STATE OF CALIFORNIA
FRANCHISE TAX BOARD
Legal Division
Kathy Shin, Tax Counsel IV
P.O. Box 1720
Rancho Cordova, CA 95741-1720
916.845.2593

Respondent's Representative

BEFORE THE THREE-MEMBER FRANCHISE TAX BOARD

OF THE STATE OF CALIFORNIA

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

SMITHFIELD PACKAGED MEATS CORPORATION AND ITS COMBINED AFFILIATES

Years

12/28/2014
1/03/2016
1/01/2017
12/31/2017

STAFF'S BRIEF

INTRODUCTION

Pursuant to Title 18 of California Code of Regulations ("CCR") section 25137, subdivision (d), Smithfield Packaged Meats Corporation and its Combined Affiliates (collectively, "Smithfield" or "Taxpayer") petition the Franchise Tax Board (the "FTB") to consider its request pursuant to California Revenue and Taxation Code ("CRTC") section 25137 for alternative apportionment (the "Petition") in open session.

Taxpayer filed its Petition requesting to use an equally-weighted three-factor apportionment formula, rather than the mandatory single-sales factor ("SSF") formula, as a secondary position on a claim for refund. Taxpayer's primary position was that it qualified for the three-factor formula for agricultural businesses,[1] which was denied after an audit examination.

Taxpayer asserts in its Petition that the term "business activity" in CRTC section 25137 means all factors that drive profitability; and as applied to its vertically integrated pork processing and hog producing business, the statutory SSF apportionment formula results in an unfair reflection of its business activity in this state (7.7% on average[2]) because its capital and labor, as represented by its property and payroll factors located largely outside of this state,[3] are omitted from the factors used to apportion its business income.

After much deliberation, FTB staff denied the Petition upon finding Taxpayer's arguments unpersuasive for purposes of CRTC section 25137 relief. First, Taxpayer failed to demonstrate that the SSF formula, as applied, does not fairly measure its market in California. Taxpayer argues that the apportionment formula must take into account all of its income-producing activities outside of this state in order to fairly represent the extent of its business activity in this state. However, the standard apportionment formula specifically excludes property and payroll and measures business activity by sales factor only. Thus the standard apportionment formula must only fairly reflect the market, which the sales factor measures. Taxpayer's sales attributable to California during the four years at issue were $960 million for the first year,

[1] CRTC section 25128, subdivisions (c) and (d)(2)
[2] Taxpayer's Opening Brief filed on June 22, 2020, p. 11
[3] *Ibid.*

increasing to $1.2 billion for the fourth year. Therefore, Taxpayer maintains a significant and growing market in this state that generates revenue. Second, Taxpayer's proposed alternative is not reasonable because the Taxpayer requests to use the equally-weighted three-factor formula allowed for agricultural business, to which Taxpayer has not shown that it qualifies as such under the law.

As the following analysis will indicate, Taxpayer has not carried its burden of demonstrating that the SSF formula does not fairly represent the extent of its business activity in this state. Moreover, Taxpayer's position taken to its logical end will lead to the usurpation of SSF apportionment method, which was passed by sixty-one (61) percent of California voters as the standard rule that applies to almost all taxpayers,[4] by a UDITPA relief provision CRTC section 25137,[5] that permits departures from the standard only in a limited situations. Accordingly, this three-member board of the FTB (the "Board") should affirm FTB staff's denial of Taxpayer's request for an alternative apportionment.

ISSUE

Whether application of the statutory single-sales factor apportionment formula to Taxpayer constitutes an unfair representation of its business activity in this state, and if yes, whether use of an alternative equally-weighted three-factor formula consisting of property, payroll and sales factor is reasonable.

FACTS

A. Background

Smithfield was founded in 1936 and is headquartered in Virginia. (Taxpayer's Opening Brief or "TOB," p. 2.) On September 26, 2013, it was acquired by WH Group Limited, a publically traded Hong Kong-based corporation. (2015 WH Group Annual Report.) Whereupon, Taxpayer changed its method of filing from worldwide to water's-edge basis for the short year

---

[4] Codified in CRTC section 25128.7, Proposition 39 is a ballot initiative approved by the 61.1% of the voters during the November 6, 2012 general election, effective as of November 7, 2012, applicable to taxable years beginning on or after January 1, 2013. (http://www.sos.ca.gov/elections/sov/2012-general/sov-complete.pdf)

