

CONAGRA BRANDS, INC.

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IN THE

vs.

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MARYLAND TAX COURT

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COMPTROLLER OF THE TREASURY

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No. 09-IN-OO-0150

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MEMORANDUM OF GROUNDS FOR DECISION

On August 30, 2007, the Comptroller assessed corporate income taxes against Petitioner, ConAgra Brands, Inc., for the years 1996 through and including 2003 in the amount of \$1,411,977, together with interest and penalties.

This appeal stems from a Notice of Final Determination issued on January 23, 2009 ("Notice") upholding the Comptroller's assessment of taxes, interest and penalties for the 1996 through 2003 tax years ("Tax Years") in the aggregate amount of \$3,053,222. In his Notice, the Comptroller alleges that ConAgra Brands, Inc., a Nebraska corporation (hereinafter sometimes referred to as "Petitioner" or "Brands"), a direct and indirect wholly owned subsidiary of ConAgra Foods, Inc., formerly known as ConAgra, Inc., ("ConAgra"), was operated, at least in part, as a conduit to shift income out of the reach of Maryland taxing authorities. Petitioner contests the Notice and argues that Brands was established for legitimate economic business purposes.

The questions presented for the Court to consider are as follows:

1) Did ConAgra Brands, Inc., formerly a Nebraska corporation, have sufficient contacts with Maryland to require it to file returns and pay income taxes in the years 1996 through 2003?

2) If ConAgra Brands, Inc. had sufficient contacts with Maryland to require it to file returns and pay income taxes in the subject years, did the Comptroller fairly apportion income to the taxpayer's Maryland-related income producing activities?

3) Are the assessments against ConAgra Brands, Inc. barred by the applicable statute of limitations on assessments, where the taxpayer failed to file Maryland tax returns for any of the years at issue?

4) Should the Court exercise its discretion to waive interest and/or penalties for reasonable cause?

Petitioner claims that Brands was established for independent corporate purposes to (1) centralize ownership; (2) centrally and uniformly protect intellectual property; and (3) to ensure consistent promotion of the intellectual property by all operating companies. When formed, intellectual property from the ConAgra Food's family of companies was exchanged for stock in Brands equal to the fair market value of the contributed intellectual property as determined by independent appraisal. In furtherance of its corporate purposes, Brands managed, controlled, promoted and marketed its brand names and trademarks and incurred substantial legal and consulting fees protecting the trademarks. During the time the tax period in question, Brands had no employees, agents or representatives present or engaged in activities in the State of Maryland. Brands did not own or lease property in the State, conduct business or derive income from business conducted in the State. Petitioner concludes that Brands had real and substantial economic substance outside Maryland and thus the Comptroller is unable to establish the required nexus to impose the States taxing jurisdiction.

The Petitioner argues that the assessment violates the Due Process Clause and the Commerce Clause of the United States Constitution. For state tax nexus purposes, there must be some minimum connection between the state and the person, property or transaction it wishes to tax. Although the Supreme Court has stated that an out-of-state company can establish a nexus if it has purposely directed its activities toward customers in that state, Brands, an out of state company, has not purposefully directed its activities toward the state. Moreover, Petitioner, for state tax purposes, further contends there must be a substantial nexus, which requires a physical presence in the taxing state. Therefore, because Brands is not physically present in Maryland, the tax violates the Commerce Clause. If argued that the substantial nexus can be satisfied through an "economic presence", the assessment still must fail because Brands has not exploited the State's marketplace.

As the Court of Appeals of Maryland has consistently held, certain constitutional principles must be satisfied before an entity is subject to Maryland income tax. "Under both the Due Process and the Commerce Clauses of the Constitution, a state may not, when imposing an income-based tax, 'tax value earned outside its borders'." *Container Corp. of America v. Franchise Tax Bd.*, 463 U.S. 159, 164, 103 S. Ct. 2933, 2939 (1983). "Both the Due Process and Commerce Clauses require that there be 'some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax'." *Allied-Signal, Inc. v. Dir., Div. of Taxation*, 504 U.S. 768, 777, 112 S. Ct. 2251, 2258 (1992). Both constitutional provisions are distinct, and "reflect different constitutional concerns". *Quill Corp. v North Dakota By and Through Heitkamp*, 504 U.S. 298, 305, 112

