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CHIEF COUNSEL RULING 2012-05

Subject: Chief Counsel Ruling Request for Taxpayer

Dear Requestor,

By letter dated October 14, 2011, you requested advice from the California Franchise Tax Board in the form of a Chief Counsel Ruling on behalf of your client and its subsidiaries, **********, CCN *******, regarding the California franchise tax consequences of *****'s sales to third parties of various ***** grown and produced by independent third-party farmers, and the applicability of section 25128 of the Revenue and Taxation Code to these sales.

We conclude that, subject to audit verification of the factual representations made in the request for ruling and as more fully described below, *****'s receipts from sales of ***** grown by the growers do not constitute receipts from a qualified business activity.

FACTS

********** ("*****," "The Company," or "Taxpayer"), a company headquartered in **********, **, markets and distributes various patented and nonpatented *****. These ***** consist primarily of organic and conventionally grown ***** sold into domestic and international markets. These products are grown both domestically and internationally.[1]

[1] With the exception of ******** grown in ****, ***** sells and distributes ***** grown by third-party growers in the local market. With respect to ******** in ****, ***** sells and distributes ******** produced directly by a ***** subsidiary, *****'s of ****, *.*. ("***"), as well as by third-party growers. However, the amount of sales from ***** produced directly by *** is minimal. (For 2010, total ***** sales of ***** grown in ****, including both ***- and the grower-grown *****, was less than $*******, which is approximately ** percent of *****'s total annual sales of $******.)

Third-party farmers ("the Growers") grow the vast majority of the ***** sold and distributed by *****. The Growers work with ***** as independent contractors and are not employees, representatives, or agents of *****. ***** provides patented seedlings to the Growers, which the Growers use to produce the *****. After the Growers produce the *****, the Growers harvest and process the ***** for delivery to ***** coolers for chilling. Ultimately, ***** sells the ***** to unrelated third-party wholesalers and retailers.

***** undertakes research, evaluation, and development activities to develop the plant varieties and seedlings provided to the Growers. To that end, the company has developed its own natural breeding program for cultivating its plants to create patented varieties through natural breeding methods as well as extensive in-field testing. The plants are patented and cultivated in ***** and third-party nurseries.

Under the typical agreement with the Growers ("Grower's Agreement"), the plants are not for sale and are specifically provided to the Growers for the production of *****. The Growers choose the type of plants that ***** will propagate in exchange for a fee provided to ***** for a license to use the propagated plants. Although the Growers pay for the right to use the plants, not for the plants themselves, ***** grants farmers the freedom to use the plants "as necessary to grow a crop" for *****. Nonetheless, throughout the life of the agreement, ***** retains ownership, title, and property interests in the plants, plant materials, and *****. Consequently, the Growers cannot reproduce the plants, sell the plants to any third party, or deliver the ***** to anyone other than *****. In addition, the Growers are required to destroy or return any plants and ***** to ***** at the end of the productive life of the plant. The purpose of this arrangement is to protect the interests of ***** in its proprietary and patented plant types and resulting *****.

At times, ***** representatives share and learn best practices for plant growth with the Growers by studying and analyzing plants. The ***** representatives then make suggestions to enhance the Grower's ability to produce *****. However, the Growers make the ultimate decision whether to implement the suggestions communicated to them.

The Growers use their agricultural skill and experience to grow the ***** in fields that they own or lease. As such, the Growers Agreement grants the Growers the discretion to care for the plants "in the best farmlike manner." Additionally, the Growers Agreement specifically states the following:

> ***** has not assumed any right of supervision or control over the planting of the Plants, the growing of the ***** or the management of Grower's own employees or contractors, who at all times will be under the exclusive supervision, direction and control of Grower.

***** relies on the expertise and knowledge of the Growers to produce the *****. The Growers are allowed to subcontract any of their obligations under the ***** agreement. Although ***** grants the Growers the autonomy to conduct growing activities, the Growers must comply with applicable regulations and laws. Thus, through the life of the

Growers Agreement, the Growers must comply with all laws related to farming and to the growing, harvesting, and/or delivery of **** crops, and the use and application of pesticides, chemicals, and fertilizers. In addition, the Growers must comply with *****'s Food Safety Program. To ensure that the Growers comply with these requirements, ***** reserves a right to enter the Grower's land and conduct an audit to determine compliance with the terms of the agreement. Generally, ***** uses a third-party agent to conduct these audits. In addition, ***** can prohibit the use and application of any chemicals, pesticides, or other substances to the plants, the crop, or the soil in which the plants are grown.

In addition to growing the *****, the Growers conduct harvesting activities by picking the ripened ***** in the field. Generally, the Growers also sort and pack all the ***** that they grow and harvest, and conduct inspection and grading prior to delivery to *****. ***** provides certain materials to the Growers used to package the products. To protect the ***** trademark, the Growers Agreement specifies that the packaging materials used by the Growers must meet specifications set forth by *****. The Growers maintain detailed records of the ***** grown and packed as well as all chemicals, pesticides, and fertilizers used on the plants. The harvested ***** are taken to ***** coolers by the Growers to be chilled to remove field heat and are prepared for immediate shipment to food service distributors. ***** from certain areas of land owned and/or used by the Growers are combined each week in a pool for purposes of *****'s distribution and sale. Pools hold ***** of like kind, size, and/or grade from multiple ranches of different Growers. ***** markets and sells the ***** to customers.

