reliance on Taxpayer's flawed premise. For instance, the 90 percent sales figure reflects a percentage of "franchised sales" compared to "all systemwide sales," which include both company-operated and franchisee-operated restaurant operating activities.[40] Similarly, the 79 percent total net operating income figure reflects a percentage of "franchise operating profit" over "systemwide operating profit," which also includes both company-operated and franchisee-operated operating activities. Taxpayer has not demonstrated how the operating activities (i.e. burger sales) of the third-party franchisees

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[38] Taxpayer's Petition, p. 10.
[39] *Id.* at p. 11.
[40] Taxpayer's Petition, Exhibit 3.

and its contribution to the systemwide operating sales or profit is a proper reflection of Taxpayer's business activities. These comparisons erroneously conflate the operational activities of the third-party franchisee (i.e. burger sales) with Taxpayer's operational activities (i.e. burger sales) and ignores the distinction between Taxpayer's operational activities at its company-operated restaurants and its franchisor activities (i.e. leasing and licensing) at the franchisee-operated restaurants. As stated above, any analysis that does not distinguish between Taxpayer's activities and the activities of the third-party franchisees is improper for Section 25137 consideration.

In addition, Taxpayer's comparison of its "137 company-owned restaurants" having the same receipts as the "2,100 franchised restaurants" is also irrelevant because those receipts represent a comparison of Taxpayer's operational activities and the operational activities of the third-party franchisees. Numerical comparisons of receipts generated by the third-party franchisee activities to Taxpayer's receipts generated from its own separate and distinct activities do nothing to show that Taxpayer's own business activities within the state are not being fairly reflected in the standard apportionment formula. While it can be appreciated that the gross receipts generated by the third-party franchisee-operated restaurants may be valuable information to include in Taxpayer's financial statements to inform its shareholders and investors about the financial health and profitability of a company over a specific period of time, gross receipts generated by these third-party franchisee-operated restaurants ***do not give rise to income to Taxpayer*** for tax purposes nor are they ***activities of the Taxpayer*** and, therefore, they are appropriately excluded from Taxpayer's gross receipts.

Moreover, Taxpayer's reliance on *Microsoft Corp v. Franchise Tax Board ("Microsoft")* to argue that "[m]ost of the activity required to produce franchise income is not reflected in the apportionment formula, but franchising generates nearly *four times* as much net operating income for Taxpayer as operating company-owned restaurants" is misguided.[41] As explained above, Taxpayer's activities that produced income received from its franchisees (i.e. rent, royalties, franchise fees) ***is*** properly included as gross receipts in its apportionment formula. Taxpayer's statement that "franchising generates nearly *four times* as much net operating income for Taxpayer as its company-owned restaurants" is not only unsubstantiated and lacks numerical support, but also erroneously compares the third-party franchisee's operational activities (i.e. burger sales) with Taxpayer's operational activities (i.e. burger sales). The analysis contained in *Microsoft* is clear that the Supreme Court of California looked only to the different activities of ***the taxpayer*** (Microsoft) in determining whether its activities were distortive under the standard formula and, therefore, *Microsoft* does not support Taxpayer's argument.[42]

3. The number of restaurant locations within and without the state do not properly reflect Taxpayer's business activities.

Taxpayer also argues that the disproportionate number of company-operated restaurants in California causes an overstatement of Taxpayer's business activity in California.[43] To support this argument, Taxpayer provides that "in 2019, only 6 percent of JIB's restaurants were company-owned, and 80 percent of those company-owned locations were in California."[44] "In contrast, 94 percent of JIB restaurants are franchised, and over 60 percent of those are located outside the state."[45] However, comparisons of various percentages consisting of company-operated and franchisee-operated restaurant locations

[41] Taxpayer's Petition, p. 11.
[42] *Microsoft, supra,* 39 Cal.4th 750.
[43] Taxpayer's Petition, p. 2.
[44] *Id.* at p. 3.
[45] *Ibid.*

within and without the state do not demonstrate that the standard apportionment unfairly represents the extent of ***<u>Taxpayer's business activities</u>*** in California as Taxpayer suggests.

