4/26/99

SYL, INC.	*	IN THE
	*	
	*	MARYLAND TAX COURT
	*	
V.	*	
	*	
	*	
COMPTROLLER OF THE TREASURY	*	NO. C-96-0154-01
	*	
	*	

* * * * * * * * * * * *

MEMORANDUM OF GROUNDS FOR DECISION

SYL, Inc. (hereinafter "Petitioner"), appeals an assessment issued by the Comptroller of the Treasury (hereinafter " Respondent") for Maryland income tax for the tax years 1986 through 1993. Taxes assessed totaled $326,685 for the eight years, plus penalties and interest, for total assessments of $637,362. At hearings, testimony was taken, documents were presented, and subsequently, memorandum were filed.

Petitioner was formed in December, 1986 as a subsidiary of Syms, a corporation engaged in the retail of off-price men's, women's, and children's retail clothing with its principal place of business in New Jersey. Syms has retail operations in Maryland. Evidence indicates that Petitioner was formed to hold and manage intangible asset such as trademarks, service marks, and trade names of its parent, Syms. The intangible assets transferred to Petitioner produced certain benefits to the corporate family, among them being the reduction of Maryland income tax liability of its parent, Syms. Petitioner and Syms executed a licensing agreement whereby the " marks" , now owned by Petitioner, were licensed to Syms for a fee. This fee paid to Petitioner reduced the Maryland taxable income of Syms and increased income to Petitioner. However, Delaware law does not tax Petitioner's licensing income. Since Maryland law requires each entity of an affiliated group to file their tax returns separately, the money paid to Petitioner from Syms was never taxed by Maryland.

An audit by Respondent claimed a basis for finding that the licensing fees paid to Petitioner were taxable. An assessment was issued, which was affirmed by the Respondent's hearing officer.

Issues Presented

The central issue for this Court involves whether Maryland statute or case law permits the imposition of tax on the income of an out-of-state affiliate of a Maryland parent corporation. The issue is identical to that addressed in *MCIIT v. Comptroller*, Maryland Tax Court No. C-96-0028-01 (1999) and it is to that decision that most of our analysis will refer. The major difference between this case and *MCIIT* is that the entity involved here is a holding company, not an operating corporation.

Similar to *MCIIT*, Petitioner asserts that a sufficient nexus does not exist between itself and Maryland to subject Petitioner to Maryland income tax. Respondent relies on Maryland case law for support of its assessment. In addition, Petitioner claims that the imposition of tax on an out-of-state holding corporation without the promulgation of a regulation or the enactment of legislation violates Maryland case law and the Administrative Procedures Act. Respondent argues that the assessment reflects current law, is not a change in policy and therefore, no regulation or legislation was required in order for the assessment to be issued.

In addition, Petitioner asserts that, even if subject to the tax, Respondent utilized the incorrect apportionment formula and that the Respondent should have waived penalty and interest.

I. Nexus.

The nexus arguments were fully addressed in *MCIIT*, supra. The parties presented the same statutory and case law as support of their positions as in the instant appeal. The *MCIIT* analysis provided:

> Maryland imposes a tax on the taxable income of a corporation defined as "its Maryland modified income as allocated to the State..." §10-301 of the Tax-General

Article of the Annotated Code of Maryland.[1] Maryland modified income of a corporation is its federal taxable income, adjusted by the Maryland additions and subtractions, §10-304 through 10-308. The computation of the tax requires the corporation to allocate Maryland modified income "derived from or reasonably attributable to its trade or business in this State", §10-402(a). If the entity earns its income from in and out of the State, that income derived from instate business activities must be allocated to Maryland, §10-402(a)(1) & (2). If the corporation is unitary, then a 3-factor apportionment formula is applied to its income in order to determine Maryland taxable income of that corporation, §10-402(c). Under subsection (d) of §10-402, the Respondent may alter the allocation and apportionment of a corporation's income "to reflect clearly the income allocable to Maryland". Each corporate member of an affiliated group, even if unitary, is required to file a separate tax return to the Respondent, §10-811...