S. Ct. 1904, 1909 (1992).

The Due Process Clause imposes the requirement of fairness on governmental activity, while the Commerce Clause primarily concerns "the effects of state regulation on the national economy". *Quill*, 504 U.S. at 312, 112 S. Ct. at 1913. Contrary to Petitioner's contention, physical presence is not required to satisfy due process, so long as the business engages in some purposeful direction to the state. The Commerce Clause requires that if the tax is applied to an activity with a substantial nexus with the taxing State, the tax must be fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services provided by the State. *Trinova Corp. v. Michigan Dep't of Treasury*, 498 U.S. 358, 372, 111 S. Ct. 818, 828 (1991).

Under the unitary business principle, the State is authorized to tax the portion of value that a unitary business derived from its operation with the particular state. The unitary business principle enables taxation by apportionment when the characteristics of "functional integration, centralized management, and economies of scale" are present. However, when a "discrete business enterprise" is responsible for that value, then the State cannot tax that value, even by apportionment.

Moreover, the unitary business principle does not confer nexus to allow a state to directly tax a subsidiary based on the fact that the parent company is taxable and that the parent and subsidiary are unitary. In the present case, the Petitioner disputes its nexus with Maryland, and contends that the unitary business principle cannot be used to clear the constitutional hurdles of the Due Process and Commerce Clauses.

Maryland courts have consistently concluded that the basis of a nexus sufficient to justify taxation is the economic reality of the fact that the parent's business in Maryland was

what produced the income of the subsidiary. *The Classics Chicago, Inc., et al [v.] Comptroller of the Treasury*, 189 Md. App. 593 (2010); *Comptroller of the Treasury v. SYL, Inc.* 375 Md. 78, cert. denied 540 U.S. 982 and 540 U.S. 1090 (2003). Thus, the Court's initial inquiry is to determine whether the taxpayer had real economic substance as a business separate from ConAgra.

An examination of the facts support the Comptroller's position that Brands lacked real economic substance. ConAgra Foods, Inc. is a multi-national producer and marketer of processed foods and agricultural products. In the 1970's, ConAgra, Inc. began acquiring other agricultural and food processing companies, such as Swiss Miss, Peter Pan, Hunt's, Healthy Choice, Orville Redenbacher, Butterball Turkey, and Act II. ConAgra also acquired United Agri Products, a manufacturer and distributor of agricultural chemicals and feeds.

From the early 1970s until the early 1990s, ConAgra operated as a loosely controlled corporate entity.

In 1996, ConAgra accelerated and intensified a program of corporate centralization. By late 1996, ConAgra had centralized legal services, tax services, human resources (including payroll), treasury functions, cash management, marketing, corporate relations, information services, research & development, and general corporate management. The ConAgra family of companies was run by a small ConAgra Management Group, which consisted of the President and senior vice-presidents from 10-12 of the various operating companies.

During this time period, ConAgra investigated the possibility of creating a separate subsidiary to hold and monitor the conglomerate's many valuable trademarks. In April, 1996, ConAgra incorporated Brands to hold and enforce trademarks, conduct central

advertising for the corporate brands, and achieve other corporate efficiencies, including tax savings. Brands was capitalized by ConAgra Foods, which also provided its board of directors and officers from among the corporate executive corps. In late 1996, the parent and three ConAgra subsidiaries-Beatrice Foods, Inc., Hunt-Wesson, and Swift-Eckrich contributed 46 trademark groups to Brands in exchange for 2,207 shares of Brands' common stock. Thereafter, Brands held the 46 initial trademark groups and subsequently acquired numerous others from these entities.

Brands was physically housed on the ConAgra corporate campus in Omaha. It rented space and equipment from the corporate parent. Brands had its own officers, who were actually paid by Brands, although their payroll was serviced by corporate. Brands gradually acquired several employees, and had as many as 23 employees in the latter part of the period in question.

