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A Washington National Tax Services (WNTS)
Publication

June 1, 2012

Out-of-state licensing company not subject to West Virginia tax - would offend due process and commerce clause substantial nexus

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On May 24, 2012, the West Virginia Supreme Court of Appeals (the highest court in West Virginia, the "Court") held that ConAgra Brands, Inc. ("ConAgra"), an out-of-state corporation, was not liable for corporation net income tax or business franchise tax on royalties earned from the licensing of trademarks and trade names used on food products sold by licensees throughout the United States, including West Virginia. [[*Griffith v. ConAgra Brands, Inc.*, West Virginia Supreme Court of Appeals, Dkt. No. 11-0252 \(5/24/12\)](#)].

The Court ruled that net income and business franchise tax assessments against ConAgra did not satisfy either Due Process or the Commerce Clause because:

- ConAgra had no physical presence in West Virginia;
- ConAgra did not sell or distribute products or provide services in West Virginia;
- All products bearing the trademarks and trade names were manufactured solely by unrelated or affiliated licensees of ConAgra outside of West Virginia;
- ConAgra did not direct or dictate how its licensees distributed the products; and



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- The licensees operated no retail stores in West Virginia and their sales into West Virginia were made only to wholesalers and retailers.

Background

ConAgra, a Nebraska corporation and a wholly-owned subsidiary of ConAgra Foods, Inc., was established for the purpose of centralizing the management and protection of trademarks and trade names. ConAgra received trademarks and trade names from its parent, its affiliates, and from unrelated entities. ConAgra entered into licensing agreements with its parent, affiliate licensees, and unrelated third party licensees (collectively, "licensees"). Through these agreements, ConAgra collected royalty payments from the licensees measured by the licensees' sale of food products bearing the trademarks and trade names to customers throughout the United States, including West Virginia. ConAgra did not manufacture or sell any products bearing its trademarks or trade names.

Following an audit for the period June 1, 2000 through May 31, 2003, ConAgra was issued two notices of assessment for unpaid corporation net income tax and for business franchise tax (collectively, the "assessments"). ConAgra filed petitions for reassessment alleging that it was subject to neither corporation net income tax nor business franchise tax in West Virginia. The Office of Tax Appeals upheld the two assessments, and ConAgra filed an appeal in the Circuit Court of Berkeley County.

The circuit court concluded that ConAgra was not doing business in West Virginia and reversed the order of the Office of Tax Appeals. The State Tax Commissioner ("Commissioner") filed an appeal with the Court. In its review, the Court will give deference to the findings of facts by the administrative law judge unless it concludes the findings to be clearly wrong. Further, questions of law will be reviewed *de novo*.

State Tax Commissioner: Purposeful direction and substantial nexus existed

In support of the assessments, the Commissioner argued that, because ConAgra received royalty payments attributable to sales made by its licensees in West Virginia in excess of \$1 million during the audit period, ConAgra and its licensees were working together toward a "common economic goal." In particular, the Commissioner argued that the trademarks and trade names "were as important to sales as the quality of the product itself" and that ConAgra retained an interest in the quality of the products through the licensing agreements. Consequently, "whether ConAgra had a 'physical presence' in [West Virginia] is irrelevant" because it "purposefully directed its intangible assets toward West Virginia, thereby satisfying the minimum contacts standard of the Due Process Clause, and established a significant economic presence in West Virginia, thus satisfying the substantial nexus component pertaining to the Commerce Clause."

Court: Conagra facts distinguished from *MBNA*

The Court disagreed with the Commissioner, citing and distinguishing its decision in *Tax Comm'r v. MBNA America Bank*, 220 W. Va. 143 (2006). The Court noted that the facts which supported a finding of significant economic presence in *MBNA* were absent in the case at hand. Specifically, "MBNA continuously and systematically

engaged in direct mail and telephone solicitation in West Virginia" such that physical presence was not a requirement, for Commerce Clause purposes, in upholding the corporation net income and business franchise tax assessments against MBNA.

