

I. Introduction

The question for the Three-Member Franchise Tax Board (“Board”) is both easily stated and easily resolved.

Smithfield asks the Board to determine that the standard single-sales factor formula does not fairly reflect Smithfield’s business activities in California based on consideration of Smithfield’s entire unitary business, and if so, to remedy that situation with a reasonable alternative apportionment formula. Because the California apportionment formula rests exclusively on sales and approximately 99 percent of the capital investment and employees responsible for generating Smithfield’s income are located outside of California, the standard single-sales factor formula is not fair as applied to Smithfield. In contrast, the Franchise Tax Board Staff (“Staff”) asks the Board to limit the inquiry to whether the sales factor alone fairly represents Smithfield’s business activities for apportionment purposes.¹ Staff is wrong.

Pursuant to California Revenue and Taxation Code (“CRTC”) Section 25137,² if it is determined that the single-sales factor formula does not fairly reflect Smithfield’s business activities in this State, then Smithfield is allowed to use a reasonable alternative apportionment formula to determine its tax obligation in California. If the single-sales factor formula does fairly represent Smithfield’s business activities in the state, then the matter is at an end.

Smithfield provides statutory and case authorities to support its position that the business activities relevant to determine whether the standard single-sales factor formula “fairly represents” Smithfield’s activities in this State under CRTC Section 25137 include consideration of Smithfield’s entire unitary business—not just the market. A formula that ignores 99 percent of the production and manufacturing activities responsible for generating taxable income is not “fair.”³

¹ See *Franchise Tax Board Staff Opening Brief*, at 2, 8 [hereinafter “*FTB Staff Opening Brief*”].

² Unless otherwise indicated, all section references are to the version of the California Revenue and Taxation Code in effect for the years at issue.

³ CAL. REV. & TAX. CODE § 25137; *Microsoft Corp. v Franchise Tax Bd.*, 39 Cal.4th 750, 772 n.16 (2006).

By comparison, Staff provides no authorities to support its position limiting the inquiry and effectively asks the Board to blindly trust its interpretation. Smithfield appreciates that some deference may be accorded Staff – but that deference is not unlimited, especially in light of the legal authorities supporting Smithfield’s position. Taxpayers deserve more than unsupported and unpublished rhetoric as the basis for tax determinations. Smithfield asks the Board to follow the only meaningful authorities on this issue and recognize that Smithfield’s entire business must be considered when determining “fair representation” of its activities in this State for apportionment purposes. We therefore ask that you grant Taxpayer’s petition for an alternative apportionment formula.

II. Discussion

Absent authority for its position, Staff attempts to create issues apparently intended to distract the Board or otherwise muddle the issue for consideration.⁴ To be clear, this case is only about whether Smithfield can establish by clear and convincing evidence that the single-sales factor is distortive when applied to Smithfield’s facts, or more precisely, does not “fairly represent the extent of [Smithfield’s] business activity in this state.”⁵ Nothing more.

Smithfield contends that all of its business activities including not only sales, but also the contribution of its employees and both tangible and intangible property which help generate income must be considered when evaluating whether the standard apportionment formula fairly represents business activities in the state. In support of its position, Smithfield relies on the

⁴ Contrary to Staff’s suggestions, Smithfield does not challenge the general validity of the standard formula, does not challenge the validity of the US Supreme Court’s decision in *Moorman Mfg. Co. v. Bair*, does not question that the market plays an important role in Smithfield’s business and does not intend to “usurp” existing legal or regulatory authorities. See discussion *infra* pp. 11-14.

⁵ CAL. REV. & TAX. CODE § 25137. Smithfield need only prove that the apportionment is not fair—the lesser statutory standard adopted by California—as compared to the more burdensome federal constitutional standard which requires a showing that “the income attributed to that State is in fact “out of all appropriate proportions to the business transacted . . . in that State,” [citation], or has “led to a grossly distorted result,” [citation].” See *Microsoft Corp.*, *supra* note 3.

plain statutory language of CRTS Section 25137 and longstanding authorities such as the *Appeal of Merrill, Lynch, Pierce, Fenner, & Smith, Inc.*, decided on June 2, 1989 by the former State Board of Equalization (“SBE”). Staff provides no contrary legal authority to support its position.

