## I. Introduction

This case is about how a taxpayer generates income and how that income is to be fairly taxed by the State of California. Like most states, California adopts the unitary method of taxation. The unitary method rests on the premise that "in the apportionment of a unitary business the formula used must give adequate weight to the essential elements responsible for the earning of the income."[1] More specifically, "income from sales is attributable to the series of transactions from which the income is derived."[2] The FTB staff determination in this matter challenges these fundamental precepts of California tax and undermines the purpose of the unitary method which is to achieve the fair apportionment of income for tax purposes.

Smithfield Packaged Meats Corporation and its Combined Affiliates (hereinafter "Taxpayer" or "Smithfield"), raises hogs and earns income from the sale of hogs and the use of industry-leading practices and economies of scale in the pork production process including hog genetics, fertilization, birthing, feeding, rearing, housing, slaughter and packaging. In the commodity business, Smithfield excels in the marketplace because its production model is better than its competitors'.

At issue is whether the results of California's single-sales factor apportionment method, as applied to Smithfield, fairly represent Smithfield's business activities in California for apportionment purposes or whether Smithfield should be allowed to apportion its income based on all of the factors which drive profitability in its business.

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[1] *John Deere Plow Co. of Moline v. Franchise Tax Bd.*, 38 Cal.2d 214, 224 (1951).
[2] *Butler Bros. v McColgan*, 17 Cal.2d 664, 670 (1941).

California's single-sales factor method as applied to Smithfield produces an unfair result because it does not fairly reflect Smithfield's in-state business activities. According to the Supreme Court, "the enterprise of a corporation which manufactures and sells its manufactured product is ordinarily a unitary business and *all* the factors in that enterprise are essential to the realization of profits."[3] The single-sales factor formula adopted by the people of the state of California may work for some taxpayers, but it categorically does not work for Smithfield.

The single-sales factor formula as applied to Smithfield's business model fails to fairly reflect those production activities which drive its profit. Simply put, there is no rational relationship between the apportioned income subject to California tax and the intrastate values of the enterprise in California.[4] As such, the standard formula does not fairly reflect Smithfield's business activities in the state and Smithfield's income for California tax purposes should be apportioned using an alternative method.

For these reasons, Smithfield should be granted the use of an alternative apportionment formula that fairly reflects all of its business activities based on sales, property, and payroll for the 2014 to 2017 years in issue.

## II. Facts

### a. Background

Smithfield began business in 1936 when Joseph W. Luter and his son, Joseph W. Luter, Jr., opened a small meatpacking plant in Virginia.[5] Since then, Smithfield has become the world's

[3] *Hans Rees' Sons, Inc. v. State of North Carolina ex rel. Maxwell*, 283 U.S. 123, 133 (1931) (emphasis added).
[4] *See Container Corp. of America v. Franchise Tax Bd*, 463 U.S. 159, 180 (1983).
[5] Smithfield, *About*, available at: http://www.smithfield.com/about/.

largest pork processor and hog[6] producer with over $15 billion in companywide sales.[7] As a result of the "One Smithfield" initiative, Smithfield's 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.[8]

i. *Hog Production*

As the world's largest hog producer, Smithfield's Hog Production segment operates facilities that produced over 15.9 million market hogs in 2015. Smithfield uses advanced management techniques to produce premium quality hogs on a large scale at a low cost. Smithfield develops its own breeding stock, optimizes diets for the hogs at each stage of the growth process, developed its own feed for the hogs, and designed specialized housing for the hogs to enhance their health and growth. Again, none of these operations are in California.[9] In 2015, the Hog Production segment accounted for over $3 billion in sales and over $19 million of operating profit.

ii. *Fresh Pork*

The Fresh Pork segment produces a wide variety of fresh, unprocessed pork cuts harvested from hogs in the United States and markets them nationwide and to numerous foreign markets, including China, Japan, Mexico, Canada, and Russia.[10] These hogs are processed in nine plants

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[6] The words hog, pig and swine are generic terms with regard to animal gender, size or breed. We will use the word hog throughout this submission. By way of background, all hogs and pigs are swine, while hogs and pigs may be distinguished based on size with hogs weighing more than 120 pounds. A male hog is called a boar, while a female hog is called a gilt if she hasn't had piglets and a sow if she has.
[7] *See* Smithfield, *Smithfield Foods at a Glance: A Quick Look at Our Global Food Company*, available at: https://www.smithfieldfoods.com/sustainability/report/2018/smithfield-foods-at-a-glance.
[8] *See* Smithfield, *Smithfield Foods at a Glance*: *We're the No. 1 U.S. Producer of Packaged Pork Products*, available at: https://www.smithfieldfoods.com/integrated-report/2015/smithfield-at-a-glance.
[9] *Id.*
[10] Smithfield Form 10-K (For the twelve months ended: Jan. 3, 2016) (hereinafter "Smithfield 10-K").

(six in the Midwest and three in the Southeast), none of which are in California.[11] In 2015, the Fresh Pork segment processed 30.5 million hogs and sold 4.4 billion pounds of fresh pork. During that same year, the Fresh Pork segment accounted for over $5 billion in sales and over $177 million of operating profit.[12]

iii. *Packaged Meats*

Smithfield's Packaged Meats segment produces a variety of value-added products including sausage, hot dogs, deli meats, and specialty products such as pepperoni.[13] In 2015, Smithfield's Packaged Meats segment sold approximately 3 billion pounds of packaged meats products. These products were produced in approximately 33 plants across the country, none of which are in California.[14] In 2015, the Packaged Meats segment accounted for over $7 billion in sales and over $673 million of operating profit.

iv. *International*

Smithfield's 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. In 2015, the international segment accounted for over $1 billion in sales and over $66 million of operating profit.