With regard to risk of loss, the Grower's Agreement states the following:

> ***** will bear the entire risk of its own loss of or damage to the Plants and ***** while in Grower's possession or otherwise, except only that Grower will be responsible for loss or damage to the Plants or the ***** caused by its own negligence or intentional act or that of its subcontractors or agents. *This Section does not obligate ***** to compensate Grower for any of Grower's own related losses or damages*. (Emphasis added.)

Therefore, ***** bears the risk of "its own loss of or damage to the Plants and *****." ***** allocates an additional two percent of the Grower's dig order for replants at no additional charge. However, ***** is not otherwise obligated to reimburse the Grower for the Grower's loss of the plants. If the Grower is unable to obtain the balance necessary to cover its costs for the season, then the Grower will face a loss for the year because the Grower pays all costs for water, food, labor, supplies, etc.

The Grower has no obligation to obtain insurance on the plants, plant materials, or *****. As a practical matter, however, the onus is on the Grower to purchase crop insurance because ***** does not provide such insurance to the Grower. The Grower is also responsible for paying taxes on its operations, income, land, and other property. However, ***** maintains responsibility for the payment of all personal property and other taxes assessed on its plants, *****, and other plant material.

In a small percentage of cases, ***** invests in the profits of certain Growers by using a fee advance agreement to advance funds ("Fee Advance") to Growers prior to harvest. ***** uses an affiliate, ********** ("*****"), to effect the transfer of such funds. To maintain a strong position in the **** distribution market, ***** relies on the ability of the Growers to produce ***** year round. As such, ***** provides Fee Advances to attract Growers to the market in undesirable locations during difficult growing seasons. In 2010, however, the net *** revenue of produce whereby the Growers received a Fee Advance ("Fee Advance Sales") represented only $********* of approximately $********** of total sales, or approximately ********** percent.[2]

*****'s major revenue stream is through the sale of ***** to third parties ("**** Revenue"). As a result of the nature of the agricultural market, ***** calculates the fee paid to the Growers through the use of pools from multiple ranches and Growers rather than on an individual Grower basis. In exchange for the growing services, ***** remits to the Growers their share of the ***** Revenue through a fee, reflected as a Cost of Sale to ***** ("Service Fee"). The Service Fee makes up the majority of the costs associated with *****'s *** Revenue. In calculating the Service Fee for a particular Grower, ***** uses Gross Sales as a base less packaging costs and *****'s fee for selling and distribution services, which is a commission ranging from ** to ** percent ("Commission Fee"). The remaining ** to ** percent of Gross Sales encompasses the Service Fee with several adjustments made for packaging costs, *** quality adjustments, propagation costs, and harvesting or marketing credits.

The Growers bear the risks of production, as they are rewarded by the market price for both the quantity and quality of the *****. In addition, the Growers obtain the largest upside of a successful crop sale by receiving profits, less *****'s commission for selling and distribution services. Essentially, the Growers receive the bulk of any profit margin realized on the sale of *****. Conversely, if prices for ***** decrease the Growers may lose money, but ***** will nevertheless earn its commission.

According to its 2010 Financial Statements, ***** had total gross business receipts of approximately $**********. These gross business receipts consisted of *** Revenue

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[2] ***** places certain requirements on the Grower in order to protect its investment. For example, the Grower may submit a written budget detailing projected expenses for approval by *****. The Grower must also report to ***** on the use of the Fee Advance during the prior month. ***** maintains the right to inspect the Grower's operations and suggest changes regarding best practices. If the Grower fails to manage its operations in accordance with *****'s suggestions, ***** may reduce or withhold any remaining advances.

Growers do not assume the risk associated with Fee Advance payments. As such, ***** is not entitled to any other repayment of the Fee Advance even if the sales proceeds from the crop are insufficient to repay them. In consideration of the Fee Agreement, ***** is responsible for withholding of amounts otherwise payable to Grower as Service Fees under the Growers Agreement. Such amounts are paid by ***** to *****. ***** is solely responsible for any payments to ***** in consideration of the Fee Advances, and the Grower bears no responsibility to ***** for such payments. In exchange for the risk borne by ***** and ***** in providing the Fee Advance, ***** obtains an equity interest in the sales of *****. Thus, ***** and its affiliate ***** bear the risk of loss for Fee Advance Sales but maintain the upside of such sales.

totalling $**********, which comprised approximately ** percent of total revenue, and services totalling $********, which comprised approximately ** percent of total revenue. Service Revenue primarily consisted of "freight, ancillary services, and royalties."