[5] *Microsoft Corp. v. Franchise Tax Board,* (2006) 39 Cal.4th 750*,* p. 757

beginning on April 29, 2013 and ending on September 26, 2013 (SYE 9/26/13), as the mandatory SSF became effective. The water's-edge method of filing allows a taxpayer to exclude the results of its unitary foreign operations, such as that of its foreign parent, on its California tax return with some exceptions. Notably, Taxpayer's Petition does not include either SYE 9/26/13 or the subsequent short year beginning on September 27, 2013 and ending on December 31, 2013 (SYE 12/27/13), which resulted in net operating losses for the Taxpayer. Accordingly, for these loss years, Taxpayer is not challenging the application of the SSF apportionment.

Taxpayer is the world's largest pork processor and hog producer.[6] (TOB, p.3.) Its operating structure is organized into four key business segments under a single corporate umbrella: (1) Hog Production, (2) Fresh Pork, (3) Packaged Meats, and (4) International. (*Ibid.*) The Hog Production segment uses advanced management techniques to produce premium quality hogs on a large scale at a low cost; the Fresh Pork segment produces a wide variety of fresh, unprocessed pork cuts harvested from hogs in the United States ("U.S.") and markets them nationwide and to numerous foreign markets; the Packaged Meats segment produces a variety of value-added products including sausages, hot dogs, deli meats, and specialty products such as pepperoni; and the International segment includes meat processing and distribution operations in Poland, Romania and the United Kingdom, as well as interests in meat processing operations in Mexico. (TOB, pp. 3-4.) The Hog Production operations occur completely outside of California (*Id.,* p.3), whereas limited pork processing operations occur in this state. (Taxpayer's description of its activities in California, dated May 19, 2019, at Exhibit 1.)

B. Procedural History

Taxpayer filed two claims for refund by a letter dated June 7, 2018 for the tax years ending on December 28, 2014 ("2014"), January 3, 2016 ("2015"), and January 1, 2017 ("2016"); and by a letter dated December 21, 2018 for the tax year ending on December 31, 2017 ("2017") arguing that: *(1)* it is entitled to apportion its income using the equally-weighted

[6] The words hog, pig and swine are generic terms with regard to animal gender, size or breed. (TOB, Footnote 6.)

three-factor formula allowed for agricultural businesses pursuant to CRTC section 25128, subsections (b) and (c); *(2)* in the event CCR section 25128-2 is interpreted to exclude the Taxpayer from using an equally-weighted, three-factor formula, that regulation exceeds the scope of the statute and is therefore invalid; and *(3)* in the alternative, the standard apportionment formula based on a single-sales factor does not fairly reflect Taxpayer's business activities in this state and should be remedied by the use of an alternative apportionment method pursuant to CRTC section 25137. After an audit examination, FTB denied Taxpayer's claims based on the application of CRTC section 25128(b), whereupon Taxpayer requested a review of its request for an alternative apportionment method by FTB staff. On November 18, 2019, Taxpayer presented its case to FTB staff and after due consideration, FTB staff issued a denial of the request for an alternative apportionment method by a letter dated December 12, 2019. Taxpayer now requests a review by this Board of its Petition for an alternative apportionment method by timely filing its opening brief on June 22, 2020.

C. Petition

Taxpayer asserts that the single-sale formula apportionment does not result in fair reflection of its business activity in this state because it overstates the impact of California's marketplace and understates its out-of-state production activities that drive the profit. As a reasonable alternative, Taxpayer advocates for an equally-weighted three-factor apportionment formula comprising of property, payroll and sales factors because it accounts for the capital and labor intensive nature of its activities.

ARGUMENT

I.

TAXPAYER HAS NOT CARRIED ITS BURDEN OF SHOWING THAT THE SINGLE-SALES FACTOR APPORTIONMENT FORMULA DOES NOT FAIRLY REPRESENT THE EXTENT OF ITS BUSINESS ACTIVITY IN THIS STATE.

