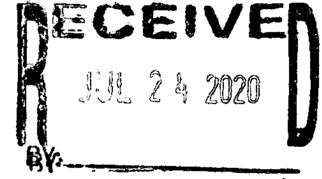
IN THE ILLINOIS INDEPENDENT TAX TRIBUNAL
STATE OF ILLINOIS



efiled 7/23/20

SMITHFIELD PACKAGED MEATS CORP.,	
Petitioner,	
v.	No. 20 TT ____________ 20 TT 82
ILLINOIS DEPARTMENT OF REVENUE,	
Respondent.	

PETITION

NOW COMES the petitioner, Smithfield Packaged Meats Corp. ("Petitioner") (Taxpayer ID 36-2332471), by and through its attorney, Reed Smith LLP, and brings this petition (this "Petition") against the respondent, the Illinois Department of Revenue (the "Department"), pursuant to the Illinois Independent Tax Tribunal Act of 2012 (35 ILCS 1010/1-1 *et seq.*), in protest of the Department's June 2, 2020 Notice of Deficiency, stating as follows:

INTRODUCTION

1. This Petition arises out of the Department's audit (Audit ID: A1697468416) and issuance of a Notice of Deficiency dated June 2, 2020 (the "NOD") for Corporation Income and Replacement Tax, by Letter ID CNXXXX4XX6X12644 in the amount of $266,779.05 for the tax year ending April 30, 2011 (hereinafter, the "2011 tax year"). In its NOD, the Department sets forth its Explanation of Adjustments, which include the Department's (1) re-characterization of the gain (the "Gain") Petitioner realized from the sale of its investment interests in the Turkey Group (defined below) from nonbusiness income, not taxable in Illinois, to business income apportionable to the state; (2) exclusion of royalty income from Petitioner's sales factor; and (3)

assessment of a late-payment penalty. A copy of the Department's NOD is attached as Exhibit A.

PARTIES

2. Petitioner is incorporated in Delaware, its principal place of business is located at 805 E. Kemper Road, Cincinnati, Ohio 45246, and the general telephone number for Petitioner is (757) 365-3000.

3. The Department is an agency of the Executive Branch of the State of Illinois government and is charged with administering and enforcing many of the revenue laws of the State of Illinois, including the Illinois Income Tax Act ("IITA"), 35 ILCS 5/201 *et seq*.

4. Petitioner is represented by David P. Dorner of Reed Smith LLP, located at 10 S. Wacker Drive, 40th Floor, Chicago, Illinois 60606, who can be reached at (312) 207-2402 or ddorner@reedsmith.com. Petitioner is also represented by Paul G. Bogdanski of Reed Smith LLP, located at 10 S. Wacker Drive, 40th Floor, Chicago, Illinois 60606, who can be reached at (312) 207-3923 or pbogdanski@reedsmith.com.

JURISDICTION

5. The Tax Tribunal has jurisdiction pursuant to 35 ILCS 1010/1-45(a) because (i) the NOD arises from the IITA and the amount at issue exceeds $15,000, exclusive of penalties and interest, (ii) Petitioner has remitted the $500 filing fee and a timely filed petition, and (iii) Petitioner is represented by counsel authorized to practice law in the State of Illinois.

FACTUAL ALLEGATIONS

6. Smithfield Foods, Inc. ("Smithfield") is the parent company of Petitioner. Smithfield is headquartered in Smithfield, Virginia. Hereinafter, any reference to "Smithfield" includes Petitioner and Petitioner's subsidiaries and affiliates, unless expressly stated otherwise.

7. For the 2011 tax year, Petitioner filed an Illinois unitary combined income tax return with a group of subsidiaries and affiliates engaged in pork production and processing under the name John Morrell & Co. John Morrell changed its name in 2017 to Smithfield Packaged Meats Corp. Hereinafter, John Morrell (n/k/a Smithfield Packaged Meats Corp.) is referred to as "Petitioner".

8. Smithfield produces pork products that are marketed across the U.S. and internationally.

9. Smithfield is the world's largest pork processor and hog producer.

10. Smithfield sells its pork products under common household names such as Smithfield®, Farmland®, John Morrell®, Armour®, Eckrich®, Cook's®, as well as others.

11. With very few and limited exceptions, meats sold under these well-known brand names include only pork products to ensure continuity of brand recognition.

12. Beginning in 1999, Smithfield held an investment interest in a business engaged in the growing and processing of turkeys through various holdings (collectively, the "Turkey Group"). This business investment included the following interests until sold in December 2010:

12.1 Petitioner, through its wholly-owned interest in Murphy-Brown Holdings LLC ("Murphy Brown"), held a 49% minority membership interest in Carolina Turkeys (n/k/a Butterball, LLC), which is a North Carolina limited liability company engaged in the processing of turkeys. The 51% majority interest in Butterball was owned by Maxwell Farms, Inc ("Maxwell"), an unrelated third-party.

12.2 Murphy-Brown also held a 50% interest in Tar Heel Turkey Hatchery, Inc. ("Tar Heel"). Tar Heel is a corporation engaged in hatching turkeys. The other 50% interest in Tar Heel was owned by the President of Tar Heel, an individual unrelated to Smithfield.