A. Undisputed Facts

Smithfield conducts a unitary business which includes breeding, raising, slaughtering and packaging pork products throughout the world. In a very general sense, Smithfield can increase profits by increasing the sales price or by reducing costs. Because processed pork is a fungible commodity, the sales price is generally tied to market prices over which Smithfield itself has little or no control. Recognizing this limitation, Smithfield chooses to increase profits and market share by reducing costs. Smithfield’s costs are lower and market-share larger because of its industry-leading technology and economies of scale—all of which is attributable to activities conducted outside of California.

During the years under consideration, Smithfield generated between six and nine percent of its overall sales in California. During those same years, roughly 99 percent of Smithfield’s research and development, production and processing activities as reflected by its payroll and property occurred outside of California. As set forth in detail in Smithfield’s opening submission, those activities outside of California generated income that the State of California now wants to tax using the single-sales factor formula. Staff apparently does not dispute those facts acknowledging that Smithfield’s “Hog Production operations occur completely outside of California.”⁶

⁶ *FTB Staff Opening Brief, at 4.* Smithfield acquired some California production and processing operations in 2017 when it acquired Farmer John from Hormel.

B. *The Statutes and How They Apply*

1. CRTC Section 25128.7

As in effect for the years under consideration, CRTC Section 25128.7 read in its entirety as follows:

Notwithstanding Section 38006, for taxable years beginning on or after January 1, 2013, all business income of an apportioning trade or business, other than an apportioning trade or business described in subdivision (b) of Section 25128, shall be apportioned to this state by multiplying the business income by the sales factor.⁷

This new statute enacted by the People of the State of California through Proposition 39 eliminated Taxpayer's ability to elect between the four-factor and single-sales factor formulas and thereby reduced the competitive disadvantage for California-based companies as compared to companies based outside the state.⁸

Neither Proposition 39 nor CRTC Section 25128.7 changes or references any other statute, case authority, or administrative pronouncement. Nonetheless, Staff suggests that the Board and Taxpayers must imply a radical change to existing law which would limit the inquiry under CRTC Section 25137 to only the sales factor.⁹ That's not how the law works. Taxpayers and administrators do not get to guess (or second guess) as to what the new law should have, would have, or could have said. Rather, all must apply the law as written and as construed by the applicable authorities.

Staff even argues that Smithfield's "position taken to its logical end will lead to the usurpation of [the single-sales factor] apportionment method."¹⁰ Staff goes too far in its effort to scare the Board into a decision adverse to Smithfield. Smithfield does not question the validity of CRTC Section 25128.7. Instead, Smithfield acknowledges that the single-sales factor formula is likely fair in most cases and has already been determined to be "presumptively valid"

⁷ CAL. REV. & TAX. CODE § 25128.7

⁸ Proposition 39 (approved on Nov. 6, 2012).

⁹ See *FTB Staff Opening Brief*, at 2, 8.

¹⁰ *FTB Staff Opening Brief*, at 3.

by the United States Supreme Court in *Moorman Manufacturing Company v. G. D. Bair*.¹¹

However, as applied to Smithfield – whose bottom line depends so heavily on production efficiencies and savings gained from its out-of-state activities – the single-sales factor formula does not fairly represent Smithfield’s business activities in the state.

2. CRTC Section 25137

As in effect both before and after the change to the single-sales factor, CRTC Section 25137 reads as follows:

If the allocation and apportionment provisions of this act do not fairly represent the extent of the taxpayer’s business activity in this state, the taxpayer may petition for or the Franchise Tax Board may require, in respect to all or any part of the taxpayer’s business activity, if reasonable:

- (a) Separate accounting;
- (b) The exclusion of any one or more of the factors;
- (c) The inclusion of one or more additional factors which will fairly represent the taxpayer’s business activity in this state; or
- (d) The employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer’s income.¹²

Since its enactment in 1966, CRTC Section 25137 has remained unchanged even though the State has enacted no less than four different standard apportionment formulas. As written, the statute considers “all or any part of the taxpayer’s business activity” in determining whether those activities are fairly represented by the standard formula.¹³ Further, the proposed remedies allow for the inclusion or exclusion¹⁴ of one or more factors or “the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer’s income.”¹⁵ Each aspect of the statute encourages consideration of activities outside of the

¹¹ *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 273 (1978).

