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 8 **BOARD OF EQUALIZATION**  
 9 **STATE OF CALIFORNIA**

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 11 In the Matter of the Appeal of: ) **HEARING SUMMARY**  
 12 ) **CORPORATION FRANCHISE TAX APPEAL**  
 13 **CONAGRA FOODS, INC.**<sup>1</sup> ) Case No.'s 597512, 785058, 799162  
 14 )  
 15 )

<u>Year Ending</u>	<u>Proposed Assessment</u>	<u>Claim for Refund</u>
05/2004	N/A	\$764,350 <sup>2</sup>
05/2005	\$1,535,460	N/A
05/2006	N/A	\$2,113,238 <sup>3</sup>

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 24 <sup>1</sup> This appeal was postponed from the April 28-30, 2015 oral hearing calendar to conduct a pre-hearing conference.

25 <sup>2</sup> This is the amount stated in the refund claim. Respondent disallowed \$458,005 of the amount claimed. Approximately  
 26 \$127,000 of the disallowed amount is at issue for the 2004 tax year. (785058 Appeal Letter, p. 1, fn. 1.) Unless otherwise  
 noted, references to briefing refer to briefing in case number 785058, which includes the most recent briefing.

27 <sup>3</sup> This is the amount claimed on appellant's amended tax return filed on June 15, 2009. Appellant also filed two other  
 28 amended tax returns for the same year, but the amounts claimed in those amended tax returns are not at issue. According to  
 appellant, the amount of tax at issue for 2006 with regard to the business/nonbusiness issue raised in this appeal is  
 \$2,096,494.

Appeal of ConAgra Foods, Inc.

**NOT TO BE CITED AS PRECEDENT** - Document prepared for  
 Board review. It does not represent the Board's decision or opinion.

1 Representing the Parties:

2 For Appellant: Fred O. Marcus, Horwood, Marcus & Berk Chartered  
3 Jennifer A. Zimmerman, Horwood, Marcus & Berk Chartered  
4 Edwin P. Antolin, Silverstein and Pomerantz, LLP

5 For Franchise Tax Board: Delinda R. Tamagni, Tax Counsel III

7 QUESTION: Whether certain interest, dividends, and capital gain received by appellant  
8 ConAgra Foods, Inc. (ConAgra) constitute business income.

9 HEARING SUMMARY

10 Section 40 Appeal

11 This appeal involves an amount in controversy that is \$500,000 or more and thus is  
12 covered by Revenue and Taxation Code section 40, as explained below in Staff Comments.

13 Background

14 Appellant is headquartered in Nebraska. It has historically operated in four business  
15 segments: Packaged Foods (frozen and refrigerated foods), Food Ingredients (including spices, milling  
16 operations, and basic food ingredients), Agricultural Products (fertilizer, seed, and crop chemicals) and  
17 Meat Processing (poultry, beef and pork). (Appeal Letter, pp. 1 – 3.)<sup>4</sup>

18 In 2002 and 2003, as part of a restructuring, appellant sold its fresh beef and pork  
19 operations and its chicken processing business, in two separate transactions. In the 2002 sale of the  
20 beef and pork operations, the buyer was S&C Holdco, Inc. (Swift Foods).<sup>5</sup> In the 2003 sale of the  
21 chicken business, the buyer was Pilgrim’s Pride Corporation (Pilgrim’s Pride). (*Id.*)

22 Both the 2002 sale to Swift Foods and the 2003 sale to Pilgrim’s Pride were taxable  
23 transactions, and appellant reported the resulting gains (or losses) as business income (or loss) that was

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27 <sup>4</sup> As noted previously, unless otherwise stated, references to briefing refer to briefing in case number 785058.

28 <sup>5</sup> S&C Holdco, Inc. was owned by a parent company, and also owned direct and indirect subsidiaries. For simplicity, unless otherwise indicated, references to Swift Foods herein refer to S&C Holdco, Inc. and its affiliates.

1 apportionable to California in accordance with appellant's California apportionment percentage.<sup>6</sup> The  
 2 parties do not dispute that these gains (or losses) were correctly characterized as business income. (See  
 3 Resp. Op. Br., pp. 2 – 3; Appeal Letter, pp. 4, 9.)

4 This appeal concerns the proper treatment of capital gain, interest income, and dividends  
 5 that appellant later earned from stock and notes that appellant received in the 2002 and 2003  
 6 transactions, and to a lesser extent income arising from debt it extended on a line of credit in connection  
 7 with the Swift Foods transaction. Most of the income at issue, approximately 79 percent, arose from  
 8 capital gain recognized when appellant later sold Pilgrim's Pride stock that it received in the 2003  
 9 transaction. (See Appeal Letter, pp. 1 – 2, Exhibit B.)

10 In the 2002 transaction, appellant sold its fresh beef and pork operations to Swift Foods,  
 11 a new joint venture organized by Hicks, Muse, Tate & Furst (Hicks Muse), a private equity firm. In  
 12 connection with the transaction, appellant received \$766 million in cash, a 46 percent equity interest in  
 13 Swift Foods which was valued at \$150 million, a \$150 million note issued by a subsidiary of  
 14 Swift Foods, and a \$30 million note issued by Monfort Finance Company, Inc. (Monfort). Monfort  
 15 was a subsidiary of appellant that was sold to Swift Foods in the transaction. Appellant also extended a  
 16 \$350 million line of credit to Monfort, through which approximately \$266 million was borrowed by  
 17 Monfort at closing. In addition to the \$150 million received for the assets sold, appellant also  
 18 purchased a \$150 million 12.5 percent senior subordinated note issued by a subsidiary of Swift Foods,  
 19 which effectively reduced the amount of cash received by appellant from \$766 million to \$616 million.<sup>7</sup>  
 20 The remaining 54 percent of Swift Foods was owned by HMTF Rawhide, L.P., a partnership formed by  
 21 Hicks Muse and Greeley Investments, LLC. The consideration received by appellant was equivalent to  
 22

23 <sup>6</sup> At the hearing, appellant should be prepared to clarify whether the transactions generated gain or loss. Staff's  
 24 understanding is that the 2002 Swift Foods transaction was initially reported as generating a small loss. However, the IRS  
 25 examined the transaction, resulting in certain adjustments related to the basis of the assets sold. (See ConAgra SEC Form  
 26 10-K for fiscal year ending 2004 (hereinafter "ConAgra SEC Form 10-K FY 2004") [regarding the tax adjustment, see  
 27 Cons. Financial Statement Note 21 "Restatement of Previously Issued Financial Statements, first bullet; see p. 41 for  
 information regarding the Pilgrim's Pride transaction and p. 43 for information regarding the Swift Foods transaction;  
 available at: <http://www.conagrafoods.com/investor-relations/financial-reports/annual-reports>].) According to appellant,  
 the adjustments were reported to the appropriate taxing authorities, including California. It appears that the IRS adjustments  
 are not at issue in this appeal.

28 <sup>7</sup> According to appellant, this purchased note was disposed of prior to the years at issue, and no interest on this note is at  
 issue in this appeal.

1 the estimated book value of the business sold.<sup>8</sup>

2 As noted above, Monfort, a subsidiary of appellant that was sold to Swift Foods in the  
3 transaction, issued notes to appellant in the transaction. Monfort operated feed lots in Colorado.  
4 Monfort's debt under the notes was secured by Monfort stock.<sup>9</sup>

5 Appellant entered into a stockholders agreement with Hicks Muse and Swift Foods  
6 which provided for the election of directors, registration rights for the stock, restrictions on transfer and  
7 other rights regarding the sale of Swift Foods common stock and the Monfort cattle feeding business.<sup>10</sup>  
8 An SEC filing states that the stockholders agreement provided “. . . a right of [appellant] to force the  
9 sale of Swift Foods after five years.”<sup>11</sup> Appellant appointed two of Swift Foods' seven board members,  
10 and, according to appellant, it and Swift Foods were managed and operated separately. (Appeal Letter,  
11 pp. 11 – 12; Swift Foods Transaction Form 8K.)

12 Swift Foods entered into a “market-based preferred supplier agreement” with appellant.  
13 Pursuant to the agreement, Swift would supply fresh beef and pork products “at fair market prices  
14 based on prior pricing practices between [appellant] and its fresh beef and pork processing businesses.”  
15 (Swift Foods Transaction Form 8K; Appeal Letter, p. 12.)

16 In the 2003 transaction, appellant sold its chicken processing business to Pilgrim's Pride,  
17 in return for approximately \$310 million in cash and approximately 25.4 million shares of Pilgrim's  
18 Pride stock, which was valued at approximately \$246 million. The stock represented approximately  
19 seven percent of the outstanding shares of Pilgrim's Pride. Appellant states that it and Pilgrim's Pride  
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21 <sup>8</sup> See ConAgra SEC Form 8-K, September 19, 2002 (hereinafter “Swift Foods Transaction Form 8K”) (available at  
22 <http://www.sec.gov/Archives/edgar/data/23217/000090044002000038/0000900440-02-000038.txt>); Appeal Letter, pp. 9 –  
10; 597512 Appeal Letter, pp. 10 -11, fn. 2; Resp. Op. Br., pp. 1 – 2.)

23 <sup>9</sup> Principal on the debt under the line of credit was repaid as cattle assets were sold. (Swift Foods Transaction Form 8K.)  
24 The purchase price for the sale of Monfort was financed by appellant through loans to Monfort. As a result, for financial  
25 accounting purposes, the sale of Monfort was not treated as a divestiture. (See page 43 of ConAgra SEC Form 10-K FY  
26 2004.)

26 <sup>10</sup> At staff's request, appellant provided a copy of this agreement, as well as other relevant agreements. These materials  
27 were distributed as additional exhibits on May 1, 2015.

27 <sup>11</sup> This right to force a sale was not discussed in the briefing. At a pre-hearing conference, appellant argued that it was  
28 negotiated as a way to ensure that it could liquidate its investment. The parties should be prepared to discuss at the hearing  
the relevance, if any, of appellant's right to force a sale.

1 entered into a supply agreement which made Pilgrim's Pride its preferred provider of poultry products,  
2 with sales made on arm's-length terms. As discussed further below, appellant's ability to sell its  
3 Pilgrim's Pride stock was restricted by a Registration Rights and Transfer Restriction Agreement  
4 (Registration Rights Agreement). Appellant states that Pilgrim's Pride was managed and operated  
5 independently from it, with no sharing of officers or directors. (Resp. Op. Br., p. 2; Appeal Letter, pp.  
6 4 – 5, 6; see also ConAgra SEC Form 10-K FY 2004.)

