STATE BOARD OF EQUALIZATION
CORPORATION FRANCHISE TAX APPEAL

CALIFORNIA STATE BOARD OF EQUALIZATION

SUMMARY DECISION UNDER REVENUE AND TAXATION CODE SECTION 40

In the Matter of the Appeal of: **CONAGRA FOODS, INC.**	Case No.'s 597512, 785058, 799162 Oral hearing date: May 27, 2015 Decision rendered: June 26, 2015 Publication due by: October 24, 2015

Representing the Parties:

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

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

Counsel for the Board of Equalization: Grant S. Thompson, Tax Counsel IV

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LEGAL ISSUE

Whether certain interest, dividend, and capital gain income constitutes business income.

BACKGROUND AND FINDINGS OF FACT

In 2002 and 2003, appellant sold its fresh beef and pork operations and its chicken processing business, in two separate taxable transactions. In the 2002 sale of the beef and pork operations, the buyer was a new joint venture, S&C Holdco, Inc. (Swift Foods). In the 2003 sale of the chicken processing business, the buyer was Pilgrim's Pride Corporation (Pilgrim's Pride).

This appeal concerns the proper treatment of income that appellant later earned, in tax years ending in May of 2004, 2005 and 2006, from stock and notes that appellant received in connection with the transactions, and to a lesser extent from amounts earned in connection with amounts loaned to Monfort Finance Company (Monfort) on a line of credit in connection with the Swift Foods transaction.

In the Swift Foods transaction, appellant contributed its fresh beef and pork operations to Swift Foods, a new joint venture organized by Hicks, Muse, Tate & Furst (Hicks Muse), a private equity firm. In connection with the transaction, appellant received $766 million in cash, a 46 percent equity interest in Swift Foods, a $150 million PIK (payment in kind) note issued by a subsidiary of Swift Foods, and a $30 million note issued by Monfort. Monfort was a subsidiary of appellant that operated cattle feed lots and was sold to Swift Foods in the transaction. Appellant also extended a $350 million line of credit to Monfort, through which approximately $266 million was borrowed by Monfort. The purchase price for Monfort was entirely financed by appellant through debt. In addition to the $150 million received for the assets sold, appellant also purchased a $150 million 12.5 percent senior subordinated note issued by a subsidiary of Swift Foods, which effectively reduced the amount of cash received by appellant from $766 million to $616 million. The remaining 54 percent of Swift Foods was owned by a partnership formed by Hicks Muse and Greeley Investments, LLC.

The consideration received by appellant was stated to be equivalent to the book value of the business sold. A term sheet prepared for the Swift Foods joint venture states that appellant would establish reserves and a line of credit in order to reduce the book value of Monfort to $30 million, which would be paid to appellant through the issuance of a promissory note. A "Deal Overview" prepared for the joint venture states that appellant would receive $300 million in a subsequent liquidation of the Monfort cattle business and that appellant would manage and wind down cattle feeding operations. As of May 30, 2004, appellant's notes receivable from the cattle feeding business totaled approximately $315 million.

In September 2004, approximately two years after appellant's entry into the joint venture, appellant reacquired the Monfort stock in lieu of foreclosing on loans extended to Monfort, and recognized a gain of approximately $35 million. Approximately a month later, appellant sold Monfort to a third party for no additional gain or loss. In addition, during the years at issue, appellant recognized interest income from the Monfort line of credit and the $30 million note. Also in September 2004, Hicks Muse exercised an option to purchase appellant's interest in Swift Foods, generating approximately $40 million of gain for appellant. Appellant also recognized interest income from the $150 million PIK note issued to appellant.