A. Relevant Law

i. Constitutional Framework – Apportionment and Unitary Business Principles

The United States Supreme Court in *Moorman Manufacturing Co. v. Bair* (1978) 437 U.S. 267 ("*Moorman*") upheld Iowa's SSF apportionment formula over four decades ago:

> Since 1934 Iowa has used the formula method of computing taxable income. This method, unlike separate accounting, does not purport to identify the precise geographical source of a corporation's profits; rather, it is employed as a rough approximation of a corporation's income that is reasonably related to the activities conducted within the taxing State. The single-factor formula used by Iowa, therefore, generally will not produce a figure that represents the actual profits earned within the State. But the same is true of the Illinois three-factor formula. Both will occasionally over-reflect or under-reflect income attributable to the taxing State. Yet despite this imprecision, the Court has refused to impose strict constitutional restraints on a State's selection of a particular formula. [Footnote omitted.]
>
> *Thus, we have repeatedly held that a single-factor formula is presumptively valid.*

(*Id.*, 273; emphasis added.) The *Moorman* Court further unequivocally stated that the U.S. Constitution is neutral with respect to the *content of any uniform rule of apportionment.* (*Id.,* p. 279.)

In a leading case upholding California's unitary method of taxing multijurisdictional businesses, *Container Corp. of America* v. *Franchise Tax Bd.*, (1983) 463 U.S. 159 ("*Container*"), the U.S. Supreme Court once again affirmed the holdings of *Moorman,* as it and other courts had done repeatedly and continue to do so since. If fact, the *Container* opinion relied heavily on *Moorman,* citing it nine times with approval. Based on this solid foundation, thirty states have adopted the SSF apportionment formula including California.[7] Nonetheless, Taxpayer attempts to minimize *Moorman*'s authority by characterizing it as "based on the burden of proof" and as having applied the higher "constitutional standard". (TOB, p. 28.)

B. Statutory Framework – UDITPA and Single-Sales Factor Apportionment Formula

Taxpayers that have business activities in and outside of this state are required to determine the amount of income properly attributed to activities in this state by use of California's version of the Uniform Division of Income for Tax Purposes Act ("UDITPA") codified in CRTC

[7] According to CCH® State Tax SmartChart as of June 29, 2020, 26 states have already transitioned to SSF and four states will be doing so by 2022.

sections 25120 to 25141. Under UDITPA, a taxpayer's income is first divided into business and nonbusiness income (CRTC § 25120 subd. (a) and (d).) Then business income is apportionable to each state by *use of an apportionment formula* (CRTC §§25128 and 25128.7), while nonbusiness income is allocable "to this state" by statute. (CRTC §§ 25123 – 25127.) Accordingly, within this framework, *UDITPA only addresses issues relating to the allocation and apportionment of income*. An apportionment formula (or apportionment percentage) is used to determine a taxpayer's business income to be subject to a jurisdiction's taxation. (CRTC §§ 25120, 25128, and 25128.7.)

During the November 6, 2012 general election, Californians overwhelmingly approved the ballot initiative Proposition 39 and chose the SSF formula over any other formula as the measurement by which to impose corporate franchise tax on most apportioning taxpayers with a market in this state.[8] Accordingly, for tax years beginning on or after January 1, 2013, pursuant to CRTC section 25128.7, all business income of an apportioning trade or business is subject to SSF apportionment, other than those businesses engaged in a "qualified business activity," such as agriculture. (CRTC §25128(b).)

C. CRTC Section 25137 Alternative Apportionment

Pursuant to CRTC section 25137, "[i]f the allocation and apportionment provisions of [UDITPA] 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" the inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this state. (CRTC § 25137, subd. (c).)

The party invoking relief under CRTC section 25137 has the burden to prove with clear and convincing evidence that: 1) the approximation by the standard formula is not a fair representation of the extent of its business activity within California; and 2) the proposed

[8] Proposition 39 is a ballot initiative approved by the 61.1% of the voters during the November 6, 2012 general election, effective as of November 7, 2012, applicable to taxable years beginning on or after January 1, 2013. (http://www.sos.ca.gov/elections/sov/2012-general/sov-complete.pdf)

alternative is reasonable. (*Microsoft Corp. v. Franchise Tax Bd., (2006) 39 Cal. 4th 750,* 765 ("*Microsoft I*").)

D. Analysis

i. Section 25137 is a remedy limited in application to apportionment formula and allocation provisions of UDITPA.

The first inquiry of a CRTC section 25137 petition is whether the taxpayer has met its burden of proving with clear and convincing evidence that the standard formula does not fairly represent the extent of its business activity in this state. Section 25137 expressly grants statutory authority to provide variances only as to the apportionment formula and the allocation provisions. Accordingly, with respect to apportionment of Taxpayer's business income, the applicable apportionment formula necessarily frames the inquiry under section 25137 and dictates what "business activity in this state" thereunder means. Accordingly, since in this case the applicable apportionment formula consists only of the sales factor and indisputably it is designed to measure the taxpayer's market, "business activity" under section 25137 must be measured by Taxpayer's market in this state.

