Mixing Net Receipts & Gross Receipts Fails to Fairly Reflect Jack in the Box's CA Activities

May 14, 2025

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Why are we here?

- Jack in the Box ("JIB") is being penalized for being a California home grown business as its franchise locations, which are largely outside California, are *underrepresented* in the apportionment formula.
- In FYE 2019, only ~40% of JIB locations are in California,
    - ➢ The standard formula seeks to tax ~60% of JIB's total income.
    - ➢ California apportionment factor distorting JIB's activity in California by ~50%.

California Apportionment Formula Goal

- The goal of the standard California apportionment formula is to measure the business activity in the state.
- If 40% of the business activity is occurring in California, then 40% of the income should be apportioned to the state.

California Single Sales Apportionment

$$\frac{\text{California Sales}}{\text{Everywhere Sales}} = \text{Apportionment \%}$$

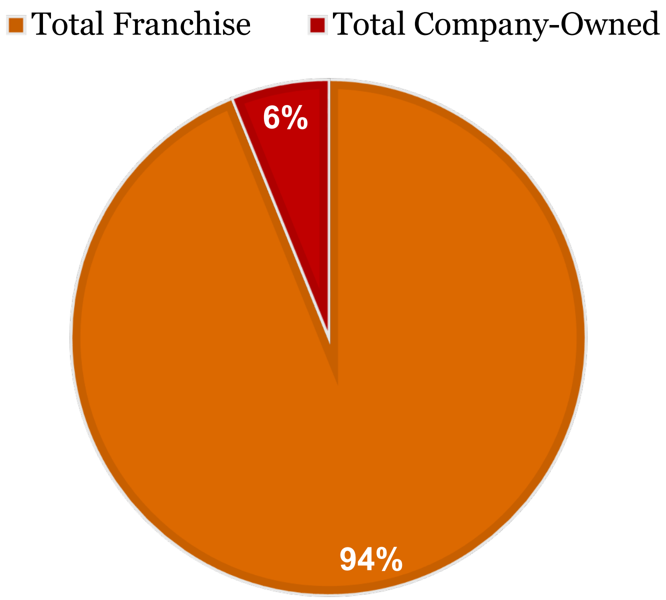
California Apportionment Formula

- California is only permitted to tax California sourced income.
  - *See Container v. FTB*
- The apportionment formula **can** be adjusted if the formula does **not fairly represent** the activities of the taxpayer.
  - *Section 25137*

Jack in the Box

- In 1951, Jack in the Box ("JIB") opened its first restaurant in San Diego.
- JIB is now operating one of the nation's largest hamburger chains with approximately 2,200 restaurants across 22 states.[1]
  - ➢ While JIB operates as a single brand most restaurants are franchised.

Restaurant Count Breakdown[2]



Total Franchise – 2106
Total Company-Owned – 137

Total Systemwide – 2243

1. JIB operated Qdoba restaurants until March 21, 2018.
2. Restaurant count data is for 2019.

JIB's Business Model

- Single Brand with owned and franchised restaurants
- Franchised Restaurants = JIB earns ~15% of the franchisee's sales for rent and royalties.
- Customer experience is meant to be exactly the same at both company-owned and franchised restaurants.

Franchised Restaurants Sales Drive Profitability

JIB quarterly reports to investors headline with systemwide sales

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Jack in the Box Inc. Reports First Quarter 2025 Earnings

February 25, 2025

Jack in the Box same-store sales growth of 0.4%

Del Taco same-store sales of (4.5%)

Jack in the Box systemwide sales growth of 0.5%; Del Taco systemwide sales of (1.9%)

Diluted earnings per share of $1.75; Operating EPS of $1.92

JIB Investors News Website. Note, same-store sales growth is systemwide sales growth that is not attributable to new store openings.

Franchised Restaurants Sales Drive Profitability

JIB Annual Report, Form 10K:

"We believe franchised and system restaurant sales information is useful to investors as they have a **direct effect on the Company's profitability**."