¹² CAL. REV. & TAX. CODE § 25137 (emphasis added).

¹³ *Id.*

¹⁴ *Id.*; see e.g., *Appeal of Oscar Enterprises*, L.T.D., 87-SBE-069 (Oct. 6, 1987), wherein the FTB successfully argued for the exclusion of the property factor from the apportionment formula used to determine the taxpayer’s income apportioned to California.

¹⁵ CAL. REV. & TAX. CODE § 25137(d).

current standard single-sales factor formula in order to challenge and achieve fair apportionment.

Staff argues that the “business activities” relevant to the analysis under CRTC Section 25137 are somehow limited to those factors (or the factor) which comprise[s] the standard apportionment formula. Based on that premise, Staff argues repeatedly that Smithfield may only look to the sales factor and whether it fairly represents Smithfield’s market activity in California¹⁶ to determine whether or not the standard formula “fairly represents [Smithfield’s] business activities in the state” under CRTC Section 25137.¹⁷

Unfortunately, in spite of repeating its fundamental position to the point of exhaustion, Staff fails to provide any legal authority to support its interpretation of the standard - because there is none. Absent such authority, Staff asks the Board to somehow contrive or imply authority based on what Staff wished the statute said or what Proposition 39 should have said but did not. Worse still, Staff’s circular reasoning essentially renders CRTC Section 25137 – a statute in place for nearly 55 years – superfluous. If the “sales factor measures [the market]”, and, as Staff contends, “the standard apportionment formula must only fairly reflect the market”,¹⁸ then effectively no taxpayer ever would succeed in carrying its burden under CRTC Section 25137.

Staff’s effort to limit the CRTC Section 25137 inquiry to Smithfield’s market activities is inconsistent with the plain language of the statute which considers “all or part of the Taxpayer’s business activities” and allows for any possible method to remedy distortion.¹⁹ The only limit

¹⁶ To the extent Staff argues that it need only consider activities in California for purposes of evaluating distortion, such a position runs contrary to every single distortion case decided by the Board of Equalization, the California Courts, and the United States Supreme Court which consider the appropriateness of the in-state measure as compared to the measure of all activities both inside and outside the state.

¹⁷ See *FTB Staff Opening Brief*, at 2, 8, 11-12.

¹⁸ *FTB Staff Opening Brief*, at 2.

¹⁹ CAL. REV. & TAX. CODE § 25137

imposed by statute is the concept of fair representation of a taxpayer's business activities in this State. As such, Staff should not be allowed to limit the Board's inquiry beyond that key standard.

C. Appeal of Merrill Lynch

In addition to the plain language of CRTC Section 25137, Smithfield points to the *Appeal of Merrill, Lynch, Pierce, Fenner, & Smith, Inc. ("Merrill Lynch")*,²⁰ which considered and rejected the Franchise Tax Board's ("FTB") argument that the standard sales factor did not fairly reflect the taxpayer's market activities in the state. In rejecting the FTB's argument, the SBE concluded that the relevant "business activity" for purposes of CRTC Section 25137 "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 availability of real and intangible property, as reflected in the property factor."²¹

Staff somehow rejects *Merrill Lynch* and argues that, "[t]axpayer misinterprets the import of the referenced dicta of that opinion."²² Staff's interpretation is convenient but wrong. In *Merrill Lynch*, the FTB argued that the distortion in the sales factor alone was sufficient to prove distortion. The SBE disagreed and held that all of the Taxpayer's business activities must be considered to determine whether the standard formula does not fairly represent the taxpayer's activities in the state.²³ The crux of the SBE's determination was that the property and payroll factors balanced out any perceived distortion resulting from the sales factor. The FTB makes the same argument against Smithfield that it lost in *Merrill Lynch* by arguing that the discussion regarding the fair representation of a taxpayer's activities in a State may be limited to the sales factor - the result should be the same and the Board should reject Staff's

²⁰ *Appeal of Merrill, Lynch, Pierce, Fenner, & Smith, Inc.*, 89-SBE-017 (June 2, 1989) [hereinafter "Merrill Lynch"].