Taxpayer argues however that the meaning of “activity” should be interpreted more broadly to include all activities of the unitary business which drive its profit, namely Taxpayer's out-of-state production activities measured by capital and labor costs. (TOB, p. 20.) Thus, it is this overbroad definition of "activity" and the resulting conflation of profit generating activities of a unitary business, with more limited "business activity in this state" test under CRTC section 25137 that is at the core of Taxpayer's flawed position.

Taxpayer refers to U.S. Supreme Court cases on the unitary method of taxation to suggest that the FTB's application of the statutory apportionment method in this case caused a distortive result. Despite Taxpayer's focus on unity principles when arguing that all of its activities must be reflected in the factors used to determine its income apportioned to California, unity is not at issue here. With that in mind, it is axiomatic as stated by the Taxpayer that "if the profits of any portion of the unitary business are separated from the rest, the base is necessarily inaccurate as the profit from any segment cannot be determined with certainty." (TOB, p. 19; quoting a

seminal unity case, *Chase Brass & Copper Co. v. Franchise Tax Bd,*, (1977) 70 Cal.Ap.3d 457, p.473 ("*Chase Brass*").) However, contrary to Taxpayer's assertions, fairness as it relates to determining the extent of a unitary trade or business or what the *Container* Court referred to as "extrinsic consistency" test (*Container*, *supra*, 463 U.S. 159.), is not the relevant question in the CRTC section 25137 distortion context. The extrinsic consistency analysis discussed in unity cases is distinct from that of "fair reflection of the taxpayer's business activities" under section 25137. Taxpayer's attempt to conflate the unity principles with determination of a taxpayer's business activities in California is based on its extensive and misleading use of the unity case law (E.g., *John Deere Plow Co. of Moline v. FTB*, (1951) 38 Ca.2d 215 [the taxpayer argued unsuccessfully for distortion based on separate accounting] at TOB, pp. 1 and 29; *Butler Bros. v. McColgan* (1941) 17 Cal.2d 664 [a California Supreme Court's decision that became a leading unity case decided by the U.S. Supreme Court that established the "three unities test"] at TOB, page 1; and *Container*, *supra,* 463 U.S. 159 [a seminal case upholding California's unitary method of taxation] at TOB, pp. 2 and 17.*)*

Under UDITPA the unitary tax base is taken as a starting point and then the statutory apportionment formula is applied to calculate the portion of the business income that will be subject to California taxation. (CRTC §§ 25120, 25128, 25128.7.) Therefore, UDITPA does not govern how the unitary tax base is determined. CRTC section 25137, which is a relief provision within UDITPA, is concerned with the result of the application of the apportionment formula to the business income. That is, section 25137 only grants statutory authority to provide variances to the apportionment formula and the allocation provisions applied to the unitary business income. As a corollary, it does not grant authority to provide variances to items unrelated to the apportionment formula and the allocation provisions. Therefore, "business activity" under Section 25137 must be interpreted in reference to the governing statutory method of apportionment, which in this case is the SSF apportionment formula. "Business activity" should not be equated to "activity" encompassing all activities driving the profit such as production costs as the Taxpayer argues, which are appropriate consideration for cases concerning unitary

combination or de-combination of separate businesses. Professor William Pierce, who was the primary drafter of UDITPA, stated as much:

> [UDITPA] assumes that the existing state legislation *has defined the base of the tax* and that the only remaining problem is the amount of the base that should be assigned to the particular taxing jurisdiction. Thus, the statute does not deal with the problem of ascertaining the items used in computing income or the allowable items of expense."[9]

As such, contrary to the Taxpayer's position, CRTC section 25137 is not concerned with alleged issues created by the application of California authority outside of apportionment and allocation, including whether California's SSF method gives adequate weight to the elements responsible for the earning of the income such as capital and labor.