7 As noted above, both the 2002 sale to Swift Foods and the 2003 sale to Pilgrim's Pride  
8 were taxable transactions, and appellant reported the resulting gains (or losses) as business income (or  
9 loss) that was apportionable to California in accordance with appellant's California apportionment  
10 percentage. The parties do not dispute that these gains (or losses) were correctly characterized as  
11 business income (or loss). (See Resp. Op. Br., pp. 2 – 3; Appeal Letter, pp. 4, 9.)

12 As noted above, most of the income at issue was generated when appellant later sold the  
13 Pilgrim's Pride stock that it had received when it sold a portion of its business in 2003. In late 2004  
14 (during the 2005 tax year), appellant sold 10 million shares of the Pilgrim's Pride stock that it had  
15 received in the 2003 transaction and recognized a gain of approximately \$186 million. In August 2005  
16 (during the 2006 tax year), appellant sold the remainder of its Pilgrim's Pride stock (15 million shares),  
17 recognizing gain of \$327 million. Appellant also received dividend income from the Pilgrim's Pride  
18 stock. (Appeal Letter, pp. 1 – 2, 9 - 10 [regarding the 2004 and 2005 tax years]; 597512 Appeal Letter,  
19 pp. 4, 10 – 11 [regarding the 2006 tax years].)

20 Appellant also recognized other income from the stock and notes received in the 2003  
21 and 2004 sale transactions, and from financing it provided to Monfort. The parties also dispute whether  
22 this income constitutes business income. In September 2004, appellant sold its Swift Foods stock, as  
23 Hicks Muse (the private equity firm that led the Swift Foods venture) exercised its option to purchase  
24 appellant's Swift Foods stock at that time. Also in September 2004, it became apparent that Monfort,  
25 which was now a subsidiary of Swift Foods, would default on its debt obligation to appellant under a  
26 note and line of credit. In lieu of foreclosure, appellant received the Monfort stock that had been  
27 pledged as security. Appellant recognized gain when it reacquired the Monfort stock in exchange for  
28 the note. (About a month later, it sold the Monfort stock to an unrelated third party for no additional

1 gain or loss.) (Appeal Letter, pp. 1 – 2, 9 - 10 [regarding the 2004 and 2005 tax years]; 597512 Appeal  
2 Letter, pp. 4, 10 – 11 [regarding the 2006 tax years].)

3 Appellant filed refund claims on original and/or amended tax returns for the 2004 and  
4 2005 tax years. For the 2004 tax year, following an audit, the FTB issued a November 6, 2013 Reissued  
5 Notice of Proposed Overassessment proposing a smaller overpayment than the refund requested.  
6 Pursuant to R&TC section 19331, the Board has jurisdiction to review the claimed refunds for the 2004  
7 and 2005 tax years on the basis of the deemed denial of those refund claims. For the 2005 tax year,  
8 following audit and protest, the FTB issued a Notice of Action (NOA) dated November 6, 2013,  
9 proposing \$1,535,460 of additional tax, which appellant timely appealed. The appeal for the 2006 tax  
10 year (case number 597512) arises from appellant’s timely appeal from respondent’s September 21, 2011  
11 NOA which partially denied appellant’s claim for refund. (Appeal Letter, pp. 1 – 2, Exhibit A [2004  
12 and 2005 tax years]; 597512 Appeal Letter, pp. 1 – 2, Exhibit B [regarding the 2006 tax year].)

### 13 Applicable Law<sup>12</sup>

#### 14 California Law

15 As an equitable and constitutional method for taxing corporations that do business in  
16 multiple states and countries, California, like many other states, has adopted the Uniform Division of  
17 Income for Tax Purposes Act (UDITPA). (See Rev. & Tax. Code, §§ 25120 – 25141.) Under UDITPA,  
18 a corporation’s income is divided into business or nonbusiness income. Business income or loss (as  
19 determined after the deduction of business expenses) is typically apportionable to each state by the use  
20 of a formula. Nonbusiness income or loss (as determined after the deduction of nonbusiness expenses)  
21 is allocable only to the taxpayer’s commercial domicile. (*Hoechst Celanese Corporation v. Franchise*  
22 *Tax Board* (2001) 25 Cal.4th 508, 513 (*Hoechst Celanese*).)

23 R&TC section 25120, subdivision (a) defines “business income” as “income arising  
24 from transactions and activity in the regular course of the taxpayer’s trade or business and includes  
25 income from tangible and intangible property if the acquisition, management, and disposition of the  
26 property constitute integral parts of the taxpayer’s regular trade or business operations.” R&TC section  
27

28 <sup>12</sup> Applicable law is provided prior to contentions in order to assist in reviewing the legal issues raised in the contentions.

1 25120, subdivision (d) defines “nonbusiness income” as “all income other than business income.”

2 In *Hoechst Celanese, supra*, the California Supreme Court analyzed R&TC section  
3 25120, subdivision (a) and related case law and Board decisions, and set forth the applicable analysis,  
4 under California law, to determine whether an item of income (or expense) is business or nonbusiness in  
5 nature. The Court held that income constitutes business income if either the “transactional” test or the  
6 “functional” test is satisfied. (*Hoechst Celanese, supra*, at pp. 520-526.)

7 Under the transactional test, the relevant inquiry is whether the transaction or activity  
8 that gave rise to the income arose in the regular course of the taxpayer’s trade or business. (*Id.* at  
9 p. 526.) Under the functional test, income from property is considered business income if the  
10 acquisition, management, and disposition of the income-producing property were “integral parts” of the  
11 taxpayer’s regular trade or business operations, regardless of whether the income arose from an  
12 extraordinary transaction. (*Id.* at pp. 527, 530.)

13 The functional test focuses on the income-producing property and the “critical inquiry” is  
14 the “relationship between this property and the taxpayer’s business operations.” (*Id.* at p. 527.) It is not  
15 necessary that the taxpayer hold legal title to the income-producing property but the taxpayer must  
16 “(1) obtain some interest in and control over the property; (2) control or direct the use of the property;  
17 and (3) transfer, or have the power to transfer, control of that property in some manner.” (*Id.* at pp. 528-  
18 529.)

19 In providing meaning to the term “integral” in the statute, a determination must then be  
20 made as to whether the property has a “close enough relationship to the taxpayer to satisfy the functional  
21 test.” (*Ibid.*) Thus, “‘integral’ requires an organic unity between the taxpayer’s property and business  
22 activities whereby the property contributes materially to the taxpayer’s production of business income.”  
23 (*Ibid.*) In summary, income is business income “if the taxpayer’s acquisition, control and use of the  
24 [income-producing] property contribute materially to the taxpayer’s production of business income[.]”  
25 such that “the income-producing property becomes interwoven into and inseparable from the taxpayer’s  
26 business operations.” (*Id.* at p. 532.)

27 On the facts before it, the Court considered income arising from the reversion of surplus  
28 assets of the taxpayer’s pension plan. The Court found that the taxpayer had sufficient control and use

1 of the pension assets, and further found that the taxpayer's control and use of the property was an  
 2 integral part of the taxpayer's normal or typical business activities as the pension assets were held to  
 3 retain its employees and attract new employees. It therefore found that pension reversion income  
 4 constituted business income under the functional test because the taxpayer's control and use of the  
 5 pension assets "contributed materially to its production of business income by improving the efficiency  
 6 and quality of its workforce, which, in turn, generated [its] business income." (*Id.* at p. 536.)

7 Respondent's determination regarding the character of income as business or  
 8 nonbusiness income is presumed correct, and the taxpayer has the burden of proving error in that  
 9 determination. (*Appeal of Twentieth Century-Fox Film Corporation*, 89-SBE-007, Mar. 2, 1989.)  
 10 Also, California Code of Regulations, title 18, section (Regulation) 25120, subdivision (a), provides  
 11 that income "is business income unless clearly classifiable as nonbusiness income."

12 Regulation 25120, subdivision (c), provides in part as follows:

13 (2) Gains or losses from sales of assets. Gain or loss from the sale, exchange or other  
 14 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.

15 . . .

16 (3) Interest. Interest income is business income where the intangible with respect to  
 17 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. . . .

18 (4) Dividends. Dividends are business income where the stock with respect to which the  
 19 dividends are received arises out of or was acquired in the regular course of the taxpayer's  
 20 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. . . .

21 In the *Appeal of General Dynamics*, 75-SBE-037, decided June 3, 1975 (*General*  
 22 *Dynamics*), the taxpayer's unitary business included the buying and selling of aircraft. In the ordinary  
 23 course of that business, the taxpayer agreed to purchase aircraft from Swissair and Scandinavian  
 24 Airlines. The price to be paid by General Dynamics was contingent on, and determined by reference to,  
 25 the resale price received by it on the resale of the aircraft. The purchase agreement also provided that, if  
 26 securities were later received on the resale of the aircraft, General Dynamics would convert the  
 27 securities to cash, with the cash received used to determine the final purchase price for the aircraft.

28 In 1960, the aircraft were resold to Airlift in return for a down payment and notes

1 payable in monthly installments over a five-year period. Airlift defaulted and in lieu of payment  
2 appellant accepted cash, a further note, and shares of Airlift stock. The Board stated that the stock  
3 could not be immediately converted to cash due to restrictions on the sale of the stock imposed by a  
4 voting trust. In 1967, appellant sold the shares and recognized the gain at issue. The gain from the  
5 stock sold was then used to determine the final purchase price paid by General Dynamics for the  
6 purchase of the aircraft.

7           Evaluating the foregoing facts, the Board found that, although the taxpayer did not  
8 normally receive stock in return for aircraft, “. . . the purchase and sale of the seven aircraft were  
9 integral parts of appellant’s unitary business . . .” with the result that all of the gain recognized,  
10 including gain from the later stock sale, constituted business income. The Board stated that “[t]his  
11 conclusion is emphasized by the fact that the entire cost of the aircraft sold, including that portion of  
12 the gain on the sale of the stock which was paid to Swissair and SAS pursuant to the agreement, was  
13 charged against unitary income.” The Board further found that “[t]he acquisition, retention, and  
14 disposition of the Airlift stock was so inextricably entwined with appellant’s unitary business  
15 operations involving the purchase and sale of the seven aircraft that it compels the conclusion that the  
16 gain accruing . . . from the conversion of the stock to cash was business income.”

17           The Board rejected the taxpayer’s argument that the stock was held for an investment  
18 purpose. The Board found that the receipt of the stock, which was accepted in substitution for a note,  
19 “was merely a continuation of the financial dealings connected with the payment for the aircraft by  
20 Airlift.” The Board found that, under its contract with Swissair and SAS, the taxpayer was required to,  
21 and did, convert the stock into cash “in order to firm up the price to be paid to Swissair and SAS for the  
22 aircraft.” The Board concluded that, rather than demonstrating an investment intent, the substantial  
23 time delay from the receipt of the stock until its sale was attributable to restrictions imposed on the sale  
24 of the stock.