For 2010, *** Revenue itself was comprised of the following key components of revenue:

1. Major *** Revenue—The primary component of *** Revenue was derived from sales of ***** grown by the Growers pursuant to the Growers Agreement, was greater than $*******, and comprised approximately ** percent of total revenue;

2. Minor *** Revenue—The minor components of *** Revenue ("Minor *** Revenue") consisted of the following three sources:

   (a) Propagation Fee--$*********, which was approximately ** percent of total revenue; a defrayment of plant propagation costs for providing plants to the Growers to produce the *****. Plant propagation costs are related to the maintenance of nursery operations as necessary to provide plants to the Growers.
   (b) *****'s of ****, *.*. ("***") sale of ***** (less than $*****)—***** sold and distributed ********* produced directly by *** as well as by ****** Growers. As such, ***** sold ***** produced directly by ***;[3] and
   (c) Fee Advance Sales--$*********, which was approximately ** percent of total revenue. ***** provided a Fee Advance to Growers through *****, an affiliate finance company, for certain production services in order to entice the Growers to provide growing services in undesirable climates and seasons. ***** financed the Growers in growing the ***** and, as such, assumed their proportionate cost from **** production.[4]

The approximate percentage of ***** **** sales for the period ended December 31, 2011, is as follows:

- ********: ** percent
- ********: ** percent
- ********: ** percent
- ********: ** percent

Growers incur the vast majority of costs required to grow the *****. Specifically, Growers incur approximately ** percent and ** percent of ******** and ******** costs, respectively. ***** costs, primarily nursery, account for the remaining ** percent and ** percent of ******** and ******** costs, respectively. For any individual plant that a

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[3] *See* footnote 1, *supra,* for further discussion of ***.

[4] *See* footnote 2 and accompanying text, *supra*, for further discussion of advance sales through *****.

Grower receives from *****, the amount of time that the Grower spends with that plant (including cultivating, nursing, fertilizing, watering, etc.) to cultivate the plant to maturity such that it yields ***** available for sale is much greater than the amount of time ***** spends developing that individual plant.[5]

REPRESENTATIONS

***** has reviewed the facts set forth above and represents that the facts are true and all material facts have been disclosed. ***** also represents that the issues in this ruling request are not the subject of an existing California audit, protest, appeal, or litigation concerning the taxpayer or a group member.

RULING

Based on the accuracy and completeness of the facts and representations provided by the Taxpayer, and subject to possible verification by Audit of the facts, the FTB Chief Counsel rules that the gross receipts from Major *** Revenue do not constitute gross business receipts of a qualified business activity pursuant to Revenue and Taxation Code section 25128. The activities of ***** in effecting these sales do not rise to the level of an agricultural business activity as defined in Revenue and Taxation Code section 25128(d)(2). Assuming that no more than 50 percent of *****'s gross business receipts are from qualified business activities, ***** is not required to use the equally weighted apportionment formula.

APPLICABLE LAW

Revenue and Taxation Code section 25128 states in pertinent part:

> (b) If an apportioning trade or business derives more than 50 percent of its "gross business receipts" from conducting one or more qualified business activities, all business income of the apportioning trade or business shall be apportioned to this state by multiplying business income by a fraction, the numerator of which is the property factor plus the payroll factor plus the sales factor, and the denominator of which is three.

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[5] These representations by ***** as to the incurring of costs and the amount of time spent with each plant by ***** and the Growers, respectively, are generally consistent with studies of the industry prepared by the University of California Davis, *University of California Cooperative Extension* ********** ********* and *University of California Cooperative Extension* ********** *********. The UC Davis studies analyze the costs to produce ********* and ********* in the *** **** Region and ********** Region, and are based on production procedures typical of the crop and area being studied. According to the studies, growers incur approximately ** percent of ******** costs and ** percent of ******** costs, respectively, while nursery costs account for the remaining ** percent and ** percent of ******** and ******** costs. Approximately **** hours per acre are spent cultivating the ******** versus **** hours per acre spent harvesting the ********.

> (c) For purposes of this section, a "qualified business activity" means the following:
>
> (1) An agricultural business activity.
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> ....
>
> (d) For purposes of this section:
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> ....
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> (2) "Agricultural business activity" means activities relating to any stock, dairy, poultry, fruit, furbearing animal, or truck farm, plantation, ranch, nursery, or range. "Agricultural business activity" also includes activities relating to cultivating the soil or raising or harvesting any agricultural or horticultural commodity, including . . . the handling, 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 so treated.

