State & Local Tax **Alert**

Breaking state and local tax developments from Grant Thornton LLP

Maryland Tax Court Finds Out-of-State Subsidiary Lacked Economic Substance Separate From Maryland-Based Parent

The Maryland Tax Court recently upheld the assessment of state corporate income tax on interest income received by an out-of-state subsidiary from its Maryland-based parent because the subsidiary lacked economic substance separate and apart from its parent. In its decision, the Court also upheld the Maryland Comptroller's use of the parent company's apportionment factor to determine the Maryland income of the subsidiary. The Court's holding is notable for its consistency with a series of Maryland court cases that rely on the economic substance test to establish a finding of nexus.[1]

Background

Host International (Parent), based in Bethesda, Maryland, operates food and merchandise concessions through its subsidiaries at locations throughout the United States. Michigan Host, an affiliate of Parent, operates restaurants and retail stores primarily at Detroit Metropolitan Airport. Michigan Host owns no real property in Maryland and no non-management employees are located in the state.

The Comptroller audited Parent for the 2000-2003 tax years and discovered that the company had made substantial amounts of interest payments to Michigan Host. Michigan Host did not file Maryland corporation income tax returns for the tax years under audit. The Comptroller assessed income tax and penalties on the interest income received by Michigan Host from Parent and other related entities, using the Maryland apportionment factor of Parent to apportion Michigan Host's interest income. The Comptroller's assessment rested on a finding that Michigan Host lacked economic substance as a separate business entity from its parent.

Michigan Host disputed the assessment arguing that it was not required to file a Maryland corporate income tax return because it had no income-producing sales, employees or property in Maryland, and thus had zero percent property, payroll and sales factors resulting in no Maryland corporate income tax liability. Michigan Host also pointed to the lack of a "sufficient connection" between Maryland and either: (i) the company itself; or (ii) the activities producing the interest income, and argued that the assessment violated Federal Due Process and Commerce Clause provisions.

Release date
October 31, 2017

States
Maryland

Issue/Topic
Corporate Income Tax

Contact details

Eric Cheek
Metro DC - Arlington
T 703.637.4201
E eric.cheek@us.gt.com

Jamie C. Yesnowitz
Washington, DC
T 202.521.1504
E jamie.yesnowitz@us.gt.com

Chuck Jones
Chicago
T 312.602.8517
E chuck.jones@us.gt.com

Lori Stolly
Cincinnati
T 513.345.4540
E lori.stolly@us.gt.com

Priya D. Nair
Washington, DC
T 202.521.1546
E priya.nair@us.gt.com

www.GrantThornton.com/SALT

[1] *Michigan Host, Inc. v. Comptroller of the Treasury*, Maryland Tax Court, No. 12-IN-00-1187, Feb. 1, 2017.

Economic Substance Separate From Parent

The Maryland Tax Court rejected Michigan Host's arguments and upheld the assessment, explaining that the ability of Maryland to constitutionally tax Michigan Host's income producing activities turned on the question of whether the company had economic substance separate and apart from its parent during the audit period. The determination of this question rested on a two-part analysis that first looked to Michigan Host's ties to Parent, and then addressed the applicable standard developed through Maryland case law for establishing a finding of nexus.

Michigan Host's Connections to its Parent

The Court found that Michigan Host had sufficient nexus with the state because Bethesda, Maryland served as the location for Michigan Host's loan servicing operations as well as the location for the corporate officers that directed the management of the company. Specifically, the Court noted that the offices of all Michigan Host directors and corporation-level officers were located in Bethesda and the company's high-level administrative functions were performed at that location. Furthermore, Michigan Host's loan operations, which constituted 75 percent of its revenue, were serviced in Bethesda.

Turning to the specific relationship between Michigan Host and Parent, the Court explained that the company was "functionally and economically dependent" on Parent. Michigan Host relied on Parent for all non-operational corporate functions, and in essence, was a corporate financier locked in an integrated corporate system with Parent under which corporate funds moved in a circular manner between itself and Parent. The Court explained that this circular movement of funds in an integrated corporate system was the "central and predominant legal justification" for the state's assessment against Michigan Host.

