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Maryland Tax Court Conflates Tax Principles; Rules Holding Companies Taxable

On November 9, 2010, the Maryland Tax Court issued another unfavorable decision against a taxpayer and upheld the Maryland Comptroller's assessment against out-of-state intangible holding companies. In *W.L. Gore & Associates, Inc., Gore Enterprise Holdings, Inc., and Future Value, Inc. v. Comptroller of the Treasury*, Md. T.C., Dkt. Nos. 07-IN-OO-0084; 07-IN-OO-0085; 07-IN-OO-0086, 11/09/2010, the Maryland Tax Court's decision managed to conflate the unitary business principle, economic substance, and nexus principles in holding that the Delaware holding companies (DHCs) were subject to Maryland corporate income tax. The holding and its rationale are similar to what is becoming a stream of decisions issued by the Maryland Tax Court addressing intangible holding companies.¹

Background

W. L. Gore & Associates (W. L. Gore), a Delaware-headquartered company, produces and manufactures a variety of fluoropolymer products. W. L. Gore maintained two wholly owned DHCs: Gore Enterprise Holdings, Inc. (GEH), engaged in intercompany intangible property licensing, and Future Value, Inc. (FVI), engaged in intercompany lending.

W. L. Gore had Maryland manufacturing facilities and filed Maryland income tax returns. Neither GEH nor FVI had a physical presence in Maryland and therefore did not file Maryland corporate income tax returns. The Comptroller issued corporate income tax assessments against GEH and FVI for the 1983 through 1992 and 1993 through 2003 tax years—tax years that occurred up to 25 years ago. The Comptroller's assessments were based on its position that: "neither company has an identity as a separate business entity and that the intangible income it receives is directly connected to Maryland activity through the unitary business conducted in Maryland."

Sutherland Observation: Maryland imposes its corporate income tax on corporations doing business in Maryland. However, "doing business" is not statutorily defined in Maryland tax law. The Maryland Comptroller has indicated that it imposes its corporate income tax to the full extent permitted by law. See Administrative Release No. 2 (Sept. 1, 2009). The Maryland Court of Appeals (Maryland's highest court) was unclear in *SYL, Inc. and Crown, Cork & Seal Co.* as to whether its holdings were premised on the taxpayers' having established an economic nexus in Maryland, stating, "The records in these cases demonstrate that SYL and Crown Delaware had no real economic substance as separate business entities. They resembled the subsidiaries involved in the *Armco* case, except that SYL and Crown Delaware had a touch of 'window dressing' designed to create an illusion of substance." Further, the Maryland Court of Appeals continually referenced the taxpayers as "phantom corporations."

¹ *Comptroller v. SYL, Inc. and Crown Cork & Seal Co. (Delaware), Inc.*, 825 A.2d 399 (Md. 2003). *Nordstrom, Inc. v. Comptroller*, No. 07-IN-OO-0317, 07-IN-OO-0318, 07-IN-OO-0319, 2008 WL 4754842 (Md. Tax Oct. 25, 2008); *The Classics Chicago, Inc. v. Comptroller*, 985 A.2d 593 (Md. Ct. Spec. App. 2010).

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Maryland Tax Court's Flawed Decision

The Maryland Tax Court held that GEH and FVI were engaged in a unitary business with W. L. Gore and were not separate business entities. However, the Tax Court muddled the appropriate analysis as to whether the Comptroller was justified in assessing the out-of-state DHCs. The Tax Court stated that:

The principle issue is whether GEH and FVI, wholly owned subsidiaries of W. L. Gore and which have no physical presence in Maryland, can be constitutionally required to pay State income taxes on its income when W. L. Gore maintains a physical presence in this State.

While GEH and FVI presented evidence that they had “economic substance as separate business entities” and that “patent management is a substantive activity which should be distinguished from the manufacture or sale of products of the parent company, W. L. Gore,” the court held that the companies were “passive, non-operational entities and did not have a business existence separate and apart from their parent company.”

Sutherland Observation: While the Maryland Tax Court held that the DHCs did not have a separate existence, the court upheld the tax assessed on the DHCs. Thus, the court’s reasoning is inconsistent—it both disregarded and, at the same time, taxed the DHCs.

The Maryland Tax Court applied an “interdependence test” with respect to the DHCs and specifically found that GEH was dependent on its parent company for a supply of intangible assets (as W. L. Gore developed intangibles that were ultimately owned by GEH). The Tax Court also rejected the DHCs’ claims that:

- **Third-party license agreements substantiated the independence of DHCs.** The Maryland Tax Court found that the third-party agreements were not dependent upon the profits earned by the DHCs;
- **GEH was established due to changes in the Federal court organization in which jurisdiction for appeals in patent cases was transferred from Federal Circuit Courts to a new U.S. appellate court.** The Maryland Tax Court found that because the taxpayer’s expert witness acknowledged that GEH was interdependent with its parent suggests that GEH could not control the patent activities of its parent;
- **The 7.5% royalty rate contained in the license agreement between GEH and its parent was reasonable and equivalent to a third-party rate.** The Maryland Tax Court relied on testimony from the taxpayer’s witness (and found relevant) that GEH and its parent had “integrated goals” and that synergies existed between them; and
- **FVI was formed to manage cash according to a long-term investment plan.** The Tax Court rejected this justification of FVI because, in its view, FVI was intercompany dependent with its parent as the royalties that GEH paid to its parent were paid to FVI and then loaned to the parent. As a result, the Maryland Tax Court held that this resulted in a circular flow of funds between W. L. Gore, FVI and GEH.

Sutherland Observation: The DHCs presented other evidence regarding their separate existence, including separate expenses, employees and corporate officers, and management and strategic decisions made by the DHCs without W. L. Gore’s involvement. Despite the evidence presented, the Maryland Tax Court stated that the entities were “passive, non-operational entities” and even questioned whether patent management was a substantive business activity.

Conclusion

The Maryland Tax Court’s decision is analytically flawed. The court stated that “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.” This analysis is tantamount to replacing Maryland’s separate tax reporting system with a forced unitary combination system similar to the systems employed by California and Illinois. Under the court’s flawed analysis nearly every unitary subsidiary will be subject to Maryland tax if its parent company does business in Maryland.

Finally, and further confusing whether the court premised its holding on economic nexus or disregarded the status of the DHCs, the Maryland Tax Court approved use of the parent company’s apportionment formula to apportion the income of the DHCs. This methodology ignores Maryland’s statutory separate entity reporting regime and Maryland’s apportionment provisions as GEH and FVI have no payroll or property in Maryland.

Sutherland Observation: The Maryland Comptroller imposed a 25% penalty against the DHCs for failure to file Maryland income tax returns and for failure to participate in Maryland’s 2004 amnesty settlement program applicable to intangible holding companies. However, the Maryland Tax Court held that the penalty assessed against the DHCs should be waived.

Further Maryland litigation regarding Maryland’s nexus standards is almost certain. Please contact a member of Sutherland’s State and Local Tax team for more information.



If you have any questions about this development, please feel free to contact any of the attorneys listed below or the Sutherland attorney with whom you regularly work.

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