The parties both agree that Petitioner is a part of a unitary group of entities. Accordingly, relying on precedent established in two Maryland Court decisions, *Comptroller of the Treasury v. Armco Export Sales Corp.*, 82 Md. App. 429 (1990) and *Comptroller of the Treasury v. Atlantic Supply Co.*, 294 Md. 213 (1982), the Respondent asserted nexus over Petitioner based on the in-state activity of an affiliate, MCIT. Respondent first determined that Petitioner lacked "substantial economic substance", labeling Petitioner as a "phantom" corporation. As such, Respondent determined that the cases cited permit the attribution of "nexus and apportionment factors of the company or companies actually engaging in any real activity to the phantom company", Notice of Final Determination (Petitioner's Exhibit # 63).

We disagree with the Respondent's nexus attribution to Petitioner based on the *Armco* and *Atlantic Supply* decisions. Fundamental in both Court decisions is the determination that the taxpaying entity was a shell or phantom corporation with no economic substance. In *Armco*, the Court was faced with a statutorily created business organization known as a Domestic International Sales Corporation or DISC. The Court characterized the DISC as a "phantom book entry corporation created under federal tax laws...". In expounding on the phantom nature of a DISC, the Court noted that the DISC performed "no activity..to earn the income" *Armco*, *supra*, at 431; that "none of the DISC's had any tangible assets or employees anywhere; and that the DISC "can only conduct its activity and do business through branches of its unitary affiliated parent", *supra* at 430,435. In addition, the Court concluded there was specific legislative intent to subject the DISC's to Maryland income taxation.

In *Atlantic Supply*, nexus was not an issue. The taxpayer was clearly doing business in Maryland. The Court's focus was the taxation of an affiliate created for the specific purpose of obtaining the favorable wholesale price from a major supplier, Coca-Cola, which its parent, Macke Company, as a retailer, could not acquire. Emphasis was placed on the fact that the employees of the out-of-state affiliates were authorized to, and did, act in the name of the taxpayer outside of the state. In addition, the Court noted that the taxpayer's business "could not function without the

[1] All future statutory references shall be of the Tax-General Article, unless otherwise noted. FN. 3, *MCIIT v. Comptroller*, supra

> funds supplied by Macke-parent and without the Macke branches as captive customers." *Atlantic Supply*, supra at 223. The court concluded then that the taxpayer could apportion its income among the states in which it did business.
>
> It is clear to this Court that the above holdings are limited in their scope. The entities involved lacked <u>any</u> economic substance,[2] thus earning their "phantom" status. Respondent's attempt to impose that status on corporations with substance is not justified through *Armco* and *Atlantic Supply*. Indeed, in this technologically advanced era, it is not practical as well. It is conceivable that, for legitimate business purposes, a seemingly insignificant affiliate (i.e. one employee and/or one computer) can exist which generates substantial income yet have little or no expense. To attribute nexus solely on the basis that there is reliance on Maryland affiliates for some or all of that income expands the limited holdings of *Armco* and *Atlantic Supply* and ignores the reality that they are separate non-phantom entities required to report their income separately. *MCIIT*, supra, pages 6-8.

Based on *MCIIT,* applying *Armco* and *Atlantic Supply* to the Petitioner is justified only if Petitioner is a "phantom" corporation. For the following reasons, we conclude that Petitioner is an entity of substance and not a "phantom".

In the instant case, the evidence clearly indicates that Petitioner is not just a book entry corporation. Petitioner maintains an office in Delaware. That office contains office furniture and corporate and financial records are kept there. Mail is received at the Delaware office location. It has its own bank account and has an employee. Legal counsel was retained by Petitioner for purposes of protecting its "marks". The requisites for corporate existence were met; i.e. the drafting of by-laws, the election of a board of directors and corporate officers, the holding of regular and annual meetings, the recording of corporate minutes, and the ratification of dividends.

Respondent claims that Petitioner "was little more than a corporate vehicle designed to reduce state income taxes", (Respondent's Memorandum, p. 40), and points to the minimal expenses, the one employee, the mere formality of the corporate existence of Petitioner, and the timing of inter-entity transactions as support that Petitioner was creating the "illusion of substance", (Resp's Memorandum, p. 31). In short, Respondent assessed on the basis that the Petitioner was a sham entity for the sole purpose to avoid Maryland taxes.

