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The Due Process Clause as a Bar To State Tax Nexus

by Paul H. Frankel, Craig B. Fields, and Richard C. Call

Paul H. Frankel Craig B. Fields Richard C. Call

In May the Oklahoma and West Virginia supreme courts held that due process bars the imposition of a state tax on a company. Those decisions illustrate the U.S. Constitution's due process clause restraints on states' taxing jurisdiction. Both are supported by U.S. Supreme Court precedent, including *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), and *J. McIntyre Machinery, Ltd. v. Nicastro*, 131 S. Ct. 2780 (2011). In 1992 in *Quill*, the Court emphasized a two-part constitutional nexus framework — nexus under the due process clause and nexus under the commerce clause. Over the years since *Quill*, much attention has been given to commerce clause nexus because *Quill* articulated a physical presence standard for purposes of the commerce clause but not for purposes of the due process clause. In this article, we instead focus our attention on the due process el ements of the two state court decisions and the holdings in *Quill* and *McIntyre* and analyze the due process clause constraints on states' imposition of taxes.

As discussed in more detail below, the cases discussed herein support the following four conclusions:

- the due process clause purposeful availment test applies to all taxes;
- due process may prohibit a state's imposition of tax on an entity even though the entity targets a nationwide market;
- arguments for nexus based on a "stream of commerce" theory are suspect; and
- courts tend to apply a facts and circumstances test for determining whether the requirements of the due process clause are satisfied.

Moreover, unlike Congress's power regarding the commerce clause restraints reiterated in *Quill*, Congress may not pass laws that would lower the due process restraints on the states' imposition of tax on companies.

Scioto — The Oklahoma Decision

In May, in *Scioto Insurance Co. v. Oklahoma Tax Commission*, the Oklahoma Supreme Court held that Oklahoma could not impose a corporate income tax on our client, Scioto Insurance Co., as a result of its licensing of intellectual property to a related party.[1] Scioto was organized as an insurance company under the laws of Vermont. It licensed intellectual property to Wendy's International Inc. under a licensing contract that was executed outside Oklahoma. Wendy's International then sublicensed the intellectual property to Wendy's restaurants, including restaurants located in Oklahoma.

Scioto "ha[d] no say where a Wendy's restaurant [would] be located, including Oklahoma."[2] The amount of money that Scioto received from Wendy's International for use of the intellectual property was "based on a percentage of the gross sales of the Wendy's restaurants in Oklahoma."[3] Wendy's International's obligation to pay Scioto was "not dependent upon the Oklahoma restaurants actually paying Wendy's International."[4]

The Oklahoma court held that "due process is offended by Oklahoma's attempt to tax an out-of-state corporation that has no contact with Oklahoma other than receiving payments from an Oklahoma taxpayer . . . who has a bona fide obligation to

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[1]279 P.3d 782 (2012). Paul H. Frankel of Morrison & Foerster LLP argued the case before the Supreme Court of Oklahoma. (For the decision, see *Doc 2012-9384* or *2012 STT 86-28*.)

[2]*Id.* at 783.

[3]*Id.*

[4]*Id.*

do so under a contract not made in Oklahoma."[5] The court found no "basis for Oklahoma to tax the value received by Scioto from Wendy's International under a licensing contract . . . no part of which was to be performed in Oklahoma."[6]

ConAgra — The West Virginia Decision

Just a few weeks after *Scioto* was issued, the West Virginia Supreme Court of Appeals held in *Griffith v. ConAgra Brands, Inc.* that due process prohibited the imposition of tax on ConAgra Brands Inc.[7] ConAgra licensed intellectual property to licensees that manufactured products bearing the intellectual property, some of which were eventually sold in West Virginia.

ConAgra licensed its intellectual property to related and unrelated parties and derived royalties from that licensing. ConAgra did not manufacture or sell products that bore the intellectual property. All those products were manufactured by ConAgra's licensees in facilities that were located outside West Virginia.

Some of ConAgra's licensees sold or distributed products bearing the intellectual property to wholesalers and retailers located in West Virginia, and those licensees provided services in West Virginia to clients and customers. Notably, products that bore the ConAgra intellectual property were "found in many, if not in most, retail grocery stores in" West Virginia.[8] However, ConAgra Brands did not direct or dictate the licensees' distribution of products bearing the intellectual property and did not provide services to the wholesalers and retailers that were located in West Virginia.

