

AN ALERT FROM THE BDO STATE AND LOCAL TAX PRACTICE

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► SUBJECT

MARYLAND COURT OF APPEALS HOLDS THAT AN OUT-OF-STATE PATENT HOLDING COMPANY AND AN OUT-OF-STATE INVESTMENT MANAGEMENT COMPANY HAD INCOME TAX NEXUS WITH THE STATE

► SUMMARY

On March 24, 2014, the Maryland Court of Appeals in *Gore Enterprise Holdings, Inc. v. Comptroller of the Treasury*, (No. 36, Md. App., Mar. 24, 2014), held that an out-of-state patent holding company and an out-of-state investment management company had income tax nexus with the state. In addition, the court upheld the Comptroller's discretionary use of an alternative apportionment formula.

► DETAILS

Facts

This case involves three entities: (1) W.L. Gore & Associates, Inc. ("Gore"), a Delaware headquartered specialty manufacturing company that operates in several states, including Maryland; (2) Gore Enterprise Holdings, Inc. ("GEH"), a Delaware holding company and Gore subsidiary that managed a portfolio of Gore's patents which were licensed back to Gore; and (3) Future Value, Inc. ("FVI"), a Delaware corporation and Gore subsidiary that was organized primarily to perform investment management functions with respect to Gore's excess capital and that would extend credit to Gore in the event Gore experienced negative cash flow.

GEH had one employee, a patent administrator who managed the patent portfolio out of a Delaware office rented from Gore. Under a legal services agreement, Gore's attorneys assisted with patent defense and provided legal

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advice with respect to the patents GEH managed. Two members of Gore's board and GEH's vice president comprised FVI's board of directors. Thus, while the court found that GEH and FVI may have relied on Gore for revenue and services, neither GEH nor FVI had a physical presence in Maryland.

The Comptroller audited GEH and FVI and issued corporate income tax assessments against each entity. The assessments against GEH and FVI were based on a determination that each entity had nexus with the state and the use of Gore's three-factor (*i.e.*, property, payroll, and sales) Maryland apportionment percentage to apportion GEH and FVI's income. GEH and FVI filed an appeal, which worked its way through a Comptroller hearing officer, the Maryland Tax Court, the Circuit Court for Cecil County, the Court of Special Appeals, and ultimately to the Maryland Court of Appeals.¹

Issues

The primary issue on appeal was whether GEH and FVI had income tax nexus with Maryland. A secondary issue was whether the Comptroller's use of Gore's apportionment factor to apportion GEH's and FVI's income was proper.

Holding and Rationale

The Maryland Court of Appeals held that GEH and FVI had income tax nexus with Maryland and upheld the Comptroller's use of Gore's Maryland apportionment factor. With respect to the nexus issue, the court applied the "real economic substance as a separate entity" test developed in *Comptroller of the Treasury v. SYL, Inc.*, 375 Md. 78, 825 A.2d 399 (2003), *cert. denied*, 540 U.S. 984 (2003), and *The Classics Chicago, Inc. v. Comptroller of the Treasury*, 189 Md. App. 695, 985 A.2d 593 (2010), finding that neither GEH nor FVI had substantial activity apart from Gore. The court reasoned that Gore's activity generated GEH's and FVI's income and the operations of the entities were so intertwined as to make them inseparable. Evidence of arm's-length transactions between Gore and its subsidiaries and some third-party royalty transactions, and the fact that the court did not disclaim that GEH and FVI engaged in more substantive activities than the taxpayers in *SYL, Inc.*, were not enough to convince the court to conclude that the subsidiaries had economic substance as separate business entities.