Taxpayer argues that all factors responsible for the production of the income should be used, citing *McDonnell Douglas Corporation v. Franchise Tax Board*, 69 Cal.2d 506 (1968) [10] ("*McDonnell Douglas*"). (TOB, p. 17) However, that case in fact supports FTB's position that it is the application of the factor or the factors used in the apportionment formula that should be examined. The California Supreme Court in *McDonnell Douglas* determined that the FTB's reallocation based in part on property factor including only property owned by the plaintiff, and excluding property owned by the U.S. government, resulted in distortion of that factor. Similar to the Court's analysis of the structure and operation of the property factor in *McDonnell Douglas*, under the SSF apportionment regime, a CRTC section 25137 distortion must be limited to the review of the structure and the operation of the apportionment factor used to source income, namely the sales factor.

Similarly, in *Microsoft I, supra,* 39 Cal.4th 750, the California Supreme Court in finding distortion under CRTC section 25137, focused its inquiry on the construct of the sales factor and determined that distortion resulted from the mixing of gross receipts from Microsoft's main line of business and gross receipts from its treasury function: "This situation, when one mixes apples—the receipts of low-margin sales—with oranges—those of much higher margin

---

[9] William J. Pierce, *The Uniform Division of Income for State Tax Purposes* (1957) 35 Taxes 747 [emphasis in original].

[10] This case should not be confused with the later California appellate court decision, *McDonnell Douglas Corp. v. Franchise Tax Bd.,* (1994) 26 Cal App 4th 1789.

sales—presents a problem for the UDITPA. The UDITPA's sales factor contains an implicit assumption that a corporation's margins will not vary inordinately from state to state." *(Id.*, p. 768)

Finally and perhaps most importantly, Taxpayer's interpretation would result in no less than an unauthorized return for this taxpayer and similarly situated taxpayers to the classic three-factor formula formally encompassed in the UDITPA, from which the voters of California and a majority of states have diverged. As the U.S. Supreme Court in *Moorman* noted, states have a wide latitude in selecting an apportionment method and "the Constitution is neutral with respect to the content of any uniform rule," which requires "a policy decision based on political and economic considerations that vary from State to State." (*Moorman, supra*, 437 U.S. 267, 273, p. 279.) Therefore, the fact that the SSF method may have been "motivated by budget, political and tax policy concerns," (TOB, p. 16) as suggested by the Taxpayer, does not make it less valid.

Contrary to Taxpayer's focus on *all* the factors contributing to the production of income, since SSF formula explicitly disregards capital and labor, "business activity" under CRTC section 25137 must necessarily reflect and be measure by Taxpayer's market in this state.

ii. Single-sales factor apportionment reflects a taxpayer's market in this state.

The historical context of the sales factor, the only factor of which the current standard formula is comprised, supports FTB's interpretation and application of CRTC section 25137. The sales factor recognizes the "contribution of the consumer states toward the production of the income."[11] The inclusion of the sales factor in the three-factor apportionment formula is based on the idea that "'a state which provides a market for a product is entitled to some tax returns on the income which it has helped to produce.'"[12] Indisputably, the sales factor measures an apportioning taxpayer's market within a jurisdiction. Based on the acknowledged purpose of the sales factor, business activity within the meaning of CRTC section 25137 relates

---

[11] William J. Pierce, *The Uniform Division of Income for State Tax Purposes* (Oct. 1957) Tax Magazine, at p. 750.

[12] *Microsoft Corp. v. Franchise Tax Bd.* (2012) 212 Cal.App.4th 78, 86 ("*Microsoft II*"), citing *Hoffmann–LaRoche, Inc. v. Franchise Tax Bd.* (1980) 101 Cal.App.3d 691, 699.

only to the Taxpayer's market in this state, rather than all the activities contributing toward the production of income.

iii. Taxpayer has not met its burden of proving that application of the SSF formula results in unfair representation of its business activity in this state.

Taxpayer has not shown that as applied to its vertically integrated pork product business, the standard formula gives rise to apportionment that does not fairly represent the extent of its business activity in this state because Taxpayer maintains a substantial market here. Taxpayer's distortion arguments are addressed in turn below.

Taxpayer's Business Model

Taxpayer argues that" [its] business model presents an extreme factual situation which requires a departure from the standard SSF apportionment." (TOB, p. 20.) This assertion is based on Taxpayer's view that "it makes money because it produces bigger, healthier hogs at lower costs than its competitors," which take place exclusively outside of California. (TOB, pp. 20-21.) Clearly Taxpayer is free to choose its business model, including where to market its product, invest its capital and locate its labor force. However, for California franchise tax purposes, Taxpayer maintains a consumer market in this state that generates revenue for its business and it is by this market that corresponding tax liability is determined.