25           The taxpayer filed a petition for rehearing arguing that the Board erroneously  
26 determined, as a matter of fact, that there were restrictions on sale imposed by the voting trust  
27 agreement. (*Appeal of General Dynamics Corp.*, 75-SBE-063, Sept. 17, 1975.) In its decision denying  
28 the petition for rehearing, the Board stated that the holding in its prior opinion was not controlled by

1 any restrictions on the sale of the stock, but rather was based on its determination that “the acquisition,  
2 retention, and disposition of the stock was inextricably entwined with appellant’s unitary business.” In  
3 support, the Board quoted from the portions of its prior opinion finding that the purchase and sale of the  
4 aircraft were integral parts of the taxpayer’s unitary business and that all the gain from the sale,  
5 including the gain on the sale of the Airlift stock, arose in the ordinary course of that sale.

6 Constitutional Issues

7 In *Allied-Signal, Inc. v. Director, Division of Taxation* (1992) 504 U.S. 768, 772  
8 (*Allied-Signal*), the taxpayer acquired stock in a mining company during 1977 and 1978, and sold the  
9 stock in 1981. The United States Supreme Court found that the state of New Jersey did not have the  
10 constitutional power to tax an apportioned share of the stock gain because the stock served an  
11 investment function, rather than an operational function, and the taxpayer and the mining company were  
12 not part of a unitary business.

13 In *MeadWestvaco Corp. v. Illinois Department of Revenue* (2008) 553 U.S. 16  
14 (*MeadWestvaco*), the United States Supreme Court considered whether the state of Illinois could  
15 constitutionally tax an apportioned share of the gain recognized by Mead, a subsidiary of the taxpayer,  
16 when Mead sold its Lexis business division. The Court found that the appellate court erred in applying  
17 the operational function test without determining whether Lexis was part of Mead’s unitary business.  
18 The Court stated that its prior decisions regarding an operational function did not announce a new  
19 ground for constitutional apportionment in the absence of a unitary business. Accordingly, it remanded  
20 the case for a determination of whether Lexis was a unitary part of Mead’s business considering the  
21 “hallmarks” of a unitary relationship, namely functional integration, centralized management, and  
22 economies of scale.

23 The California Constitution prohibits any agency, including the Board, from refusing to  
24 enforce a California statute on the basis that federal law prohibits the enforcement of the statute, unless  
25 an appellate court has made a determination that the enforcement of such statute is prohibited by federal  
26 law. (Cal. Const., Art. III, § 3.5.) Further, the Board has a long-standing policy of abstaining from  
27 deciding constitutional issues, so that such issues may be litigated and definitively resolved in the courts.  
28 (See, e.g., *Appeal of Vortex Manufacturing Co.*, 30-SBE-017, Aug. 8, 1930; *Appeal of Benjamin R. Du*

1 *and Carmela Du*, 2007-SBE-001, July 17, 2007, fn. 3.)

2 Contentions

3 Summary

4 Appellant argues that it paid tax based on the fair market value of the notes and stock it  
5 received on the sales of portions of its unitary business and reported the resulting gain as business  
6 income. Appellant argues that these sales transactions were closed, and that it subsequently held the  
7 stock and notes received as an investment. Appellant contends that the relevant assets producing the  
8 income at issue are the stock and notes, rather than the portions of its business which it sold. Appellant  
9 contends that the stock and notes were not integrated into its regular business operations and should not  
10 be taxed as business income.

11 Respondent contends that income received from the stock and notes constitutes business  
12 income because the stock and notes were received when appellant sold portions of its unitary business.  
13 Respondent argues that, because the businesses sold were parts of appellant's unitary business, income  
14 subsequently received by appellant from stock and notes received in the sale also constitutes business  
15 income. Respondent argues that the relevant assets in this inquiry are the business assets that appellant  
16 sold rather than the stock and notes themselves.

17 Appeal Letter

18 Appellant contends that the U.S. Supreme Court's apportionment jurisprudence bars  
19 California from including the income in dispute in its apportionable tax base. Appellant observes that  
20 the Commerce Clause and Due Process Clause limit a state's power to tax out-of-state activities, citing  
21 *Mobile Oil Corp. v. Comm'r of Taxes* (1980) 445 U.S. 425, 454 (*Mobile Oil*) and other cases.  
22 Appellant notes that states may tax an apportioned share of a corporation's multistate business if the  
23 business is unitary, citing *Allied-Signal, supra*, and other cases. Appellant states that, in  
24 *MeadWestvaco, supra*, the Court found that where the asset is another business, the hallmarks of a  
25 unitary business are functional integration, centralization of management and economies of scale.  
26 (Appeal Letter, pp. 3, 10.)

27 Appellant states that, in *Allied-Signal, supra*, 504 U.S. at 787, the Court provided  
28 examples of situations in which apportionment might be constitutional even though the payor and payee

1 were not engaged in the same unitary business, such as where the asset served an operational function in  
2 the business. Appellant notes that, in *Container Corp. v. Franchise Tax Bd.* (1983) 463 U.S. 159  
3 (*Container Corp.*), n. 19, the Court observed that corn futures contracts that were used by a corn refiner  
4 to hedge against an increase in corn prices are operational rather than capital assets. (Appeal Letter,  
5 p. 3.)

6 Appellant states that, in *MeadWestvaco*, the Court explained that its prior references to  
7 an operational function were not intended to modify the unitary business principle by adding a new  
8 ground for apportionment. Rather, the Court stated that the concept of operational function recognized  
9 that an asset can be part of a taxpayer's unitary business even if the unitary business relationship  
10 doesn't exist between the payee and the payor. Appellant argues that "the focus is on whether the  
11 income-producing asset itself is connected to the taxpayer's ongoing operations in the taxing forum[.]"  
12 citing *ASARCO v. Idaho State Tax Commission* (1982) 458 U.S. 307 (*ASARCO*), *Allied-Signal, supra*,  
13 and the California Supreme Court's decision in *Hoechst Celanese, supra*. Appellant argues that these  
14 decisions "establish the outer limits of apportionability under federal constitutional law" which limit  
15 the ability of California to include the items in dispute in appellant's apportionable tax base. (Appeal  
16 Letter, pp. 3 – 4.)

17 *Pilgrim's Pride*

18 Appellant states that the sale to Pilgrim's Pride was treated for tax purposes as a sale of  
19 assets. Appellant also states that the Pilgrim's Pride stock it received in the transaction was subject to a  
20 Registration Rights Agreement between it and Pilgrim's Pride which required Pilgrim's Pride to file a  
21 registration statement for the sale of appellant's stock and limited appellant's ability to sell the stock.  
22 Appellant states that, in December 2004, it sold 10 million shares of its Pilgrim's Pride stock in an  
23 initial public offering and recognized gains of approximately \$185 million. Appellant also states that it  
24 received dividends on the stock prior to the sale. (Appeal Letter, p. 5.)

25 Appellant states that it reported both the gain on its sale of the Pilgrim's Pride stock, and  
26 income from the dividends received, as nonbusiness income, with the result that the income was  
27 sourced to Nebraska for its 2004 and 2005 tax years. (*Id.*)

28 Appellant argues that it and Pilgrim's Pride did not operate a unitary business.

1 Appellant notes that the United States Supreme Court has stated that the signature features of a unitary  
2 business are “functional integration, centralization of management, and economies of scale[,]” quoting  
3 *Exxon Corp. v. Wisconsin* (1980) 447 U.S. 207, 222; *ASARCO, supra*, at p. 317, and other authorities.  
4 (Appeal Letter, p. 5.)

5 Appellant contends that there was no unitary business here because there was never any  
6 ownership or control between appellant and Pilgrim’s Pride. Appellant states that it never held more  
7 than seven percent of Pilgrim Pride’s voting stock, never shared officers or directors with Pilgrim’s  
8 Pride, and there was no unity of ownership or control. Appellant asserts that it (i.e., appellant) was  
9 operated and managed separately from Pilgrim’s Pride and that, following the sale of its chicken  
10 business to Pilgrim’s Pride, it no longer engaged in the chicken processing business. Appellant further  
11 contends there was no transfer of personnel, know-how, intellectual property, expertise or similar  
12 property between the two companies, other than what was acquired as part of Pilgrim Pride’s  
13 acquisition of its chicken business. Appellant argues that there were no common employees, employee  
14 benefit programs, insurance plan, or workmen’s compensation plans. (*Id.*)

15 Appellant states that it and Pilgrim’s Pride entered into a supply agreement which made  
16 Pilgrim’s Pride its preferred provider of poultry products. However, appellant states that this does not  
17 establish unity because the transaction was at arm’s-length, citing *Container Corp., supra*, at p. 180,  
18 n. 19 and *Allied-Signal, supra*, at page 789. (Appeal Letter, p. 6.)

19 Appellant states that the companies also entered into a transition services agreement,  
20 pursuant to which appellant agreed to continue providing the administrative services it had provided to  
21 its chicken processing business for a limited period of time. Citing *Mobile Oil, supra*, at page 438,  
22 appellant argues that this agreement does not evidence a unitary business because it had only a one-year  
23 term with consideration based on “actual usage and charges.” Appellant further argues that there was  
24 “no shared use of plants or facilities,” that the companies separately handled legal, environmental, tax,  
25 and other matters, and that the companies did not lend each other funds. (*Id.*)

26 Appellant further contends that its equity interest in Pilgrim’s Pride was not integral to its  
27 unitary business. Appellant argues that, without a unitary business relationship, the only constitutional  
28 basis for apportionment would be if there “existed some link between ConAgra’s ownership of the

1 Pilgrim's Pride stock and ConAgra's California unitary business." (Appeal Letter, p. 6.)

2 Appellant argues that the inquiry "considers the objective characteristics of the income-  
3 producing asset and asks if there is any nexus between the asset and the taxpayer's operations in the  
4 taxing forum[.]" citing *Allied-Signal, supra* at pp. 784-85 and *Container Corp., supra* at p. 180, n. 19.  
5 Appellant further argues that respondent erroneously looked in error to its unitary business prior to the  
6 sales, rather than its activities at the time the income was generated. (*Id.*)

7 Appellant contends that its interest in Pilgrim's Pride "had no constitutionally relevant  
8 connection with any of [its] ongoing operations in California." In this connection, appellant argues that  
9 its retail products business included shelf-stable products such as cooking oils and that Pilgrim's Pride  
10 did not produce or sell any of the same products. Appellant contends that, although its foodservice  
11 products business purchased product from Pilgrim's Pride, its transitory interest in the poultry process  
12 "could not have contributed to ConAgra's foodservice or ingredients operations in California." (Appeal  
13 Letter, p. 7.)