ConAgra centrally managed and provided for uniformity in brand image and brand presentation for its intellectual property. It paid the expenses for defending its intellectual property and national marketing. ConAgra would have brought legal actions to protect its intellectual property rights exclusively in federal courts under federal laws that protect intellectual property even if those actions "ar[ose], entirely or in part, from conduct occurring in West Virginia."[9]

The West Virginia court found for ConAgra, holding that tax assessments against a foreign licensor "on royalties earned from the nation-wide licensing of food industry trademarks and trade names [did not] satisfy . . . *'purposeful direction'* under the Due Process Clause."[10] In doing so, the court rebuffed the state's assertions based on a "stream of commerce" theory that due process was not offended, and noted the Supreme Court's lack of consensus regarding the "stream of commerce" theory. The court distinguished ConAgra's facts from the facts of an earlier West Virginia decision that applied the "stream of commerce" theory.[11]

The Supreme Court Has Held That Due Process Requires Purposeful Availment

Quill Due Process

In *Quill*, the U.S. Supreme Court explained that the due process clause "requires some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax."[12] In analyzing due process, the Court's focus "is whether a defendant had minimum contacts with the jurisdiction 'such that the maintenance of the suit does not offend traditional notions of fair play and substantial justice.'"[13] Further, the Court explained that a foreign corporation without physical presence in a state may be subject to the state's jurisdiction if it "purposefully avails itself of the benefits of an economic market in the forum State."[14] The *Quill* Court found that due process did not prohibit the imposition of a sales and use tax collection obligation on a "mail-order house that is engaged in continuous and widespread solicitation of business within a State" inasmuch as such a corporation "clearly has 'fair warning that [its] activity may subject [it] to the jurisdiction of a foreign sovereign.'"[15]

Due Process Under *McIntyre*

In 2011, in *McIntyre*, the U.S. Supreme Court overturned a decision of the New Jersey Supreme Court and held that due process prohibited New Jersey's assertion of jurisdiction over a corporation that was not physically present in New Jersey.[16] *McIntyre* involved a tort action in the New Jersey courts against a manufacturer located in England that had no physical presence in New Jersey but had products that ended up in New Jersey.[17]

J. McIntyre was a British manufacturer that had no office in New Jersey, owned no property in New Jersey, did not send employees into New Jersey, and did not advertise in New Jersey. McIntyre held U.S. patents. It had an agreement with a distributor in

[5] *Id.* at 784.
[6] *Id.*
[7] 728 S.E.2d 74 (2012). (For the decision, see *Doc 2012-11406* or *2012 STT 103-33*.)
[8] *Id.* at 76.
[9] *Id.* at 82.
[10] *Id.* at 84 (emphasis added).
[11] *Id.* at 82-83.
[12] 504 U.S. 298, 306 (1992) (internal citations omitted).
[13] *Id.* at 307 (citing *Int'l Shoe Co. v. Washington*, 326 U.S. 310 (1945)).
[14] *Id.* at 307-308 (citing *Burger King Corp. v. Rudzewicz*, 471 U.S. 462, 476 (1985)).
[15] *Id.* at 308 (alterations in original and citations omitted).
[16] 131 S.Ct. 2780 (2011).
[17] *Id.*

the United States. That distributor "'structured [its] advertising and sales efforts in accordance with' [the manufacturer's] 'direction and guidance whenever possible'" and "'at least some of the machines were sold on consignment to'" the distributor.[18] The New Jersey courts stated that McIntyre's only contact with New Jersey was that it had products ending up in New Jersey.[19]

> ***A purposeful availment analysis should apply to all state taxes. . . .* Quill*'s due process analysis provides no basis for asserting that the purposeful availment standard applies only to one type of tax.***

In holding for McIntyre, the *McIntyre* Court reiterated a due process analysis that is similar to the analysis set forth in *Quill*. The Supreme Court explained that "the Due Process Clause protects an individual's right to be deprived of life, liberty, or property only by the exercise of lawful power" and applies "to the power of a sovereign to prescribe rules of conduct for those within its sphere."[20] The Court then reiterated the notions of fair play and substantial justice, as it did in *Quill*, as well as the fact that purposeful availment of the economic market of a state is necessary to satisfy due process standards.[21] Applying that precedent, the *McIntyre* Court found that due process was not satisfied even though the foreign manufacturer "directed marketing and sales efforts at the United States."[22]

The Due Process Clause as a Bar to State Taxation

Scioto and *ConAgra* are examples of the fact that the due process clause serves as a barrier to states' taxing authority. To the extent that *Scioto* and *ConAgra* are based on a lack of purposeful availment of a state's market by the entity at issue, these decisions are consistent with *Quill* and *McIntyre*. The following are a few points to consider.