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[11] *Id.*
[12] *Id.*
[13] *Id.*
[14] *Id.*

b. Smithfield's Business Model or How Smithfield Makes Money

Smithfield's overall business results depend largely upon factors over which it has complete control (i.e., production costs, yield ratios, overhead, etc.) and factors which are beyond its control (i.e., market prices for food commodities, global feed prices, demand for protein-based food, etc.). Consistent with these limitations, profitability in the meat industry depends on controlling costs and enhancing the return on each dollar spent on the production process. As a result, Smithfield's business profits are almost entirely determined by the efficiency of its production process and the innovations Smithfield developed at its facilities outside of California.

Smithfield is a leader in its industry due to (1) its commitment to controlling all aspects of hog production through vertical integration, and (2) its use of technology and management systems to guide the hog production process.[15]

i. *Total Vertical Integration and Contract Farming*

"Profit margins in hog farming are tantalizingly small, but narrow advantages multiplied over large volumes of hogs translate into potentially decisive competitive advantages."[16] Smithfield utilizes vertical integration to industrialize and control the hog production process from conception to packing. By controlling every aspect of the pork production process including genetics, fertilization, birthing, feeding, housing, slaughter and packaging, Smithfield has been able to produce "high quality, consistent products with consistent genetics" which allowed

[15] David Barboza, *Goliath of the Hog World; Fast Rise of Smithfield Foods Makes Regulators Wary*, N.Y. TIMES (Apr. 7, 2000) https://www.nytimes.com/2000/04/07/business/goliath-of-the-hog-world-fast-rise-of-smithfield-foods-makes-regulators-wary.html.
[16] Shi-Ling Hsu, *Scale Economies, Scale Externalities: Hog Farming and the Changing American Agricultural Industry*, 94 OR. L. REV. 23, 30-33 (2015).

Smithfield to "command a premium for fresh pork, something that has historically been thought of as a commodity item."[17] Smithfield achieved total vertical integration largely due to its use of contract farming.

Control over its supply chain and production process is an essential part of Smithfield's corporate and operational strategy as it helps reduce exposure to fluctuations in commodity prices (especially considering historic volatility in hog and feed prices), ensures operational efficiency, and uses biosecurity to protect its invaluable breeding stock from outside exposures to diseases or other adverse factors.[18]

Smithfield contracts with individual farmers to manage specific aspects of the production process consistent with strict guidelines developed by Smithfield. [19] For example, one farmer may provide breeding services, one farmer may focus on birthing and one farmer will focus on feeding and housing full grown hogs – with all activities leading to Smithfield's processing plants. Smithfield uses contract farming as a key strategy to achieve production process efficiencies and create economies of scale.[20]

For Smithfield, the hog production process functions much like an assembly line running between individual farmers. This process of delegating discrete tasks to farmers who specialize in a particular phase has exponentially increased efficiency[21] and allowed Smithfield to "eliminate the variability in production and to optimize production from birth to slaughter

[17] SMITHFIELD ANNUAL REPORT (2015); SMITHFIELD ANNUAL REPORT (2001).
[18] *See* SMITHFIELD ANNUAL REPORT (2009); SMITHFIELD ANNUAL REPORT (2010); SMITHFIELD ANNUAL REPORT (2014). Biosecurity refers to the procedures implemented by Smithfield to keep diseases and pathogens that carry them away from the hogs. Porcine Epidemic Diarrhea Virus, the leading cause of hog euthanasia at Smithfield, highlighted the importance of tight biosecurity measures at the hog facilities.
[19] Hsu, *supra* note 16.
[20] *Id.*
[21] *Id.*

processing to marketing."[22] Smithfield retains a tight network of contract farmers near its operations – all of which are outside of California. In fact, geographic concentration is essential to the viability of contract farming because conglomerates like Smithfield need to be located in clusters near processing or infrastructure specialized to their needs in order to fully integrate (and still maintain control over) the production process.[23]

Smithfield maintains ownership of the hog at all phases of the hog rearing process and maintains absolute control over every facet of the process. As of 2014, Smithfield raises pigs on approximately 460 company-owned farms and contracts with 2,100 hog farms that raise company-owned pigs in the US.[24]

ii. *Technology and Animal Care*

Smithfield continuously researches and analyzes every aspect of its hog production and processing operations. Through the use of technology and advanced management techniques, Smithfield has increased efficiency and, in turn, increased profitability. These strategies include, but are not limited to (1) genetics, (2) nutrition and feeding, and (3) an industry standard animal care management system.