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In connection with the joint venture, appellant entered into a stockholders agreement which provided for the election of directors, registration rights for the stock, restrictions on transfer, and other rights regarding the sale of Swift Foods common stock and the Monfort cattle feeding business. Appellant appointed two of Swift Foods' seven board members. Appellant had a right to force the sale of Swift Foods after five years. Hicks Muse received an option to buy-out appellant's interest in the Swift Foods joint venture. As noted above, Hicks Muse exercised that option approximately two years after appellant entered into the joint venture. Swift Foods also entered into a supplier agreement with appellant under which it would provide fresh beef and pork products at fair market prices.

In the Pilgrim's Pride transaction, appellant sold its chicken processing business to Pilgrim's Pride, in return for cash and shares of Pilgrim's Pride stock valued at approximately $246 million. The stock represented a minority interest in Pilgrim's Pride, which was and is a large public company with shares traded on the NASDAQ stock market. The value of the Pilgrim's Pride stock was determined through an independent appraisal conducted by Houlihan Lokey Howard & Zukin Financial Advisors, Inc. Appellant and Pilgrim's Pride entered into a supply agreement that made Pilgrim's Pride its preferred provider of poultry products, with sales made on arm's-length terms. Appellant's ability to sell its Pilgrim's Pride stock was restricted by a registration rights agreement that also provided Pilgrim's Pride would register the stock for sale on public stock markets. Appellant and Pilgrim's Pride were managed and operated independently, with no sharing of officers or directors.

During the years at issue, appellant received dividends on its shares of Pilgrim's Pride stock and recognized gain when it sold the shares.

Appellant filed refund claims on original and/or amended tax returns for the 2004 and 2005 tax years. Pursuant to Revenue and Taxation Code (R&TC) section 19331, the Board has jurisdiction to review the claimed refunds for the 2004 and 2005 tax years on the basis of the deemed denial of those refund claims. For the 2005 tax year, following an audit and protest, the Franchise Tax Board (respondent or FTB) issued a Notice of Action (NOA) dated November 6, 2013, proposing $1,535,460 of additional tax, which appellant timely appealed. The appeal for the 2006 tax year arises from appellant's timely appeal from respondent's September 21, 2011 NOA, which partially denied appellant's claim for refund.

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APPLICABLE LAW

R&TC section 25120, subdivision (a) defines "business income" as "income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations." R&TC section 25120, subdivision (d) defines "nonbusiness income" as "all income other than business income."

In *Hoechst Celanese v. Franchise Tax Board* (2001) 25 Cal.4th 508, 532, the California Supreme Court explained that, under the functional test for business income, income is business income "if the taxpayer's acquisition, control and use of the [income-producing] property contribute materially to the taxpayer's production of business income[,]" such that "the income-producing property becomes interwoven into and inseparable from the taxpayer's business operations."[1]

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

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

> (2) Gains or losses from sales of assets. Gain or loss from the sale, exchange or other disposition of real or tangible or intangible personal property constitutes business income if the property while owned by the taxpayer was used in the taxpayer's trade or business. . . .
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> (3) Interest. Interest income is business income where the intangible with respect to which the interest was received arises out of or was created in the regular course of the taxpayer's trade or business operations or where the purpose for acquiring and holding the intangible is related to or incidental to such trade or business operations. . . .
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> (4) Dividends. Dividends are business income where the stock with respect to which the dividends are received arises out of or was acquired in the regular course of the

[1] Under the transactional test for business income, income may also constitute business income if it arises from transactions and activity in the regular course of the taxpayer's trade or business. Respondent's proposed assessment and its arguments on appeal were based on the functional test, and the evidentiary record on appeal does not establish a basis for the application of the transactional test. Accordingly, we do not address it further.

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> taxpayer's trade or business operations or where the purpose for acquiring and holding the stock is related to or incidental to such trade or business operations. . . .

FURTHER FINDINGS OF FACT, ANALYSIS & DISPOSITION

As noted above, for purposes of determining whether income is business income, it must be determined whether the income-producing property was an integral part of the taxpayer's regular trade or business operations.