California Code of Regulations, title 18, 25128-2 states in pertinent part:

> (b) *Definitions.*
> (1) Section 25128, subdivision (d)(2), of the Revenue and Taxation Code sets forth the statutory definition of "agricultural business activity." In general, the term applies only to taxpayers engaged in "the business of farming" as defined in Treasury Regulation section 1.175-3[6] and includes only activities encompassed within "the business of farming" as so defined.
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> ....
>
> (3) Wherever the definition of agricultural business activity in this regulation refers to the production of a product, the term "production" means planting, growing, breeding, raising or fattening one's own agricultural commodity. Production includes processing activities which are normally incident to the growing, raising, planting, breeding, or fattening of agricultural products. For Example, assume an apportioning trade or business is in the business of growing and selling fruits and vegetables. When the fruits and vegetables are ready to be harvested, the business picks, washes, inspects, and packages the fruits and vegetables for sale. Such activities are normally incident to the raising of these crops by farmers. The receipts from the sale of these fruits and vegetables are gross business receipts from a qualified agricultural business activity. The term production does not include the processing of

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[6] Treasury Regulation section 1.175-3 states in pertinent part: "A taxpayer is engaged in the business of farming if he cultivates, operates, or manages a farm for gain or profit, either as owner or tenant."

> agricultural products beyond those activities which are normally incident to the production of such products according to industry practice.
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> ....
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> (e) Gross Business Receipts from Agricultural Business Activity.
> (1) .... [G]ross receipts from sales of produce which were not produced by the apportioning trade or business are not gross business receipts from agricultural business activity.

In *Maple Leaf Farms, Inc. v. Commissioner*, (1975) 64 T.C. 438, the court held that a taxpayer is properly considered a grower for purposes of farming within the meaning of Treasury Regulations section 1.471-6(a) if "it participated to a significant degree in the growing process and it bore a substantial risk of loss from that process."[7] In *Maple Leaf Farms*, the court held that the owner of a duck farm that hired third-party growers to raise ducklings was significantly involved with the growing process and bore the risk of loss such that the owner was properly considered a farmer for the activities conducted by the third-party growers.

The owner raised approximately 10,000 ducks a month on its property, and also slaughtered and processed approximately 100,000 ducks a month. The owner contracted with several growers who raised ducks exclusively for the owner to facilitate the owner in growing activities to accommodate the owner's processing capacity. The contract between the owner and growers was comprehensive and set forth requirements regarding the layout of the area, the provision of food and water for the ducklings, ventilation, bedding, fencing, lighting, landscaping, and the makeup of ramps and driveways. The owner purchased the ducklings and all necessary supplies and provided these items to the growers at a cost. The owner retained title to all the materials delivered to the growers and paid all relevant insurance and tax costs associated with these items. The owner established an account for each grower, whereby the grower would be debited costs for the ducklings and supplies, and credited for the matured ducks raised by the growers on behalf of the owner. Typically, the amount the owners actually paid for the costs of the ducklings and supplies differed from the amount the owner agreed to charge the growers at the beginning of the year. In addition, the owner occasionally assisted growers who were unable to deliver matured ducks according to the terms of the contract. The account balance was cleared at year end, such that the owner would pay each grower for any credits owed. However, growers did not pay the owner for debit balances. For example, if a grower had a debit balance it would be

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[7] 64 T.C., at 448. Treasury Regulation section 1.471-6(a) concerns inventories of livestock raisers and other farmers, and provides that:

> A farmer may make his return upon an inventory method instead of the cash receipts and disbursement method. It is optional with the taxpayer which of these methods of accounting is used but, having elected one method, the option so exercised will be binding upon the taxpayer for the year for which the option is exercised and for subsequent years unless another method is authorized by the Commissioner as provided in paragraph (e) of § 1.446-1.

carried over to the next year if a relationship continued between the owner and grower. Even if the owner and grower discontinued their agreement, neither party "considered [the debit balance] to be an outstanding debt owing."[8] As a result of these activities, the court held that the owner was a farmer because the owner significantly participated in the growing process and bore the risk of loss.

In *Ward AG Products, Inc. v. Commissioner*, T.C. Memo 1998-84, 75 T.C.M. (CCH) 1886, the court found that a taxpayer that sold seeds, fertilizer, and other supplies to farmers and provided advice and some financial assistance did not qualify as a farmer for purposes of using the cash method of accounting. Citing *Maple Leaf Farms* with approval, the court held that, to be a farmer, the taxpayer must have participated to a significant degree in the growing process and borne a substantial risk of loss from that process. The taxpayer did not meet that standard because it did not bear a substantial risk of loss from farming. The taxpayer did not keep title to the seed, fertilizer, or pesticides; it sold merchandise to farmers. Instead, the farmers in *Ward AG Products* had no recourse if their crops failed or the market for their crops was poor. The taxpayer had liens, collateral, security interests, and other rights and protections that the farmers did not have, nor were its liens and other security limited to the current crop.

In *National Labor Relations Board v. Bayside Enterprises, Inc.,* (1st Cir. 1975) 527 F.2d 436, the court held that the Bayside Company, a poultry processing company, was not a farmer with respect to activities conducted in supporting the raising of poultry on contract farms despite the fact that the Bayside Company was otherwise a farmer for other activities. Although the decision in *Bayside* was given in the context of the application of the National Labor Relations Act rather than in a tax case, it provides some insight as to the court's mindset regarding the application of the farming doctrine to specific activities conducted by businesses otherwise engaged in farming. Specifically, the court held that an entity that pays contract growers to grow and supports the contract growers in conducting growing activities is not considered to be engaged in farming for purposes of those activities in relation to its non-farming enterprises.