Standard Established by SYL and Gore

The Court relied on two seminal Maryland cases, *Comptroller v. SYL*[2] and *Gore Enterprise Holdings, Inc. v. Comptroller*[3] to establish that an intercompany banker entity is taxable in Maryland if it earns intangible income from the activities of its controlling parent and has no operational existence as a separate entity independent from its parent. Applying this standard, the Court noted that Michigan Host's interest income has a 'direct and substantial connection' to the state because it arises from loans made to Parent that are serviced in Maryland. Specifically, Michigan Host's interest income was produced from Parent's Maryland business and served as the connection needed between Maryland and Michigan Host to create the nexus needed to justify the tax on the interest income. Next, the Court noted that Michigan Host lacked economic substance separate and apart from Parent because its support services, cash management, funding of legal services and executive staffing were all provided by Parent. Based on these findings, the Court concluded that Michigan Host had the requisite minimum contacts needed with Maryland to result in a corporation income tax filing obligation.

---

[2] 825 A.2d 399, *cert. denied*, 124 S. Ct. 478 *and* 124 S. Ct. 961 (2003).

[3] 437 Md. 492 (2014).

Use of Blended Apportionment Factor Upheld

Having established that Maryland had the power to tax Michigan Host's interest income, the Court then determined the appropriate amount of tax. The Court noted that Maryland Host's lack of property, payroll or sales as calculated by the Maryland apportionment factor provisions yielded a zero apportionment factor that was not reflective of its income attributable to Maryland. As a result, the Comptroller's use of an apportionment factor derived from Parent's Maryland returns was upheld by the Court because it was neither unreasonable nor did it distort Michigan Host's income. The Court waived 50 percent of the interest and all penalties, finding that Michigan Host acted in good faith, given that the law surrounding economic substance was unclear during the audit period.

Commentary

The decision by the Maryland Tax Court rifles through weighty nexus and apportionment topics in the context of a corporate group in only six pages. While brief, the decision is noteworthy in its continued adherence to the economic substance doctrine that has emerged in a series of Maryland court cases.[4] The Court addresses the doctrine in the discussion on its decision to waive penalties for Michigan Host, which it attributes to the economic substance doctrine being not fully developed during the 2000-2003 tax years audited by the Comptroller. The emergence of the economic substance doctrine can be traced to *Gore*, in which the Maryland Court of Appeals tied an economic substance analysis to the determination of whether out-of-state subsidiaries have nexus with the taxing state. However, *Gore* left many unanswered questions in its wake, most notable of which was the level of economic substance needed for a finding that a subsidiary is an independent entity. The *Gore* decision also opened the door for an increased likelihood that subsidiaries that are closely related to their corporate parents stood a higher chance of being held by the Maryland Comptroller as not having enough economic substance.

Several recent cases have applied the Maryland Court of Appeals' economic substance test, the first of which was the Maryland Tax Court's decision in *ConAgra*, which held that an out-of-state intangible holding company had corporate income tax nexus with Maryland because it was considered to have no real economic substance as a business entity separate from its parent company.[5] Against this backdrop, the Court's decision in this matter superficially serves as a reminder that Maryland adheres to the economic substance doctrine laid out in *Gore* and its progeny, as a means of establishing nexus for out-of-state intangible property holding companies. However, a closer look at the decision uncovers some disturbing trends. Both *Gore* and *ConAgra* dealt with intellectual property holding companies. Unlike those cases, Michigan Host did not hold intellectual property and was