14 Appellant argues that the sale to Pilgrim's Pride marked its exit from the *fresh* chicken  
15 business, but it remained in the *prepared* chicken business. Appellant contends that, although it  
16 purchased fresh chicken from Pilgrim's Pride for use in its retail and foodservice products businesses,  
17 the purchases were based on arm's-length pricing and it "did not take Pilgrim's Pride stock as partial  
18 consideration for the sale of its chicken business to secure a source of supply of chicken for its prepared  
19 chicken products business." (Appeal Letter, p. 7.)

20 Appellant argues that the opinion in *Hercules Inc. v. Illinois Dep't of Revenue* (Ill. 1st  
21 Dist. 2001) 324 Ill. App. 3d 329 (*Hercules*) is "instructive." Hercules produced polypropylene and, in  
22 1983, formed a joint venture company, Himont, with Montedison, an Italian polypropylene maker.  
23 Hercules and Montedison contributed all of their polypropylene manufacturing assets to the new joint  
24 venture company, Himont, in exchange for interests in the company. Hercules later sold its stake in  
25 Himont in order to avoid a hostile takeover by Montedison. The court found that Hercules' stake in  
26 Himont did not serve an operational function and did not constitute business income. (*Id.*)

27 Appellant argues that *Hercules, supra*, is analogous here because the court found that  
28 transactions between Hercules and Himont were conducted at arm's-length, with Hercules purchasing

1 commodities from Himont at open market prices. Appellant argues that the ConAgra Supply  
2 Agreement with Pilgrim's Pride also provided fair market terms based on average industry indexed  
3 prices and gave it no pricing advantage. Appellant contends that its transactions were arm's-length and  
4 "did not contribute materially to the operation of its own prepared chicken products business." (Appeal  
5 Letter, p. 8.)

6 Appellant argues that, in *ASARCO* the Supreme Court considered whether income from  
7 a subsidiary was apportionable business income and required a finding of a unitary relationship  
8 between the parent and a subsidiary, rather than a unitary relationship between the parent and its  
9 investment in the subsidiaries. Appellant contends that the Court rejected as overbroad the argument  
10 that income received from the stock was apportionable because the stock was acquired, managed, and  
11 disposed for purposes contributing to or relating to the taxpayer's business. Appellant notes that the  
12 Court stated that, in some sense, all of a corporation's operations relate to or contribute to the  
13 corporation's business. (*Id.*)

14 Appellant contends that, in *F. W. Woolworth Co. v. Taxation & Revenue Dep't* (1982)  
15 458 U.S. 354, the Court also rejected the theory that income from a capital investment is subject to  
16 apportionment merely because the investment advanced a business purpose. Appellant further  
17 contends that the Court rejected the corporate purpose theory in *Allied-Signal, supra*, in which  
18 New Jersey attempted to tax gain from the sale of a corporation's minority interest in a nonunitary  
19 affiliate. Appellant cites the Court's reasoning that the acquisition of an intangible asset "pursuant to a  
20 long-term corporate strategy of acquisitions and dispositions does not convert an otherwise passive  
21 investment into an integral operational one." (Appeal Letter, pp. 8 – 9 [quoting *Allied-Signal, supra* at  
22 pp. 776-77].)

23 In view of the foregoing case law, appellant concludes that the fact it disposed of its fresh  
24 chicken business as part of a corporate acquisition and divestiture strategy is immaterial, as is the fact it  
25 used the proceeds from its liquidation of its Pilgrim's Pride holdings to reduce corporate debt.  
26 Appellant argues that neither its corporate strategy or the debt reduction provide a "constitutionally  
27 significant connection" between its ownership of Pilgrim's Pride securities and its "ongoing business  
28 operations in California." (Appeal Letter, p. 9.)

1           *Swift Foods*

2           Appellant argues that it acquired and held its Swift Foods stock “as an investment and  
3 did not have a prearranged plan, commitment, or binding obligation to dispose of its Swift Foods  
4 [s]hares.” Appellant notes that its interest in Swift Foods constituted less than 50 percent of  
5 Swift Foods’ equity and that it appointed only two of Swift Foods’ seven board members. Appellant  
6 argues that Swift Foods was managed independently and that no officers or directors of Swift Foods  
7 was an officer or director of appellant or its affiliates. Appellant further argues that, after the sale, it no  
8 longer engaged in the fresh beef and pork business, and there were no transfers of personnel or  
9 know-how between the two companies. (Appeal Letter, p. 9.)

10           Appellant notes that it and Swift Foods entered into a Preferred Supplier Agreement, but  
11 argues that the terms were at arm’s-length and that it purchased most of its fresh beef and pork from  
12 other suppliers. (Appeal Letter, p. 10.)

13           Appellant states that Hicks Muse exercised an option to acquire its minority interest in  
14 Swift Foods and that appellant also received interest income from the notes received. Appellant states  
15 that it reported the gain on the sale of stock as nonbusiness income which was allocated to Nebraska.  
16 Appellant states that it initially reported the interest income as business income, but then amended its  
17 returns to recharacterize the interest income as nonbusiness income, which was also allocated to  
18 Nebraska. (Appeal Letter, p. 10.)

19           Citing *Allied-Signal* and *Container Corp.*, appellant contends that, because it and  
20 Swift Foods did not operate a unitary business, the only constitutional basis for apportioning the  
21 income would be if there was some link between the capital assets that generated the income and its  
22 activities in California. Appellant argues that it and Swift Foods did not form a unitary business, and  
23 that the Swift Foods notes and stock did not contribute materially to its operations. (Appeal Letter, pp.  
24 10 - 11.)

25           With regard to whether the assets in question contributed materially to its operations in  
26 California, appellant first contends that respondent erroneously argues that the income-producing asset  
27 was its fresh beef and pork business that it sold, rather than the stock and notes that actually generated  
28 the income. Appellant asserts that stocks and notes were not integral to its continuing business

1 operations in California. Appellant states that it historically operated in the packaged foods, food  
2 ingredients, agricultural products, and meat processing businesses. After its divestment of its fresh beef,  
3 pork, and chicken businesses in fiscal years 2003 and 2004, appellant states that it competed only in  
4 retail products, foodservice products, and food ingredient segments and did not compete in the fresh  
5 beef and pork business which was sold to Swift Foods. (Appeal Letter, p. 11.)

6 Appellant separately addresses the note and line of credit issued to finance Swift Foods'  
7 ongoing Monfort operations. Appellant explains that one of the assets it sold to Swift Foods was  
8 Monfort, a cattle feeding operation located in Colorado and Idaho. Appellant states that it extended  
9 credit to Monfort under a line of credit and note which were secured by Monfort stock. Appellant states  
10 that, in September of 2004, it became aware that Monfort would default on its obligations and reached a  
11 settlement in which Swift Foods agreed to transfer its Monfort stock back to appellant. Appellant  
12 further states that it realized a gain on its reacquisition of the Monfort stock, which it classified as  
13 nonbusiness income for the 2005 tax year. Appellant states that, in October 2004, it sold the Monfort  
14 stock to Smithfield Foods, an unrelated third party, with no additional gain or loss recognized. (Appeal  
15 Letter, pp. 11 – 12.)

16 Appellant argues that, after it sold the Monfort operations, the Monfort operations were  
17 operated separately from it, with “complete autonomy.” Appellant contends that there were no shared  
18 employees or directors and that the financing agreements between it and Monfort were conducted at  
19 arm’s-length. Appellant further contends that the shares Monfort pledged as security were unrelated to  
20 appellant’s business operations after it sold Monfort to Swift Foods. (Appeal Letter, pp. 12 – 13.)

#### 21 *California Law*

22 Appellant contends that the capital gains and interest income are properly classified as  
23 “non-business income” under California law because neither type of income satisfies the transactional  
24 test or the functional test, citing *Hoechst Celanese, supra*. Appellant notes that it appears undisputed  
25 that the transactional test is not satisfied. (Appeal Letter, p. 13.)

26 With respect to the functional test, appellant notes that *Hoechst Celanese, supra*,  
27 required an “organic unity” between the property and the taxpayer’s business activities whereby the  
28 property “contributes materially to the taxpayer’s production of business income[,]” quoting *Hoechst*

1 *Celanese, supra* at page 532. Appellant argues that respondent erroneously contends that the income-  
 2 producing asset in this appeal was the fresh chicken, fresh beef, and pork businesses that it sold, rather  
 3 than the stock and notes that produced the income at issue. (Appeal Letter, pp. 13 – 14.)

4 Appellant contends that respondent wrongly relies on *General Dynamics*. Citing the  
 5 *Appeal of Borden, Inc.*, 77-SBE-007, decided February 3, 1988 (*Borden*), the *Appeal of Beck*  
 6 *Industries, Inc.*, 82-SBE-247, decided November 17, 1982, and other precedential Board decisions,  
 7 appellant argues that the Board of Equalization has “clearly stated in numerous rulings” that *General*  
 8 *Dynamics, supra* only arose under the transactional test.<sup>13</sup> (Appeal Letter, p. 14; see also App. Reply  
 9 Br., pp. 4 - 10.)

10 Appellant further argues that *General Dynamics* involved materially different facts.  
 11 Appellant notes that, in *General Dynamics* the taxpayer was engaged in the business of buying, selling,  
 12 and leasing aircraft. Appellant argues that the income was determined to be business income under the  
 13 transactional test because it was generated in the normal course of business. In this appeal, appellant  
 14 contends the sale to Pilgrim’s Pride marked its exit from the fresh chicken business and the sale to  
 15 Swift Foods marked its exit from the fresh beef and pork business. Appellant argues that the  
 16 constitutional standard is whether the stock and notes received were integral to ConAgra’s ongoing  
 17 business operations and that the stock and notes had “absolutely no connection” to its activities in  
 18 California. (Appeal Letter, p. 14; see also App. Reply Br., pp. 4 - 10.)

19 Appellant further argues that *General Dynamics* involved different facts on the grounds  
 20 that, in *General Dynamics* the purchase price for the assets sold (aircraft) was calculated by reference to  
 21 the price later received on the sale of stock later received by the taxpayer on the resale of the aircraft.  
 22 Appellant contends that the taxpayer acquired aircraft which it then resold to a third party. When the  
 23 taxpayer purchased the planes, it and the sellers agreed that any stock received by the taxpayer on a later  
 24 resale of the plane would be sold quickly with the cash proceeds used to determine the price paid by the  
 25 taxpayer on its purchase of the planes. Appellant contends that this case is different because, as of the  
 26 closing dates of the sales of the businesses in question (i.e., the fresh chicken business, and the fresh  
 27

28 <sup>13</sup> Appellant also points to two nonprecedential cases decided by the Board, *Appeal of Rheem Manufacturing Company*, Case  
 No. 485872 and *Appeal of Comcast Cablevision Corp. of California, et al.*, Case No. 424198.