This argument, which relies on Taxpayer's flawed premise, also fails because it ignores the distinction between Taxpayer's business activities of "burger sales" at its company-operated restaurants and its franchisor activities of leasing and licensing at the franchisee-operated restaurants and conflates Taxpayer's activities with the activities of the third-party franchisees. A restaurant location count does not distinguish between the underlying activities that generate income to Taxpayer from its company-operated restaurants (which generate "burger sales" income to Taxpayer) and the franchisee-operated restaurants (which generate rent, royalty, and franchise fee income to Taxpayer). Without this distinction, an apportionment formula based on restaurant location count does not accurately depict ***<u>all of Taxpayer's business activities</u>***, which include both: (1) operating its company-operated restaurants where it sells burgers, and (2) franchising to third-party franchisees in return for rent, royalites, and franchise fees. Likewise, a restaurant location count also does not account for the party that is generating the revenue from company-operated and franchisee-operated restaurants and, therefore, necessarily conflates Taxpayer's "burger sales" activities with the "burger sales" activities of the third-party franchisees, which is improper.

Moreover, an apportionment formula based on restaurant locations is merely an attempt to use separate geographic accounting to apportion Taxpayer's income which Courts have repeatedly rejected, warning that it is susceptible to manipulation.[46] In *Container Corp. v. Franchise Tax Board* ("*Container*"), the United States Supreme Court stated:

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[46] *Microsoft*, *supra,* 39 Cal.4th 750, p. 768.

> [The formula apportionment method] rejects geographical or transactional accounting, and instead 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.[47]

Taxpayer implies that, if the apportionment formula were working correctly, the apportionment formula would equal the ratio of restaurant locations within and without the state.[48] However, Taxpayer has not explained how the ratio of restaurant locations (which includes both company-owned and franchisee-operated locations) measures Taxpayer's business activities within and without the state since some of those activities are performed by the franchisees. Without this explanation, Taxpayer's statement is nothing more than an attempt to offer a preferred alternative rather than what the standard apportionment provides. However, it is not enough that a taxpayer comes up with a formula that it believes is "better" than the standard formula.[49] "[W]hat must be shown is sufficient distortion that the [taxpayer's] business activity in the state is not fairly reflected."[50]

E. Taxpayer's Proposed Inclusion of Third-Party Gross Receipts Creates the Severed Relationship Between Income and the Formula that Apportions that Income that Taxpayer Seeks to Avoid.

Taxpayer also argues that the "standard formula's exclusion of Taxpayer's franchised restaurant receipts severs the necessary relationship between how income is earned and how the formula apportions that income."[51] In other words, Taxpayer argues that the exclusion of the third-party franchisee's operational gross receipts (i.e. burger sales) creates

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[47] *Container Corp. v. Franchise Tax Board* ("*Container*") (1983) 463 U.S. 159, 165. *(Emphasis added)*
[48] Taxpayer's Petition, p. 1.
[49] *Merrill Lynch, supra,* 89 SBE-017. (*See also Kikkoman, supra,* 82-SBE-098).
[50] *Merrill Lynch, supra,* 89 SBE-017.
[51] Taxpayer's Petition, p. 9.

a mismatch between Taxpayer's income and its apportionment formula. Taxpayer cites to *Container*, where the United States Supreme Court made clear that the "factor or factors used in the apportionment formula must actually reflect a reasonable sense of how the income was generated" to support its argument.[52]

Here, as explained above, the gross receipts that generated Taxpayer's income have been properly included in Taxpayer's apportionment formula. The operational gross receipts of third-party franchisees that Taxpayer seeks to include in its apportionment formula are neither income to Taxpayer nor gross receipts of Taxpayer. Therefore, the exclusion of these franchisee operational receipts is appropriate and does not create a mismatch between ***Taxpayer's*** income and ***Taxpayer's*** apportionment formula. Rather, Taxpayer's request would cause the mismatch it urges the Board to avoid. Taxpayer seeks to include unrelated third-party franchisee operational receipts in Taxpayer's apportionment formula without the associated third-party franchisee income to also be included in Taxpayer's taxable income. If franchisee operational receipts were included in Taxpayer's sales factor, this would result in a formula that apportions Taxpayer's income based on activities that were not conducted by Taxpayer. Consequently, such an apportionment formula would not reflect a reasonable sense of how the income was generated and would cause the mismatch of income that is constitutionally prohibited.