	2019	2018
Company-owned restaurant sales	$ 336,807	$ 448,058
Franchised restaurant sales (1)	3,167,920	3,018,067
System sales (1)	$ 3,504,727	$ 3,466,125

Vast Majority of Income Comes from Franchisor Activity, not Company Restaurant Operations

By 2019, the franchisor net operating income exceeded 4x that of company-owned restaurant activity and it is still growing.

Restaurant Operator Net Operating Income	58M
Franchisor Net Operating Income	223M
	4x

Every Sale Recorded in the Company's Point-Of-Sale System

JIB Franchise Disclosure Document, Item 11, Page 45

(b) a Company-specified point-of-sale ("POS") system that is integrated with the Company-specific computer system, and is used to collect data on sales, product mix, and inventory, among other things. The POS system will include Company-approved order terminals, kitchen video equipment, a web-based mobile training device, and a printer, and it may include other items such as cash drawers, receipt printers, customer interfacing POS integrated selling systems, POS integrated mobile payment systems, PCI compliant payment systems, integrated order confirmation boards, and drive-thru communications headsets. The cost of these additional items varies. You may purchase your own web-based mobile training device upon request. (See Exhibit P.)

Security Interest in Bank Accounts

JIB Franchise Disclosure Document, Exhibit H-1, Page 18

F. Security Interest

To secure prompt and complete payment of the "Obligations," as hereinafter defined, Franchisee hereby grants to Company a security interest in and to all of Franchisee's assets of any kind or nature used or useful in connection with the ownership and operation of the Franchised Restaurant, including, without limitation, the following (the "Collateral"):

1. all equipment, furnishings, fixtures, merchandise, inventory, goods and other tangible personal property;

2. all accounts, accounts receivable, other receivables, contract rights, leases, software, chattel paper and general intangibles;

3. all instruments, documents of title, policies and certificates of insurance, securities, bank deposits, bank accounts and cash;

Franchise Restaurants Gross Receipts Not Included In the Standard Formula

- **Company-owned location** = gross receipts are included in the standard formula.
- **Franchised location** = gross receipts are NOT included in the standard formula.
- ***Underlying activity (burger sales) is the same.***

Instead Franchised Restaurants Receipts Included at 15%

Company-Owned

- $1 million of burger sales

- *Amount Represented in the Apportionment Formula =*

$1 million

Franchised

- $1 million of burger sales
- Franchisor receives 15% of the franchise's $1 million in sales.

- *Amount Represented in the Apportionment Formula =*

$150K

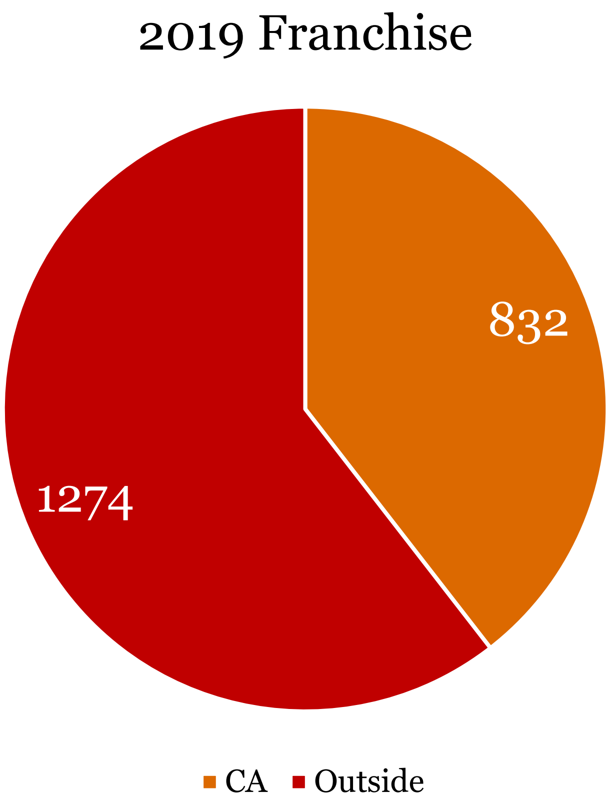
Same Amount of Underlying Activity: Burger Sales

