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Inside Maryland State Taxes: And the Saga Continues…Maryland Tax Court Hears New Intangible Holding Company Case

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Last week, the Maryland Tax Court heard arguments in ConAgra Brands, Inc. v. Comptroller of the Treasury, No. 09-IN-OO-0150. ConAgra Brands is the most recent case in which the Comptroller has asserted nexus over an intangible holding company, and is the first case to be heard by the Tax Court on an intangible holding company issue since the court's October 2008 decision in Nordstrom, Inc., et al. v. Comptroller of the Treasury.[1] However, it does not appear to be the last. Several other intangible holding company appeals are pending in Maryland. It remains to be seen whether ConAgra Brands or any of the taxpayers in the other pending cases will break the Comptroller's winning streak stretching back to Comptroller of the Treasury v. SYL, Inc.

Background

ConAgra Brands, Inc. ("CBI") was a Nebraska corporation and subsidiary of ConAgra Foods, Inc., a leading packaged food company.[2] CBI was created in 1996 and licensed intellectual property to certain independent operating companies (IOCs) of the ConAgra family for use in the manufacture and distribution of food and related food products at locations outside of Maryland. In return, the IOCs paid CBI a royalty for their use of the intellectual property. CBI did not file Maryland tax returns and had no property, payroll or sales in the state. In addition, CBI performed quality control testing, licensed intellectual property to third parties, and defended and protected the intellectual property. CBI was also responsible for ConAgra's national advertising and marketing programs-spending millions of dollars on advertising and marketing campaigns each year.

In 2005, the Comptroller audited the Maryland returns filed by the IOCs. After the audit, and despite the aforementioned facts, the Comptroller determined that CBI was operated, at least in part, as a conduit to shift income outside of the state. However, instead of disallowing the deductions taken by the IOCs for the royalties paid to CBI, the Comptroller instead issued an assessment against CBI covering all years going back to 1996. For purposes of this assessment, the Comptroller attributed income to CBI equal to the royalties deducted by the IOCs. Further, in apportioning CBI's "income," the Comptroller used the combined apportionment factors of all of the IOCs that filed in Maryland. The total amount of tax, interest and penalties assessed against CBI exceeded $2.8 million for the tax years 1996 through 2003. Upon the Comptroller's Notice of Final Determination, which upheld the audit assessment, CBI appealed the matter to the Maryland Tax Court.

Maryland Tax Court Hearing

Last week, Maryland Tax Court Chief Judge Walter C. Martz, II heard arguments from both parties.

During the hearing, counsel for CBI focused heavily on the activities of CBI and its relationship with ConAgra Foods and the IOCs, and compared those activities and relationships with those described in Comptroller of the Treasury v. SYL, Inc. In SYL, the Tax Court found that an intangible holding company had nexus with Maryland based on the presence of the holding company's parent within Maryland, and the fact that the subsidiary had no economic substance separate from its parent. Counsel for CBI argued that, unlike the holding company in SYL, CBI had economic substance and was formed for a valid business purpose. Counsel for CBI also argued that, even if CBI was subject to tax in Maryland, the Comptroller's assessment was distortive because it used the receipts of the IOCs to apportion CBI's income to Maryland.

In contrast, the Comptroller argued that SYL did not require a licensing arrangement to be deemed a sham or to lack economic substance in order for Maryland to assert nexus with the intangible holding company. In fact, during the hearing, the Comptroller's Audit Manager testified that CBI was determined to have nexus with Maryland, because it was involved in "income shifting" transactions with the IOCs, not because the transactions between CBI and the IOCs lacked economic substance. (Of course, it is not clear how the Comptroller was able to come to the conclusion that the transactions between CBI and the IOCs involved "income shifting" without examining the economic substance of those transactions.)

Both parties will submit post-trial briefs after a transcript of the proceedings has been prepared. The Tax Court is expected to issue a decision sometime next year.

More Cases to Follow

A number of other cases involving intangible holding company-type issues are lined up behind ConAgra Brands at the Maryland Tax Court. The next cases scheduled to be heard by the Tax Court are Staples, Inc. v. Comptroller, No. 09-IN-OO-0148 ("Staples") and Staples the Office Superstore, Inc. v. Comptroller, No. 09-IN-OO-0149 ("Staples Superstore"). Staples involves the Comptroller's attempt to tax the interest receipts of Staples received from two affiliates that operated retail stores in Maryland. Staples, a corporation with more than 1000 employees and payroll in excess of $100 million, provided loans to the two affiliates and, in return, received interest payments from the affiliates. The Comptroller, looking at the significant Maryland activities of the affiliates, and their reduction in federal, and therefore, Maryland taxable income, determined that Staples was conducting financing activities in Maryland based on the activities of those affiliates. Staples had no Maryland property, payroll, or sales of its own, and did not file tax returns with Maryland.

In Staples Superstore, the Comptroller is using the same theory posited in the Staples case to attempt to tax the royalty receipts of Staples Superstore. In this case, Staples Superstore licensed certain trademarks to two affiliates that operated retail stores in Maryland, and in turn, those affiliates paid royalties to Staples Superstore for use of the trademarks. While Staples Superstore operated retail stores and distribution centers in various states, none were located in Maryland. Despite this, the Comptroller asserts that Staples Superstore is subject to tax in Maryland based on the significant Maryland activities of its affiliates from which it receives royalty payments.

The Tax Court is scheduled to hear arguments in the Staples and Staples Superstore cases on November 9 and 10, 2010.

The hearing dates for the other intangible holding company cases pending before the Maryland Tax Court have not yet been set.

Reed Smith Observations

Taxpayers should keep an eye on the intangible holding cases in Maryland. Although previous decisions suggest that relief at the Maryland Tax Court may be difficult to obtain, the possibility remains that the Tax Court will determine that not all intangible holding-company cases are alike.

The ConAgra Brands, Staples, and Staples Superstore cases are of particular importance because if the court rules in favor of the Comptroller, the decisions could be used by the state as support for the proposition that mere assertion of "income shifting" by the Comptroller-regardless of the existence, or lack thereof, of economic substance-is enough to assert nexus over out-of-state affiliates. Such holdings would make it almost impossible for taxpayers to successfully challenge intercompany transactions. However, if any of the cases results in a taxpayer victory, it may serve as support for companies that truly have economic substance to avoid nexus.

For more information on the ConAgra Brands case and the other intangible holding company cases pending in Maryland, contact the authors of this Alert or another member of the Reed Smith State Tax Group. For more information on Reed Smith's Maryland tax practice, click here.

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1. Nordstrom was later remanded back to the Tax Court to address other issues in that case, and a decision was issued by the court on those supplemental issues in February 2010.

2. In 2007, ConAgra Brands, Inc. was merged into ConAgra Foods, Inc., and ceased to exist.