1 beef and pork business), it had no agreement or plan to dispose of the stock and notes received. (Appeal  
2 Letter, pp. 14 – 15; see also App. Reply Br., pp. 4 - 10.)

3 Respondent’s Opening Brief

4 Respondent argues that the functional test for business income is satisfied on the basis  
5 that appellant’s sale of its fresh beef, pork, and chicken businesses disposed of assets that were integral  
6 to its unitary business. Respondent argues that the facts here are similar to those in *General Dynamics*.  
7 Respondent states that the taxpayer in that case was in the business of trading aircraft, and received cash,  
8 notes, and stock on its sale of its aircraft. Respondent states that the stock could only be sold with the  
9 approval of the issuer and was sold four and one-half years after the sale. Respondent notes that the  
10 Board found that the gain from the sale constituted business income. (Resp. Op. Br., p. 4.)

11 Respondent argues that, in *General Dynamics*, the Board focused on R&TC section  
12 25120, which defines “business income” as “income arising from transactions and activity in the regular  
13 course of the taxpayer’s trade or business and includes income from tangible and intangible property if  
14 the acquisition, management, and disposition of the property constitute integral parts of the taxpayer’s  
15 regular trade or business operations.” Respondent notes that its regulations provide that income is  
16 presumed to be business income unless it is clearly classifiable as nonbusiness income. Respondent  
17 observes that Regulation 25120, subdivision (c)(2)-(4), provides as follows: that gain from the sale of  
18 assets is business income if the property was used in the taxpayer’s trade or business; that interest is  
19 business income if the “intangible with respect to which the interest was received arises out of or was  
20 created in the regular course of the taxpayer’s trade or business operations or where the purpose for  
21 acquiring and holding the intangible is related to or incidental to such trade or business operations[;] and  
22 that dividends are business income where the stock arose out of or was acquired in the regular course of  
23 the taxpayer’s trade or business operations or where the purpose for acquiring and holding the stock is  
24 related to or incidental to such trade or business operations.” (Resp. Op. Br., p. 5.)

25 Quoting *Hoechst Celanese, supra* at page 527, respondent states that the focus is on the  
26 income-producing property with the critical inquiry being “the nature of the relationship between this  
27 property and the taxpayer’s ‘business operations.’” Respondent notes that *Hoechst Celanese* held that  
28 the term “integral” requires an “organic unity between the taxpayer’s property and the business

1 activities whereby the property contributes materially to the taxpayer's production of business  
2 income[,]” quoting *Hoechst Celanese, supra*, at page 530. (Resp. Op. Br., p. 6.)

3 Respondent asserts that “[i]t is not disputed in this appeal that Appellant’s income-  
4 producing property, its fresh beef, pork, and chicken businesses, was integral to its business activities  
5 and contributed materially to its business income . . . .” Respondent contends that, by reporting the gain  
6 from the sale as business income, appellant affirmed this integral connection. Respondent contends,  
7 appellant “nevertheless” now contends that subsequent income generated from the consideration it  
8 received should be classified as nonbusiness income. Respondent argues that appellant’s analysis  
9 erroneously argues that the income at issue is nonbusiness income on the basis that the stock and notes  
10 received had no unitary connection with its business activities. Respondent further argues that this  
11 position “misapplies the functional test by attempting to focus on the relationship between the stock and  
12 promissory notes it received from the sale of a portion of its unitary business operations, rather than the  
13 relationship between the assets sold and its unitary business.” (Resp. Op. Br., p. 7.)

14 Respondent argues that this is “the precise issue” addressed in *General Dynamics*,  
15 quoting the Board’s statement in that decision that the income received was “merely a continuation of  
16 the financial dealings connected with the payment for the aircraft” and holding that all of the gain  
17 received, including the gain ultimately realized on the sale of the stock received, should be included in  
18 unitary income.<sup>14</sup> Respondent reiterates its view that the income-producing property is the businesses  
19 that were sold rather than the stock and note received from the sale.<sup>15</sup> Respondent argues that  
20 “Appellant’s receipt of income is identical to the taxpayer’s receipt of income in *General Dynamics*, and  
21 requires identical treatment.” (Resp. Op. Br., p. 7.)

22 Respondent argues that the length of time appellant held the stock before selling it “does  
23 not transmute the classification of its income.” Respondent contends that, like the taxpayer in *General*  
24 *Dynamics*, appellant accepted restricted stock as a partial payment for the sale of its unitary business.

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26 <sup>14</sup> In footnote 3 of its brief, respondent notes that *General Dynamics* applied the transactional test, rather than the functional  
27 test. Respondent argues that its reliance on the case is not illogical as the receipt of income here is “strikingly similar to  
28 Appellant’s receipt of income, and the application of the transactional test in *General Dynamics* should not preclude the  
application of the functional test [here] since both tests are permitted under [R&TC] section 25120(a).”

<sup>15</sup> It appears that respondent is referring to all the notes received in the transactions.

1 Respondent states that the restrictions prohibited appellant from selling any Pilgrim’s Pride stock  
2 within 12 months following the sale, and required the consent of Pilgrim Pride to approve subsequent  
3 sales of more than one-third of the stock during any 12-month period. Respondent states that appellant  
4 sold 10 million shares approximately one month after the initial restriction period ended and,  
5 approximately eight months later, sold its remaining Pilgrim’s Pride shares. Respondent observes that  
6 appellant sold all of the Pilgrim’s Pride stock within 21 months of receiving it and sold all of the  
7 Swift Foods stock within 24 months of receiving it. (Resp. Op. Br., p. 8.)

8 Respondent argues that, in *General Dynamics*, the Board found that the four-and-half  
9 year period in which the taxpayer held the stock received did not cause the gain to constitute  
10 nonbusiness income and noted that the delay did not occur because the taxpayer was holding the stock  
11 for investment, but because the terms of its agreement with the buyer restricted its ability to sell the  
12 stock. Respondent contends that the shorter holding periods here should not cause the gain on the sale  
13 of the stock to be treated as nonbusiness income. Quoting the decision in *General Dynamics*,  
14 respondent concludes that the stock received was “merely the continuation of the financial dealings  
15 from the initial sale.” (Resp. Op. Br., pp. 8 - 9.)

16 Respondent argues that the *Appeal of Consolidated Freightways, Inc.*, 00-SBE-001,  
17 decided September 14, 2000 (*Consolidated Freightways*), also supports its contention that the passage  
18 of time between appellant’s receipt and sale of the stock should not “transmute” the income into  
19 nonbusiness income. Respondent states that the taxpayer in that appeal sold part of its business and  
20 invested the proceeds in long-term securities. Respondent observes that, at the time of the sale, the  
21 proceeds were classified as business income, and the taxpayer’s intent was to use the cash to acquire a  
22 company to expand its business. However, the taxpayer ultimately held the proceeds for seven years  
23 before selling the securities, and the Board still found that the gain on the sale constituted business  
24 income. (Resp. Op. Br., p. 9.)

25 Respondent further contends that the income received from the stock and promissory  
26 note was properly included in appellant’s apportionable tax base. Respondent argues that the income at  
27 issue is a “direct result of the stock and promissory note that Appellant received as partial payment for  
28 its [businesses].” Respondent argues that appellant “concedes” that these businesses were a part of its

1 unitary business and therefore “argues inappropriately that subsequent income generated by the stock  
2 and promissory note are not business income because Appellant was not unitary with the corporations  
3 that issued the stock and promissory note.” (Resp. Op. Br., p. 10.)

4 Respondent states that it “does not contend that the income in question is business  
5 income . . . because Appellant was unitary with the corporations that issued the stock or the note.”  
6 Instead, respondent explains, “its business income determination rests on the facts that the assets sold,  
7 which led to the generation of the income in question, [were] integral to the business operations of  
8 Appellant’s unitary business.” Citing *Allied-Signal, supra*, at page 787, respondent argues that in order  
9 for income to be apportionable, the capital transaction must serve an operational rather than investment  
10 function, but the payee and payor need not be in a unitary relationship. For these reasons, respondent  
11 contends that “. . . the lack of unitary relations between Appellant and the corporations that issued the  
12 stock and promissory note, i.e., the buyers of elements of Appellant’s unitary business, does not affect  
13 the determination that the income . . . is business income.” (Resp. Op. Br., pp. 10 - 11.)

#### 14 Appellant’s Reply Brief

15 Appellant disputes respondent’s contention that the income-producing property is the  
16 businesses sold rather than the stock and note. Appellant argues that Regulation section 25120,  
17 subdivision (c), which respondent cites, clearly focuses on the relationship between the income-  
18 generating intangible property and the taxpayer’s trade or business. The regulation provides that stock  
19 generates business income if it is used in the taxpayer’s business, and interest and dividend income  
20 constitutes business income if the intangible property generating the income was either created in the  
21 regular course of the taxpayer’s business or acquired or held for a purpose related or incidental to such  
22 trade or business. Appellant therefore contends that the focus in this appeal should be on whether the  
23 intangible property that generated the income, the Pilgrim’s Pride stock, Monfort Stock, Swift Foods  
24 stock and the Swift Foods note, were integral to appellant’s California business operations at the time  
25 the income was generated. (App. Reply Br., pp. 3 – 5.)

26 Appellant contends that the FTB relies on a single source to support its position, *General*  
27 *Dynamics*, and notes that the FTB argues that this appeal is “identical” to the facts in *General Dynamics*.  
28 Appellant reiterates that *General Dynamics* involved the transactional test, rather than the functional

1 test, citing *Borden, supra*, and other Board decisions. Appellant argues that the FTB’s reliance on  
2 *General Dynamics* is misplaced because the FTB’s position is based on the functional test and, as the  
3 FTB acknowledges and the decision in *Hoechst Celanese* indicates, the tests are independent and not  
4 interchangeable. (App. Reply Br., pp. 5 – 6.)

5 Appellant reiterates and expands upon its arguments that *General Dynamics* involved  
6 substantially different facts and argues that the decision highlights the flaws in the FTB’s argument.  
7 Appellant notes that, in *General Dynamics*, the purchase agreement between General Dynamics and the  
8 companies selling the aircraft, Swiss Air and SAS, provided that any securities subsequently received by  
9 General Dynamics on the resale of the aircraft would be converted to cash and the amount realized used  
10 to determine the final purchase price paid by General Dynamics to acquire the aircraft. The party that  
11 purchased the aircraft from the taxpayer on resale, Airlift International, Inc. (Airlift), paid in cash and  
12 notes and then subsequently defaulted on the notes, causing General Dynamics to receive Airlift stock  
13 which it then sold pursuant to the terms of its original purchase agreement with Swiss Air and SAS and  
14 used to calculate the final purchase price. Appellant argues that the entire purchase price paid for the  
15 aircraft by General Dynamics, including the gain from the sale of stock received, was charged against  
16 cost of goods sold for both accounting and tax purposes. (App. Reply Br., pp. 6 – 7.)