Brands licensed the ConAgra trademarks back to the ConAgra subsidiaries from which they had been acquired, although in a few cases, Brands also licensed ConAgra trademarks to third-party corporations. Brands most significant activity was conducting national advertising campaigns for the trademark brands. Brands' employees performed quality control for the licensed brands, and monitored trademark infringements over the time periods in question. In exchange for the licensed trademarks, the licensees paid annual royalties to Brands, which was the primary source of Brands' income, all of which was paid back to the ConAgra parent in the form of inter-company payments of various types.

Brands was organized in part to obtain a reduction in taxes. One of the advantages of organizing and using ConAgra Brands to own and manage trademarks for the ConAgra

family of companies was a potential royalty deduction from income taxes that would be claimed by ConAgra companies in those states that did not require combined income tax reporting.

Brands was entirely owned, directly and indirectly, by ConAgra, Inc., the parent corporation. ConAgra itself held 1,000 shares of Brands (45%), while the remaining 1,207 shares were owned by three of ConAgra's wholly owned subsidiaries, Swift-Eckrich, Inc., Hunt-Wesson, Inc., and Beatrice Cheese, Inc. In its fiscal year ending May, 1997 through May, 2004, ConAgra Brands, Inc. received millions of dollars of royalty income from ConAgra companies doing business and filing tax returns in Maryland.

The evidence suggests during the entire period at issue, ConAgra utilized centralized legal services, tax services, human resources (including payroll), treasury functions, cash management, marketing, corporate relations, information services, research & development, purchasing, accounting, and general corporate management. In fact, Brands itself was organized for the purpose of centralizing control over trademarks and conducting centralized national advertising ConAgra-wide.

ConAgra corporate executives were routinely assigned to interlocking directors' boards of the several subsidiary corporations; officers were assigned to various subsidiaries from an existing central pool of executives; and many corporate officers were assigned as special portfolio officers to numerous subsidiaries.

ConAgra, Inc. had a vice-president for taxes. That officer was simply assigned as the vice president for taxes to Brands and to many other subsidiaries. Likewise, ConAgra, Inc.'s corporate secretary was cross-assigned as the corporate secretary for Brands, Hunt-Wesson, Swift-Eckrich, and Beatrice Foods. Kenneth DiFonzo testified by deposition that

he was assigned as an officer and director to so many different subsidiaries that he could only recall the names of a few of the subsidiaries to which he was assigned. The annual assignment of officers to subsidiaries were effectively carried out by the ConAgra, Inc. corporate secretariat, which circulated "consents in lieu of" annual meetings and boards of the various entities signed the consents.

From a revenue standpoint, Brands depended for the vast majority of its annual revenue on royalty payments from ConAgra and its subsidiaries. All profits from its operation were transferred back to ConAgra in annual payments called "cost of capital" payments and through other internal financial arrangements. The payments to and from ConAgra and its subs, and to and from Brands in particular, were entirely circular.

Brands could not have functioned as a corporate entity without the support services it received from "corporate". All of Brands' everyday support services - ranging from its physical housing, to payroll, accounting, cash management, tax services, funding of legal services, capital requirements, financing, executive staffing, and information services - were supplied by its corporate parent.

The facts indicate functional integration and control through stock ownership, as well as common employees, directors and officers. The functional source of Brands income is derived from the ideas and discoveries generated by ConAgra Corporate. The circular flow of money is traced by and through the valuable trademarks.

In addition, the facts also indicate Brands' reliance on ConAgra corporate personnel, office space and corporate services. The tax returns and other financial data reflect the lack of separate substantial activity of Brands.

The Court agrees with the Comptroller that similar to the subsidiary corporations in *SYL, Inc. and Gore Enterprise Holdings, Inc. v. Comptroller of the Treasury*, 437 Md. 492 (2014), Brands lacked any economic substance *separate from its parent(s)*. The Court of Appeals in *Gore* reiterated the economic substance doctrine as set forth in *Comptroller v. SYL, Inc.*, 375 Md. 78 (2003). A subsidiary must have economic substance as a separate entity from its parent to avoid nexus and taxation. In the present case, the income of Brands is produced from the parent's business in Maryland which establishes nexus sufficiently to justify taxation. Consequently, the Comptroller's assertion of substantial nexus sufficient to support income taxation of Brands' Maryland business activity was proper.