In *Bayside Enterprises*, the Bayside Company controlled chick hatchery facilities and breeding farms, both of which are considered farming activities; and feed mill and processing plant operations, neither of which are considered farming activities. The Bayside Company paid third-party contract farmers to grow the chicks. Although the chicks were raised by third-party growers, the Bayside Company retained title to the chicks and ordered truck drivers, employed by the company, to transport chicken feed from the Bayside Company's milling operations to the contract farmers to support the growth of the chicks. The Bayside Company argued that the truck drivers were conducting farming services because the Bayside Company was engaged in farming and the truck driver services were incidental to the Bayside Company's farming activities. Nonetheless, the court held that the Bayside Company was not considered a farmer for the activities related to the raising of the chicks on contract farms since the actual farming activity was conducted by the contract farmers. Retention of title to the chicks pending maturity on contract farms does not entitle

[8] 64 T.C., at 445.

a business to be classified as a farmer under current Department of Labor regulations. In addition, the delivery of feed to the farmers, although crucial to the development of the chickens, was not sufficient to classify the Bayside Company as a farmer. Thus, the court concluded that the portion of the Bayside Company's business supporting contract farmers was not considered farming since the activities related to that business were not part of the Bayside Company's actual farming businesses.

DISCUSSION

A. California Statutory and Regulatory Authority

California requires application of the equally weighted apportionment formula for an apportioning trade or business if the business derives more than 50 percent of its gross business receipts from qualified business activity, which includes agricultural business activity. Specifically, Revenue and Taxation Code section 25128(d)(2) (emphasis added) defines agricultural business activity as follows:

> "Agricultural business activity" means activities relating to any stock, dairy, poultry, fruit, furbearing animal, or truck farm, plantation, ranch, nursery, or range. "Agricultural business activity" also includes activities relating to cultivating the soil or raising or harvesting any agricultural or horticultural commodity . . . as well as the handling, 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* so treated.[9]

Therefore, according to the statute, agricultural business activity can be separated into two categories. The first is activities relating to any "fruit . . . farm [or] . . . nursery." The second is certain related activities "but only if the owner, tenant, or operator of the farm regularly produces more than one-half of the commodity . . . ."[10]

***** has receipts from Major *** Revenue and Minor *** Revenue. ***** receives an immaterial amount of receipts from Minor *** Revenue, which may include activities relating to any "fruit . . . farm [or] . . . nursery" that it performs directly. These activities include undertaking nursery operations to produce the plants it provides to Growers, propagating seeds to seedlings in production of plants it provides to Growers, and *****'s subsidiary *** growing an immaterial amount of ********* for sale to third parties. Although ***** does perform some of its own farming, which appears to qualify as

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[9] "The term 'farm' is used in its ordinary and accepted sense, and generally means land used for the production of crops, fruits, or other agricultural products or for the sustenance of livestock or poultry. . . . Thus, a farm includes livestock, dairy, poultry, fish, fruit . . . and truck farms, plantations, ranches, nurseries, ranges, orchards . . . and greenhouses and other similar structures used primarily for the raising of agricultural or horticultural commodities." (Cal. Code Regs., tit. 18, § 25128-2(b)(2).)

[10] Rev. & Tax. Code, § 25128(d)(2).

qualified agricultural business activities, the receipts from these business activities are significantly less than 50 percent of Taxpayer's gross receipts.

The vast majority of *****'s gross receipts are derived from the Major *** Revenue component, which is earned from selling and distributing ***** produced by the Growers pursuant to *****'s Grower Agreements. ***** essentially earns a commission fee ranging from ** to ** percent in exchange for selling the ***** produced by the Growers. The vast majority of the Major *** Revenue is remitted to the Growers after adjustments are made for *****'s commission, packaging costs, and credits, as reflected in the cost of sales, and as set forth in the Grower's Agreement. The service fee remitted to the Growers is accounted for as a cost of sales such that ***** ultimately receives a commission fee related to sales of ****. ***** is not "the owner, tenant, or operator of the farm [that] regularly produces more than one-half of the commodity . . . ." Therefore, ***** does not earn more than 50 percent of its gross business receipts from a qualified business activity, and based solely on the statute, ***** should not be required to use the equally weighted apportionment factor.

The California regulations further clarify that only one's own farming activities undertaken as an owner or tenant are counted for purposes of the 50-percent test. Thus, Regulation 25128-2(b)(1) (emphasis added) explains that "In general, the term [agricultural business activity] applies only to taxpayers engaged in 'the business of farming' as defined in Treasury Regulation section 1.175-3 *and includes only activities encompassed within 'the business of farming' as so defined*." Therefore, one could be in the business of farming and nevertheless conduct activities that would not be counted as the business of farming for purposes of the agricultural business activity rule. Applying this limitation to *****, while it could be considered to be in the business of farming with respect to its nursery and propagation activities, since the Growers are third parties growing on their own account, ***** is not in the business of farming with respect to the **** production activities they undertake. As such, these are not activities attributable to ***** for purposes of the 50-percent test.