1. Genetics

The primary ingredient in Smithfield's products is the hog itself. In 2015, Smithfield spent approximately 78.5 million dollars in research and development to improve existing products

[22] *Id.* at 31.
[23] *See* Charles W. Abdalla, *The Industrialization of Agriculture: Implications for Public Concern and Environmental Consequences of Intensive Livestock Operations*, 10 PENN ST. ENVTL. L. REV. 175, 178-82 (2002).
[24] SMITHFIELD ANNUAL REPORT (2014).

and processes.[25] Part of this investment in its genetics program allowed Smithfield to isolate ideal hog traits that will produce the highest quality products for its customers and identify new ways to improve genetic traits of the animals.[26]

Smithfield employs more than 200 technicians, genetics researchers, and veterinarians at its facilities in North Carolina and Texas. Those employees work to find new ways to improve the genetic traits of the animals by "focusing on everything from a sow's nursing skills to a piglet's feeding abilities to the characteristics that result in the greatest flavor with the perfect amount of fat and marbling."[27] The genetics team utilizes the science of genomics[28] to help them achieve the most favorable results.[29]

2. Nutrition and Feeding

Smithfield's focus on the science of nutrition and feeding have improved both efficiency of production and the quality of Smithfield's hogs[30]

The most significant expenditure the hog production division makes at Smithfield is feed grains (including corn, soybean meal, and wheat) which represents approximately 65 percent of the costs of raising hogs.[31] Smithfield takes an active role in locating high-quality grain at the lowest possible cost. These efforts include, but are not limited to, buying lower-cost corn from local

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[25] SMITHFIELD ANNUAL REPORT (2015).
[26] *Id.*
[27] *Id.*
[28] Genomics involves geneticists taking "millions of genetic data points about the animals and their environment and, with the help of sophisticated statistical software, calculating which ones have the gene characteristics we want to see in the next generations of hogs we will raise."
[29] SMITHFIELD ANNUAL REPORT (2015).
[30] SMITHFIELD ANNUAL REPORT (2010).
[31] SMITHFIELD ANNUAL REPORT (2014).

farmers around their feed mills near their operations and importing grain or soybean meal from South America.[32]

Feed grains are subject to significant fluctuations year to year. As such, Smithfield takes an active role in creating more sustainable alternatives to traditional feed grains by partnering with Mid-Eastern universities, such as Virginia Tech, North Carolina State, and North Carolina Biotechnology Center.[33] Recognizing that producing alternative grain in the Carolinas and Virginia would reduce spending on transporting in grain from the Midwest, Smithfield continues to fund research on the nutritional and production benefits of high-quality and high-protein grain at the lowest price possible.[34]

### 3. Animal Care Management System

Smithfield is committed to being the industry leader in animal care practices to assure respectful and humane treatment of animals, to produce wholesome food products, and to analyze its operations and practices, including internal and independent third-party audits, to ensure continual improvement.[35] Smithfield's Animal Care Policy applies to company-owned farms, contract growers, and processing plants across Smithfield, and underscores its commitment to appropriate shelter, food/water, humane treatment and healthcare for the hogs. While achieving humane care for the animals, the animal care policy is also good for Smithfield's business. Healthy animals are more resistant to disease and gain weight faster, and healthy sows have larger and stronger liters.

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[32] Smithfield 10-K.
[33] Smithfield, *2016 Sustainability Report*, available at: https://www.smithfieldfoods.com/pdf/past-reports/smithfield-2016-sustainability-report.pdf.
[34] *See* SMITHFIELD ANNUAL REPORT (2015).
[35] Smithfield, *Animal Care Policy*, available at: https://www.smithfieldfoods.com/our-policies-and-disclosures/animal-care.

All of these technologies drive profitability for Smithfield, and none of these activities take place in California.

c. Smithfield's California Activities

Smithfield has over 50,000 employees in North America and Europe, and its largest production facilities in the United States are located in Iowa, Arkansas and North Carolina. In 2015, Smithfield owned property, plant and equipment worldwide of some $2.3 billion and had a payroll of more than $1.8 billion.

By comparison, Smithfield has very few employees and/or facilities in California. In 2015, Smithfield owned property, plant and equipment in California of only $4.5 million (.19% of worldwide) with a California payroll of just over $14 million (.77% of worldwide payroll). Smithfield owned no land in California but rented the facilities it used to conduct business in the state. In other words, during the years under consideration, almost none of the research and development, production or processing which give Smithfield its leading edge in the industry occurred in California.

Smithfield's sales in California represented between six and nine percent of its overall sales during the years under consideration. Most sales inside and outside of the state are tied to market prices for pork commodities over which Smithfield itself has little or no control.

d. Procedural History

Smithfield filed claims for refund for the years at issue asserting two different theories: 1) that

Smithfield is entitled to apportion its income using the three-factor formula allowed for agricultural businesses pursuant to California Revenue and Taxation Code ("CRTC") sections 25128(b) and (c); or in the alternative, 2) that the standard apportionment formula based on a single-sales factor does not fairly reflect Smithfield's business activities in the state and should be remedied by reference to the three-factor formula based on property, payroll and sales.

i. *Smithfield's California Apportionment and Tax Profile*

During the years under consideration, Smithfield filed its original California returns based on a single-sales factor averaging between six and nine percent. During that same period, Smithfield's property and payroll in California averaged less than 2 percent. Were Smithfield allowed to apportion its income based on an equally weighted three-factor formula approved for agricultural businesses and which reflects all aspects of Smithfield's business operations inside and outside of California, Smithfield's California apportionment would average roughly 3.5 percent over the tax years at issue. The relevant data is set forth in the following table.

| | 2014 | 2015 | 2016 | 2017 | 4-Year Avg. |
|---|---|---|---|---|---|
| As Filed – CA Single-Sales Factor | 6.6533% | 7.5140% | 7.8226% | 8.8310% | 7.7052% |
| | | | | | |
| CA Property | 1.0655% | 0.9756% | 0.9102% | 2.4928% | 1.3610% |
| CA Payroll | 0.7182% | 0.7594% | 0.7598% | 4.1654% | 1.6007% |
| | | | | | |
| Equal-Weighted 3-Factor % | 2.8123% | 3.0830% | 3.1633% | 5.1631% | 3.5554% |
| | | | | | |
| % Reduction from SSF to 3-Factor | 58% | 59% | 58% | 42% | 54.25% |

ii. *Smithfield and the Three-Factor Statutory Apportionment for Agricultural Businesses.*

At audit, Smithfield argued that it should have apportioned its income using the equally weighted, three-factor apportionment formula pursuant to CRTC section 25128(b) and (c) because it derived more than 50 percent of its gross business receipts from "agricultural business activity" as defined by California Code of Regulations ("CCR") section 25128-2.[36] The law acknowledges that all three factors, including the property and payroll factors, accurately reflect how taxpayers engaged in agricultural business activity produce income.