12.3 Murphy-Brown, through one of its divisions, was engaged in the growing of turkeys through contract growers (hereinafter, "Grow-out"). In general, a turkey contract grower is an independent

> farmer who has contracted to raise turkeys for production and processing.

13. Smithfield acquired its interests in the Turkey Group in 1999, when it acquired Carroll Foods, Inc. ("Carroll Foods"). Prior to Smithfield's acquisition, Carroll Foods was the second largest hog production company in the United States.

14. Smithfield acquired Carroll Foods as a hog acquisition, and as a major step towards vertically integrating its hog producing and processing businesses. The acquisition of Carroll Foods made Smithfield the largest hog producer in the world, which was complementary to its position as already the largest pork processing company in the world.

15. As part of the acquisition of Carroll Foods, Smithfield also received Carroll Food's 50% interest in Tar Heel, 100% of Carroll Food's Grow-out operation, and Carroll Food's 49% interest in Carolina Turkeys, which was subsequently renamed Butterball, LLC (hereinafter, Carolina Turkeys will be referred to as "Butterball").

16. The Maxwell family, the majority owner of Butterball, tried to block Smithfield's acquisition of Carroll Foods because it did not want Smithfield as a minority partner in Butterball.

17. Ultimately, Maxwell consented to the acquisition, but to do so it required full control over the management and operations of Butterball. Given that Smithfield was engaged in an entirely different business (*i.e.*, the pork business) and did not have experience with the turkey business, Smithfield consented to Maxwell's control over Butterball.

18. The Turkey Group was a discrete, self-contained business, operated independently from Smithfield's significantly larger pork business.

19. Smithfield's investment in the Turkey Group represented less than 5% of Smithfield's total assets, and was reported as the "Other Segment" or just "Other" in its financial reporting.

20. Butterball and Tar Heel were reported as "equity investments" or just "investments" in Smithfield's annual reports filed with the U.S. Securities and Exchange Commission, since Smithfield owned 50% or less interests in these two companies and could not control their operations.

21. The Butterball operating agreement provides that except for certain extraordinary matters requiring unanimous agreement, the business of Butterball is to be managed by a "Majority in Interest," which is defined as more than 50% of the interest percentages owned by all members.

22. Maxwell, as the 51% "Majority in Interest" holder in Butterball, controlled Butterball and had the authority to make all operational decisions for the company.

23. Maxwell, as the majority owner, had the authority to exercise management control over Butterball, including the ability to make unilateral management decisions for the company. Smithfield could not make unilateral decisions for Butterball.

24. The Butterball operating agreement further provides that Maxwell is the tax matters member, as defined in section 6231(a)(7) of the Internal Revenue Code, and that as the tax matter member, Maxwell is authorized to take actions and to execute all tax-related statements and forms on behalf of Butterball.

25. Petitioner did not oversee or otherwise control such matters as purchasing, financing, tax compliance, personnel, marketing, investing, or legal for Butterball. These decisions were left to Butterball's standalone management team.

26. Petitioner and Butterball had their own officers, managers, business structures and operating systems, and each company made independent business decisions over such things as purchasing, financing, tax compliance, product line, personnel, marketing and capital investment.

27. Petitioner and Butterball maintained their own separate administrative functions including, among others, human resources, IT, marketing, business development, budgeting, financial planning and analysis. There was no sharing of administrative resources, such as accounting, payroll or human resource functions between Petitioner and Butterball, and no opportunities for cost savings through joint purchasing agreements or sales functions.

28. The operating differences between pork and turkey production and processing do not lend these distinct businesses to the sharing of resources (*e.g.*, facilities, machines, tools, etc.), personnel, know-how, or common branding and marketing. The industry components required to raise and process a 15 to 20 pound turkey are completely different from the industry components required to raise and process a 250 to 275 pound hog.

29. Transactions between Grow-out and Butterball were conducted at market prices, as required under the Butterball operating agreement, and did not in any way advance Petitioner's pork business.

30. Grow-out's business function was contracted out to third party farmers, who did all the work required to raise turkeys for processing. There was very little activity or oversight required of the Grow-out business owned by Petitioner as a result of the Carroll Food's hog acquisition.

31. Tar Heel's hatchery business was managed and operated by its President and 50% owner, just as it was for decades prior to Petitioner acquiring a 50% investment interest in the company solely because of the Carroll Foods hog acquisition.

32. In 2010, Petitioner decided to exercise the "Buy/Sell" option of the Butterball operating agreement.

33. Pursuant to the compulsory Buy/Sell provision of the Butterball operating agreement, Maxwell was required to either sell its majority interest in Butterball to Smithfield, or purchase Smithfield's minority interest. The Buy/Sell provision also required the selling member to sell all of its "Turkey Growing Interests" to the purchasing member.

34. The "Turkey Growing Interests" are defined in the Butterball operating agreement as all of the assets of such member and its affiliates utilized in the hatching, feeding, growing and transporting of live turkeys for sale primarily to Butterball. Thus, the Buy/Sell provision requires the buying member to acquire the other member's entire turkey interests.