The California Regulations further explain that agricultural business activity includes only production activities undertaken with respect to "one's own" crop. While the production of ***** is agricultural business activity, for purposes of determining if a taxpayer derives greater than 50 percent of gross business receipts from agricultural business activity, only receipts from one's own production are counted:

> Wherever the definition of agricultural business activity in this regulation refers to the production of a product, the term "production" means planting, growing, breeding, raising or fattening *one's own* agricultural commodity.[11]

Since the term "production" means planting, growing, breeding, raising or fattening *one's own* agricultural commodity,[12] it is clear that *****'s receipts from Major *** Revenue

[11] Cal. Code Regs., tit. 18, 25128-2(b)(3) (emphasis added).

derived from the Grower's Agreement do not constitute receipts from agricultural business activity. This is because under the Grower's Agreement, ***** earns *** revenue for the sale and distribution of ***** produced by the Growers. As indicated in the Growers Agreement, "***** has not assumed any right of supervision or control over the planting of the Plants, the growing of the ***** or the management of Grower's own employees or contractors, who at all times will be under the exclusive supervision, direction and control of Grower." Although ***** maintains title to the *****, title is held to protect *****'s patents in the ***** and plants; the Growers, not *****, conduct the "planting, growing . . . [and] raising" activities. Pursuant to the terms of the Growers Agreement, all ****-growing activities are conducted by the Growers and not by *****. ***** does not produce *its own* agricultural commodity with respect to the vast majority of its gross receipts, and therefore the Major *** Revenue does not count toward the 50-percent test.

The Regulations clearly provide that "gross receipts from sales of products [that] were not produced by the apportioning trade or business are not gross business receipts from agricultural business activity."[13] The Regulations further provide that if a company sells produce grown by others, then receipts from the sale of that produce do not count for purposes of the 50-percent test. As an example, the Regulations indicate that if a farming corporation sells *** purchased from an unrelated farming business that produced such ***, then the resale of that *** will not be considered gross business receipts from an agricultural business activity.[14] Therefore, under the Regulations, in the case of a buy-sell arrangement, receipts from the sale of *** bought from another are not gross receipts from agricultural business activity.

Tracing is required if a business both self produces and buys products from third parties. In the event an apportioning trade or business sells products produced from its own qualifying agricultural business activity, in addition to products grown by another party, then the apportioning trade or business is required to trace the portion of the total receipts related to its own qualified agricultural business activity. Reasonable estimates can be made if records are unavailable to identify the receipts related to the agricultural business activity.[15] Although ***** does not purchase ***** from the Growers for resale in a classic buy-resell relationship as exemplified in the Regulations, *****'s contractual relationship with Growers is such that Growers obtain the primary benefit of a successful crop cycle and the

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[12] *Id.*

[13] Cal. Code Regs., tit. 18, 25128-2(e)(1).

[14] Cal. Code Regs., tit. 18, 25128-2(e)(1) Example:

> If X, a farming corporation, purchases peaches from an unrelated farming business which has produced the peaches, the resale of those peaches by X will not give rise to gross business receipts from an agricultural business activity. X did not produce the peaches; therefore, the sales were not derived from a qualified agricultural business activity, as defined in section 25128 of the Revenue and Taxation Code and this regulation, conducted by X.

[15] Cal. Code Regs., tit. 18, 25128-2(e)(2).

price their ***** ultimately receive in the market. Essentially, ***** remits the majority of the Major *** Revenue to Growers and withholds a commission of between ** and ** percent for selling and distributing services. The terms of the Growers Agreement make it clear that the Growers are responsible for production activities such that ***** is not engaged in the selling of "one's own" agricultural commodity. Although ***** retains title to the *****, it holds title to protect the Company's rights to the **** patents. Similarly, the propagation service activities do not rise to the level of the production with respect to the Major *** Revenue since it is not production of "one's own" commodity with regard to the ***** sold under the Growers Agreement; indeed, the propagation does not yield any *****, just plants that are delivered to the Growers to produce *****.

Here, with respect to the Major *** Revenue, production of the ***** is by the Growers and not by *****. Thus, the majority of the production activities are not *****'s own production activities. The tracing rules apply since ***** sells both third-party produced and self-produced *****. An application of the tracing rules distinguishes *****'s gross receipts derived from Grower-produced ***** from gross receipts derived from *** self-produced *****. As such, *****'s Major *** Revenue, which is comprised of sales of Grower produced *****, does not constitute receipts from agricultural business activity. Thus, ***** will not apply an equally weighted sales factor because *****'s Major *** Revenue comprises approximately ** percent of *****'s total revenue, significantly more than the threshold established by the 50-percent test.