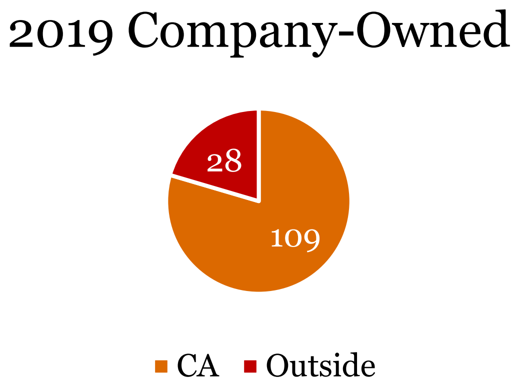
Partially Including Receipts Leads to Geographic Distortion

- Mixing net franchise receipts with gross company store receipts causes geographic distortion when:
  - (1) franchise restaurants are disproportionally located outside of the state, and/or;
  - (2) company-owned restaurants are disproportionally located inside the state.
- We have **both in this case.**

Owned vs. Franchised - Not Geographically Aligned

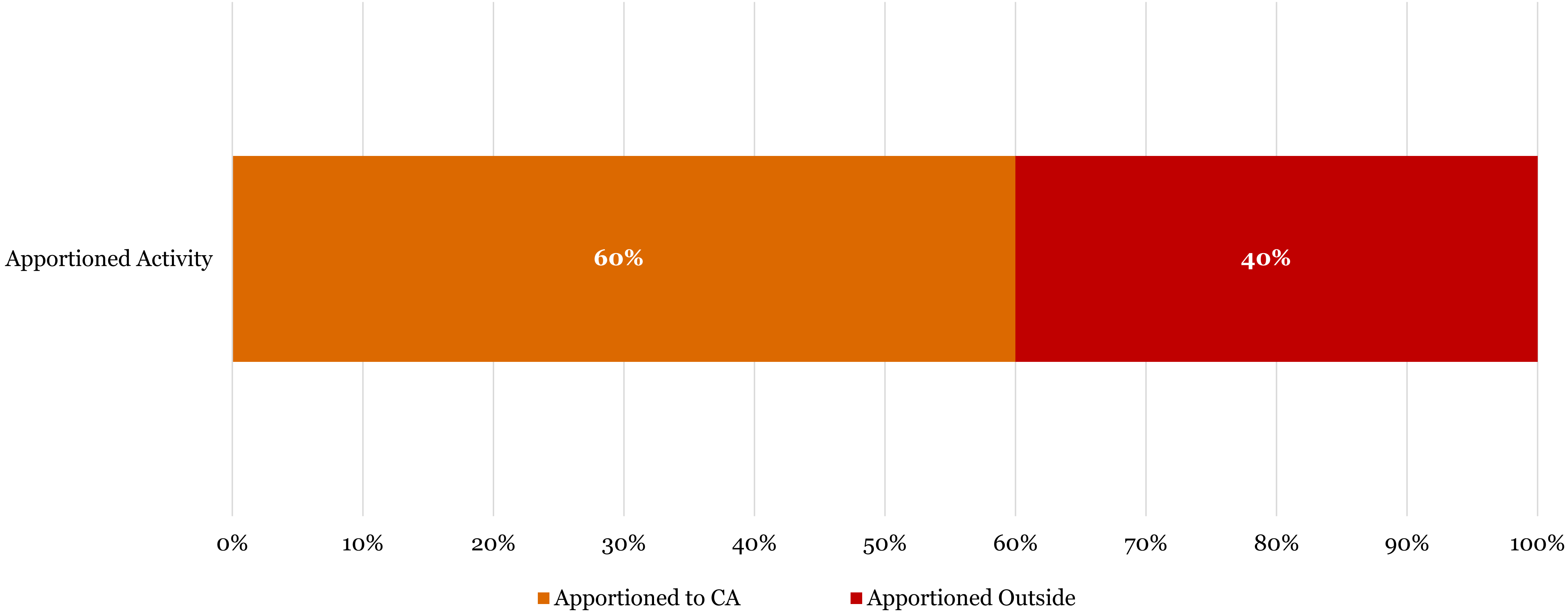
- 61% of all franchised locations are **outside** of California.
- 80% of company-owned locations are in California.