F. The Standard Apportionment Formula Does Not Unfairly Reflect Taxpayer's Business Activities in California

As discussed above, an apportionment formula consisting of the number of restaurant locations within and without the state does not properly reflect Taxpayer's business activities within the state. Despite this, Taxpayer asserts that "[w]hen the formula

[52] Taxpayer's Petition, p. 9.

works as intended, if a business has 40 percent of its activity in California, then roughly 40 percent of its income will be taxed by the State. The standard formula, however, does not always work as intended, which is the case where only 40 percent of Jack in the Box [systemwide] restaurants are in California, but the standard formula is attributing over 60 percent of [Taxpayer's] income to California."[53]

As discussed in section D.3. above, Taxpayer attempts to show that the standard apportionment is an unfair reflection of the extent of its business activities simply by comparing Taxpayer's standard apportionment formula with its proposed alternatives. Such a comparison, however, does not show that the standard apportionment formula is not working as intended. A closer examination of Taxpayer's business strategy illustrates how Taxpayer's California tax liability increased as a result of its own strategic business decisions, rather than an unfairness of California's standard apportionment provisions.

In the instant case, Taxpayer structured its business to include the operation of company-operated restaurants as well as the franchising of other restaurants to third-party franchisees. Those strategic business decisions resulted in the tax consequences that Taxpayer seeks to change through Taxpayer's Petition. However, the resulting tax consequences that stem from those business decisions cannot be altered simply because Taxpayer does not like the results. Here, the company-operated restaurants and franchisee-operated restaurants are located both within and without California.[54] Receipts derived from Taxpayer's company-operated restaurants within California are treated consistently with Taxpayer's company-operated restaurants out-of-state. Similarly, receipts derived from

[53] Taxpayer's Petition, p. 1.
[54] Taxpayer's Petition – Exhibit 1.

Taxpayer's franchisee-operated activities within California are treated consistently with receipts derived from Taxpayer's franchisee-operated activities out-of-state.

According to Taxpayer's Annual Reports, between fiscal year 2014 and fiscal year 2018, Taxpayer implemented its "refranchising strategy" which sought to increase franchise ownership by selling Taxpayer's company-owned restaurants to its franchisees. In accordance with this strategy, between fiscal year 2014 through fiscal year 2020, Taxpayer's significantly reduced its company-operated restaurants (and correspondingly increased its franchisee-operated restaurants). This resulted in a business consisting of 19 percent company-operated restaurants and 81 percent franchisee-operated restaurants in fiscal year 2014 to a business consisting of 6 percent company-operated restaurants and 94 percent franchisee-operated restaurants by the end of fiscal year 2018 and through fiscal year 2020. The table below illustrates the percentage change in restaurants operated as company-operated and franchisee-operated over the years at issue.[55]

Percentage of Company-Owned vs Franchised Restaurants			
FYE	Company-Owned	Franchised	Total Stores
2014	19%	81%	100%
2015	18%	82%	100%
2016	18%	82%	100%
2017	12%	88%	100%
2018	6%	94%	100%
2019	6%	94%	100%
2020	6%	94%	100%

While the total number of restaurant locations did not change much throughout the years at issue, the number of company-operated locations decreased while the number of franchisee-operated locations increased. This resulted a significant change to Taxpayer's business operations. As Taxpayer sold its company-owned businesses to its franchisees,

[55] Exhibit D – Percentages of Company-Operated and Franchisee-Operated Restaurant Locations by Year.

Taxpayer significantly reduced its sales of food and beverages activities (i.e. burger sales) and increased its franchisor activities (i.e. leasing and licensing). Consequently, the change in business activity also caused Taxpayer's gross receipts from its company-operated restaurants to decrease and its gross receipts from its franchisor activities (i.e. leasing and licensing) to increase.

It appears that this shift in business strategy led to the changes in Taxpayer's apportionment formula throughout the course of the years at issue. As the table below illustrates, prior to fiscal year 2018, Taxpayer's standard apportionment formula was roughly equal to the ratio of restaurant locations within and without California due to the way the business was structured at the time.

COMPARISON OF TAXPAYER'S PROPOSED FORMULA TO STANDARD FORMULA				
	09/2014	09/2015	10/2016	10/2017
Proposed Alternative #1	41.4667%	41.7074%	41.6408%	41.7148%
Standard Appt Per Audit	43.4375%	42.8552%	43.4884%	43.7359%
Difference	(1.9708%)	(1.1478%)	(1.8476%)	(2.022%)

	09/2018	09/2019	09/2020
Proposed Alternative #1	41.8416%	41.9527%	42.0794%
Standard Appt Per Audit	51.0370%	61.7416%	62.6134%
Difference	(9.1954%)	(19.7889%)	(20.5340%)

The change (increase) in standard apportionment percentages between fiscal year 2018 through fiscal year 2020 correlates to the changes in Taxpayer's business activities during that time. This demonstrates that the standard apportionment formula is actually operating the way it was intended to as it is properly reflecting the changes in Taxpayer's business activities for the years at issue.