²¹ *Id.*

²² *FTB Staff Opening Brief*, at 15.

²³ *See Merrill Lynch*.

position.

D. Fair Apportionment and the Unitary Method

The FTB's position that the business activities relevant for purposes of CRTC Section 25137 are limited by those in the standard single-sales factor apportionment formula runs afoul of the very purpose of the unitary method, which is to apportion income amongst the states in which a taxpayer does business in a manner that is fair to both the state and the taxpayer. As established by the California Supreme Court in *Butler Brothers v. McColgan* nearly 80 years ago:

If there is any evidence to sustain a finding that the operations of [taxpayer] in California . . . contributed to the net income derived from its entire operations in the United States, then the entire business of appellant is so clearly unitary as to require a fair system of apportionment by the formula method in order to prevent overtaxation to the corporation or undertaxation by the state.²⁴

In *McDonnell Douglas Corporation v. Franchise Tax Board* the California Supreme Court emphasized that such a fair system of apportionment requires consideration of those business activities responsible for generating the income subject to tax. "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 . . . the mutual dependency of the interrelated activities in furtherance of the entire business sustains the apportionment process."²⁵

Staff suggests that reference to these case authorities is somehow "misleading" and that the idea of "fairness" in the unitary concept "is not the relevant question in the CRTC Section 25137 distortion context."²⁶ This is again incorrect. In *Container Corporation v. Franchise Tax Board*, the Court discusses external²⁷ consistency and fairness under the Due Process and Commerce Clauses which require that "the apportionment formula must actually reflect a

²⁴ *Butler Bros. v. McColgan*, 17 Cal.2d 664, 668 (1941).

²⁵ *McDonnell Douglas Corp. v. Franchise Tax Bd.*, 69 Cal.2d 506, 512 (1968).

²⁶ *FTB Staff Opening Brief*, at 9.

²⁷ Staff inadvertently references "extrinsic" consistency at *id.*

reasonable sense of how income is generated.”²⁸ Citing to the seminal distortion case of *Hans Rees’ Sons, Inc.*, the Court concludes that an apportionment formula which attributed income to a state “out of all appropriate proportions to the business transacted in that State,” would not meet that fairness requirement.²⁹

It is ironic that the states initially created the unitary method in order to apportion profits based on the entire unitary business rather than suffer the shortcomings of geographic or divisional separate accounting records. Now, not only has California adjusted the formula to rest only on one segment of Smithfield’s business, Staff argues against consideration of Smithfield’s entire business to determine whether the single-sales factor formula fairly represents its business activity in this State under CRT Section 25137.

E. Distortion - Why the Standard Formula Does Not Fairly Represent Smithfield’s Business Activity in California

Applying the proper legal standard to determine whether the standard apportionment formula fairly reflects all of Smithfield’s business activities in the state requires a comparison of those business activities reflected in the standard formula (i.e., sales only) to all of the business activities which comprise Smithfield’s entire unitary business.

Microsoft looks at both qualitative and quantitative factors. From a qualitative standpoint, Staff agrees that Smithfield’s out-of-state production and processing activities are part of “one business” with the sales activities in California and that “production activity is only a step” in that business.³⁰ In this case, Smithfield’s “one” business is producing, processing and selling hogs. This case presents the inverse situation to that in *Microsoft* wherein the court excluded activities which were qualitatively different from *Microsoft’s* main trade or business of software development. There is no qualitative distinction between parts of Smithfield’s business

²⁸ *Container Corp. of America v. Franchise Tax Bd.*, 463 U.S. 159, 169 (1983).

²⁹ *Id.* at 170.

³⁰ *FTB Staff Opening Brief*, at 15.

because, as Staff agrees, it is all “one” business and all of those activities work together to generate income subject to tax.