35. In September 2010, Maxwell notified Smithfield that it would purchase Petitioner's 49% minority investment interest in Butterball, which included the sale of the Turkey Growing Interests held by Smithfield. Maxwell's purchase of Petitioner's 49% investment interest in Butterball and the Turkey Growing Interests were completed in December 2010.

36. Petitioner reported the Gain from the sale of the Turkey Group as nonbusiness income on its Illinois income tax return for the 2011 tax year, and did not allocate any of the Gain to Illinois.

37. The Department audited Smithfield's 2011 tax return and adjusted the return to treat the Gain as business income apportionable to Illinois.

38. In support of its adjustment, the Department determined that Petitioner had common ownership with Butterball, even though Petitioner owned only a minority, 49% investment interest in Butterball.

39. In support of its adjustment, the Department determined that Petitioner managed Butterball, even though the operating agreement unequivocally states that <u>all</u> matters relating to Butterball shall be decided by its majority member (*i.e*., Maxwell), except for specifically identified extraordinary events requiring unanimous agreement. Under no circumstances, could Petitioner manage or make unilateral business decisions for Butterball.

40. In support of its adjustment, the Department determined that Petitioner had common ownership with Tar Heel, even though Petitioner owned only a 50% investment interest in the company.

41. The Department also adjusted Petitioner's 2011 tax return to exclude $75,193,669 in royalty income from Petitioner's sales factor denominator of its Illinois apportionment formula pursuant to 35 ILCS 5/304(a)(3)(B-2), since, as alleged by the Department, Petitioner's royalty receipts from patents did not exceed 50% of its total receipts.

42. As a result of these two adjustments, the Department issued the NOD dated June 2, 2020 for the 2011 tax year in the amount of $266,779.05. The NOD includes $177,315 in tax, a late-payment penalty of $35,463 and interest (as of June 2, 2020) of $54,001.05.

<u>ILLINOIS INCOME TAX ACT</u>

43. Section 1501(a)(27) of the IITA defines "unitary business group" to mean:

> [A] group of persons related through common ownership whose business activities are integrated with, dependent upon and contribute to each other … Common ownership in the case of corporations is the direct or indirect control or ownership of more than 50% of the outstanding voting stock of the persons carrying on unitary business activity. Unitary business activity can ordinarily be illustrated where the activities of the members are: (1) in the same general line (such as manufacturing, wholesaling, retailing or tangible personal property, insurance, transportation or finance); or (2) are steps in a vertically structured enterprise or process (such as the steps involved in the production of natural resources, which might include exploration, mining, refining , and marketing); and, in either instance, the members are functionally integrated through the exercise of strong centralized management (where, for example, authority over such

> matters as purchasing, financing, tax compliance, product line, personnel, marketing and capital investment is not left to each member).

44. Ill. Admin. Code tit. 86§ 100.9700(g) further defines a "unitary group" as:

> Under the IITA Section 1501(a)(27), no group of persons can be a unitary business group unless they are functionally integrated through the exercise of strong centralized management. It is this exercise of strong centralized management that is the primary indictor of mutual dependency, mutual contribution and mutual integration between persons that is necessary to constitute them members of the same unitary business group. The exercise of strong centralized management will be deemed to exist where authority over such matters as purchasing, financing, tax compliance, product line, personnel, marketing and capital investment is not left to each member. Thus, some groups of persons may properly be considered as constituting a unitary business group under IITA Section 1501(a)(27) when the executive officers of one of the persons are normally involved in the operations of the other persons in the group and there are centralized units that perform for some or all of the persons functions that truly independent persons would perform for themselves. Note in this connection that neither the existence of central management authority, nor the exercise of that authority over any particular function (through centralized operations), is determinative in itself; the entire operations of the group must be examined in order to determine whether or not strong centralized management exists. A finding of "strong centralized management" cannot be supported merely by showing that the requisite ownership percentage exists or that there is some incidental economic benefit accruing to a group because such ownership improves its financial position. Both elements of strong centralized management, i.e., strong centralized management authority and the exercise of that authority through centralized operations, must be present in order for persons to be a unitary business group under IITA Section 1501(a)(27).

45. In the case of a corporation, "common ownership" means direct or indirect control or ownership of ***more than 50%*** of outstanding voting stock. Ill. Admin. Code tit. 86, § 100.9700(e) (emphasis added). In the case of any other entity, common ownership means direct or indirect ownership of an interest sufficient to exercise control over the activities of the entity. *Id*. A general partner in a partnership has an interest in the partnership sufficient to establish common ownership. *Id*.

46. Unlike a general partnership, where the partners are agents of the partnership and have authority to act on behalf of the partnership and bind the partnership, no similar authority exists in a limited liability company operating structure. *See* 805 ILCS 206/301(1). Under the Illinois Limited Liability Company Act, "[a] member is not an agent of a limited liability company solely by reason of being a member." 805 ILCS 180/13-5(a).

47. In Illinois, "business income" means all income that may be treated as apportionable business income under the Constitution of the United States. 35 ILCS 5/1501(a)(1).

48. Under the U.S. Constitution, a state is permitted to "tax a corporation on an apportionable share of the multistate business carried on in part in the taxing state." *Allied-Signal, Inc. v. Director, Div. of Taxation*, 504 U.S. 768, 778 (1992).