17 Appellant observes that the Board found that General Dynamics acquired and sold the  
18 aircraft as an integral part of its business and that all of the income from the sale, including the gain  
19 realized on the sale of the Airlift stock, arose in the ordinary course of the taxpayer’s business.  
20 Appellant argues that the Board viewed the receipt of the Airlift stock, which was accepted in  
21 substitution for a defaulted note, as merely a continuation of financial dealings as the stock received was  
22 required by contract to be converted to cash and used to determine the price paid by General Dynamics  
23 for the aircraft. (App. Reply Br., p. 7.)

24 Appellant argues that the facts here are “nothing like those in *General Dynamics*.”  
25 Appellant contends that, unlike General Dynamics, it had no agreement to sell the securities received  
26 and use the proceeds to calculate the purchase price. Appellant argues that the divestiture of its fresh  
27 chicken, beef, and pork businesses were “extraordinary events.” Appellant states that, when it received  
28 the sale proceeds, it determined the value of the intangible assets it received, including the stock and the

1 note, and incorporated that value in its calculation of the gain on the sale of the businesses, which it  
2 reported as business income. Appellant contends that, unlike the transaction in *General Dynamics*, its  
3 sale of its businesses was a closed transaction when it received the stock and note. Appellant asserts  
4 that General Dynamics charged the purchase price for the aircraft, including the gain on the stock sold  
5 that was then paid to Swissair and SAS, to cost of goods sold, and therefore was obligated to treat the  
6 gain on the sale of the Airlift stock as occurring in the ordinary course of its business. Appellant argues  
7 that General Dynamics continued to engage in the same business of buying and selling aircraft after its  
8 transaction closed, while, in contrast, its sale to Pilgrim’s Pride and sale to Swift Foods ended its fresh  
9 chicken, beef, and pork businesses. Appellant concludes that, rather than being identical to the  
10 transaction in *General Dynamics*, its transaction was not “remotely similar” to the *General Dynamics*  
11 transaction. (App. Reply Br., pp. 8 – 9.)

12 With regard to the functional test, appellant argues that the statute contains two key  
13 phrases: “acquisition, management, and disposition of the property” and “integral parts of the  
14 taxpayer’s regular trade or business operations[.]” citing *Hoechst Celanese, supra* at page 338.  
15 Appellant argues that, under *Hoechst Celanese, supra* the first phrase refers the taxpayer’s interest in  
16 and power over the income-producing property, which is not sufficient by itself to satisfy the functional  
17 test. The second phrase requires that the taxpayer’s control and use of the property must be “an integral  
18 part of the taxpayer’s regular trade or business operations.” Appellant notes that, at pages 339 – 340,  
19 *Hoechst Celanese, supra* explained that these terms require that the property contribute materially to the  
20 production of business income so that the property becomes interwoven into and inseparable from the  
21 taxpayer’s regular business activities, with both giving value to the other. Therefore, appellant argues,  
22 “merely acquiring property does not produce business income unless the property is managed as part of  
23 an integrated business.” Appellant argues that if the mere acquisition of property produced business  
24 income, “. . . any stock investment would automatically produce ‘business income’ within the statute.”  
25 (App. Reply Br., p. 10.)

26 Appellant argues that the minority stock interests that it acquired were “in no way  
27 interwoven into and inseparable” from its regular business activities. Appellant contends that the  
28 shares “were acquired for investment purposes only and . . . were never used as collateral on any loan,

1 or in any other way that would benefit [its normal business operations].” Appellant further contends  
 2 that the Swift Foods Note was also “completely unrelated” to its business. (App. Reply Br., p. 10 –  
 3 11.)

4 Appellant argues that “[t]he passage of time between the divestiture transactions and the  
 5 subsequent unrelated investment gains is irrelevant.” Appellant reiterates that the sale of the fresh beef,  
 6 pork, and chicken businesses were closed and complete and have no relevance to whether subsequent  
 7 investment gain should be classified as business income. (App. Reply Br., p. 11.)

8 Appellant contends that, contrary to the FTB’s argument, *Consolidated Freightways*,  
 9 *supra*, was not determined based on the passage of time, but on “the use of the underlying assets . . . .”  
 10 Specifically, appellant contends, the Board held that the income generated from the funds in that case  
 11 constituted business income because it was “earmarked” for the business purpose of making a future  
 12 business acquisition. In contrast, appellant contends, the Stock and Note in this appeal, and the income  
 13 generated from those assets, were not earmarked for a specific need.<sup>16</sup> Therefore, appellant argues,  
 14 *Consolidated Freightways, supra*, “simply has no application in this matter.” (App. Reply Br., pp. 11 –  
 15 12.)

16 With regard to the holding period in *General Dynamics*, appellant argues that the time  
 17 delay had no effect on the classification of the income because the receipt of the stock was merely a  
 18 continuation of the financial dealings from the initial purchase of the aircraft which required that the  
 19 stock be sold in order to determine the purchase price. In *General Dynamics*, appellant argues, the  
 20 ongoing contractual requirements from the purchase of the aircraft caused the stock to be an integral  
 21 part of the taxpayer’s business operations. (App. Reply Br., p. 12.)

22 Appellant contends that the appropriate inquiry is into the use of the assets generating the  
 23 income, “i.e., the Stock and the Note . . . and not some prior funding source from which those assets  
 24 sprang.” Appellant further contends that, contrary to the FTB’s argument, “the prior finalized  
 25 divestiture transactions cannot ‘transmute’ the subsequent investments in the Stock and Note into  
 26 unitary business assets . . . .” Appellant argues that, if the relevant inquiry considered the source of the  
 27

28 <sup>16</sup> In footnote 1 of its reply brief, appellant states that the Pilgrim’s Pride stock, Swift Foods stock, and Monfort stock will sometimes be referred to as the “Stock” and the Swift Foods note will sometimes be referred to as the “Note.”

1 proceeds, instead of the use of the underlying assets, “. . . any use of unitary-tainted funds would forever  
2 preclude the subsequent generation of nonbusiness income.” (App. Reply Br., pp. 12 – 13.)

3 Appellant asserts that, even if the income satisfied California’s statutory standard for  
4 business income, the FTB’s attempt to recharacterize the income as apportionable business income  
5 would violate the United States Constitution’s Due Process and Commerce Clauses. Discussing  
6 *Allied-Signal, supra, MeadWestvaco*, and other Supreme Court cases, appellant asserts that the unitary  
7 business principle allows states to tax an apportioned share of income from an intangible property if  
8 either (i) the payor and payee are engaged in a unitary business or (ii) the asset that generated the  
9 income was used as part of the taxpayer’s unitary business operating in California. Appellant contends  
10 that, if these constitutional standards are not satisfied, income cannot be apportioned under California’s  
11 “functional test” as a matter of federal constitutional law. (App. Reply Br., pp. 14 -15.)

12 Appellant contends that it is undisputed that there is no unitary relationship between  
13 Pilgrim’s Pride and ConAgra and Swift Foods. As a result, appellant contends, the only constitutional  
14 basis for apportionment would be if there was “some link between ConAgra’s ownership of the Stock  
15 and Note and ConAgra’s California unitary business as it existed at the time the income was  
16 generated[,]” citing *Hoechst Celanese, supra* at page 345. Appellant contends that, since it no longer  
17 engaged in the fresh chicken business and fresh beef and pork business after selling those businesses,  
18 “there is absolutely no constitutional connection between ConAgra’s minority interest in Pilgrim’s  
19 Pride, Monfort and Swift Foods stock, and the Swift Note to ConAgra’s unitary business operations at  
20 the time income from the Stock and Note was generated.” Appellant argues that the FTB “fails to  
21 address the applicability of the *Allied-Signal/MeadWestvaco* decisions to this case because it cannot.”  
22 Instead, appellant argues, the FTB “appears to rely solely on *General Dynamics*, which does not address  
23 the constitutional standard[,]” and was decided long before *Allied-Signal* and *MeadWestvaco*, and years  
24 prior to *Hoechst Celanese*. (App. Reply Br., pp. 15 – 18.)

#### 25 Respondent’s Reply Brief

26 Respondent states that there does not appear to be a dispute about the mechanics of the  
27 functional test. Instead, respondent contends, there is a dispute “as to what property is the

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1 income-producing asset for the purpose of applying the functional test to the facts in this appeal.”<sup>17</sup>  
 2 (Resp. Reply Br., p. 1.)

3 Respondent asserts that its position is correct because appellant reported the sale of its  
 4 businesses as giving rise to apportionable business income. Respondent notes that appellant did not  
 5 purchase the stock or note on the open market and that “[i]t was the sale of a portion of its unitary  
 6 business that resulted in Appellant’s ownership of the stock and promissory note.” Respondent asserts  
 7 that “[t]he sale of a portion of Appellant’s unitary business and Appellant’s final receipt of income, the  
 8 income generated by the stock and promissory note, are part of the same transaction and should not be  
 9 viewed as separate, unrelated events.” (Resp. Reply Br., p. 2.)

10 Respondent argues that the restrictions placed on the sale of the stock “do not transmute  
 11 the classification of Appellant’s income into nonbusiness income when the stock was eventually sold.”  
 12 Respondent further argues that appellant “knowingly bargained” to receive assets that could not sell  
 13 immediately, “and then followed a course of conduct consistent with disposing of the stock as soon as  
 14 the restrictions and market conditions allowed.” Respondent contends that “Appellant’s ownership of a  
 15 promissory note should not alter its classification.” Respondent argues that a promissory note is a  
 16 promise to pay later, and argues that “. . . the income that results from the note relates directly to the sale  
 17 from which the note originated.” (Resp. Reply Br., p. 2.)

18 Respondent contends that its application of the functional test “does not violate any  
 19 constitutional standard.” Respondent argues that *Allied-Signal* held that “in order for income to be  
 20 apportionable, the capital transaction at issue must serve an operational rather than an investment  
 21 function,” citing *Allied-Signal* at page 787. Respondent contends that, in *MeadWestvaco*, the  
 22 Supreme Court noted that it did not intend for the operational function concept to become a new ground  
 23 for apportionment, but reaffirmed *Allied-Signal*’s crucial holding that an asset can be a part of a unitary  
 24 business even if a unitary relationship between the payor and payee is lacking. Respondent argues that  
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26 <sup>17</sup> In footnote 1 of its reply brief, respondent acknowledges that, as asserted by appellant, respondent did accept appellant’s  
 27 classification of dividend income from UAP Holding Corp. (UAP) shares as business income for the 2005 tax year, but  
 28 states that each tax year should stand on its own. As background, appellant had previously asserted that respondent allowed  
 it to treat dividend income received on Pilgrim’s Pride stock and UAP Holding Corp. (UAP) as nonbusiness income for the  
 2005 tax year. (See Appeal Letter, fn. 2.) Respondent initially responded that each tax year stands on its own and denied  
 that the dividends from UAP were allowed as nonbusiness income. (See Resp. Op. Br., fn. 1.)