Taxpayer's revenues for the years at issue were nearly 100 percent from the Fresh Pork, Packaged Meats and International segments and nearly none from the Hog Production segment. According to Taxpayer's reporting, about 81 to 84 percent of its revenue was generated by the three pork product segments (Fresh Pork, Packaged Meats and International), and the remaining nineteen (19) to sixteen (16) percent was generated by the Hog Production segment, of which over 95 percent was intersegment sales to the pork product segments. Although the Taxpayer suggests that the Hog Production activity generated $3 billion in recognizable revenue of its own (at TOB, p. 3), most of that amount was from intersegment sales. Thus, when

combined, the three pork product segments produced nearly 100 percent of the total revenue. See the following table:

Table 1 – Segment Revenues

in millions	FY2014	%	FY2015	%	FY2016	%	FY2017	%
Fresh Pork	5,780	32.13%	5,090	30.53%	4,973	30.54%	5,398	30.32%
Packaged Meats	7,173	39.87%	7,089	42.52%	7,125	43.76%	7,810	43.86%
Hog Production	3,385	18.81%	3,070	18.41%	2,702	16.60%	2,854	16.03%
International	1,654	9.19%	1,423	8.53%	1,481	9.10%	1,743	9.79%
Total Segment Sales	17,992	100%	16,672	100%	16,281	100%	17,805	100%
Intersegment Sales								
Fresh Pork	-56		(59)					
Packaged Meats	0		(0)					
Hog Production	-2,863		(2,129)					
International	-41		(44)					
Intersegment Sales	-2,960		(2,233)		-2,018		-2,479	
Consolidated Sales	15,031		14,438		14,263		15,326	

(Smithfield's Jan. 3, 2016 Security and Exchange Commission Form 10-K ("SEC Form 10-K") at p. 44 and TP's letter claim dated December 21, 2018. Intersegment information for 2016 and 2017 is not available due to the acquisition by WH Group.)

The foregoing intersegment information also indicates that hog production and pork processing costs and the associated profits were eventually passed on to the ultimate consumers, including the consumers located in California. Accordingly, contrary to its assertion that it is primarily an agricultural business, Taxpayer's own financial reporting suggests that it is more of a customer facing business with all of its integrated parts working together to ultimately sell its pork products to the consumers. This is borne out by Taxpayer's own reporting of segment profits, albeit based on separate accounting, in which the Hog Production activity generated losses, rather than profits, by 2017, as shown in the table below.

Table 2 – Segment Profits

in millions	FY2014	%	FY2015	%	FY2016	%	FY2017	%
Fresh Pork	96.7	9.15%	177.3	18.93%	471	41.87%	440	35.12%
Packaged Meats	459.8	43.52%	673.3	71.90%	685	60.89%	721	57.54%
Hog Production	344.2	32.58%	19.7	2.10%	(140)	-12.44%	(63)	-5.03%
International	155.8	14.75%	66.1	7.06%	109	9.69%	155	12.37%
Total Segment Sales	1,056.5	100%	936.4	100%	1,125	100%	1,253	100%

(SEC Form 10-K, p. 177 and TP's letter claim dated December 21, 2018)

Moreover, Taxpayer prominently and explicitly states that its market activities were key to its business in the Executive Overview section of its SEC Form 10-K (at page 29):

> Some of the factors that [Smithfield] believe are critical to the success of our business are our ability to:
> - *maintain and expand market share, particularly in packaged meats,*
> - *develop and maintain strong customer relationships,*
> - *continually innovate and differentiate our products,*
> - manage risk in volatile commodities markets, and
> - maintain our position as a low cost producer of live hogs, fresh pork and packaged meats.

(Emphasis added.) Accordingly, Taxpayer's sales factor which represents its market is an appropriate and reasonable proxy for its business activity in this state.