49. "[T]he linchpin of apportionability in the field of state income taxation is the unitary-business principle." *Mobil Oil Corp. v. Comm'n of Taxes of Vermont*, 445 U.S. 425, 439 (1980).

50. The U.S. Supreme Court made clear in *MeadWestvaco v. Ill. Dept. of Rev.*, 553 U.S. 16, 24 (2008) that when "the asset in question is another business, we have described the 'hallmarks' of a unitary relationship as functional integration, centralized management, and economies of scale."

Based on the foregoing, Petitioner asserts the following errors related to the NOD:

ERROR I

(THE GAIN CONSTITUTES NONBUSINESS INCOME UNDER THE IITA)

51. Petitioner realleges and reincorporates paragraphs 1 through 50 of this Petition herein.

52. Under the IITA, a corporation's income is classified as either "business income" or "nonbusiness income." 35 ILCS 5/1501(a)(1), (13).

53. During the 2011 tax year, the IITA defined the term 'business income" as "all income that may be treated as apportionable business income under the Constitution of the United States." 35 ILCS 5/1501(a)(1).

54. The term "nonbusiness income" means "all income other than business income or compensation." 35 ILCS 5/1501(a)(13).

55. A non-resident multistate taxpayer is required to apportion all business income to Illinois using a single sales factor apportionment formula. 35 ILCS 5/304(h)(3).

56. Nonbusiness income from the sale of intangible personal property is allocated to a taxpayer's commercial domicile. 35 ILCS 5/303(b)(3).

57. In order to tax gains from the sale of a business, the Due Process Clause of the Fourteenth Amendment and the Commerce Clause of the United States Constitution require a showing that the taxpayer and the entity that was the source of the income have a unitary business relationship and, where the asset in question is another business, the "hallmarks" of a unitary business are functional integration, centralized management, and economies of scale. *See MeadWestvaco Corp v. Illinois Dep't of Rev.*, 553 U.S. 16, 24 (2008); *Allied-Signal, Inc. v. Director, Div. of Taxation*, 504 U.S. 768, 789 (1992); *Container Corp. of America v. Franchise Tax Bd.,* 463 U.S. 159, 167 (1983), *ASARCO Inc. v. Idaho State Tax Comm'n* 458 U.S. 307, 316-319 (1982).

58. Petitioner's pork business was separate and distinct from its investment in the Turkey Group business.

59. There was no common ownership between Petitioner and Butterball or Tar Heel.

60. There was no functional integration, centralized management or economies of scale between Petitioner and the Turkey Group.

61. The Department's taxation of the Gain is improper because Petitioner and the Turkey Group were not engaged in a unitary business.

62. The Department's classification of the Gain as apportionable business income is erroneous.

63. The Gain is properly classified as nonapportionable nonbusiness income.

64. The Gain is not allocable to Illinois because Petitioner does not maintain its commercial domicile in Illinois.

WHEREFORE, Petitioner prays that the Tax Tribunal, as applicable,

(a) enter judgment in favor of Petitioner;
(b) declare that Gain is nonapportionable nonbusiness income;
(c) declare the Gain is not allocable to Illinois;
(d) declare there is no tax deficiency for the 2011 tax year;
(e) direct the Department to withdraw the NOD; and
(f) grant Petitioner any further relief the Tax Tribunal deems appropriate.

ERROR II
(ILLINOIS IS PROHIBITED FROM TAXING THE GAIN UNDER THE DUE PROCESS AND COMMERCE CLAUSES OF THE UNITED STATES CONSTITUTION)

65. Petitioner realleges and reincorporates paragraphs 1 through 64 of this Petition herein.

66. The Due Process Clause of the Fourteenth Amendment and the Commerce Clause of the United States Constitution mandate that a state may not, when imposing an income or franchise tax, "tax valued earned outside its borders." *ASARCO Inc. v. Idaho State Tax Comm'n,* 458 U.S. 307, 315 (1982).

67. The above principle rests on the fundamental requirement that there must be a "minimal connection between the interstate activities and the taxing state … and there must be a rational relation between the income attributed to the taxing state and the intrastate value of the corporate business." *Allied-Signal, Inc. v. Director, Div. of Taxation,* 504 U.S. 768, 772 (1992).

68. In *Allied-Signal*, the U.S. Supreme Court indicated that, in the case of income from capital transactions, the two fundamental constitutional requirements are satisfied by showing either that the taxpayer and the corporation that was the source of the income have a unitary business relationship or the capital serves an operational rather than an investment function (the "operational function test"). *Allied-Signal* 504 U.S. at 787.

69. In *MeadWestvaco Corp. v. Illinois Dep't of Rev.*, 553 U.S. 16 (2008), the U.S. Supreme Court clarified its reference to the "operational function test" in *Allied-Signal* and explained that the operational function test was not intended to modify the unitary business principle by adding a new ground for apportionment, but rather the operational function test "simply recognizes that an asset can be part of a taxpayer's unitary business even if what we may term a 'unitary relationship' does not exist between the payor and payee." *MeadWestvaco Corp.* 533 U.S. at 29.