1 the capital transaction at issue was a sale of a portion of appellant’s unitary business, and that appellant  
2 conducted unitary operations in California, so that respondent’s action satisfies the required  
3 constitutional standards. (Resp. Reply Br., pp. 2 – 4.)

4 Respondent argues that *General Dynamics* “has not been overruled by a federal or state  
5 court of appellate jurisdiction and controls the issue in this appeal.” Appellant notes that, in *Hoechst*  
6 *Celanese*, the California Supreme Court found that the pension plan assets that generated the reversion  
7 income served an operational purpose and therefore generated apportionable business income.  
8 Respondent argues that, in *General Dynamics*, the stock received was subject to restrictions.  
9 Respondent notes that the Board held that the receipt of income from the stock constituted “merely a  
10 continuation of the financial dealings connected with the payment of the aircraft” and held that all the  
11 gain, including the stock gain, was business income because the sale of the aircraft was an integral part  
12 of the taxpayer’s business. Respondent argues that the Board’s decision did not violate any  
13 constitutional standard and constitutes “precedential authority that mandates classifying the income at  
14 issue as business income.” (Resp. Reply Br., pp. 4 – 5.)

15 Respondent further argues that “[a]lthough [the] Board determined that the income in  
16 *General Dynamics* was business income under the transactional test, that determination does not  
17 preclude *General Dynamics* from being applied to the facts at issue in this appeal.” Respondent also  
18 contends that “[w]hile [the] Board did not explicitly apply the functional test, its opinion emphasized  
19 the necessary integral connection between the income and the taxpayer’s property which is a central  
20 part of the functional test” by stating that “[t]he acquisition, retention, and disposition of the Airlift  
21 stock was so inextricably entwined with appellant’s unitary business operations . . .” that the gain from  
22 the stock must be business income. On this basis, respondent argues that “the precedent of *General*  
23 *Dynamics* is not limited only to the transactional test.” Respondent argues that, in *General Dynamics*,  
24 the transaction that led to the acquisition of the stock occurred in the regular course of the taxpayer’s  
25 business. In this appeal, respondent contends, “Appellant’s disposition of a portion of its unitary  
26 business operations, which led to the acquisition of the stock and promissory note in question, did not  
27 occur in the regular course of its trade or business, but rather, arose from the sale of assets that were  
28 admittedly an integral part of the taxpayer’s regular trade or business.” Respondent asserts that an asset

1 may be integral to a taxpayer's trade or business under either the transactional test or the functional test  
 2 and that "[e]ither way, so long as such a relationship exists, income arising from such an asset with the  
 3 requisite connection must be characterized as business income." (Resp. Reply Br., pp. 6 – 7.)

4 Respondent concludes that appellant's receipt of income "is similar to the fact pattern in  
 5 *General Dynamics*" in that in both cases "assets were acquired by the taxpayers from a disposition of  
 6 assets integral to [their] business activities in California." Respondent reiterates its view that *General*  
 7 *Dynamics* is binding precedent involving similar facts and should be followed. (Resp. Reply Br., p. 7.)

8 Appellant's Supplemental Brief

9 In its supplemental brief, appellant reiterates its argument that the income-producing  
 10 assets at issue in this appeal are the stock and the notes, rather than the businesses sold. Appellant  
 11 argues that respondent's argument, if taken to its "logical conclusion," would require that any income  
 12 derived from an asset acquired with cash received as consideration for the sale of a business asset be  
 13 treated as apportionable business income. Appellant also reiterates its position that *General Dynamics*  
 14 involved different facts, in that the price to be paid by the taxpayer in that case was calculated by  
 15 reference to the proceeds from the sale of the stock received, and also in that *General Dynamics* applied  
 16 the transactional test, rather than the functional test. Appellant emphasizes that, in contrast to the facts  
 17 in *General Dynamics*, it had no prearranged plan to sell the stock and notes received. (App. Supp. Br.,  
 18 pp. 2 – 5.)

19 Appellant further reiterates its position that the income at issue did not arise from the  
 20 acquisition, management, and disposition of property that constituted integral parts of ConAgra's  
 21 regular trade or business.<sup>18</sup> Appellant argues that, while respondent recognizes that the capital gain,  
 22 dividends, and interest arose from the stock and notes, respondent still "insists that for purposes of the

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26 <sup>18</sup> In footnote 5 of its supplemental brief, appellant notes that respondent's reply brief acknowledges that it accepted  
 27 appellant's classification of dividend income from UAP as nonbusiness income for the 2005 tax year but respondent states  
 28 that each tax year stands on its own. Respondent states that it sold business assets to UAP in return for preferred stock in a  
 transaction that was the same as the transactions in this appeal. Appellant argues that "If the 2005 tax year stands on its own,  
 the point is that these similar dividends were not treated consistently by California under audit for that year."

1 functional test the income-producing properties . . . are the previously divested [businesses].”<sup>19</sup>

2 Appellant contends that the FTB’s argument is a “red herring.” (App. Supp. Br., pp. 6 - 7.)

3 Appellant argues that there is no dispute that the dividends, interest, and gains at issue  
4 were generated from the stock and notes rather than the sale of the businesses. Appellant reiterates that  
5 the sale of the businesses were “extraordinary events,” which terminated the operation of the businesses  
6 by ConAgra. Appellant argues that the FTB acknowledges that the sale of the businesses generated  
7 apportionable business income, and states that, when it determined the tax due, it included in the sales  
8 price the value of the stock and notes received. Appellant further contends that, “[b]ecause there is no  
9 issue with regard to the treatment of the gain on the prior sales of the businesses, the sole focus should  
10 be on the actual assets that generated the dividends, interest and gains in issue, and not on the  
11 [businesses sold] which were previously disposed of and taxed.” (App. Supp. Br., p. 7.)

12 Appellant asserts that respondent’s argument also “has no basis in California law.”  
13 Citing *Hoechst Celanese* and Regulation 25120, subdivision (c), appellant argues that the functional  
14 test requires an analysis of the relationship between the business and the intangible property that  
15 produced the income. Citing the *Appeal of Fibreboard Corporation*, 87-SBE-002, decided January 6,  
16 1987, appellant argues that the focus for the functional test is whether the asset was integrally related to  
17 the unitary business “at the time the income was generated, not at any previous time.” Appellant  
18 asserts that “[t]here is no authority in California law which would look to assets that have already been  
19 divested for purposes of applying the functional test.” (App. Supp. Br., pp. 8 – 9.)

20 Appellant states that respondent suggests at page two of its reply brief that its position  
21 might have been different if the stock and notes were purchased on the open market. Appellant argues  
22 that “[r]espondent is essentially arguing that any asset received upon the sale of a unitary business is a  
23 unitary asset[,]” and that this argument is “unfounded.” Appellant contends that “[t]he prior finalized  
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25 <sup>19</sup> In footnote 6 of its supplemental brief, appellant states that respondent’s reply brief at page 2 argues that the sale of the  
26 businesses and the receipt of the proceeds from the sale of the stock are part of the same transaction and cannot be treated  
27 separately. Appellant argues that “it appears that the FTB is attempting to apply what is commonly referred to as the step  
28 transaction doctrine without speaking to any one of the three alternative tests which courts have . . . applied when deciding to  
invoke the doctrine . . .” Appellant argues that the step transaction is inapplicable to this appeal under any of the relevant  
tests because, when it sold the businesses, it had no prearranged plan, binding commitment, or obligation to sell the shares or  
to acquire the Monfort stock in lieu of foreclosure.

1 divestiture transactions cannot ‘transmute’ the subsequent investments in the stock and notes into  
2 unitary business assets . . . when those assets are not managed as part of the unitary business.”  
3 Appellant argues that if respondent’s argument were accepted “. . . any use of unitary-tainted funds  
4 would forever preclude the subsequent generation of nonbusiness income.” (App. Supp. Br., p. 9.)

5 Appellant reiterates its position that the constitutional standards for apportionment were  
6 not met under *Allied-Signal* and *MeadWestvaco*. Appellant contends that respondent “interchanges”  
7 and confuses California’s statutory tests, the functional test and the transactional test, with the  
8 constitutional tests. In this connection, appellant observes that *Hoechst Celanese* evaluated the  
9 statutory tests separately from the constitutional tests. Appellant argues that “[i]f the constitutional test  
10 is not satisfied, it is irrelevant whether the income is apportionable under California’s functional test.”  
11 (App. Supp. Br., p. 10.)

12 Appellant argues that, “while the functional test may be similar to the constitutional test,  
13 it is not the same.” Appellant contends that, as the case law has been clarified by *MeadWestvaco*, “. . .  
14 an item of income is subject to apportionment either if the taxpayer and the entity that generated the  
15 income are engaged in a unitary business or if the asset itself that generated the income was used as part  
16 of the taxpayer’s unitary business operating in California.” (App. Supp. Br., p. 11.)

17 Appellant asserts that neither party disputes that there is no unitary business relationship  
18 between ConAgra and Pilgrim’s Pride, ConAgra and Swift Foods, and ConAgra and Monfort. As a  
19 result, appellant contends, the only constitutional basis for apportioning the income in dispute would be  
20 there was a link between ConAgra’s ownership of the stock and the Swift Foods note and its unitary  
21 business. Appellant argues that the determination of whether the stock and note were integral to its  
22 business is made at the time the income is generated. Quoting *Hoechst Celanese, supra* at page 345,  
23 appellant states that an operational function is served if the asset helps the taxpayer “make better use of  
24 its existing business-related resources.” Appellant argues that it never owned the stock or notes at a  
25 time when it was engaged in the fresh beef and pork and chicken businesses, as it only received the  
26 stock and note when it sold those businesses. Appellant therefore contends that there can be no  
27 constitutional connection between the stock and note and its business operations at the time the income  
28 from the stock and note was generated. (App. Supp. Br., pp. 12 – 13.)

1 Appellant argues that, as pointed out its in prior briefing, *General Dynamics* involves  
2 different facts. Appellant emphasizes that, in *General Dynamics*, the price to be paid by GALCO (the  
3 General Dynamics division that conducted the transaction) for the aircraft was contingent on the price  
4 obtained on the sale of the stock. In contrast, appellant argues, it “never had any requirement that [it]  
5 sell the [stock at issue here].” Appellant further notes that *General Dynamics* did not engage in a  
6 separate constitutional analysis and argues that the Board must make its own determination as to  
7 whether those standards have been applied in light *Allied-Signal*, *MeadWestvaco*, and *Hoechst Celanese*.  
8 Appellant also asserts that respondent’s constitutional analysis with regard to the facts of *General*  
9 *Dynamics* is flawed because respondent focuses on the transaction (the sale and purchase of the aircraft)  
10 instead of focusing on the asset sold (the Airlift stock). (App. Supp. Br., pp. 14 – 15.)