By statute, a taxpayer's agricultural business activity in California is fairly represented by its relative property, payroll and sales in the state.[37] Property and payroll necessarily are considered due to the labor intensive and property-specific nature of the underlying activity, i.e., farming. Smithfield's facts attest to this. Long before any meat is sold, Smithfield is directly engaged in the entire lifecycle (six months on average) of its millions of hogs, from conducting extensive genetic research, to optimizing diets at each stage of the hogs' growth process, to developing and implementing an animal care management system to ensure property treatment. It is this activity – producing top quality hogs – that produces Smithfield's income.

[36] Appellant further argued that if its operations did not fit under the definition of "agricultural business activity" as defined by CCR section 25128-2, the regulation should be struck down as invalid because it exceeds the scope of CRTC section 25128. The n auditor did not address Appellant's argument that the regulation exceeded the scope of the statute and was therefore invalid. *See* Claim for Refund and Distortion Petition (June 7, 2018) and FTB Audit Issue Presentation Sheet Number 001 (Jan. 4, 2019) [hereinafter "AIPS 001"]; FTB Audit Issue Presentation Sheet Number 002 (Feb. 5, 2019) [hereinafter "AIPS 002"].

[37] CAL. REV. AND TAX CODE § 25128(b).

iii. *Distortion*

In the alternative, Smithfield asserted that the standard single-sales factor apportionment formula does not fairly reflect Smithfield's business activities in California and that the FTB should remedy that distortion by use of the three-factor apportionment formula under the authority of CRTC section 25137. As applied to Smithfield's manufacturing business, the single-sales factor does not fairly reflect Smithfield's activities in the state. Smithfield generates profit because of its industry-leading technology and economies of scale conducted outside of California. As applied to Smithfield, the single-sales factor overstates the impact of the California marketplace and does not fairly reflect Smithfield's activity in the State for apportionment purposes.

The FTB rejected Smithfield's petition for relief at audit and the 25137 Distortion Committee affirmed that determination. As will be discussed in more detail below, the FTB staff's position is wrong and accomplishes a result contrary to the express provisions of CRTC section 25137 and decades of judicial and administrative authorities.

## III. The Law

### a. Statutory Apportionment in California

Drafted in 1957, the Uniform Division of Income for Tax Purposes Act ("UDITPA") sets the standard for the allocation and apportionment of income for multi-state businesses.[38] UDITPA called for the uniform adoption of the three-factor apportionment formula based on property,

[38] John S. Warren, *UDITPA – A Historical Perspective*, STATE TAX NOTES – TAX ANALYSTS: SPECIAL REPORT (Oct. 3, 2005).

payroll and sales, to equitably divide a business' income among all the states it generated income in.[39] Since that time, California has adopted a number of variations on the traditional three-factor formula, while at all times preserving the three-factor formula for agricultural, financial and extractive industries.

### *i. Three-Factor Formula*

California formally adopted UDITPA in 1966, and with it, the equally weighted three-factor apportionment formula.[40] The purposes underlying the traditional apportionment factors and their relationship to fair apportionment is straightforward and not subject to dispute. The property and payroll factors were intended to emphasize the activity of the manufacturing state, while the sales factor was intended to recognize the contribution of the consumer state, toward the production of the income of the business.[41] The purpose of the sales factor is to balance the property and payroll factors by giving weight to elements not reflected by those factors and to assist in making a reasonable apportionment of the unitary business income among the states in which the business is conducted.[42]

### *ii. Double-Weighted Sales Factor*

In 1993, California adopted a double-weighted sales factor formula for most businesses in which the new "four-factor" formula included property, payroll and a double-weighted sales factor. The impetus behind the adoption of a double-weighted sales formula was to "improve

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[39] Amicus Curiae Brief of Council on State Taxation in Support of The Gillette Company, available at https://www.cost.org/globalassets/cost/state-tax-resources-pdf-pages/amicus-briefs/gillette-co.-v.-franchise-tax-board.pdf.
[40] California Supreme Court Vindicates California and Commission in Gillette, MULTISTATE TAX COMMISSION, available at http://www.mtc.gov/The-Commission/News/California-Supreme-Court-Vindicates-California-and (hereinafter "MTC").
[41] Pierce, *The Uniform Division of Income for State Tax Purposes,* 35 TAXES 747, 780 (1957).
[42] *See generally* GEORGE ALTMAN & FRANK KEESLING, ALLOCATION OF INCOME IN STATE TAXATION, 126-28 (2d. ed. 1950).