---

[2] It is interesting to note that Respondent's hearing officer found that Petitioner had no "substantial" or "significant" economic substance. We find nothing in either statute or case law that imposes a "substantial" requirement and will not infer one here. FN. 4, *MCIIT v. Comptroller,* supra

Even if that were true, *Armco* and *Atlantic Supply* only apply to entities with no substance whatsoever. In addition, it is well settled that tax avoidance (rather than tax evasion) is a legitimate business purpose. If Petitioner was legally created with a tax avoidance purpose, absent authority and in a separate return environment, the Respondent cannot tax it. However, the evidence presented leads to the conclusion that Petitioner was established for non-tax reasons, among them:

- To hold and manage intangible assets in a separate corporation;
- To protect the transferred intangibles from the claims of Syms' creditors and from liabilities of Syms;
- To incorporate in a favorable corporate jurisdiction;
- To avert hostile take-overs; and
- To protect and enhance the value of Syms' name and its borrowing and business acquisition ability.

These facts easily distinguish the Petitioner from the phantom taxpayers in *Armco* and *Atlantic Supply*. Nexus cannot be attributed to it for Maryland taxation purposes.

Similar to *MCIIT*, the issue then turns to whether nexus can be directly found in Petitioner's activities. The Court finds the analysis provided in that case is applicable to the present facts:

> The limits on the taxing powers of a state are found in the Due Process and Commerce Clauses of the Constitution. The Supreme Court reviewed the requirements of both Clauses in *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).
>
> In *Quill*, the Court reiterated 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,' and that the 'income attributed to the State for tax purposes must be rationally related to 'values connected with the taxing State'", *supra* at p.307, *citations omitted*. Overruling prior holdings, the Court determined that the minimum contacts necessary to establish the jurisdiction to tax does not require actual physical presence in the state, but can be found "if a foreign corporation purposefully avails itself of the benefits of an economic market in the forum State", *supra* at p. 307.
>
> The Supreme Court's analysis of the Commerce Clause begins with the requirements as set forth in its decision in *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977). *Complete Auto* provides a four part test which must be satisfied in order for a tax to pass muster against a Commerce Clause challenge. A tax is sustained so long as the tax : "1) is applied to an activity with a substantial nexus with the taxing State, 2) is fairly apportioned, 3) does not discriminate against interstate commerce, and 4) is fairly

> related to the services provided by the State", *Complete Auto* at p. 279. In discussing the first prong of the test, the Supreme Court held that the "substantial nexus requirement is not, like due process' 'minimum contacts' requirement, a proxy for notice, but rather a means for limiting state burdens on interstate commerce. Accordingly...a corporation may have the 'minimum contacts' with a taxing State as required by the Due Process Clause, and yet lack the "substantial nexus' with that State as required by the Commerce Clause", *Quill* at p. 313. The Court reaffirmed the "bright-line" test it established in *National Bellas Hess, Inc. v. Department of Revenue*, 386 U.S. 753 (1967), that a taxpayer must have a physical presence in the taxing state in order to satisfy the substantial nexus requirement of the Commerce Clause.
>
> In addressing the stricter "substantial nexus" requirement, Petitioner argues that since it has no physical presence in Maryland, the attempt to tax its income is a Commerce Clause violation pursuant to *Quill*. Respondent contends that the *Quill* Court explicitly noted that the physical presence requirement applies to sales and use taxes only. Reliance is also placed on the *Armco* and *Atlantic Supply* decisions to support the application of an apportioned income tax to a corporation without any physical presence in Maryland.
>
> The Respondent is correct in that the tax the *Quill* Court analyzed was a sales/use tax. The Court did note that "concerning other types of taxes we have not adopted a similar bright-line, physical presence requirement", 504 U.S. at p. 316. However, the Supreme Court also refused to restrict the rule to only sales and use taxes. "Although we have not, in our review of other types of taxes, articulated the same physical presence requirement that *Bellas Hess* established for sales and use taxes, that silence does not imply repudiation of the *Bellas Hess* rule", *supra* at p. 314. This lack of clarity on the parameters of the physical presence test has led to differing interpretations among the States as to what the Commerce Clause requires in relation to income-based taxes.
>
> Absent apparent explicit direction, we hesitate to expand the *Quill* physical presence requirement to taxes other than sales and use. In so doing however, we note that "substantial nexus" with the taxing state is still required in order to pass constitutional muster. In the rulings of *Armco* and *Atlantic Supply*, due to the nature of the corporate phantoms , with no substance and therefore no presence anywhere, the normal nexus rules were ignored and the Courts found that nexus could be attributed based on the in-state presence and activity of an affiliate. The Commerce Clause was satisfied through the substantial nexus (the production and export of goods) of the in-state unitary affiliate.[3]
>
> However, as stated above, the instant case does not present us with a phantom. Petitioner is an entity of substance with a presence somewhere and thus the normal nexus (versus nexus attribution) rules apply. The focus of the substantial nexus requirement is on the entity sought to be taxed, not its in-state affiliate. *MCIIT*, supra, p. 9-11.