After agreeing that Smithfield conducts one single business, staff still suggests that Smithfield’s argument on this point is “baseless” because *Microsoft* discussed “gross receipts from two different business activities.”³¹ In fact, Staff again makes the point in favor of Smithfield’s petition for relief from the standard formula. It is because Smithfield’s business activities may not be separated like those in the *Microsoft* case that the single-sales factor which does not reflect those activities which deserve credit for creating Smithfield’s income fails to fairly represent Smithfield’s activities in the state for tax purposes.

With regard to the quantitative metrics, Smithfield relies on the same measures for distortion referenced in the *Microsoft* and *General Mills* decisions to show an average reduction in the apportionment factor of more than 50 percent, an amount in excess of the percentage change found to be distortive in both of those cases.³² By way of challenge to those metrics, the FTB asserts again that *Microsoft* and *General Mills* are different because, “[e]ach taxpayer in both of these cases had two different revenue streams with very different profit margins, which were significant.”³³ The two leading California cases provide metrics for distortion and Staff attempts to distinguish those cases using a qualitative description of the activities which doesn’t exist for Smithfield.

California’s single-sales factor formula selectively carves out aspects of Smithfield’s single business to apportion income from the entire business. On its face, such a measure is not necessarily in error. However, as applied to Smithfield in a way that ignores Smithfield’s out-of-state production and processing activities, California’s standard apportionment formula treats the world’s largest hog producer and processor as a mere meat seller in California. As such, the single-sales factor does not fairly represent Smithfield’s business activities in California for tax

³¹ *Id.*

³² *Taxpayer’s Opening Brief*, at 23.

³³ *FTB Staff Opening Brief*, at 17.

purposes.

F. Remedy - How Best to Cure Distortion

In order to fairly represent Smithfield's business activities in California for apportionment purposes, Smithfield offers to apportion its income using the three-factor formula reserved for agricultural businesses as that formula appears to be a good match for Smithfield's activities. This is because Smithfield's most critical and time-consuming business activity is an agricultural one, namely, the breeding and raising of premium quality hogs. Staff rejects Smithfield's proposed remedy as unreasonable because Staff determined that Smithfield did not meet Staff's mechanical application of FTB's qualified business activity regulation.³⁴ Here, however, Smithfield does not argue that it meets the receipts threshold for an agricultural business under the regulation; rather, it proposes using the three-factor formula as a reasonable alternative to a distortive standard formula because Smithfield undisputedly engages in substantial agricultural business activities. Staff also asserts that FTB alone "decides whether an alternative is reasonable," citing *Microsoft*.³⁵ Again, Staff is wrong. In *Microsoft*, the California Supreme Court determined that FTB's alternative methodology was reasonable.³⁶ Smithfield is confident that the Office of Tax Appeals or a California court similarly will find its proposed alternative reasonable, regardless of Staff's position.

G. FTB's Attempt to Mislead or Distract the Board - What this case is not about.

Staff's obvious efforts to distract the Board from applying the proper legal standard is troubling in the very least. Rather than confront the authorities Staff's brief suggests a Parade of

³⁴ See *FTB Staff Opening Brief*, at 18.

³⁵ *Id.*

³⁶ See *Microsoft Corp.*, *supra* note 3, at 771.

Horribles³⁷ which would accompany a favorable determination for Smithfield – none of which matter and many of which are simply untrue. For fear that the Board will consider some of the following points relevant to its consideration of the issues, Smithfield feels compelled to correct the record.

1. Direct Attack on Single-Sales Factor Apportionment

To begin, the FTB broadly asserts:

[t]axpayer’s position taken to its logical end will lead to the usurpation of [the single-sales factor] apportionment method, which was passed by sixty-one (61) percent of California voters as the standard rule that applies to almost all taxpayers, by a UDITPA relief provision CRTC section 25137, that permits departures from the standard [formula] only in a [sic] limited situations.³⁸

Smithfield does not intend to usurp anything. Consistent with the law as set forth in CRTC Section 25137, Smithfield asks the Board to consider whether the standard formula fairly represents Smithfield’s business activities in the State. Unlike Staff, Smithfield offers facts and law to support its position. By comparison, Staff offers rhetoric and unsupported theories which require the Board to imply a change to CRTC Section 25137 and longstanding case authorities with no written record to support such a change.³⁹