First, a purposeful availment analysis should apply to all state taxes. *Quill*'s physical presence rule, which some argue applies only to sales and use taxes, was articulated only in the context of the commerce clause.[23] *Quill*'s due process analysis provides no basis for asserting that the purposeful availment standard applies only to one type of tax.

Second, due process may prohibit a state's imposition of tax on an entity even though the entity targets a nationwide market. ConAgra licensed intellectual property nationwide. In *McIntyre*, the manufacturer "directed marketing and sales efforts at the United States."[24] The *McIntyre* Court explained that "a defendant may in principle be subject to the jurisdiction of the courts of the United States but not of any particular State" and that "jurisdiction requires a forum-by-forum analysis."[25] Regarding McIntyre's operations, the Supreme Court stated that "[t]hese facts may reveal an intent to serve the U.S. market, but they do not show that J. McIntyre purposefully availed itself of the New Jersey market."[26]

Third, arguments that due process permits taxation of an entity by a state that are based on a stream of commerce theory are suspect. As noted in *ConAgra*, the stream of commerce theory is not supported by a consensus of the Supreme Court.[27] In *McIntyre*, four justices of the Supreme Court, that is, not a majority, emphasized that, in their view, placing goods in the stream of commerce *may* indicate purposeful availment.[28] However, the justices stressed that "transmission of goods permits the exercise of jurisdiction only where the defendant can be said to have targeted the forum; as a general rule, it is not enough that the defendant might have predicted that its goods will reach the forum State."[29]

> ***Arguments that due process permits taxation of an entity by a state that are based on a stream of commerce theory are suspect.***

Fourth, the above cases indicate that courts apply a facts and circumstances approach for determining whether due process prohibits the imposition of a tax on an entity. Under that approach, the presence or absence of specific facts may not be dispositive to determining whether due process is satisfied. For instance, ConAgra did not direct or control third-party distributing. By contrast, McIntyre's third-party distributor in the United States structured its

[18]*Id.* at 2786.
[19]*Id.* at 2790.
[20]*Id.* at 2786-2787.
[21]*Id.* at 2787.
[22]*Id.* at 2790. One of the plurality opinions in *McIntyre* noted McIntyre's decision not to pay taxes as a fact supporting a finding that due process was not satisfied. *Id.* Such a fact would likely be irrelevant for determining whether due process bars the imposition of a state tax.

[23]*Quill*, 504 U.S. 298.
[24]*McIntyre*, 131 S.Ct. at 2790.
[25]*Id.* at 2789.
[26]*Id.* at 2790.
[27]*ConAgra*, 728 S.E.2d at 82-83.
[28]*McIntyre*, 131 S.Ct. at 2788.
[29]*Id.* at 2788.

advertising and sales efforts in connection with McIntyre's direction and guidance. Entities should carefully consider their individual facts.

One additional point for taxpayers to consider regarding due process is that Congress is unable to pass laws that would lower the due process restraints on states' taxation of companies. In *Quill*, the Supreme Court reiterated that Congress had the "ultimate power" to nullify the Supreme Court's jurisprudence regarding nexus under the commerce clause.[30] Congress does not hold the same power regarding the Supreme Court's due process analysis as set forth in *Quill*, *McIntyre*, and other Court decisions.[31] Therefore, although congressional action could nullify *Quill*'s commerce clause physical presence requirement, congressional action cannot expand the states' ability to tax companies under the due process clause.

[30]*Quill*, 504 U.S. at 318-319.

[31]For a recent decision regarding the interplay between congressional action and the due process clause, see *Red Earth LLC v. United States*, 657 F.3d 138 (2d Cir. 2011).

Conclusion

In 1992, the *Quill* Court emphasized that due process jurisprudence had "evolved substantially" in the years leading up to that decision.[32] That evolution continues today with *Scioto*, *ConAgra*, and *McIntyre*. These cases may lend support to a company's arguments that due process prohibits a state's imposition of tax on the company. ✰

Paul H. Frankel is a senior partner and Craig B. Fields is a partner in Morrison & Foerster LLP's New York office. Richard C. Call is an associate in Morrison & Foerster LLP's New York office.

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[32]*Quill*, 504 U.S. at 307.