Hans Rees'

Taxpayer argues, "*Hans Rees' Sons, Inc. V. North Carolina* (1931) 283 U.S. 123 ["*Hans Rees*'"] is on all fours with the facts of this case." (TOB, p. 21.) Taxpayer's attempt to analogize the current case to *Hans Rees'* based on superficial similarities is misguided. In that case, the U.S. Supreme Court held that North Carolina's single-factor apportionment based on property resulted in distortion under the U.S. Constitution. Among other things, distortion was found based on the showing of *63 percent* absolute difference between the standard and alternative apportionment percentages (80% compared to 17%). In the current case the average absolute difference is 4.15 percent, as set forth in the following table:

Table 3 – Apportionment Factor Comparison (TOB, p. 11)

	2014	*2015*	*2016*	*2017*	4 Year Average
SSF	*6.65%*	*7.51%*	*7.82%*	*8.83%*	7.70%
3-factor	*2.81%*	*3.08%*	*3.16%*	*5.16%*	3.55%
Difference	*3.84%*	*4.43%*	*4.66%*	*3.67%*	4.15%

Accordingly, in the current context, *Hans Rees*', at best, suggests an upper limit for an acceptable range of apportionment factor differences. More notable, the *Hans Rees'* opinion explicitly upheld the basic principles that the states have a wide latitude in the selection of apportionment formulas and that a formula-produced assessment will only be disturbed when the taxpayer has proved by "clear and cogent evidence" that the income attributed to the State is in fact "out of all appropriate proportions to the business transacted . . . in that State," or has "led to

a grossly distorted result". (*Moorman, supra,* 437 U.S. 267, 274, quoting *Hans Rees*'.) In the current case, Taxpayer does not suggest that any "grossly distorted result" is present. Finally, it is important to note that *Hans Rees'* was decided decades prior to UDITPA being drafted.

Microsoft I

Taxpayer argues that "Smithfield's business model presents the inverse situation [to *Microsoft I*] where the activities excluded are qualitatively part of its main line of business and should therefore be reflected in the apportionment formula." (TOB, *supra,* p. 21) Taxpayer's argument is baseless because *Microsoft I, supra, 39 Cal.4th 750,* dealt with gross receipts from two different business activities (mainline computer business and ancillary treasury function) and here we have only one business. In the instant case, Taxpayer's gross receipts are from a singular, vertically integrated operations, of which the production activity is only a step. Furthermore, the Court in *Microsoft I* looked to the mechanics of the sales factor and determined that the qualitative difference between the gross receipts from the main line of business that generated most of the profit and the treasury receipts that generated minimal profit resulted in distortion. (*Ibid*.) The Court found that the profits generated by the main line of business in various states were pulled to a single state where the treasury receipts were generated. (*Ibid*.) In the current case, there are only gross receipts from sale of pork products, and thus the profit generated by that one business should be apportioned based on where the sales were made.

Merrill Lynch

According to the Taxpayer, *Appeal of Merrill, Lynch, Pierce, Fenner & Smith, Inc*., (1980) 89-SBE-017 ("*Merrill Lynch*") held that business activities must include items reflected by sale, payroll and property factors. (TOB, p. 22.) Taxpayer misinterprets the import of the referenced dicta of that opinion. In that case, the FTB argued that the distortion in the sales factor alone was sufficient for it to prevail. The State Board of Equalization ("SBE") disagreed and held that the whole of the apportionment formula, which consisted of property, payroll and sales factors in that case, must result in distortion. (*Ibid.*) However, the apportionment factor in this

case consists of only the sales factor, unlike *Merrill Lynch*, therefore, the distortion analysis here is necessarily limited to that factor.

Agricultural Business under CRTC Section 25128, Subdivision (b)

Taxpayer states that it produces and markets "a wide variety of fresh meat and packaged meats products both domestically and internationally," and is "the world's leading vertically integrated pork processor and hog producer." (SEC Form 10-K, p. 3.) And yet, the common thread in Taxpayer's distortion arguments is a clear attempt to use the Petition process to force its treatment as an agricultural business. Taxpayer states: "Apportioning Smithfield's income to California on the basis of its sales alone as a direct result of its slaughtering activity results in impermissible qualitative distortion by ignoring Smithfield's agricultural business activity–its primary business activity–that occurs almost entirely outside of California." (TOB, p 23.)

CRTC section 25128, subdivision (b) prescribes an equally-weighted three factor apportionment formula consisting of property, payroll and sales factors if an apportioning business derives more than fifty (50) percent of its "gross business receipts" from a "qualified business activity," one of which is agriculture. Taxpayer does not qualify because its gross business receipts from agricultural business activity, that is, hog production (see subdivision (d)(2)), fell far short of fifty (50) percent of the total as required. In fact, Taxpayer produced insignificant amount of gross business receipts from its Hog Production segment because the sales were nearly all intersegment (Table 1 and Table 2, *supra*), which is explicitly excluded from the definition of "qualified business receipt." Furthermore, the Hog Production segment may have been the primary cost center but that does not mean that it was Taxpayer's primary business activity. The remaining pork product segments were the profit centers and generated all of the gross business receipts. Accordingly, Taxpayer is not entitled to use the equally-weighted three-factor formula.