California's business climate by shifting the corporate tax balance against those who simply sell into [California's] huge consumer market without putting manufacturing jobs here."[43]

Businesses involved in agricultural, financial or extractive activities were required to use the equally weighted three-factor apportionment formula to recognize the relative value of property and labor to those businesses and to ensure that businesses that had no choice as to their manufacturing location would not be penalized.[44]

*iii. Elective Single-Sales Factor*

Beginning on or after January 1, 2011, California allowed taxpayers to elect to apportion their income solely based on sales or based on the double-weighted sales factor.[45] At the time, the elective provision was intended to balance the overall negative impact on taxpayers from the suspension of Net Operating Losses and the limitation on credit utilization, and still pass a balanced budget as required by the California Constitution.[46] Proponents of the optional single-sales factor methodology argued that this elective provision option would lower California taxes for businesses with significant employment and property in the state.[47] Businesses involved in agricultural, financial and extractive activities were still required to use the equally weighted three-factor formula.

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[43] CAL. REV. AND TAX CODE § 25128, California Bill Analysis, Assembly Committee, 1993-1994 Regular Session, Senate Bill 1176 (Aug. 16, 1993).
[44] *Id.*
[45] Cara Griffith, *The Effect of Proposition 39 on California Corporate Taxpayers*, available at http://www.taxhistory.org/www/features.nsf/Articles/5340D00BFA1C807C85257AC200601901?OpenDocument (hereinafter "Tax History").
[46] *See generally California's Budget – Balanced Based on a Speculative Tax Increase*, TAX NOTES at 7 (Jul. 23, 2012).
[47] CAL. REV. AND TAX CODE § 25128.5, California Bill Analysis, Senate Floor, 2009-2010 Third Extraordinary Session, Senate Bill 15 (Feb. 14, 2009).

### *iv. Mandatory Single-Sales Factor*

In November of 2012, California voters adopted Proposition 39: California Clean Energy Jobs Act, which made single-sales factor apportionment mandatory for most multistate businesses after January 1, 2013.[48] Proponents of the change argued that the tax system in place discouraged multi-state businesses from locating jobs, offices, and facilities in California and put California-based companies at a competitive disadvantage in comparison to companies located in states where single-sales factor apportionment was mandated.[49]

As with prior iterations of the standard formula, businesses involved in agricultural, financial and extractive activities were still required to use the equally weighted three-factor formula.

### *v. Economic Policy and Statutory Apportionment*

Aside from the original three-factor formula and the continued exception for agricultural, financial and extractive industries, the subsequent changes to the statutory apportionment formula were motivated by budget, political and tax policy concerns, unrelated to the more altruistic goal of fair apportionment. Of critical importance for the instant case, none of the changes to the changes to the state's standard formula impacted or changed the express provisions of UDITPA embedded in CRTC section 25137. CRTC section 25137 remains in place to protect taxpayers if or when a new statutory formula accomplishes an unfair reflection of a taxpayer's activities in California.

[48] Proposition 39 (approved on Nov. 6, 2012).
[49] *Id.*

b. <u>CRTC Section 25137 and the Fair Reflection of Business Activity</u>

As announced by the United States Supreme Court in *Container Corporation of America v. Franchise Tax Board*, "[h]aving determined that a certain set of activities constitute a 'unitary business,' a State must then apply a formula apportioning the income of that business within and without the State. Such an apportionment formula must, under both the Due Process and Commerce Clauses, be fair."[50] CRTC section 21537 echoes that same sentiment by requiring that the apportionment formula provide a fair reflection of the taxpayer's business activities in the state.

The California Supreme Court in *McDonnel Douglas Corporation v. Franchise Tax Board* articulated the purpose of the apportionment formula as follows*:*

> [i]n the apportionment of a unitary business the formula used must give adequate weight to the essential elements responsible for the earning of the income . . .. the mutual dependency of the interrelated activities in furtherance of the entire business sustains the apportionment process.[51]

The court in *McDonnell Douglas* also noted that, at the most basic level, states apportion income by reference to the factors responsible for the production of that income.[52] "The ultimate goal is assessing whether the standard formula fairly represents the company's business activity in California."[53]

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[50] *Container Corp.*, *supra* note 4 at 169.
[51] *McDonnell Douglas Corp. v. Franchise Tax Bd.*, 69 Cal.2d 506, 512 (1968).
[52] *Id.* at 511.
[53] *General Mills, Inc. v. Franchise Tax Bd.*, 208 Cal.App.4th 1290, 1301 (2012).

CRTC section 25137 provides that, "[i]f the allocation and apportionment provisions of this act [the Bank and Corporation Tax Act] do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition for or the Franchise Tax Board may require, in respect to all or any part of the taxpayer's business activity, if reasonable:

(a) Separate accounting;
(b) The exclusion of any one or more of the factors;
(c) The inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this state; or
(d) The employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income."[54]

The party invoking the relief pursuant to CRTC section 25137 "has the burden of proving by clear and convincing evidence that (1) the approximation provided by the standard formula is not a fair representation, and (2) its proposed alternative is reasonable."[55]

The Board of Equalization's decision in the *Appeal of Merrill Lynch Pierce Fenner & Smith, Inc.* decided on June 2, 1989, informs both taxpayers and the FTB as to those "business activities" to be considered in order to determine whether the standard formula fairly reflects a taxpayer's business activities in the state:

> [b]usiness activity encompasses more than simply the ultimate revenue-generating items which are reflected in the sales factor. It also includes the activities of employees, as reflected in the payroll factor, and the use and

[54] CAL. REV. & TAX CODE § 25137.
[55] *Microsoft Corp. v. Franchise Tax Bd.*, 39 Cal. 4th 750, 765 (2006).