The record indicates that appellant's Pilgrim's Pride stock was not an integral part of its regular trade or business operations. Appellant received the stock when it exited its chicken processing business by selling the business to Pilgrim's Pride in a taxable transaction. The fair market value of the stock received in the transaction was determined through an independent appraisal taking into account the price of Pilgrim's Pride's public traded stock, with the application of discounts (e.g., to reflect restrictions on trading). When appellant acquired the Pilgrim's Pride stock, it ended its participation in its former chicken business interest and obtained a minority interest in an independent publicly-owned company. Pilgrim's Pride was a large company with international operations and substantial operating assets apart from appellant's chicken processing business. Although appellant entered into a supply agreement with Pilgrim's Pride, the agreement merely provided that appellant would offer Pilgrim's Pride the first opportunity to provide chicken to appellant at fair market value and in volumes similar to past volumes or in such volumes as the parties might mutually agree. There is no evidence suggesting that appellant's Pilgrim's Pride stock allowed it to exercise continued management or control over any assets that it sold to Pilgrim's Pride. Appellant sold its Pilgrim's Pride stock as soon as it was able to do so, and, primarily as a result of the substantial appreciation in the price of the publicly traded stock of Pilgrim's Pride (and also as a result of dividends), appellant recognized substantial income. On the evidentiary record before us, the income received by appellant from its Pilgrim's Pride stock constitutes nonbusiness income.

The remaining income at issue arose from stock and debt interests received by appellant in

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connection with the Swift Foods joint venture.[2] In the Swift Foods transaction, rather than receiving an interest in a publicly owned company with substantial operations, appellant obtained equity and debt interests in a newly formed private joint venture that was formed to hold appellant's fresh beef and pork operations, which constituted all or substantially all of the operating assets of the new joint venture. Appellant provided debt financing for the new venture and continued to use fresh beef and pork from the operations as an integral part of its packaged food business. Appellant's sale of its Monfort cattle operations to the joint venture was entirely seller-financed by appellant, and appellant continued to fund cattle operations through a $350 million line of credit that would be repaid as cattle and assets were sold. The joint venture contemplated that appellant would manage and wind down the cattle operations, and, in fact, when the cattle operations did not generate sufficient funds to repay the funding provided by appellant, appellant reacquired the Monfort stock and sold it. The foregoing evidence indicates that appellant's equity and debt interests in the joint venture materially contributed to its production of business income.

In sum, unlike appellant's receipt of Pilgrim's Pride stock, which ended appellant's participation in the chicken processing business in exchange for stock in a publicly owned company, the notes and equity received in the Swift Foods transaction appear to have repackaged appellant's fresh beef and pork operations into a joint venture interest that appellant continued to hold and use as an integral part of its business until late in 2004. As a result, appellant has not carried its burden of showing that income earned by it during the years at issue from the debt and equity it received in connection with the joint venture is "clearly classifiable" as nonbusiness income under Regulation 25120, subdivision (a).

[2] Specifically, the income at issue consists of (1) interest on a cattle feeding line of credit, (2) interest from two notes, (3) gain from appellant's sale of its equity interest in the joint venture, and (4) gain recognized by appellant when it reacquired the stock of its former subsidiary, Monfort (in lieu of foreclosing on debt secured by the Monfort stock).

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ORDER

Pursuant to the analysis of law and facts above, the Board ordered that the actions of the FTB for the years at issue be reversed as to the income recognized from the Pilgrim's Pride stock and sustained as to the income recognized from appellant's equity and debt interests in the Swift Foods joint venture, including the gain recognized on appellant's reacquisition of its Monfort stock. Adopted at Culver City, California, on this __ day of August, 2015.

_____, Chairman

_____, Member*

_____, Member

_____, Member*

_____, Member†

*Members Runner and Harkey do not join in the decision with respect to income earned in connection with debt and equity received in the Swift Foods transaction.

†For Betty T. Yee, pursuant to Government Code section 7.9.

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