Appellant's Additional Information
B2
May 27, 2015
ConAgra Foods, Inc.
597512, 785058, 799162

Regulations25120. Definition of Business and Nonbusiness Income.

. . .

(c) Business and Nonbusiness Income; Application of Definitions. The following are rules and examples for determining whether particular income is business or nonbusiness income. (The examples used throughout these regulations are illustrative only and do not purport to set forth all pertinent facts.)

(1) Rents from real and tangible personal property: . . .

(2)Gains or losses from sales of assets.

Gain or loss from the sale, exchange or other disposition of real or tangible **or intangible personal property** constitutes business income **if the property** while owned by the taxpayer **was used in the taxpayer's trade or business**. However, if such property was utilized for the production of nonbusiness income **or** otherwise was removed from the property factor before its sale, exchange or other disposition, the gain or loss will constitute nonbusiness income. (See Regulations 25129 to 25131, inclusive.)

. . .

(3)Interest.

Interest income is business income where **the intangible** with respect to which the interest was received **arises out of or was created in the regular course of** the taxpayer's trade or business operations **or** where **the purpose for acquiring and holding the intangible is related to or incidental to** such trade or business operations.

. . .

(4)Dividends.

Dividends are business income where **the stock** with respect to which the dividends are received **arises out of or was acquired in the regular course of** the taxpayer's trade or business operations **or** where **the purpose for acquiring and holding the stock is related to or incidental to** such trade or business operations.

STATE BOARD OF EQUALIZATION
Appeal Name: ConAgra Foods, Inc.
Case ID: 597512, ITEM #. B2 ID: 785058, 799162
Date: 5/27/15 Exhibit No: 5.2
TP FTB DEPT PUBLIC COMMENT

California Law

Hoechst Celanese Corp. v. Franchise Tax Board, (2001)

Transactional Test	Functional Test
• Focused on the transaction • Did income arise in the normal course of business? (ie from sales of inventory) o Frequency and regularity of similar transactions o Former practices of the business o Taxpayer's subsequent use of the income • Income from extaordinary events will not satisfy • Parties agree transactional test does not apply	• Focused on the property (how it was used) • Was the acquisition, management and disposition of the asset "integral to" the taxpayer's business? • The critical inquiry being "the nature of the relationship between this property and the taxpayer's business " o "Integral" requires an "*organic unity* between the taxpayer's property and the business activities whereby the property contributes materially to the taxpayer's production of business income." o The taxpayer's control and use of the property must contribute materially to the taxpayer's production of business income so that the property becomes *interwoven into* and *inseparable from* the taxpayer's normal or typical business activities with both giving value to the other." *Hoechst*, at 339-340

U.S. Supreme Court

In Interpreting and Applying the US Constituion
Applies the Unitary Business Principle

Tangible Assets

- Focus: what constitutes the unitary business?
  - There may be multiple trades or businesses, and separate divisions may or may not be unitary, and separate legal entities may or may not be unitary
- There must be common control (ie ownership > 50%)
- And the Three Unities Test must be met
  - Centralized Management
  - Functional Integration
  - Economies of Scale

Intangible Assets

In applying the Unitary Business Principle to Intangible Assets

- Are the payee and payor unitary with each other?
- If payee and payor are not unitary with each other, is there an operational connection between the intangible asset and the trade or business?

Summary of ConAgra's Position
ConAgra had no intention of continuing the divested meat-processing businesses. That's why it sold them off. It wanted to get out of those businesses, and sold them for roughly book value to get them to move. The only way to get the desired full book value for the businesses was to accept stock, or notes and stock, in addition to cash proceeds. The total proceeds consisted of the fair market value of the cash, the stock and the notes received. The total proceeds were used to calculate the original divestiture gains, and tax was properly paid in California. Once divested of the businesses, ConAgra had no control or even potential influence over the assets of those divested businesses.

For the years in issue the question the State Board of Equalization needs to answer is: **which assets** generated the dividends, the interest and the gains in question? ConAgra's position is that it is the stock and the notes that generated the dividends, the interest and the gains during the years in question. In contrast, the Franchise Tax Board states that it is the previously-divested meat-processing assets that generated the dividends, the interest and the gains at issue. However, the prior meat processing plants and assets had been fully divested and were no longer owned by ConAgra, so it is impossible for those assets, which ConAgra no longer owned, to generate the dividends, the interest and the gains. Instead those divested business operations generated business profits in the hands of Pilgrim's Pride and Swift Foods. Regulation 25120 (c) 2, 3, and 4 are pretty clear that "*stock*" is what generates dividend income, that an "*intangible*" (i.e. a note or a bond) is what generates interest income, and that either "tangible property" or "*intangible property*" can generate gains or losses. In this case it is "intangible property" – the sale of shares of stock – that generated the gains in question.

ConAgra doesn't understand the FTB's rationale for saying that the properties generating the income in question are meat processing plants and assets no longer owned by ConAgra. Even if it is somehow magically concluded that it is the previously divested meat processing business assets that generated the income in question in the years at issue, those previously-divested assets are no longer *"unitary with", "integral to", or "interwoven into"* ConAgra's ongoing food processing business in California (see last paragraph – on next page); therefore, under the functional test California still can't tax the income in question, because the "functional test" has not been met, in that at the time the dividends, the interest, and the gains are realized, the previously-divested business assets are no longer unitary with, integral to, or interwoven into ConAgra's continuing business operations.

Inconsistency of the FTB – In the 5/2005 year, the same Pilgrim's Pride stock that generated the dividends also generated the gain on the sale of the stock. Yet the Franchise Tax Board has allowed the treatment of the dividends earned on the Pilgrim's Pride stock as nonbusiness income, while disallowing nonbusiness income treatment on the gains realized on the same shares of stock that generated the dividends.

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Ultimately, the proper focus of this matter is the correct application of ***the "functional test"*** under California law. Both parties agree that the "transactional test" does not apply to the income at issue, so the transactional test should be disregarded. Both parties also agree that ConAgra is not unitary with either Pilgrim's Pride or Swift Foods.

Finally, under the functional test the key focus is on *the property* that generates the income, and how that property was "*integral to*" or how it had an "*organic unity*" with the regular trade or business operations. *Hoechst* refers to the property being "*interwoven into and inseparable from*" the trade or business. Moreover, with regard to income earned on "intangible assets", the U.S. Supreme Court uses similar reasoning in applying the "unitary business principle" to determine if the payee and payor are *unitary* with each other, and if not, to then determine if there is an "*operational connection*" between the intangible asset and the *taxpayer's* business conducted in the state. In this case neither the notes nor the stock were *integral to, organically unitary with, or interwoven into* ConAgra's food processing business in California. Therefore, the dividends, the interest, and the gains resulting from the stock and the notes should be treated as nonbusiness income.