STAPLES, INC. STAPLES THE OFFICE SUPERSTORE, INC.	*	IN THE
	*	
vs.		MARYLAND TAX COURT
	*	
COMPTROLLER OF THE TREASURY	*	No. 09-IN-OO-0148 & 09-IN-OO-0149
	*	

MEMORANDUM AND ORDER

On January 28, 2008, the Comptroller assessed corporate income taxes against Petitioners, Staples, Inc. ("Staples") and Staples the Office Superstore, Inc. ("Superstore"), for the years 1999 through and including 2004 together with interest and penalties. This appeal stems from a Notice of Final Determination issued on January 26, 2009 ("Notices") upholding the Comptroller's assessment of taxes, interest and penalties for the 1999 through 2004 tax years ("Tax Years") in the aggregate amount of $14,392,364. In his Notices, the Comptroller alleges that Staples and Superstore (hereinafter sometimes referred to as "Petitioners") were operated, at least in part, to avoid income taxes in the State of Maryland.

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

1) Did Staples and Superstore have sufficient contacts with Maryland to require it to file returns and pay income taxes in the years 1999 through 2004?

2) If Staples and Superstore 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) If Staples and Superstore are required to file income taxes should the Court

exercise its discretion to waive interest and/or penalties for reasonable cause?

The Comptroller contends that Staples and Superstore have no economic substance as separate entities. The Petitioners argue that Comptroller ignores the thousands of individuals employed by Superstore to whom it paid between $103 million and $222 million of salaries and wages and the over $150 million of real property, buildings and other depreciable assets owned by Superstore. Moreover, the Comptroller ignored the salaries and wages of between $54 million and $105 million paid by Staples and the real property, buildings and other depreciable assets of between $110 million and $160 million owned by Staples. Petitioners argue that the numerous services provided by Staples and Superstore were provided for fees that were charged at arm's length rates. Petitioner contends that Staples and Superstore have established operating companies with real economic substance.

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. 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 within 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.

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 examine the facts and determine whether the Petitioner had real economic substance as separate business entities.

In the years immediately preceding the audit period, specifically 1993 through 1997, Staples' intellectual property was held by Staples Properties, Inc., a subsidiary of Staples, Inc., and licensed back to Staples, Inc. Correspondingly, Staples, Inc. paid royalties to Staples Properties, Inc. Staples Properties, Inc. was previously audited and assessed for income tax liabilities due the State for the period 1993 through 1997. Staples paid assessments for those years in the following amounts:

Year	Tax	2% Penalty	Interest	Total
1993	$64,894	$1,298	$154,346	$220,538
1994	$170,317	$3,406	$382,947	$556,671
1995	$234,947	$4,699	$497,635	$737,281
1996	$353,074	$7,061	$702,067	$1,062,202
1997	$488,631	$9,773	$908,093	$1,406,496

In 1998, to minimize or eliminate its state tax liabilities in separate return states like Maryland, Staples undertook a reorganization that created a new scheme for shifting income using royalty and interest expenses.

After the Staples' reorganization in 1998, Staples was engaged in providing the managerial and administrative services, including cash pooling and management, credit support functions, paying all obligations, and providing legal, accounting, financial and payroll services, on behalf of Superstore, Staples East and Staples C&C. Superstore and Staples C&C were wholly owned subsidiaries of Staples and Staples East was a wholly owned subsidiary of Superstore. Superstore provided the franchise system services to Staples East and Staples C&C, including centralized purchasing, inventory control, lease and contract negotiations, advertising and marketing, research and development, store site selection and construction, equipment and signage.

Superstore, Staples C&C, and Staples East relied on Staples for corporate necessities, such as cash and credit, payment of their bills, the provision of legal, financial and accounting services, and strategic planning. Staples C&C and Staples East relied on Superstore for purchasing goods, advertising and marketing, inventory control, site selection, store construction and layout, licenses to use the trademarks and other intellectual property, and research and development. In reality, the activities of Staples and Superstore permeate the activities of each other and Staples C&C and Staples East. As separate entities, the Petitioners could not operate independently. The facts support the Comptroller's position that enterprise dependency existed between the Petitioners and the affiliated corporations. Thus, the Petitioners were not separate business entities, are a part of a unitary business enterprise, and accordingly, there is nexus with the State of Maryland.