70. The Court in *MeadWestvaco* went on to hold that where the asset in question is another business, the "hallmarks" of a unitary business are functional integration, centralized management, and economies of scale. *Id.; see also Container Corp. of America v. Franchise Tax Bd.,* 463 U.S. 159, 166 (1983).

71. Petitioner's pork business activities were separate and distinct from the turkey business activities of the Turkey Group.

72. There was no functional integration, centralized management or economies of scale between Petitioner and the Turkey Group.

73. The Department's taxation of Petitioner's Gain on the sale of the Turkey Group is improper because Petitioner and the Turkey Group were not engaged in a unitary business.

74. The Turkey Group business activities were completely unrelated to the pork activities conducted by Petitioner in Illinois and neither contributed to nor were dependent upon activities of each other.

75. Petitioner's acquisition of the Turkey Group served an investment function and was simply a fortuitous investment as a result of a hog acquisition.

76. The Department's taxation of the Gain violates the Due Process and Commerce Clauses of the United States Constitution because it results in the inclusion of income that bore no relationship to activities conducted in Illinois by the Petitioner.

WHEREFORE, Petitioner prays that the Tax Tribunal, as applicable,

(a) enter judgment in favor of Petitioner;

(b) declare that Due Process and Commerce Clauses of the United States Constitution bar the Department from taxing Petitioner on the Gain;

(c) declare that there was no unitary relationship between Petitioner and the Turkey Group;

(d) declare the acquisition of the Turkey Group served an investment function;

(e) declare there is no tax deficiency for the 2011 tax year in question;

(f) direct the Department to withdraw the NOD; and

(g) grant Petitioner any further relief the Tax Tribunal deems appropriate.

ERROR III

(IF IT IS DETERMINED THAT THE GAIN CONSTITUTES APPORTIONABLE BUSINESS INCOME, THE SALE PROCEEDS MUST BE INCLUDED IN THE DENOMINATOR OF PETITIONER'S SALES FACTOR)

77. Petitioner realleges and reincorporates paragraphs 1 through 76 of this Petition herein.

78. The Department has re-characterized Petitioner's Gain from the sale as apportionable business income, but did not include any of the Gain in Petitioner's sales factor denominator.

79. A non-resident multistate taxpayer is required to apportion all business income to Illinois using a single sales factor apportionment formula. 35 ILCS 5/304(h)(3).

80. The sales factor is a fraction, the numerator of which is the total sales of the taxpayer in Illinois during the tax year and the denominator of which is the total sales of the taxpayer everywhere during the tax year. 35 ILCS 5/304(a)(3)(A).

81. The term "sales" is defined as all gross receipts not allocated under the provisions of the Illinois Income Tax Act. 35 ILCS 5/1501(a)(21).

82. If it is determined that the Gain constitutes apportionable business income, the proceeds constitute a "sale" and therefore must be included in the denominator of Petitioner's sales factor.

83. If no proceeds from the sale are included in the denominator of Petitioner's sales factor, the tax as assessed by the Department is out of all appropriate proportion to, and does not fairly represent, the business conducted by Petitioner in Illinois and therefore violates both the Due Process and Commerce Clauses of the United States Constitution. *Allied-Signal, Inc. v. Director, Division of Taxation*, 504 U.S. 768, 772 (1992); *Container Corp. of America v.*

Franchise Tax Bd., 463 U.S. 159, 169-170 (1983); *Hans Rees' Sons, Inc. v. North Carolina*, 283 U.S. 123, 128-130 (1931).

84. If the Gain is business income, as alleged by the Department, then the Gain must be included in Petitioner's sales factor denominator.

WHEREFORE, Petitioner prays that the Tax Tribunal, as applicable,

(a) enter judgment in favor of Petitioner;

(b) find that the proceeds from the sale of the Turkey Group, if business income, be included in the denominator of Petitioner's sales factor;

(c) find that if the Gain is business income, then inclusion of the proceeds from the sale in the denominator of the sales factor is necessary to produce a fair apportionment method that is consistent with the Due Process Clause and the Commerce Clause of the United States Constitution; and

(d) grant Petitioner any further relief the Tax Tribunal deems appropriate.

ERROR IV

(PETITIONER IS ENTITLED TO REASONABLE ATTORNEY'S FEES AND EXPENSES UNDER 5 ILCS 100/10-55(C))

85. Petitioner realleges and reincorporates paragraphs 1 through 84 of this Petition herein.

86. The Department presumably excluded the Gain from Petitioner's sales factor denominator pursuant to Ill. Admin. Code tit. 86, § 100.3380(c)(2).

87. Regulation Ill. Admin. Code tit. 86, § 100.3380(c)(2) provides that "[w]hen gross receipts arise from an incidental or occasional sale of assets used in the regular course of the person's trade or business, such gross receipts shall be excluded from the sales factor."

88. Regulation 100.3380(c)(2) is invalid because it presumes distortion in clear violation of 35 ILCS 5/304(f), which requires a showing that the standard apportionment provisions do not fairly represent the market for a taxpayer's goods, services, or other sources of business income.