Where nexus is satisfied as in the present case, the Maryland tax on a multi-state corporation engaged in interstate business is governed by Md. Code Ann., Tax-Gen. § 10-402 (2010 Repl. Vol.). In TG § 10-402, Maryland provides for both separate accounting and formulaic apportionment as methods for allocating the income of a foreign corporation doing business in the State. See TG § 10-402(b) & (c). Formulaic apportionment, unlike separate accounting, does not purport to identify the precise geographical source of a corporation's profits; rather, it is employed to approximate a corporation's income that is reasonably related to the activities conducted within the taxing State. TG § 10-402(d) requires that net income be apportioned to this state on the basis of a formula that clearly reflects the income allocable to Maryland. The Comptroller may alter, if circumstances warrant, the methods of allocating income to Maryland. TG § 10-402(d); COMAR § 03.04.03.08F.

The Comptroller's auditors found that with respect to Brands, there were no recorded Maryland sales, no recorded Maryland payroll, and no recorded Maryland property. As a result, application of the statutory "3-factor apportionment formula" provided by TG § 10-402(c) would have yielded an apportionment factor of zero. Since a zero apportionment factor would not have "reflect[ed] clearly the income allocable to Maryland," the Comptroller's agents formulated a blended apportionment factor. The blended apportionment factor utilized by the Comptroller in allocating Brands' income was derived directly from the income tax returns of the five ConAgra entities that filed in Maryland. The Court finds that the Comptroller effectively utilized ConAgra's own apportionment figures in constructing the blended apportionment factor used in this case. There is no clear and convincing evidence that the Comptroller's blended apportionment factor is unfair.

Brands asserted an affirmative defense that the assessments made against it are barred by the applicable statute of limitations, Md. Code Ann., Tax-Gen. § 13-1101(a). The statute of limitations referenced by Petitioner, Md. Code Ann., Tax-Gen. § 13-1101(a), as relevant here, provides that an assessment of income taxes may not be made after three years from the date that the return is due, except as otherwise provided. All of the assessments against Brands were made more than three years after the respective returns were due. However, the applicable three-year statute of limitations for assessments does not apply when a taxpayer does not file a required return. TG § 13-1101(b)(3). Brands did not file a return in any of the years at issue. Therefore, the three-year statute of limitations on assessments does not bar the assessments for the tax years 1996 through 2003, inclusive, because it did not file a return for any of those years.

The final question for the Court's determination is whether interest and penalties should be waived under Tax-General Article Sections 13-606 (waiver of interest) and 13-714 (waiver of penalties). In *Frey v. Comptroller of the Treasury*, 184 Md. App. 315, 421 (2009), the Court of Special Appeals referred to the reasonable cause exception set forth in the applicable statutes. The Court finds that the Petitioner has a reasonable basis for challenging the law and acted in good faith. There was no intention on the part of the Petitioner to cause delay in the collecting of taxes and this Court notes that numerous taxpayers have challenged the Comptroller's arguments. The Court disagrees with the Comptroller that the state of the law was clear to the taxpayer at the time of the assessments. To the contrary, the state of the law has evolved through various court decisions in *SYL, Crown Cork & Seal The Classic Chicago, Inc. v. Comptroller of the Treasury*, 189 Md. App. 695 (2010), *Nordstrom, Inc. v. Comptroller of the Treasury*, (Md. Tax Ct. Oct. 24, 2008) and *Gore Enterprise Holdings*.

For all of the above reasons, the Maryland Tax Court this ^{24th} day of February 2015, **AFFIRMS** the assessment of tax, abates interest after the date of filing this appeal in the Maryland Tax Court (February 23, 2009) until the date of this Order, and abates all penalties.

CERTIFIED TRUE COPY
TEST: John T. Hearn, Clerk

NOTICE: You have the right of appeal from the above Order to the Circuit Court of any County or Baltimore City, wherein the property or subject of the assessment may be situated. The Petition for Judicial Review **MUST** be filed in the proper Court within thirty (30) days from the date of the above Order of the Maryland Tax Court. Please refer to Rule 7-200 et seq. of the Maryland Rules of Court, which can be found in most public libraries.

cc: Harry D. Shapiro, Esq.
Michael J. Salem, Esq.