Focusing solely on Petitioner, we find that its lack of in-state activity precludes the imposition of the tax. Petitioner is not doing business in Maryland. Its income producing activity

---

[3] Although the term "substantial nexus" was not used by the *Armco* Court, the *Complete Auto* Commerce Clause requirements had been established for thirteen years prior to the Armco decision. FN. 7, *MCIIT v. Comptroller*, supra.

all occurs outside of Maryland. Petitioner has no offices, employees, agents or property in Maryland. Its only Maryland contact is an affiliation with an entity with a Maryland presence. This affiliation is hardly enough to satisfy substantial nexus.

Respondent relies on *Armco* and *Atlantic Supply* as support for the application of nexus due to the presence of Syms in Maryland. That reliance has been shown above to be erroneous. Respondent then points to the decision of *Geoffrey, Inc. v. South Carolina Tax Commission*, 313 S.C. 15 (1993) as precedent in the taxing of a Delaware holding company licensing trademarks and trade names to its parent in-state company. The *Geoffrey* Court concluded that the use of intangible property (the "marks") by the in-state affiliate was sufficient to pass the constitutional nexus requirements in order to tax the out-of-state entity.

For two reasons, we disagree with the Respondent's use of the *Geoffrey* decision. First, *Geoffrey* dealt with South Carolina law and its application and therefore is not precedent for Maryland application. Second, as indicated above, we differ in our conclusions as to whether the substantial nexus requirement of the Commerce Clause was met. *Geoffrey* focused on the use of the marks by the in-state affiliate of the unitary group in order to determine the nexus of the foreign corporation. We disagree that that activity constitutes "substantial" nexus.

In addition, the unitary relationship between entities does not automatically establish nexus on all of the corporate entities in the unitary group. As we stated in *MCIIT*, supra:

> The mere presence of an in-state affiliate of a unitary group does not confer nexus on a non-phantom out-of-state affiliate of the same group, *Chesapeake Industries, Inc. v. Comptroller*, 59 Md. App. 370 (1984). In the unitary taxation scheme, the foreign corporation's income and factors may be included in determining the tax liability of the in-state affiliate. However, without nexus, the foreign corporation does not become subject to the taxing jurisdiction.
>
> The Respondent claims that the corporate structure present here allows for the diversion of income away from Maryland through the internal transactions of affiliated entities which have no overall impact on the income of the unitary group. While this may be true, all such transactions are not necessarily abusive and in any event, these are the consequences of requiring affiliated corporations to file and report income separately. The Maryland Courts have addressed the treatment of such transactions when dealing with phantom corporations. With non-phantom corporations, such as Petitioner, the nexus rules as reiterated in *Quill* must still be applied to each affiliate before the State can tax. *MCIIT*, supra, p. 11.

Accordingly, we find that the Respondent has failed to satisfy the substantial nexus requirement of the Commerce Clause and the imposition of income tax on Petitioner's income is unconstitutional.

II. Regulation Promulgation Due to Change in Policy.

Having found that the requisite nexus to warrant the imposition of income tax on Petitioner does not exist, the issue of whether a regulation had to promulgated becomes moot. However, due to the number of taxpayers involved and the likelihood of judicial review, we shall address the issue.