89. Regulation Ill. Admin. Code tit. 86, § 100.3380(c)(2) is invalid because if the proceeds from the sale are excluded from the denominator of Petitioner's sales factor, the tax as assessed by the Department is out of all appropriate proportion to, and does not fairly represent, the business conducted by Petitioner in Illinois, and therefore violates both the Due Process and Commerce Clauses of the United States Constitution.

90. The Illinois Administrative Procedure Act provides that, "[i]n any case in which a party has any administrative rule invalidated by a court for any reason . . . the court shall award the party bringing the action the reasonable expenses of the litigation, including reasonable attorney's fees." 5 ILCS 100/10-55(c).

91. To the extent Ill. Admin. Code tit. 86, § 100.3380 is declared invalid, Petitioner is entitled to reasonable expenses and attorney's fees.

WHEREFORE, Petitioner prays that the Tax Tribunal, as applicable,

(a) enter judgment in favor of Petitioner;

(b) find that Department regulation 100.3380(c)(2) as applied to Petitioner is invalid;

(c) find that, while the Tax Tribunal cannot declare a Department regulation invalid on its face or award attorney's fees (35 ILCS 1010/1-45(f) and 1010/1-55(d)), Petitioner has preserved its rights to challenge the validity of Ill. Admin. Code tit. 86, § 100.3380 on its face and to claim reasonable expenses and attorney's fees under 5 ILCS 100/10-55(c)); and

(d) grant Petitioner any further relief the Tax Tribunal deems appropriate.

ERROR V

(THE DEPARTMENT'S EXCLUSION OF ROYALTY INCOME FROM PETITIONER'S SALES FACTOR MUST BE REVERSED)

92. Petitioner realleges and reincorporates paragraphs 1 through 91 of this Petition herein.

93. The Department excluded $75,193,669 of royalty gross receipts from Petitioner's sales factor denominator pursuant to 35 ILCS 5/304(a)(3)(B-2) because, as alleged by the

Department, Petitioner's "gross receipts from [the] license, sale, etc. from patents did not exceed 50% of total receipts."

94. Petitioner did not include the $75,193,669 of intercompany royalty gross receipts the Department excluded from Petitioner's sales factor in its sales factor for the 2011 tax year.

95. The Department has grossly understated Petitioner's 2011 tax year sales factor by eliminating $75,193,669 of intercompany royalty gross receipts from Petitioner's sales factor denominator that were never included in Petitioner's sales factor.

96. The Department's adjustment eliminating royalty receipts from Petitioner's sales factor, receipts which Petitioner did not include in its sales factor in the first place, mistakenly and artificially increased the amount of income the Department asserts Petitioner should apportion to Illinois.

97. The Department's adjustment to exclude $75,193,669 of intercompany royalty gross receipts from Petitioner's 2011 sales factor denominator is erroneous and must be reversed.

WHEREFORE, Petitioner prays that the Tax Tribunal, as applicable,

(a) enter judgment in favor of Petitioner;

(b) find that the $75,193,669 in royalty gross receipts excluded by the Department was erroneous;

(c) find that the Department's $75,193,669 adjustment to Petitioner's sales factor must be reversed in its entirety; and

(d) grant Petitioner any further relief the Tax Tribunal deems appropriate.

ERROR VI

(IT IS UNCONSTITUTIONAL FOR THE DEPARTMENT TO INCLUDE ROYALTY INCOME IN A TAXPAYER'S BASE INCOME AND EXCLUDE THE SAME INCOME FROM THE TAXPAYER'S SALES FACTOR)

98. Petitioner realleges and reincorporates paragraphs 1 through 97 of this Petition herein.

99. In the context of a three-factor apportionment formula, Justice Stevens of the United States Supreme Court wrote "[u]nless the sales, payroll, and property values connected with the production of income by the payor corporations are added to the denominator of the apportionment formula, the inclusion of earnings attributable to those corporations in the apportionable tax base will inevitably cause [the taxpayer]'s Vermont income to be overstated." *Mobil Oil Corp. v. Comm'r*, 445 U.S. 425, 461 (1980) (Stevens, J., dissenting).

100. The majority in *Bass Ratcliff & Gretton, Ltd. v. State Tax Comm'n*, 266 U.S. 271, 282-283 (1924) also intimated that factor representation—*i.e.*, receipts included in the tax base must also be included in the sales factor denominator—was constitutionally required but again did not formally rule on the matter because it was not raised by the parties.

101. The inclusion of receipts in the tax base without including those same receipts in the apportionment formula violates the external consistency requirement of the dormant Commerce Clause, because such an apportionment formula will not "reflect a reasonable sense of how income [was] generated." *Container Corp. v. Franchise Tax Bd.*, 463 U.S. 159, 169 (1983). When the receipts that make up the tax base are excluded from the sales factor of the apportionment formula, the income attributed to that state will be "out of all appropriate proportions to the business transacted in the State" because the sales factor will not reflect the income which generated the apportionable tax base. *Container*, 463 U.S. at 170.