When read as a whole and in context, it is fair to conclude that the Regulations contemplate that only processing activities incident to one's own production of products should properly be considered "production" for purposes of the agricultural business activity rules.[16] As a result, gross receipts earned for picking, washing, inspecting, and packaging services will be included in the 50-percent test if they are activities which are normally *incident* to the production of such products according to industry practice. All other activities conducted by the taxpayer that are not otherwise incident to the production of the products will not be considered "production" activities and should not be included in the 50-percent test. Here, since ***** does not produce the ***** that yield the Major *** Revenue, the processing activities it conducts with respect to the Major *** Revenue do not generate gross receipts considered to be gross receipts from agricultural business activity. According to the terms of the Growers Agreement, "[a]fter harvesting, Grower will sort, grade, and pack all *****

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[16] *See* Cal. Code Regs., tit. 18, 25128-2(b)(3) (emphasis added):

> Production includes processing activities which are normally incident to the growing, raising, planting, breeding, or fattening of agricultural products. For Example, assume an apportioning trade or business is in the business of growing and selling fruits and vegetables. When the fruits and vegetables are ready to be harvested, the business picks, washes, inspects, and packages the fruits and vegetables for sale. Such activities are normally incident to the raising of these crops by farmers. The receipts from the sale of these fruits and vegetables are gross business receipts from a qualified agricultural business activity. The term 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.

grown and harvested." Moreover, ***** does not receive ***** until they are ready to be cooled. As such, Growers conduct all material processing activities since such activities occur prior to *****'s receipt of the ***** for cooling, sales, and distribution. ***** provides the service fee to Growers as consideration for growing services, which includes processing activities.

B. Case Law

To the extent any uncertainty exists with respect to Major *** Revenue because ***** retains title to the ***** while in the Grower's possession, relevant case authorities show that since the Grower's activities are not performed by ***** and ***** does not retain sufficient control and risk of loss over the process, receipts from Major *** Revenue are not gross receipts from agricultural business activity for California tax purposes. For example, with respect to specific activities, in *Maple Leaf Farms, Inc. v. Commissioner* (1975) 64 T.C. 438, the court concluded that a taxpayer will be considered engaged in the business of farming when the taxpayer exerts significant control and bears the risk of loss. In *Ward AG Products, Inc. v. Commissioner*, T.C. Memo 1998-84, 75 T.C.M. (CCH) 1886, the court held that, to be a farmer, the taxpayer must have participated to a significant degree in the growing process and borne a substantial risk of loss from that process. In *National Labor Relations Board v. Bayside Enterprises, Inc.* (1st Cir. 1975) 527 F.2d 436, although not a tax case, the court concluded that only activities related to one's own farming activity could likewise be considered farming activity, and that retention of title to products produced by third parties was not sufficient to classify one as a farmer. These authorities also support the conclusion that receipts derived from Major *** Revenue will not count toward the 50-percent test.

In *Maple Leaf Farms*, the court held that the owner significantly participated in the growth of the ducks. The owner selected and purchased all the ducklings and supplies to be used by the growers. In addition, the court found that the terms of the contract between the owner and grower went "far beyond the usual 'quality control provisions' found in franchising arrangements."[17] Also, the owner ensured that the terms of the contract were complied with by employing a fieldman who "visited each grower to make sure the requirements of the agreement were met and who gave the growers criticism and made recommendations as to their activities."[18] Unlike the owner in *Maple Leaf Farms*, ***** does not significantly participate in the growth of the ***** with respect to the Major *** Revenue. For example, unlike the growers in *Maple Leaf Farms*, the Growers choose the type of seedlings and supplies that they require in order to produce the *****. ***** provides the supplies and seedlings, but does not dictate what the Growers must use. Moreover, unlike the agreement in *Maple Leaf Farms*, the Growers grow the ***** "as necessary to produce the crop" and "in the best farmlike manner." ***** does not dictate the manner in which the Growers must produce the *****. The Growers provide the land, choose supplies and pesticides, plant the seedlings, and grow the ***** at their own discretion. As further

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[17] 64 T.C., at 449.

[18] *Ibid*.

evidence of the Grower's control over **** growth, the Growers are entitled to subcontract out any obligation under the Growers Agreement, with the Grower retaining full responsibility for the performance of the agreement. Lastly, although ***** hires an inspector to audit the Growers, the inspection is meant to ensure compliance with the law and the provisions of food safety. Ultimately, it is the Growers who have the responsibility to produce the crops in the manner they deem appropriate. Thus, unlike the owner in *Maple Leaf Farms*, ***** does not significantly participate in the growth of the produce with respect to the Major *** Revenue.

In *Maple Leaf Farms,* the court held that the owner bore the risk of loss since the major risk of loss in poultry raising was the unforeseen loss of a flock as opposed to typical mortality of ducks. In the event of a fire, the owner would suffer the loss as debits held by the grower for ducklings and supply would be reimbursed by the owner after insurance proceeds had been recouped. Even in circumstances not covered by insurance, the owner had a history of assisting growers owing a debit balance who were unable to provide ducks specified in the contract. Although a year-end debit balance owed to the owner could be carried forward to continuing years, the owner never collected on such balances as they were not considered an outstanding debt. In addition, the owner bore the market risk associated with fluctuating duckling and supply prices. The credits and debits between the owner and grower were agreed upon at the beginning of the year and were not subject to changes in the market.