In upholding the Comptroller's use of Gore's apportionment factor, the court rejected GEH's and FVI's arguments that the Comptroller was required to use an average of their property and payroll factors to apportion their income (which would have resulted in zero income apportioned to the state) and that the Comptroller's formula violated internal and external consistency under the fair apportionment requirement of the United States Constitution. The court reasoned that, while the Code of Maryland Administrative Regulations ("COMAR") 03.04.04.08.C(3)(d) requires using an average of property and payroll factors to apportion income from intangibles, COMAR 03.04.04.08.F(1) empowers the Comptroller to alter the standard apportionment formula if it does not fairly represent the extent of a corporation's activity in the state.

The court found that the Comptroller's alternative apportionment formula did not violate the United States Constitution's internal or external consistency requirements because, if applied by every jurisdiction, the apportionment formula used would result in no more than all of the subsidiaries' income being taxed. Moreover, the alternative apportionment formula captured Gore's activity in Maryland-activity which simultaneously generated GEH's and FVI's income. As such, the apportionment formula reflected a reasonable sense of how GEH and FVI generated income and was not out of proportion to the business that GEH and FVI conducted in Maryland.

¹ The Maryland Tax Court upheld the assessments against GEH and FVI on November 9, 2010, and the taxpayers appealed to the Circuit Court for Cecil County, which consolidated the cases but reversed the Tax Court's decision on September 30, 2011. The Comptroller appealed the decision to the Maryland Court of Special Appeals, which reversed the decision on January 24, 2013. The taxpayers then appealed that decision to the Maryland Court of Appeals. The decisions of the Maryland Tax Court and the Maryland Court of Special Appeals are cited in fn. 3, *infra*.

► BDO INSIGHTS

- The decision in *Gore Enterprise Holdings, Inc.* clarifies that the focus of the “real economic substance as a separate entity” test is whether the entity has economic substance separate from the related operating company. It is not a sham-transaction test and, as such, the focus is not on whether the entity itself has economic substance and followed corporate formalities such as an independent board.
- The intangible holding company nexus standard applied by the New Jersey court in the *Lanco* case and the South Carolina court in the *Geoffrey* case is based upon the presence or use of the intangible in the state.² The Maryland standard is unlike the New Jersey and the South Carolina standard in that, at least so far, it has been applied without regard to the presence or use of the intangibles in the state.
- In response to the Maryland Tax Court’s holding (*i.e.*, “[t]here is a circular flow of money through royalties, dividends and loans which support the *unitary business* of W. L. Gore and its wholly owned subsidiaries” [emphasis added]) and discussion in the Maryland Court of Special Appeals decision regarding unitary business relationships, the court in *Gore Enterprise Holdings, Inc.* also clarified that a unitary business relationship does not confer nexus.³ The court further explained that it is a principle that allows apportionment of entities already deemed taxable. However, the analysis embodied in determining whether a unitary business relationship exists (*i.e.*, business activities or operations that either result in a flow of value, or are integrated with, dependent upon, or contribute to each other) may assist in determining whether an intangible holding company has real economic substance as a separate entity.
- The apportionment discussion in *Gore Enterprise Holdings, Inc.* shows the apportionment methodology likely to be used by the Comptroller to apportion the income of an intangible holding company with a structure similar to the taxpayers in *Gore Enterprise Holdings, Inc.* and, thus, along with the nexus standard, should be considered when evaluating potential Maryland income tax exposure related to an intangible holding company structure.

² See e.g., *Lanco, Inc. v. Director, Division of Taxation*, 379 N.J. Super. 562, 879 A.2d 1234 (2005); and *Geoffrey, Inc. v. South Carolina Tax Commission*, 313 S.C. 15, 437 S.E.2d 13 (1993).

³ See *W. L. Gore & Associates, Inc., Gore Enterprise Holdings, Inc., and Future Value, Inc. v. Comptroller of Treasury*, (Nos. 07-IN-00-0084, 07-IN-00-0085, and 07-IN-00-0086, Md. Tax Ct., Nov. 9, 2010); and *Comptroller v. Gore Enterprise Holdings, Inc.*, 209 Md. App. 524, 60 A.3d 107 (2013).

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