As the above discussion demonstrates, Taxpayer's arguments require reliance on a flawed premise that cannot support its position. In addition, the standard apportionment formula avoids the mismatch that would be created between Taxpayer's income and the formula that apportions that income if Taxpayer's request for alternative apportionment was granted. Finally, the standard apportionment formula properly reflects Taxpayer's business activities and any change over the years reflects a change in Taxpayer's business activities which means that the standard formula is working as intended. Accordingly, Taxpayer has failed to meet its burden of showing, by clear and convincing evidence, that the standard apportionment formula does not fairly reflect the extent of Taxpayer's business in California.

II. TAXPAYER'S REQUEST FOR ALTERNATIVE APPORTIONMENT UNDER SECTION 25137 SHOULD BE DENIED BECAUSE TAXPAYER HAS NOT SHOWN, BY CLEAR AND CONVINCING EVIDENCE, THAT ITS PROPOSED ALTERNATIVES ARE REASONABLE

Taxpayer also has the burden of proving by clear and convincing evidence that its proposed alternative is reasonable. Taxpayer proposes two alternative apportionment formulas: (1) a sales factor that includes no sales but consists of a ratio of all California restaurant locations (company-operated and third-party franchisee-operated) over total restaurant locations, and (2) include the operational gross receipts of unrelated third-party franchisees in its own sales factor. Neither of these proposed alternatives are reasonable.

First, Taxpayer contends that an apportionment formula based on a ratio of restaurant locations is reasonable "because it apportions income in relation to [Taxpayer's] actual business activity in this state." This is inaccurate. As discussed above, Taxpayer's business activities include more than just the operations of the company-owned restaurants. It also includes its franchisor activities which are distinct from its company-owned restaurant activities. Therefore, the use of a ratio of restaurant locations does not properly reflect the extent of all of Taxpayer's business activities as it excludes its franchisor activities and includes the operational activities of the third-party franchisees.

In addition, Taxpayer's proposed ratio is essentially a geographical accounting method which courts have warned "is subject to manipulation and imprecision."[56] Use of restaurant locations is (1) not an accurate measure of Taxpayer's business activities as Taxpayer is not solely in the business of operating restaurants, and (2) it includes restaurant locations that Taxpayer does not operate. A significant part of Taxpayer's business activities (franchisor activities) would not be accurately measured by location of restaurants. Furthermore, use of franchised locations in Taxpayer's apportionment formula in the same capacity as its company-owned locations would not give a clear measure of Taxpayer's business activities in the state as it conflates both the activities of Taxpayer as well as the activities of third-party franchisees.

For its second proposed alternative, Taxpayer has not provided any concrete calculations nor any supporting documents to substantiate its request. Rather, Taxpayer simply argues that since franchised restaurant receipts represent the activities required to produce nearly 80 percent of Taxpayer's operating income, they should be fairly reflected in Taxpayer's apportionment formula. This argument is based on the flawed premise that the third-party franchisee-operated restaurant receipts reflect the activities of Taxpayer. As explained above, franchisee-operated restaurant receipts do not represent Taxpayer's activities that generated the rent, royalty and franchise fee income to Taxpayer. The activities that generated income to Taxpayer were the retail sales of food and beverages (i.e. burger sales) activities of its company-operated restaurants as well as its franchisor activities (i.e. renting of real property, licensing of Marks and Systems). The franchisee-

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[56] *Container, supra,* 463 U.S. 159, 164.

operated restaurant receipts represent the activities that produced income to the franchisee, not the taxpayer.

Accordingly, Taxpayer has failed to show that its proposed alternatives are reasonable.

CONCLUSION

For the reasons stated above, Taxpayer has not met its burden of proving by clear and convincing evidence that the standard apportionment does not fairly reflect the extent of its business activities in California and that its proposed remedies are reasonable. Accordingly, Taxpayer's request for alternative apportionment must be denied.