California Activity by Restaurant Count

California Activity According to Standard Formula



Averaged Data

The Problem

- Consider two restaurants:
  - ➢ Both company owned;
  - ➢ One located in California, one located in Arizona;
  - ➢ Each sell $1 million of burgers.

$$\frac{\text{\$1 million (sales in CA)}}{\text{\$1 million (sales in CA)} + \text{\$1 million (sales in AZ)}} = \frac{\$1M}{\$2M} = \mathbf{50\%}$$

The Problem Continued

- Now consider two restaurants:
  - ➢ *One is company owned and the other is franchised;*
  - ➢ *Company-owned restaurant is in Arizona, franchised restaurant is in California;*
  - ➢ Each sell $1 million of burgers.

$$\frac{\$150\text{K (sales in CA)}}{\$1\text{ million (sales in AZ)} + \$150\text{K (sales in CA)}} = \frac{\$150\text{K}}{\$1.15\text{M}} = \mathbf{13\%}$$

To Illustrate the Problem Continued

- In both situations, there are two restaurants, and both are generating the same amount of burger sales; however, in the second case, **we have a 13% apportionment versus 50% in the first case.**

- Why?

  - Because the FTB is not allowing franchised restaurant sales to be included in the standard formula despite burger sales being the same underlying activity.

  - Even though *both* restaurant types contribute similarly to JIB's profit, one type of restaurant is treated differently.

Alternative Apportionment – Section 25137

If a taxpayer can demonstrate that the standard apportionment formula does not **fairly represent** its business activity within California, then it may request that an alternative apportionment formula be applied in respect to all or any part of the taxpayer's business activity.

Container Corp. v. Franchise Tax Board

- The "factor or factors used in the apportionment formula **must actually reflect a reasonable sense of how income is generated**."

    - *Container Corp. of Am. v. Franchise Tax Bd.* (1983) 463 U.S. 159, 169.

- In other words, there should be a reasonable and **fair relationship** "between the particular sources of income that are included in the apportionable tax base and the factors that are used to apportion such income."

    - *Hellerstein, State Taxation (3rd ed. 2021) Allocation and Apportionment of Corporate Net Income Under State Law, §9.15, pg. 836.*

Microsoft Corp. v. Franchise Tax Board

- Short-term investments that produced less than 2% of the company's income but 73% of its gross receipts.
- However, the Court also noted that when an out-of-state activity generates a large portion of income, it would also be distortive to ignore the gross receipts from which the income is derived.
- Specifically, the Court noted that the FTB's approach of removing large receipts can result in an exaggeration of California tax when the receipts account for a substantial portion of the taxpayer's income.

Microsoft Corp. v. Franchise Tax Board Cont.

"By **mixing net receipts** for a particular set of out-of-state transactions **with gross receipts** for all other transactions, it minimizes the contribution of those out-of-state transactions to the taxpayer's income and exaggerates the resulting California tax.

If, unlike here, treasury operations provide a **substantial portion of a taxpayer's income**, this exaggeration may result in an apportionment that **does <u>not</u> fairly represent California business activity**."

- *Microsoft Corp. v. Franchise Tax Bd.* (2006) 39 Cal.4th 750, 771.

Microsoft Corp. v. Franchise Tax Board

- The situation that Microsoft warned about is based on two conditions both of which are present in this case.

  1. Out-of-state activities reflected at net?

     - Yes, the company-owned restaurants are included at gross and the predominately out-of-state franchise restaurants are included at net.

  2. Do those out-of-state activities contribute a substantial portion of income?

     - Yes, **franchising generates nearly four times as much net operating income** for the Taxpayer as operating company-owned restaurants.

Standard Formula Does Not Fairly Reflect Business Activity in the State

- **6%** of JIB's restaurants (137 out of 2,200) make up **half the apportionment formula**.
- Result: **only ~40%** of JIB restaurants are in California, the standard formula seeks to tax **~60%** of total income.
    - The distortion increases the California apportionment factor as much as **50%**.

2019 Data

Requested Remedy

- JIB seeks consistent and fair treatment.
  - ➢ Option 1: Restaurant count ratio, *i.e.*, restaurants in California/restaurant everywhere.
  - ➢ Option 2: The inclusion of franchised restaurant receipts in JIB's apportionment formula.