102. The Illinois Supreme Court held that the tax base and the apportionment formula are inextricably linked, such that income removed from the tax base must also be removed from the apportionment formula. *Continental Illinois Nat'l Bank & Trust Co. v. Lenckos*, 102 Ill. 2d 210, 221-225 (1984). The inverse principle also holds true—income included in the base must also be represented in the apportionment formula.

103. Any royalty gross receipts included in Petitioner's base income must also be included in Petitioner's sales factor.

104. The Department's exclusion of royalty receipts from Petitioner's sales factor is unconstitutional because it violates the external consistency test imposed by the dormant Commerce Clause as described in *Container Corp. v. Franchise Tax Bd.*, 463 U.S. 159 (1983), and as explained by the majority in *Bass Ratcliff & Gretton, Ltd. v. State Tax Comm'n*, 266 U.S. 271 (1924), and the dissent in *Mobil Oil Corp. v. Comm'r*, 445 U.S. 425, 461 (1980) (Stevens, J., dissenting).

105. The Department's exclusion of Petitioner's royalty gross receipts from Petitioner's sales factor violates the principles concerning factor representation expounded by the Illinois Supreme Court in *Continental Illinois Nat'l Bank & Trust Co. v. Lenckos*, 102 Ill. 2d 210 (1984).

WHEREFORE, Petitioner prays that the Tax Tribunal, as applicable,

(e) enter judgment in favor of Petitioner;

(f) find that any royalty receipts included in Petitioner's base income must also be included in the denominator of Petitioner's sales factor;

(g) find none of the royalty receipts should be included in the numerator of Petitioner's sales factor; and

(h) grant Petitioner any further relief the Tax Tribunal deems appropriate.

ERROR VII

(PENALTIES SHOULD BE ABATED FOR REASONABLE CAUSE)

106. Petitioner realleges and reincorporates paragraphs 1 through 105 of this Petition herein. The Department has assessed Petitioner with late payment penalties on the Illinois income tax allegedly owed to the State of Illinois.

107. Petitioner does not owe any Illinois income tax to the State of Illinois as alleged by the Department per its NOD, and therefore no penalties may be assessed by the Department

and no penalties are due to the State of Illinois. However, if any tax is due, any penalties assessed on such tax should be abated for reasonable cause. 35 ILCS 735/3-8.

108. Petitioner has relied in good faith on its understanding of Illinois law with respect to the reporting of its Gain from the sale of the Turkey Group and the reporting of its royalty income.

109. A taxpayer's good-faith reliance on an interpretation of Illinois statutory or regulatory law or a court decision can provide a basis for the abatement of penalties for reasonable cause. Ill. Admin. Code tit. 86, § 700.400(e)(8).

110. Petitioner has presented viable defenses based on Illinois law that the Gain realized from the sale of the Turkey Group is nonbusiness, nonapportionable income, and that Petitioner's royalty income should not be excluded from its sales factor denominator.

111. Accordingly, Petitioner has exercised ordinary care and prudence and has a good-faith legal basis for filing its 2011 tax return as originally filed.

WHEREFORE, Petitioner prays that the Tax Tribunal, as applicable,

(a) enter judgment in favor of Petitioner;

(b) declare that Petitioner is not liable for any Illinois penalties as alleged by the Department in its NOD;

(c) cancel or modify the Department's NOD in its entirety; and

(d) grant Petitioner any further relief the Tax Tribunal deems appropriate.

Respectfully submitted,

SMITHFIELD PACKAGED MEATS CORP.,
Petitioner

By: ______________________________
One of Petitioner's Attorneys

David P. Dorner
Paul G. Bogdanski
REED SMITH LLP
10 S. Wacker Drive, 40th Floor
Chicago, Illinois 60606
(312) 207-2402
ddorner@reedsmith.com

July 23, 2020

CERTIFICATE OF FILING AND SERVICE

I hereby certify that the foregoing Petition was filed with the Illinois Independent Tax Tribunal via email at ITT.TaxTribunal@illinois.gov and a copy of the Petition with the $500 filing fee was sent via U.S. mail to the Tribunal, 160 N. LaSalle Street, Room N506, Chicago, Illinois 60601; and one copy was served by certified mail on the Illinois Department of Revenue, Office of Legal Services, 100 W. Randolph St., 7-900, Chicago, Illinois 60601, this 23rd day of July, 2020.

Counsel for Petitioner

EXHIBIT A

Notice of Deficiency

for Form IL-1120, Corporation Income and Replacement Tax Return

#BWNKMGV
#CNXX XX4X X6X1 2644#
SMITHFIELD PACKAGED MEATS CORP
112 COMMERCE ST
SMITHFIELD VA 23430-1202

June 2, 2020

Letter ID: CNXXXX4XX6X12644

Taxpayer ID:	36-2332471
Audit ID:	A1697468416
Reporting period:	April 2011
Total Deficiency:	$266,779.05
Balance due:	$266,779.05

We have audited your account for the reporting period listed above. The attached statement explains the computation of your deficiency and the balance due. **Illinois law requires that we notify you of this deficiency and your rights.**

If you agree to this deficiency, pay the total balance due as soon as possible to minimize penalty and interest assessed. Make your check payable to the "Illinois Department of Revenue", write your taxpayer ID on your check, and mail a copy of this notice along with your payment.