In *Gore Enterprise Holdings, Inc. v. Comptroller of the Treasury* and *Future Value, Inc. v. Comptroller of the Treasury*, 437 Md. 492, 87 A. 3d 1263 (2014), the Court of Appeals sanctioned the constitutionality, propriety, and fairness of applying the apportionment factor of the licensee/in-state retailer to the affiliated entities that received the royalty and interest payments. The Court stated that the apportionment formula used by the Comptroller should reflect a reasonable sense of how [the petitioners'] income is generated. The apportionment formula used by the Comptroller in that case captured Gore's expenses in Maryland-expenses that simultaneously constituted income for its subsidiaries. The Comptroller's responsibility was to capture and tax only that income of the Petitioners that was reasonably attributable to Maryland.

Superstore, in this case, received royalty income which has been taken as an expense by Staples C&C and Staples East. Staples received interest income which has been taken as an expense by Staples C&C and Staples East. Using an apportionment methodology identical to that used in *Gore*, the Comptroller's assessments in this case have captured the royalty and interest expenses of Staples C&C and Staples East-expenses that simultaneously constituted the income for Superstore and Staples.

The reasonableness of these assessments is readily apparent when the uncontested assessments against Staples Properties, Inc. for the prior period of 1993 to 1997 are considered. As stated above, in 1993, Staples placed its intellectual property in Staples Properties, Inc., licensing the use of those intangibles back to Staples, Inc. Thus Staples, Inc. reduced its state taxable income by shifting income to the out-of-state entity vis-à-vis the royalty expense payment it made to Staples Properties, Inc.

Staples Properties' royalty income, paid to it by Staples, Inc. rose from $18,884,807 in 1993 to $132,002,909 in 1997. The uncontested tax assessed by the Comptroller for this period rose from $64,894 in 1993 to $488,631 in 1997, an average annual increase of approximately 65.5%. In 1997, the apportionment factor, as derived from Staples, Inc.'s own calculations, was .052881.

In 1998, the first year the reorganization took effect and the first year of the audit period, Petitioners reported royalty payments, now paid by Staples C&C and Staples East to Superstore, in the amount of $186,387,520. The apportionment factor, as derived from Staples C&C's and Staples East's own calculations, was .073377 and the tax assessed for 1998 was $957,358.

Petitioners claim that the Comptroller's assessments "grossly distort the income of Superstore and Staples attributable to Maryland." The Petitioners offered the testimony of Dr. Brian J. Cody, as purported evidence in support of its claim that the Comptroller's computation is distortive. But, Dr. Cody's testimony was further premised on the assumption that Staples operated as a single entity prior to 1998 and opined that the assessments were distortive.

The Court finds that Dr. Cody's opinion was not persuasive. Staples did not operate as a single entity prior to 1998. Rather, Staples, Inc. was the operating entity; and Staples Properties, Inc. owned the intellectual property, receiving substantial royalty payments from Staples, Inc. for the use of that property. The Court concludes that the Comptroller's assessments reasonably reflected how the Petitioners' income was generated and fairly represented income attributable to Maryland.

The final question 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 Petitioners had a reasonable basis for challenging the law and acted in good faith. The state of the law has evolved through various court decisions in *Quill, SYL, Classics Chicago,* and *Gore.*

For all of the above reasons, the Maryland Tax Court this 28th day of May, 2015, **AFFIRMS** the assessments of tax, abates interest after the date of filing this appeal in the Maryland Tax Court (February 20, 2009) until the date of this Order, and abates all penalties.

cc: Harry D. Shapiro, Esq.
Craig B. Fields, Esq.
Brian L. Oliner, Esq.

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.