Staff also argues that, “[Smithfield’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.”⁴⁰

Smithfield makes no such assertion and Staff’s unabashed threat to the Board taints this entire proceeding. The case is about application of the standard apportionment formula to

³⁷ “Parade of Horribles” is defined as a “litany of detrimental or retrograde consequences that will, in the view of an opponent of some proposed action, occur if the action is taken.” BLACK’S LAW DICTIONARY (11th ed. 2019).

³⁸ *FTB Staff Opening Brief*, at 3.

³⁹ Smithfield did seek to correct the FTB’s repeated incorrect assertions that CRTC Section 25128.7 was enacted by the legislature. *Taxpayer’s Opening Brief*, at 10.

⁴⁰ *FTB Staff Opening Brief*, at 11.

Smithfield’s unitary business – nothing more. The Board’s determination, whether favorable or not, is limited to the facts of this case and does not apply to other taxpayers. Smithfield does not seek to change the law as Staff asserts. Rather, Smithfield works within the law to show that the standard formula simply doesn’t work for Smithfield’s business which invests 99 percent of its capital and payroll outside of California.

2. Validity of the Single Sales Factor Under CRTC Section 25128.7

According to Staff, Smithfield suggests that the SSF may be “less valid” because it was “motivated by budget, political and tax policy concerns.”⁴¹ Smithfield does not question the validity of CRTC Section 25128.7 or the mandatory single-sales factor formula. Smithfield does challenge Staff’s position that application of the single-sales factor formula fairly represents Smithfield’s business activity in California.

Smithfield’s actual assertion was that when statutes are motivated by budget, political and economic considerations intended to favor in-state businesses– such motivations likely have little connection to the goal of “fair representation” as articulated in the plain language of CRTC Section 25137 and related cases and deserve somewhat limited deference in that context.

3. Relevance of Moorman and Microsoft

Staff argues that “[t]axpayer attempts to minimize *Moorman*’s authority by characterizing it as ‘based on the burden of proof’ and as having applied the higher ‘constitutional standard.’”⁴² In spite of Staff’s statement to the contrary, there should be no dispute with regard to the basic teachings of the *Moorman* case and in fact, Staff’s suggestion to the contrary is misleading to the Board.

⁴¹ *Id.*

⁴² *Id.* at 6.

Microsoft held that there is both a federal constitutional standard for distortion and a “lesser statutory standard” in California.⁴³ Smithfield does not attempt to minimize *Moorman*’s authority in this case because the more burdensome constitutional standard described in *Moorman* is not at issue in this matter. The only question presented is whether the standard apportionment formula is “fair” as applied to Smithfield and as required by *Microsoft*.

Further, *Moorman* was in fact decided based on taxpayer’s failure to provide sufficient evidence to prove that the single sales factor produced an arbitrary result. The Court concluded that “the Iowa statute afforded appellant an opportunity to demonstrate that the single-factor formula produced an arbitrary result in its case. But this record contains no such showing and therefore [Iowa’s] assessment is not subject to challenge under the Due Process Clause.”⁴⁴

Staff should not be allowed to simply ignore and recast foundational legal premises in order to achieve a certain result. The law matters.

III. Conclusion

Smithfield asks the Board to determine that the standard single-sales factor apportionment formula does not “fairly represent” Smithfield’s business activities in California. In support of its position Smithfield offers undisputed facts, the plain language of CRTC Section 25137, direct citation to Board of Equalization precedent in *Merrill Lynch* and the foundational case authorities for the unitary method in California. In contrast, Staff asks that Board to literally change the language of CRTC Section 25137 based on nothing more than Staff’s view of how the world ought to be. Staff is wrong. Smithfield’s business activities should be apportioned in a manner that recognizes the contribution of its out-of-state production and manufacturing activities.

⁴³ See *Microsoft Corp.*, *supra* note 3.

⁴⁴ *Moorman*, *supra* note 11, at 275.