Quantitative Metrics under Microsoft I and General Mills

Taxpayer argues that the quantitative metrics support the determination of distortion in this case primarily relying on *Microsoft I* and *General Mills, where the* California Supreme Court and Appellate court, respectively, found distortion. (TOB, p. 23.) Each taxpayer in both of these cases had two different revenue streams with very different profit margins, which were significant. In *Microsoft I*, supra, *39 Cal.4th 750*, the taxpayer had receipts from its treasury function with 0.18 percent profit margin mixing with receipts from the computer related business with 31 percent profit margin. In *General Mills v. Franchise Tax Bd.,* 208 Cal. App. 4th 1290*,* the taxpayer had receipts from commodity hedging activity with a negative profits (or losses) mixing with receipts from the grain product business with 7.17 percent profit margin. In the current case, a profit margin analysis is not applicable because there is only one revenue stream, instead of multiple revenue streams (from multiple activities) for comparison. Rather, the only available metric is the percentage change in the standard apportionment formula versus Taxpayer's proposed formula, which are 7.7 versus 3.5 percent, respectively. (Table 3, supra.) Therefore, Taxpayer is essentially comparing its tax liability under two different statutory schemes and arguing that the resulting difference is distortive. This argument is insufficient for purposes of CRTC section 25137 because the ultimate tax liability will always vary under different taxing schemes, so that difference cannot reasonably evince an unfair reflection of business activity. The SBE held in *Merrill Lynch, supra,* 89-SBE-017:

> [A petitioner's] attempt to impugn…use of the statutory sales factor by showing a difference between the sales factor as computed…pursuant to the statute and as computed by the [petitioner] as it desires to be computed, and labeling that difference a 'gross distortion,' is equally unavailing.

Thus, percentage difference, alone, is not indicative of quantitative distortion.

Lastly, although the percentage change between 7.7 and 3.5 percent may seem significant, it is not, based on the context of the market potential in California, which constitutes approximately 12 percent of the U.S. population.[13] Also, in relative terms, a 7.7 percent

[13] https://www.census.gov/2010census/popmap/.

apportionment factor is still less than the 12 percent California population and may fairly approximates the size of Taxpayer's market in California.

In summary, CRTC section 25137 relief is not warranted in this case because Taxpayer has not proven by clear and convincing evidence that apportionment using only the sales factor unfairly represents its market in this state. Almost all taxpayers are subject to the exclusion of property and payroll causally related to the production of income from their apportionment formula, as intentionally decided by the electorate of the State of California.

II.

TAXPAYER'S PROPOSED ALTERNATIVE IS NOT REASONABLE.

The second inquiry of a CRTC section 25137 Petition is whether the proposed alternative apportionment formula is reasonable. Taxpayer's proposed equally-weighted three-factor formula is not reasonable. The reasonableness issue has been discussed in *Microsoft I*, in which the Court held that "if the Board's proposal is reasonable, we are not empowered to substitute our own formula." (*Microsoft I*, *supra*, 39 Cal.4th, p. 771 citing *McDonnell Douglas, supra,* 69 Cal.2d 506, 514-515.) Therefore, the taxing agency decides whether an alternative is reasonable.

With the enactment of the mandatory single-sales factor apportionment methodology, California began disregarding capital and labor in favor of the market only. It is intentional that most taxpayers, with narrow exceptions for certain businesses with qualified business activities, are subject to the exclusion of property and payroll from their apportionment calculation. As discussed above, it has already been determined that Taxpayer's business does not qualify for such exception. Accordingly, it would be inappropriate to allow the qualified business activity treatment as an alternative apportionment method under CRTC section 25137. For these reasons, the alternative method proposed by the taxpayer is not reasonable.

CONCLUSION

For the reasons stated herein, this Board should sustain FTB staff's denial of Taxpayer's Petition.

Respectfully submitted,
FRANCHIES TAX BOARD

By: 

Kathy Shin

Date: July 20, 2020