Smithfield Foods: Request for Alternative Apportionment

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Cal. Rev. & Tax Code (“CRTC”) Section 25137

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.

Smithfield’s Position on Distortion:

- Because the single-sales factor apportionment formula *ignores* the contribution of Smithfield’s out-of-state manufacturing activities to income, the formula *overstates* the impact of the California marketplace and does not fairly represent Smithfield’s business activities in California for apportionment purposes.

- Smithfield’s out-of-state manufacturing activities *directly contribute* to the income subject to tax by the State of California and should be represented in the apportionment formula.

The Facts:
Smithfield's Business

"Profit margins in hog farming are tantalizingly small, but narrow advantages multiplied over large volumes of hogs translate into potentially decisive competitive advantages."

Shi-Ling Hsu, Scale Economies, Scale Externalities: Hog Farming and the Changing American Agricultural Industry, 94 OR. L. REV. 23, 30-33 (2015)

The Facts:
Mr. Brady Stewart

1. <u>Introduction</u>
2. <u>Overview</u>
3. <u>Details</u>
   a. *Feeding*
   b. *Breeding*
   c. *Raising*
   d. *Harvest*
4. <u>California Presence</u>

The Law:
Distortion and a Remedy

The party requesting relief pursuant to CRTC section 25137 has the burden of proving by clear and convincing evidence that:

(1) the approximation provided by the standard apportionment formula is not a fair representation of the Taxpayer's business activities in the State, and

(2) its proposed remedy is reasonable.

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

The Law:
Distortion Pursuant to Section 25137

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 Law:
Purpose of the Apportionment Formula and Fair Representation

"[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. . . .

The ultimate goal is assessing whether the standard formula fairly represents the company's business activity in California."

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

The Law:
What are the Relevant Business Activities?

"Business 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 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**."

Appeal of Merrill Lynch Pierce Fenner & Smith, Inc. 89-SBE-017 (1989)

The Law:
Qualitative and Quantitative Distortion

- In *Microsoft,* the Supreme Court held that an alternative formula could be imposed to exclude certain activities from the apportionment formula if the challenged activity both qualitatively differs from the taxpayer's principal business and quantitatively distorts the formula by a substantial amount.

- Qualitative difference and quantitative distortion are … two factors in the fair representation legal standard.

Microsoft Corp. v. Franchise Tax Bd., 39 Cal. 4th 750, 757 and 766 (2006);
General Mills, Inc. v. Franchise Tax Bd., 208 Cal.App.4th 1290, 1299 and 1302, fn. 9 (2012)

The Law:
Qualitative Distortion

- Qualitative distortion is determined by reference to the Taxpayer's "principal corporate business purpose" or "main line of business."

- Smithfield's manufacturing plant and personnel are Smithfield's "main line of business" and for that reason, it is qualitatively distortive to exclude those activities from the apportionment formula.

General Mills, Inc. v. Franchise Tax Bd., 208 Cal.App.4th 1290, 1305 and 1306 (2012);
Microsoft Corp. v. Franchise Tax Bd., 39 Cal. 4th 750, 766 (2006)

The Law:
Quantitative Distortion

	2014	2015	2016	2017
CA Property %	1.0655%	0.9756%	0.9102%	2.4928%
CA Payroll %	0.7182%	0.7594%	0.7598%	4.1654%
CA Sales %	6.6533%	7.5140%	7.8201%	8.8310%
Total %	8.4370%	9.2490%	9.4901%	15.4891%
Divided by 3	2.8123%	3.0830%	3.1633%	5.1631%
Difference	3.8410%	4.4310%	4.6593%	3.6679%
Relative % Reduction in Apportionment Factor	58%	59%	58%	42%

The Law:
Quantitative Distortion

Tax Year	% Reduction in Apportionment Factor	% Found to be Distortive in *Microsoft*	% Found to be Distortive in *General Mills*
FY 2014	58%	50%	8.2%
FY 2015	59%	50%	8.2%
FY 2016	58%	50%	8.2%
FY 2017	42%	50%	8.2%

The Law:
Remedy for Distortion

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 following remedies may be considered:

(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.

Remedy:
The Three-Factor Formula

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.”

John Deere Plow Co. of Moline v. Franchise Tax Bd., 38 Cal.2d 214 (1951)

Thank you

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