This Court concludes that the Respondent's attempt to assert tax against non-nexus, non-phantom trademark protection companies as a result of their licensing of the use of their trademarks, trade names and service marks to entities which have a nexus with the State amounts to a substantially new or change in policy which can only be instituted through the rulemaking procedures pursuant to *CBS, Inc. v. Comptroller*, 319 Md. 687 (1990) and the Maryland Administrative Procedures Act , Md. Code Ann., State Gov't §§10-101 through 10-139. In *CBS, Inc.*, the Maryland Court of Appeals held that a change in an agency's "policy of general application" which results in "materially modified or new standards" may be made by prospective rulemaking only, *CBS*, p. 699. The Administrative Procedures Act requires that a change or implementation of policy by a State agency must be promulgated by regulation and that regulation may only be promulgated prospectively.

Prior to 1995, companies such as Petitioner were not subject to the tax. Phantom companies like those found in *Armco* and *Atlantic Supply* were subject to tax. In his latest statement of policy, ADR No. 2, titled "Interstate Commerce Tax Act -- Domestic and Foreign Corporation -- Nexus Requirements –Apportionment of Net Income, published in 1989, Respondent set forth the parameters of taxing foreign corporations. Nothing in that release, any regulation or statute since 1989 suggests that a foreign corporation with substance, with no business location, representatives, or other activities within the State of Maryland could be subject to income tax as a result of the licensing of the use of intangible "marks" to in-state entities.

Beginning in 1995, (subsequent to the issuance of the *Geoffrey* decision), Respondent began asserting deficiencies against foreign trademark protection companies based on the in-state activities of their affiliates. Rather than a reflection of current policy, these assessments against substantial entities represented a change from its own stated policy (the 1989 Release) and that affirmed in *Armco* and *Atlantic Supply*. That change "materially modified" existing jurisdiction to tax standards to the detriment of taxpayers which had relied on the Respondent's past pronouncements. No regulations were promulgated or legislation enacted to effect this change in policy and, pursuant to *CBS, Inc.*, any retroactive attempt to tax Petitioner is improper. Respondent apparently believed that a regulation was necessary to expand the *Armco* policy as evidenced by the attempt to promulgate regulations relating to payments made by a Maryland taxpayer for "marks" from a contractor to an out-of state affiliated entity.[4] That attempt was rejected by the legislature and a review of their comments demonstrated that the retroactive application of the Respondent's policy was unacceptable.

III. Apportionment.

MCIIT, Inc., supra, provides guidance in regards to the apportionment issue:

> Having found that the requisite nexus to warrant the imposition of income tax on Petitioner does not exist, the issue of which apportionment factor is appropriate becomes moot. As an entity of substance with no nexus to Maryland, there is no Maryland income to calculate.
>
> Even if there were ties to Maryland, with an entity of substance rather than a phantom, the proper apportionment formula would utilize the sales, property and payroll of Petitioner itself. Only if Petitioner were a phantom would the principles of *Armco* and *Atlantic Supply* be applicable. In those cases, the Courts allowed the Respondent to employ the factor of the taxpayer's in-state parent and apply it to the phantom's income. With the present facts, i.e. no phantom, there is no authority for the use of the in-state affiliate's factors. *MCIIT, Inc.*, supra, p. 12.

[4] 24 Md. Reg. 1294 (Aug. 29, 1997) and 24 Md. Reg. 1314 (Aug. 29, 1997). The Respondent also attempted to enact legislation (HB 682, General Assembly Regular Session, 1998) to specifically provide for the taxation of foreign holding companies, but the bill was withdrawn before being bought to a vote.

While agreeing with the Petitioner that the appropriate formula is that applying its own factors, we are not convinced that the traditional apportionment formula results in a distorted enough income figure for Petitioner to warrant the three-factor formula proposed by its witness.

IV. Penalties and Interest.

Similar to the prior issues, having found that the Petitioner has no tax liability, the issue of penalties and interest are moot. However, it is the position of this Court that the Petitioner acted in good faith, complied with existing (and current) law and that, if liability for income tax had been found, no penalty should have been imposed. It is also the consistent position of this Court that the ability to waive interest lies solely with the Respondent.

Conclusion.

For the above reasons, we shall pass an Order reversing the assessments imposed on the Petitioner, SYL, Inc., by the Respondent for all of the tax years involved.