In this case, the Court noted that ConAgra did not engage in the solicitation of its business to the degree found in *MBNA*.

Though recognizing that *MBNA* concluded physical presence was not a requirement for Commerce Clause purposes relating to net income and business franchise taxes, the Court noted that ConAgra "did not own or rent any offices, warehouses or other facilities in West Virginia and did not maintain any inventory or sell or distribute merchandise in this State" and employed no employees or agents in West Virginia. Here, it was the licensees that "sold or distributed the products bearing the trademarks and trade names to wholesalers and retailers located in West Virginia, and the licensees [that] provided services in West Virginia to those clients and customers." Most importantly, ConAgra "provided no services in that regard *and did not direct or dictate how the licensees distributed the products bearing the trademarks and trade names*" (emphasis in original).

Due process offended

The Court addressed "whether the placement of trademarks and trade names...into the 'stream of commerce' through the licensees' products was sufficient to warrant the tax assessments imposed." The Court distinguished ConAgra from its decision in *Hill v. Showa Denko, K.K.*, 188 W. Va. 654 (1992) in which it found that the exercise of personal jurisdiction over a Japanese drug manufacturer satisfied the requirements of Due Process. The Court's decision in *Hill* was based upon a separate opinion filed by Justice Brennan in *Asahi Metal Industry Co. v. Superior Court of California*, 480 U.S. 102. In his opinion in *Asahi*, Brennan stated that "The stream of commerce refers not to unpredictable currents or eddies, but to the regular and anticipated flow of products from manufacture to distribution to retail sale. As long as a participant in this process is aware that the final product is being marketed in the forum State, the possibility of a lawsuit there cannot come as a surprise."

In *Hill*, the manufacturer's sole American distributor was its wholly owned subsidiary, a "shell corporation" that the manufacturer had the authority to direct. However, in this case, ConAgra was "not a shell corporation created solely for tax avoidance purpose." The record shows that ConAgra "was created to centrally manage and provide for uniformity in brand image and brand presentation." Further, in addition to executing licensing agreements with its parent and affiliates, ConAgra "acquired trademarks and trade names from unrelated entities and, through licensing agreements, earned royalty payments from unrelated entities." Consequently, the Court determined that the assessments could not be upheld on the theory that ConAgra was a shell corporation.

Facts supporting the absence of Commerce Clause substantial nexus

The Court found that even if the elements of Due process were satisfied, the assessments against ConAgra would fail under the substantial nexus component of the Commerce Clause. The Court held that "assessments against a foreign licensor

for West Virginia corporation net income and business franchise tax, on royalties earned from the nation-wide licensing of food industry trademarks and trade names, satisfied neither 'purposeful direction' under the Due Process Clause nor 'significant economic presence' under the Commerce Clause, where the foreign licensor, with no physical presence in this State, did not sell or distribute food-related products or provide services in West Virginia" and where:

- All products bearing the trademarks and trade names were manufactured solely by unrelated or affiliated licensees of ConAgra outside of West Virginia;
- ConAgra did not direct or dictate how its licensees distributed the products; and
- The licensees operated no retail stores in West Virginia and their sales into West Virginia were made only to wholesalers and retailers.

PwC Observes

"This is a very fact intensive decision," notes Steve Arluna, PwC Partner in Tyson's Corner, VA. "The Court acknowledged that there is no 'one size fits all' in such cases."

"The Court drew important distinctions between MBNA and ConAgra in that here the licensor was two steps further removed from any contacts with the state than MBNA was. ConAgra licensed to companies that manufactured the products completely outside of West Virginia. The licensees then sold the product to wholesalers and retailers located in West Virginia. In this case, the contacts between ConAgra and West Virginia were too tenuous for ConAgra to be expected to subject to tax in the State. That being said, it is likely the West Virginia Department of Revenue will appeal the decision."

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