Similarly, in *Ward AG Products, Inc. v. Commissioner*, T.C. Memo 1998-84, 75 T.C.M. (CCH) 1886, the taxpayer was a seller of seeds, fertilizer, and other supplies to farmers. Although it provided advice and some financial assistance to farmers, it was not found to be a farmer because it did not participate to a significant degree in the growing process and did not bear a substantial risk of loss. The farmers in *Ward AG Products,* on the other hand, had no recourse if their crops failed or if the market for their crops was poor.

In contrast, ***** does not bear the risk of loss with regard to sales from the Major *** Revenue. Unlike the owner in *Maple Leaf Farms*, ***** does not carry insurance coverage on growing crops. Although ***** has the option to absorb a portion of a Grower's loss in certain limited circumstances, the major risk of unforeseen crop loss is borne by the Grower. Moreover, ***** is diversified against such a calamity by investing in various crops throughout the world during all seasons. The Growers, on the other hand, face substantial risk of loss and are well invested in the success of their particular **** pool. In addition, the Grower pays ***** a fee for the use of the seedlings and supplies provided to the Grower. However, unlike the owner in *Maple Leaf Farms,* at times ***** actually collects the proceeds owed by the Growers for the provision of supplies and does not forgive uncollected debt. In addition, the Growers bear the risk of variability involved with production of plants. ***** charges the Growers a change fee for any surplus of the dig order over the original plant selection made by the Grower. Although ***** provides a minor coverage buffer of ** percent for the excess of the dig order over the plant selection, the Growers by and large bear the greatest risk of a required change in order. Lastly, and perhaps most importantly, unlike the growers in *Maple Leaf Farms*, *****'s Growers are not guaranteed a set fee for the production of the *****. Instead, the Growers receive a service fee which varies according to the quantity and quality of the production of the

*****. Essentially, ***** retains a pre-determined minority percentage of the selling price of the ***** and pays the remainder to the Growers. If the crops fail, the Growers will not obtain an amount sufficient to cover the costs of their labor and farming. As described in the Growers Agreement, ***** "intended to reward and incentivize quality production and to allocate the fees for a Pool equitably among all Growers." Thus, unlike the owner in *Maple Leaf Farms*, ***** shifts the risk of loss to the Grower with regard to Major *** Revenue derived from the Growers Agreement.

Therefore, with respect to Major *** Revenue, ***** does not significantly participate in the growth of the ***** and the Growers bear the risk of loss. Thus, sales from selling and distribution services pursuant to the Growers Agreement are not gross receipts from agricultural business activity as defined in Revenue and Taxation Code section 25128 and the Regulation. Thus, sales from the Major *** Revenue should be excluded from the 50-percent test in determining whether the equally weighted apportionment factor applies to *****.

Similar to the Bayside Company in *National Labor Relations Board v. Bayside Enterprises, Inc.* (1st Cir. 1975) 527 F.2d 436, *****'s support of the Grower's growing activities does not constitute farming despite the fact that ***** might otherwise be considered a farmer with respect to other activities, e.g., propagation of seedlings. Like the Bayside Company, ***** can be considered to own operations that conduct farming activities since ***** maintains the nurseries that propagate the seedlings and plants for delivery to the Growers. However, even though ***** might be a farmer with regard to the seedlings, and other de minimis activities that collectively account for the Minor *** Revenue, *Bayside Enterprises* shows that the activities of third-party Growers should not be attributed to ***** as *****'s own farming activities. Specifically, although not ruling in a tax case, the court held in *Bayside Enterprises* that "retention of title . . . pending maturity on contract farms does not entitle a business to be classified as a farmer" and that conducting activities "crucial to the development" of the product is not sufficient to classify the taxpayer as a farmer.[19]

***** nurseries are similar in nature to the Bayside Company's chick hatchery business, in the sense that both of these facilities provide Growers and contractors with material necessary to conduct the **** and chick growing activities. Similar to the Bayside Company's chick hatchery in *Bayside Enterprises*, *****'s nursery operations can be considered farming, but these activities should not include any of *****'s other nonfarming activities. The actual growing activities were conducted by the third-party Growers and not by *****. Although ***** maintains title to the ***** and *****'s propagation activities provide the Grower with the plants to produce the *****, a review of the decision in *Bayside Enterprises* suggests that such activities are not sufficient to classify *****'s selling and distribution activities governed by the Growers Agreement as farming. Moreover, the support ***** provides to the Growers is not material to the actual production of the *****, which is conducted by the Growers. As such, *****'s gross receipts earned from

[19] 527 F.2d, at 438.

Major *** Revenue are excluded for purposes of the 50-percent test in determining whether ***** engages in agricultural business activity.

SCOPE OF RULING

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 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 paragraph (1) of subdivision (a) of section 21012 of the Revenue and Taxation Code. 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,

Frederick W. Campbell-Craven
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