11 Appellant argues that in this appeal respondent “tries to apply *General Dynamics*” by  
12 focusing on the transaction that resulted in the acquisition of the stock and notes, rather than, as required  
13 by the functional test, focusing on the property that generated the income and whether the property is  
14 used as part of the business. Appellant argues that respondent’s analysis therefore misapplies the  
15 functional test and erroneously argues that *General Dynamics*, a case based on the transactional test, is  
16 applicable. (App. Supp. Br., pp. 15 – 16.)

17 STAFF COMMENTS

18 The California Supreme Court has held that, under the functional test, income is business  
19 income “if the taxpayer’s acquisition, control and use of the [income-producing] property contribute  
20 materially to the taxpayer’s production of business income[,]” such that “the income-producing property  
21 becomes interwoven into and inseparable from the taxpayer’s business operations.” (*Hoechst Celanese*,  
22 *supra*, 25 Cal. 4th 508, 532.) At the hearing, respondent will want to explain further how the relevant  
23 legal authorities and facts in this appeal support its position that, for purposes of the functional test, the  
24 relevant income-producing properties are the business properties that appellant sold in return for stock

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1 and notes, rather than the shares of stock and notes themselves.<sup>20</sup> Although respondent's argument  
2 focuses on the relationship of the operating assets sold to appellant's business, both parties should be  
3 prepared to address any questions that the Board may have regarding the relationship, if any, between  
4 the notes and stock and appellant's business operations.

5 Respondent will want to address further appellant's argument that *General Dynamics* is  
6 distinguishable because it did not apply the functional test, and because the purchase agreement in  
7 *General Dynamics* provided that if the taxpayer subsequently received stock on the resale of the aircraft,  
8 the stock would be sold and the resulting cash proceeds would be used to determine the purchase price  
9 paid by the taxpayer. To the extent respondent places emphasis on the fact that the stock received by  
10 appellant was subject to restrictions on transfer, it should address the fact that the decision on petition  
11 for rehearing in *General Dynamics, supra, 75-SBE-063*, states that the restrictions on transfer present in  
12 that appeal were not the basis of the Board's holding.

13 Both parties should be prepared to discuss whether distinctions might be drawn between  
14 the transactions and assets at issue. In the Pilgrim's Pride transaction, appellant received a seven  
15 percent equity interest in an existing large publicly-owned company, and the assets sold to Pilgrim's  
16 Pride by appellant made up a relatively small portion of Pilgrim's Pride assets. Respondent should be  
17 prepared to address whether the gain recognized by appellant on its sale of Pilgrim's Pride stock was  
18 attributable to a significant increase in the price at which Pilgrim's Pride stock traded on the public  
19 markets and, if so, whether this should be a factor in considering whether an apportioned share of the  
20 gain should be taxed by California as business income rather than being treated as investment income.

21 In connection with the Swift Foods transaction, appellant received a 46 percent interest  
22 in a newly formed private joint venture, and the business assets sold to Swift Foods by appellant  
23 apparently constituted the new venture's sole or primary operating assets. Appellant had a right to  
24 force the sale of the new venture after five years.

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26 <sup>20</sup> In this connection, respondent should be prepared to provide its view of the circumstances in which, in applying the  
27 functional test to a sale of stock, it is appropriate to focus on the relationship between the taxpayer's business and the assets  
28 that were sold in exchange for the stock, as opposed to focusing on the relationship between the taxpayer's business and the  
stock sold. Staff notes that there have been many appeals in which the Board analyzed whether stock that was sold  
constituted an integral part of the taxpayer's business. (See, e.g., *Appeal of CTS Keene, Inc., et al.*, 93-SBE-005, Feb. 10,  
1993, *Appeal of VSI Corporation*, 91-SBE-002, May 2, 1991; *Appeal of American Biltrite*, 92-SBE-026, Nov. 19, 1992.)

1           In the Monfort portion of the Swift Foods transaction, appellant loaned Swift Foods all  
2 of the funds necessary for Swift Foods to purchase appellant’s cattle operations and extended a line of  
3 credit to fund Monfort’s operations. Did these loans materially contribute to appellant’s business  
4 operations by sustaining a needed supplier of cattle that may have been thinly capitalized? With regard  
5 to loans extended to Monfort, the parties should be prepared to discuss whether a distinction should be  
6 drawn between interest income from loans extended by appellant to fund Monfort’s operations and  
7 interest earned on notes received by appellant as consideration for its sale of Monfort.

8           Appellant should be prepared to discuss the value placed on the Swift Foods stock when  
9 appellant received it, how that value was determined by appellant and Hicks, Muse and/or Swift Foods,  
10 and the factors causing appellant to recognize a taxable gain of approximately \$40 million when it sold  
11 the stock. Similarly, appellant should be prepared to discuss the value placed on the Monfort stock  
12 when it sold the stock to Swift Foods, how that value was determined, the factors causing appellant to  
13 recognize a \$35 million gain when it reacquired the stock and how the stock came to be resold  
14 approximately a month after reacquisition. In this connection, it would be helpful if appellant could be  
15 prepared to discuss how the value used to calculate this \$35 million gain was determined, as well as the  
16 tax treatment of the Monfort debt (as the Monfort stock was accepted in lieu of foreclosure when it  
17 became apparent that Monfort would default on its debt obligations).

18           Both parties should be prepared to discuss whether any of these factual distinctions  
19 between the assets and transactions may be relevant in determining which assets generated the income  
20 at issue and whether the income-generating asset being considered formed an integral part of  
21 appellant’s business operations.

22           Appellant should be prepared to address the fact that *Hoechst Celanese* indicates that  
23 legal ownership of the income-generating assets is not necessary as long as the acquisition, control, and  
24 use of the assets “contribute[s] materially to the taxpayer’s production of business income so that the  
25 property becomes interwoven into and inseparable from the taxpayer’s business.” (*Hoechst Celanese*,  
26 *supra*, 25 Cal. 4th at pp. 527 – 529.) Appellant should be prepared to address the relevance, if any, of

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1 this analysis to the assets it sold.<sup>21</sup>

2 Both parties should be prepared to discuss the treatment of the income by other states.  
3 Appellant has provided an exhibit regarding the treatment of the transactions by other states. Staff's  
4 understanding is that the matter is currently under examination or subject to dispute in some states,  
5 some states have accepted the treatment (e.g., Pennsylvania), and appellant has settled the matter with  
6 some states.

7 At a pre-hearing conference, appellant indicated that it viewed *Robert Half International,*  
8 *Inc. v. Franchise Tax Board (Robert Half)* (1998) 66 Cal.App. 4th 1020, as relevant authority, and noted  
9 that it was cited in *Hoechst Celanese*. In *Hoechst Celanese, supra*, at page 533, the California Supreme  
10 Court noted that the Court of Appeal in *Robert Half* found that losses incurred from the repurchase of a  
11 stock warrant constituted nonbusiness income. The Court explained that, although the Court of Appeal  
12 mistakenly focused on the extraordinary nature of the transaction, it reached the correct result under the  
13 functional test because “[t]he taxpayer’s control and use of the warrants did not contribute materially to  
14 the production of any business income and were separate and distinct from the taxpayer’s business  
15 operations.” At the hearing, the parties should be prepared to provide their views with regard to  
16 *Robert Half*.

#### 17 Additional Evidence

18 At staff’s request, the parties provided as additional exhibits some of the relevant  
19 background documents, such as the sale agreements for the transactions with Swift Foods and Pilgrim’s  
20 Pride. These materials were distributed as additional exhibits on May 1, 2015. Staff thanks the parties  
21 for their cooperation in providing the requested materials for the record.

22 If either party has any additional evidence or exhibits to provide, staff requests that,  
23 pursuant to the Rules for Tax Appeals, Regulation 5523.6, such evidence be provided to the Board’s  
24 Board Proceedings Division at least 14 days prior to the hearing, in order to facilitate a productive  
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26 <sup>21</sup> Appellant has indicated that Monfort was operated independently. Appellant should be prepared to discuss further its  
27 relationship with Monfort, and to address whether, through the line of credit and debt extended to Monfort, its supply  
28 agreement, and any other continuing connections to Monfort, it was able to exercise influence over and use the cattle  
operations for its unitary business. In the Swift Foods transaction as a whole, did appellant’s participation in the newly  
formed Swift Foods joint venture effectively constitute a way for appellant to segregate and repackage the pork and beef  
business into a separate entity for later sale?

1 hearing.

2 Section 40 Matter

3 As noted above, this matter is subject to Revenue and Taxation Code section 40.  
4 Therefore, within 120 days from the date the Board's vote to decide the appeal becomes final, a written  
5 opinion (i.e., Summary Decision or Formal Opinion) must be published on the Board's website.  
6 (Cal. Code Regs., tit. 18, § 5552, subds. (b), (f).) The Board's vote to decide the appeal will become  
7 final 30 days following the date of the Board's vote, except when a petition for rehearing is filed within  
8 that period.<sup>22</sup> (Cal. Code Regs., tit. 18, § 5460, subd. (a).)

9 Following the conclusion of this hearing, if the Board votes to decide the appeal, but  
10 does not specify whether a Summary Decision or a Formal Opinion should be prepared, staff will  
11 expeditiously prepare a nonprecedential Summary Decision and submit it to the Board for consideration  
12 at a subsequent meeting. (Cal. Code Regs., tit. 18, § 5551, subd. (b)(2).) Unless the Board directs  
13 otherwise, the proposed Summary Decision would not be confidential pending its consideration by the  
14 Board (Cal. Code Regs., tit. 18 § 5551, subd. (b)(5)); accordingly, it would be posted on the Public  
15 Agenda Notice for the meeting at which the Board will consider and vote on the Summary Decision.

16 A taxpayer may request that the Board hold in abeyance its vote to decide the appeal so  
17 the taxpayer may review the Board's written opinion prior to the expiration of the 30-day period for the  
18 filing of a petition for rehearing. If the vote is held in abeyance, the proposed Summary Decision will  
19 be confidential until it is adopted by the Board. (Cal. Code Regs., tit. 18, § 5551, subd. (b)(5).) Any  
20 request that the Board's vote be held in abeyance should be made in writing to the Board Proceedings  
21 Division prior to the hearing or as part of oral argument at the hearing. Any such request would then be  
22 considered by the Board during its deliberations on the appeal.

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28 <sup>22</sup> If a petition for rehearing is filed, the Board's decision will not become final, and no written opinion under Section 40 will be considered until after the petition for rehearing is decided.