If you do not agree, you may contest this notice by following the instructions listed below.

- **If the amount of this tax deficiency, exclusive of penalty and interest is more than $15,000,** ***or*** **if no tax deficiency is assessed, but the total penalties and interest is more than $15,000**, file a petition with the Illinois Independent Tax Tribunal within **60 days** of this notice. Your petition must be in accordance with the rules of practice and procedure provided by the Tribunal (35 ILCS 1010/1-1, *et seq.)* .
- **In all other cases,** file a protest with us, the Illinois Department of Revenue, within **60 days** of the date of this notice. If you file a protest on time, we must reconsider the proposed deficiency, and if requested, grant you or your authorized representative and administrative hearing. An administrative hearing is a formal legal proceeding conducted pursuant to the rules adopted by the Department and is presided over by an administrative law judge. Submit your protest on Form EAR-14, Format for Filing a Protest for Income Tax, (available on our website at **tax.illinois.gov**). If we do not receive your protest within **60 days**, this deficiency will become final. A protest of this notice does not preserve your rights under any other notice.
- **In any case,** you may instead, under Sections 2a and 2a.1 of the State Officers and Employees Money Disposition Act (30 ILCS 230/2a, 230/2a.1), pay the total liability under protest using Form RR-374, Notice of Payment Under Protest (available on our website at **tax.illinois.gov**), and file a complaint with the circuit court for a review of our determination.

If you do not protest this notice or pay the assessment total in full, we may take collection action against you for the balance due which, may include levy of your wages and bank accounts, filing of a tax lien, *or* other action.

Note: If you are under bankruptcy protection, see the "Bankruptcy Information" section on the following page of this notice for additional information and instructions. If you have questions, call us at the telephone number shown below.

Sincerely,

David Harris
Director

ILLINOIS DEPARTMENT OF REVENUE
AUDIT BUREAU
PO BOX 19012
SPRINGFIELD IL 62794-9012
217 524-2230

IDR-393 (R-05/19)

Notice of Deficiency

for Form IL-1120, Corporation Income and Replacement Tax Return

June 2, 2020

Letter ID: CNXXXX4XX6X12644

Taxpayer ID:	36-2332471
Audit ID:	A1697468416
Reporting period:	April 2011
Total Deficiency:	$266,779.05
Balance due:	$266,779.05

#BWNKMGV
#CNXX XX4X X6X1 2644#
SMITHFIELD PACKAGED MEATS CORP
112 COMMERCE ST
SMITHFIELD VA 23430-1202

Bankruptcy Information

If you are currently under the protection of the Federal Bankruptcy Court, contact us and provide the bankruptcy case number and the bankruptcy court. The bankruptcy automatic stay does not change the fact you are required to file tax returns. For those under the bankruptcy protection, this notice is not an attempt to collect tax debt. Illinois law requires issuance of this notice to advise you of an amount due or a missing return that must be filed.

Taxpayer Bill of Rights

- You have the right to call the Department of Revenue for help in resolving tax problems.
- You have the right to privacy and confidentiality under most tax laws.
- You have the right to respond, within specified time periods, to Department notices by asking questions, paying the amount due, or providing proof to refute the Department's findings.
- You have the right to appeal Department decisions, in many instances, within specified time periods, by asking for Department review, by filing a petition with the Illinois Independent Tax Tribunal, or by filing a complaint in circuit court.
- If you have overpaid your taxes, you have the right, within specified time periods, to file for a credit (or, in some cases, a refund) of that overpayment.

The full text of the Taxpayers' Bill of Rights is contained in the Illinois Compiled Statutes, 20 ILCS 2520/1 et seq.

REDACTED

REDACTED

Explanation of Audit Adjustments

Income Tax

June 2, 2020

Letter ID: CNXXX11535674729

#BWNKMGV
#CNXX X115 3567 4729#
SMITHFIELD PACKAGED MEATS CORP
112 COMMERCE ST
SMITHFIELD VA 23430-1202

Taxpayer ID: 36-2332471
Account ID: 17724-24192
Audit ID: A1697468416
Reporting period: April 2011

Explanation of adjustments for tax period ending 04/30/2011	Return Impact	Tax impact
We re-characterized as business income the amount of gain (or loss) you received from the sale of property previously used in your trade or business operations. [86 IL Adm. Code 100.3010(c)(3)]	-$32,613,593.00	$166,132.00
We adjusted your sales factor to exclude royalties since the gross receipts from license, sale, etc., from patents did not exceed 50% of total receipts. [35 ILCS 5/304(a)(3)(B-2)]	-$75,193,669.00	$11,184.00

Interest on tax and penalty, if applicable, has been computed as allowed by Illinois law. [35 ILCS 735/3-2]

We are imposing a penalty because you did not pay the amount required to be shown due on your return by the due date for payment. Once an audit has been initiated, the late payment penalty is assessed at 15 percent of the late payment. Failure to pay the amount due or invoke protest rights within 30 days from the "Date of Issuance" on the auditor's report issued with the EDA-143-I-APT, Notice of Audit Results, has resulted in this penalty increasing to 20 percent. [35 ILCS 735/3-3(b-20)(2)]