---

[4] *ConAgra Brands, Inc. v. Comptroller of the Treasury*, Maryland Tax Court, No. 09-IN-00-0150, Feb. 24, 2015, which is discussed in GT SALT Alert: Maryland Tax Court Holds Intangible Holding Company Had Corporate Income Tax Nexus; *In re ConAgra Brands, Inc.*, Maryland Circuit Court for Anne Arundel County, No. C-02-CV-15-993, Oct. 19, 2015, which is discussed in GT SALT Alert: Maryland Circuit Court Affirms Intangible Holding Company Had Corporate Income Tax Nexus; *Staples, Inc. v. Comptroller of the Treasury; Staples The Office Superstore, Inc. v. Comptroller of the Treasury*, Maryland Tax Court, Nos. 09-IN-OO-0148; 09-IN-OO-0149, May 28, 2015, which is discussed in GT SALT Alert: Maryland Tax Court Again Subjects Affiliated Taxpayers to Corporate Income Tax with "Fair" Apportionment.

[5] For a discussion of the economic substance test in the context of intangible holding companies, *see* Jamie Yesnowitz, et.al, *Maryland Tax Court Adopts Economic Substance Doctrine*, THE TAX ADVISER, February 1, 2009.

akin to a financier. It bears noting that the Court glosses over this distinction between *Gore* and Michigan Host by referring to the *Gore* holding as one addressing "intangibles holding companies." In essence, the Court appears to be confirming the fear that practitioners had when *Gore* was issued, namely that the decision would be used to target entities engaged in other activities beyond the pure holding of intellectual property intangibles. While the decision is likely to be appealed, if history serves as any indicator, higher-level courts in Maryland have been willing to follow Tax Court guidance on economic substance issues. The Maryland Court of Appeals' decision affirming *Gore* is an example.

Another controversial aspect of the decision is the Comptroller's decision to use the apportionment factors of the parent to derive an apportionment factor for its subsidiary. Parent's apportionment to Maryland was substantial given its headquarters location in Maryland, and on its face, seems unlikely to be a completely fair representation of what Michigan Host actually did in the state. The Tax Court adopted the Comptroller's interpretation in this area because the Court deemed the use of Michigan Host's own Maryland apportionment factors to be distortive. In reaching this conclusion, the Tax Court briefly noted that the company had "no recorded Maryland sales, no recorded Maryland payroll, and no recorded Maryland property," and, as a result, the application of the "statutory 3-factor apportionment formula would have yielded an apportionment factor of zero."

While it is relatively clear that Michigan Host had no physical presence and therefore had a zero Maryland payroll and property factor, the calculation of the sales factor is not as intuitive. Assuming that Michigan Host did not earn any income but for the intercompany interest income, the application of a Maryland regulation could explain why Michigan Host would have a zero Maryland sales factor as well. The regulation provides that gross income from intangible items such as interest is sourced based on the average of the property and payroll factors and in this case, would yield a zero sales factor.[6] If the application of Maryland's rules led to a result that would have required sourcing some of the interest income to the state, perhaps the Tax Court would have been less willing to fully employ the use of blended apportionment in this decision.

The information contained herein is general in nature and based on authorities that are subject to change. It is not intended and should not be construed as legal, accounting or tax advice or opinion provided by Grant Thornton LLP to the reader. This material may not be applicable to or suitable for specific circumstances or needs and may require consideration of nontax and other tax factors. Contact Grant Thornton LLP or other tax professionals prior to taking any action based upon this information. Grant Thornton LLP assumes no obligation to inform the reader of any changes in tax laws or other factors that could affect information contained herein. No part of this document may be reproduced, retransmitted or otherwise redistributed in any form or by any means, electronic or mechanical, including by photocopying, facsimile transmission, recording, re-keying or using any information storage and retrieval system without written permission from Grant Thornton LLP.

[6] See MD. REGS. CODE tit. 03, § 03.04.03.08(C)(3)(d).

This document supports the marketing of professional services by Grant Thornton LLP. It is not written tax advice directed at the particular facts and circumstances of any person. Persons interested in the subject of this document should contact Grant Thornton or their tax advisor to discuss the potential application of this subject matter to their particular facts and circumstances. Nothing herein shall be construed as imposing a limitation on any person from disclosing the tax treatment or tax structure of any matter addressed.