> availability of real and tangible and intangible property, as reflected in the property factor. These three factors are used to balance each other, each reflecting a different type of contribution to the business activity and income of the unitary business as a whole.[56]

In *Microsoft Corp. v. Franchise Tax Board*, the California Supreme Court considered whether it was distortive to include treasury receipts which accounted for only 2 percent of income but represented some 73 % of Microsoft's gross receipts in the sales factor. The court ultimately excluded treasury receipts from the sales factor on the basis that the receipts were "qualitatively different from [Microsoft's] principal business, and [that] the quantitative distortion from inclusion of its investment receipts is substantial."[57] Conversely, if the activities are "not qualitatively different from [the] main business" then the court would agree that the activities are part of the taxpayer's principal business and should be reflected in the apportionment formula.[58]

## IV. Discussion

Every meaningful California authority regarding fair apportionment mandates an apportionment formula that fairly reflects all of the activities which give rise to the income subject to tax. "[If] the profits of any portion of the unitary business are separated from the rest, the base is necessarily inaccurate as the profits from any segment cannot be determined with certainty."[59]

[56] *In the Matter of the Appeal of Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, (1989) 89-SBE-017 (citing *In the Matter of the Appeal of The Babcock and Wilcox Company*, (1978) 78-SBE-001 [hereinafter "*Merrill Lynch*"].
[57] *Microsoft Corp.*, *supra* note 55 at 766.
[58] *Id.*
[59] *Chase Brass & Copper Co. v. Franchise Tax Bd.*, 70 Cal.App.3d 457, 473 (1977).

Justice Brennan of the United State Supreme Court noted in a separate opinion, “if commercial activity in more than one state results in a sale in one of them, that State may not claim as all its own the gross receipts to which the activity within its borders has contributed only a part.”[60]

In the present case, Smithfield generates income from both the in-state sales of its pork products and the out-of-state manufacturing activities necessary to produce those products. As applied to Smithfield’s business, the single-sales factor overstates the impact of California sales on income and understates the impact of Smithfield’s out-of-state production activities. As a result, the standard formula unfairly reflects Smithfield’s business activities in California for apportionment purposes and relief is appropriate pursuant to CRTC section 25137 and the related authorities.

a. <u>As Applied to Smithfield, the Single-Sales Factor Apportionment Formula does not Fairly Reflect Smithfield’s Business Activities in the State</u>

Smithfield’s business model presents an extreme factual situation which requires a departure from the standard singles sales factor apportionment. Smithfield is a manufacturing business with less than 2 percent of its production activities within California. By comparison, more than 98 percent of its production activities occur outside the state. Smithfield sells between 6 and 9 percent of its product into California. While there is no dispute that the California marketplace contributes to Smithfield’s taxable income, there is also no dispute (or should not be any dispute) that Smithfield’s production activities outside of California also contribute to the income California wants to tax. In fact, based on Smithfield’s business model, those production activities create the income California now seeks to tax. Smithfield realizes revenue from the sales of its products, but it makes money because it produces bigger, healthier hogs at lower

[60] *Moorman Mfg. Co. v. G. D. Bair*, 437 U.S. 267 (1978) (Brennan, J., dissenting).

costs than its competitors. Those production activities are fundamental to and inseparable from Smithfield's ability to sell product in the California marketplace.

The United States Supreme Court decision in *Hans Rees' Sons v. State of North Carolina* ("*Hans Rees")*,[61] is on all fours with the facts of this case. In *Hans Rees*, the US Supreme Court reviewed and rejected a single factor apportionment formula based on property. In that case, the Court recognized the unitary character of the business as a manufacturing and selling enterprise extending into several states and to which a formula method of apportionment was appropriate, but refused to approve the particular formula employed for the reason that it consisted simply of the property factor and failed to give proper weight to the extensive activities of the company without the state, so that the result reached was unreasonable.[62]

*Microsoft* makes clear that business activities which are qualitatively different from the taxpayer's main line of business should be excluded from the apportionment formula, while those business activities that are part of the taxpayer's "main line of business" are not qualitatively different and should be reflected in the apportionment formula in order to fairly reflect a taxpayer's business activities in the state. In *Microsoft*,[63] it was distortive to include the gross receipts from the taxpayer's treasury function in the taxpayer's apportionment formula because the treasury activity was qualitatively different from the taxpayer's software activity. Smithfield's business model presents the inverse situation wherein the activities excluded are qualitatively part of its main line of business and should therefore be reflected in the apportionment formula.

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[61] *Hans Rees' Sons*, *supra* note 3.
[62] *Id.* at 132-36.
[63] *Microsoft*, *supra* note 55.

Smithfield's primary business activity as the world's largest hog producer is undeniably an "agricultural business activity,"[64] namely, "the production [and] feeding of hogs."[65] In 2015 alone, Smithfield produced nearly 16 million hogs, with feed making up approximately 65 percent of the costs of raising those hogs. As described above, Smithfield goes to painstaking lengths to produce the highest quality hogs possible and incurs tremendous costs in terms of resources, time and expense in doing so.

Smithfield's California footprint related to this business activity was, and remains, extremely minimal, with only a few in-state facilities and a California property and payroll percentage that averaged around one-and-a-half percent during the years in issue.

The standard formula creates an incongruous result when applied to Smithfield. It takes the world's largest hog producer and all of its industry-leading hog production activities – and treats it as a mere meat seller for apportionment purposes. When consumers buy Smithfield products in the Fresh Pork and Packaged Meats segments, they are paying for the meat (i.e., the hog) bred, born, and raised outside the state.

The appropriate inquiry under CRTC section 25137 is whether the standard formula fairly reflects the Taxpayer's business activities in California. Pursuant to the *Appeal of Merrill Lynch,* those business activities include "more than simply the ultimate revenue-generating items which are reflected in the sales factor. [They] also include[] the activities of employees, as reflected in the payroll factor, and the use and availability of real and tangible and intangible property, as reflected in the property factor."[66]

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[64] CAL. REV. AND TAX CODE § 25128(c)(1).
[65] CAL. CODE OF REGS. § 25128-2(c)(2)(C).
[66] *Merrill Lynch*, *supra* note 56.

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.

The quantitative metrics suggested by *Microsoft* and other cases also support the determination that the standard apportionment formula does not fairly reflect Smithfield's business activities in the state. Those cases have identified a number of numerical tests for showing quantitative distortion. The California Supreme Court indicated in both the *Microsoft*[67] and *General Mills*[68] decisions that overall reduction of the apportionment factor provides an accurate measure of the level of distortion. As clearly shown in the table below, Taxpayer's overall change in all of the years at issue far exceeds the amount found to be distortive in both *Microsoft* and *General Mills*.

| Tax Year | % Reduction in Apportionment Factor | % Found to be Distortive in *Microsoft* | % Found to be Distortive in *General Mills* |
|---|---|---|---|
| FY2014 | **58%** | 5o% | 8.2% |
| FY2015 | **59%** | 5o% | 8.2% |
| FY2016 | **58%** | 5o% | 8.2% |

This is not a case of a taxpayer crying foul because the change to single-sales factor apportionment caused an increase in its California apportionment factor. Instead, Smithfield's California apportionment factor more than doubled (an increase of over 100 percent) because its minimal property and payroll in the state – and necessarily Smithfield's vast property and payroll outside of California and at the heart of its agricultural business activity – were ignored, thereby grossly overstating the extent of its business activity in California.

67 *Microsoft, supra* note 55.
68 *General Mills, supra* note 52 at 1314.

Regardless of the measure, as applied to Smithfield, the single-sales factor does not fairly reflect Smithfield's business activity for apportionment purposes.

### b. FTB Objections to Distortion

Both the FTB auditor and the 25137 Distortion Committee rejected Smithfield's request for alternative apportionment. None of the grounds identified as the basis for rejecting the petition hold up to even the most minimal objective scrutiny.

#### *i. Asserted Definition of Business Activity*

The primary basis for the FTB staff decision to reject Smithfield's petition rests on the unfounded assertion that the California legislature has somehow redefined the business activities relevant to fair apportionment. According to the FTB auditor and the 25137 Distortion Committee, "[c]ontrary to the taxpayer's position on all the factors contributing to the production of income, the CA legislature chose to measure business activity using a taxpayer's market in the state."[69]

First, neither Proposition 39 nor the related statutory change impacts the language or import of CRTC section 25137 which allows for alternative apportionment if the statutory apportionment formula does not fairly reflect the Taxpayer's business activities in the State. If a taxpayer offers clear and convincing evidence of distortion caused by the standard formulas aa applied to the facts of that taxpayer, then CRTC section 25137 allows for a reasonable remedy. That law has not changed.

[69] FTB Audit Determination on Petition for Alternative Apportionment, at 7 (Oct. 9, 2019).

Second, the People of the State of California enacted the single-sales factor as part of Proposition 39 in an effort to encourage multi-state businesses to locate jobs, offices, and facilities in California and put California-based companies on equal footing with interstate businesses.[70] The legislature did not change the apportionment formula; the people of the state of California changed the law to raise tax revenues and help California-based businesses. Neither Proposition 39 nor the related statutory change alter the meaning of “business activity.”

Last, neither Proposition 39 nor the related statutory change redefines or repeals decades of Federal and State judicial authorities describing those business activities which are relevant for the unitary method and fair apportionment.

### *ii. Consideration of only in-state Activities*

The FTB claims in circular fashion that “[t]he singles-sales factor reflects the taxpayer's market in this state and therefore by definition it does not unfairly represent the extent of taxpayer's business activities in CA which the legislature chose to measure using market.”[71] The FTB’s summation suggests that the only question of any relevance to the distortion analysis is whether California market percentage was properly determined (i.e. if the calculation is accurate, then it must fairly reflect taxpayer’s business activities in the state).

First, if true, the FTB’s assertion effectively repeals CRTC section 25137 from the law, as the sales factor “by definition” is a fair method of apportion not subject to challenge. CRTC section 25137 is alive and well – irrespective of the FTB’s suggestion to the contrary.

[70] Proposition 39.
[71] FTB Audit Determination on Petition for Alternative Apportionment, at 7 (Oct. 9, 2019).

Second, and contrary to the FTB's suggestion, while the mathematically correct percentage calculation of the current California market may be consistent with California's standard single-sales factor apportionment methodology, that does not mean that the formula fairly reflects Smithfield's business activities in California. Again, the FTB simply ignores CRTC section 25137.

Third, the FTB's statement also ignores the more obvious point that the fair reflection of activities "in the state" may only be determined by reference to activities outside the state. Every distortion case considering every variation of standard apportionment formula does so by comparing both in-state and out-of-state activities. We need look no further than the *Microsoft* case in which the court never questioned the activities reflected in the California sales factor – but rather focused exclusively on the treasury activities in Washington and their impact on the California sales factor.

*iii. Three-Factor Formula for Agricultural Businesses*

Both the FTB auditor and the 25137 Distortion Committee suggest that Smithfield may not meet the requirements for distortion because only those qualified activities such as agricultural and extractive businesses are allowed a remedy for distortion.[72] Regardless of whether Smithfield qualified for the agricultural or extractive exception to the standard apportionment formula, the three-factor formula is still a valid remedy under CRTC section 25137 which allows for the use of "any other method" to achieve fair apportionment.

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[72] *See id*. at 6-8, FTB Distortion Committee Determination, at 1 (Dec. 12, 2009).

The distortion created by the single-sales factor for Smithfield is further illustrated by the legislature's steadfast conviction that an evenly weighted, three-factor apportionment formula is the appropriate apportionment method for the agricultural industry.

The FTB determined that Smithfield did not meet the statutory threshold to apportion its income using the three-factor formula for agricultural businesses because Smithfield both produced and slaughtered hogs. Had Smithfield sold all of its hogs prior to slaughter, instead of only a portion, it would have been required to apportion its income using a three-factor formula. Just because Smithfield slaughtered some of the hogs prior to sale does not negate all of the time, resources, effort, research and expense that went into the production of the hogs (i.e., the agricultural business activity). Yet that is what single-sales factor apportionment does in this instance – it treats the world's largest hog producer as a mere meat seller.

To the extent that the FTB believes Smithfield does not qualify under a mechanical application of CCR section 25128-2, it does so with the clear knowledge that it is prohibiting Smithfield from using the apportionment factor deemed most appropriate by the California legislature for fairly reflecting the business activities of livestock producers, and further that many of Smithfield's competitors are enjoying a business advantage from the three-factor formula purely as a result of their business structure.

### *iv. Impact of the US Supreme Court's Moorman Decision*

The FTB suggests that the US Supreme Court decision in *Moorman Manufacturing Company v. G. D. Bair* provided some sort of blanket approval for the single-sales factor.[73] That is not true.

[73] *Moorman, supra* note 61.

In *Moorman,* the US Supreme Court considered and upheld Iowa's single-sales factor apportionment method over the Taxpayer's objection that its out-of-state operations were responsible for some of the profits generated by sales in Iowa. There are at least two key differences between the taxpayer in *Moorman* and the instant matter.

First, the Court rejected the taxpayer's position based on the burden of proof. According to the Court, "the record [did] not contain any separate accounting analysis showing what portion of appellant's profits was attributable to sales, to manufacturing, or to any other phase of the company's operations."[74] For Smithfield, the evidence is overwhelming that its industry-leading practices and economies of scale achieved by more than 98 percent of Smithfield's activities outside the state generated the income subject to tax. Sales in the state occur based on market rates – and while those sales are important to profit, Smithfield owes its economic success to factors other than sales as demonstrated above.

Second, the Court applied the constitutional standard for challenging the state's apportionment formula. Under California law, rather than showing that the apportionment outcome is "out of all proportion" or "arbitrary," Smithfield need only show that the single-sales factor does not fairly reflect its business activities for apportionment purposes. The relevant business activities for apportionment include all of Smithfield's business activities, and the standard formula fails because it does not reflect those activities which are so key to the generation of income subject to tax.

[74] *Id.* at 272.

c. <u>Remedy - The manifest distortion in Smithfield's apportionment formula should be remedied by use of the equally weighted three-factor formula to fairly reflect the contributions of all of the Smithfield activities which generate income subject to tax.</u>

The facts are not in dispute in the present case. Smithfield is a manufacturing business that thrives because of the industry leading practices and economies of scale achieved by its people and manufacturing operations outside the state. For Smithfield, the failure to reference <u>all</u> of those factors responsible for the production of income subject to tax, including property and payroll outside of California, is not fair and merits a remedy under the authority of CRTC section 25137.

The California Supreme Court's decision in *John Deere Plow of Moline v. Franchise Tax Board*[75] reiterated that the "underlying concept of formula apportionment in the allocation of income from a unitary business [is] that the unitary income is derived from the functioning of the business as a whole, to which the activities in the various states contribute."[76]

The three-factor formula "has been recognized as embracing factors sufficiently diversified to reflect 'the relative contribution of the activities in the various states to the production of the total unitary income' so as to allocate to California, its just proportion of the profits earned from a unitary business."[77]

Having found distortion in the application of the single-sales factor to Smithfield's manufacturing business, the Board should adopt the equally weighted three-factor formula as a

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[75] *John Deere Plow Co. of Moline*, *supra* note 1.
[76] *Id.* at 223.
[77] *Id.* at 222.

means to remedy that distortion. The three-factor formula reflects all of the activities that Smithfield relies on to generate income and fairly reflects its business activities both inside and outside of California.

## V. Conclusion

In spite of the FTB's effort to pretend otherwise, when California moved to a single-sales factor apportionment methodology, the State did not change the fundamental principles of fair apportionment and did not change CRTC section 25137. The single-sales factor apportionment formula income may lead to a fair apportionment of income in most cases, but it does not do that for Smithfield because it fails to reflect those activities responsible for generating income in the formula.

The FTB auditor and the 25137 Distortion Committee applied the wrong standard and unerringly achieved the wrong result. Taxpayer now asks this Board to apply the right standard for distortion and approve a remedy consistent with both constitutional and statutory requirements.