Maryland high court – Nexus attributed to affiliates without economic substance as separate entities, unitary nexus rejected

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In brief

On March 24, 2014, the Maryland Court of Appeals (the state's highest court) ruled that two subsidiaries of an in-state parent had nexus with Maryland because the subsidiaries had no real economic substance as business entities separate from their parent. In doing so, the court rejected the lower court's ruling that established nexus between Maryland and the subsidiaries due to their unitary relationship with their in-state parent. Although rejecting unitary nexus, the entities' unitary relationship justified the state applying to the subsidiaries an alternative apportionment formula that incorporated unitary elements. [*Gore Enterprise Holdings, Inc. v. Comptroller of the Treasury*, Md. Ct. App., No 36 (March 24, 2014)]

In detail

Facts

During the years at issue, W.L. Gore & Associates, Inc. (Gore) operated manufacturing factories in several states, including Maryland.

In 1983, Gore formed Gore Enterprise Holdings, Inc. (GEH), a wholly-owned subsidiary, to operate in Delaware and to hold all Gore patents. GEH granted Gore an exclusive license to use all US patents presently owned or thereafter acquired. In exchange, Gore paid GEH a 'reasonable fee.' Additionally, Gore and GEH executed a Legal Services Consulting Agreement under which Gore attorneys performed certain legal services for GEH involving the protection and maintenance of the patents.

In 1996, Gore formed Future Value, Inc. (FVI), a wholly-owned subsidiary, to manage Gore's excess capital. FVI was funded entirely by contributions from Gore and GEH, and by reinvesting its investment income. FVI also made loans to Gore.

Neither GEH nor FVI had property or employees present in Maryland and neither filed Maryland corporate income tax returns during the years at issue. An audit by the Comptroller determined that GEH and FVI were subject to Maryland tax from 1983 to 2003 and from 1996 to 2003, respectively. On appeal, the Maryland Court of Special Appeals found that GEH and FVI had nexus with Maryland based on their unitary relationship with Gore. Click here for our summary of the lower court's decision. Gore appealed to the Maryland Court of Appeals (Court)

The unitary principle is not a basis for determining nexus

The Court first addressed whether the lower court erred when it found nexus between

Maryland and GEH and FVI. The Court recognized that the unitary business principle authorizes a state to tax the apportioned value that a unitary business derives from its operation within a particular state.

However, the Court rejected the notion that the unitary principle could be used to establish nexus between an entity and the state by stating that:

> "the principle does not confer nexus to allow a state to **directly** tax a subsidiary based on the fact that the **parent** company is taxable and that the **parent and subsidiary are unitary**. . . . the unitary principle cannot be used to clear the constitutional hurdles of the Due Process and Commerce Clauses." (emphasis in original)

Nexus may be attributed to affiliates with "no real economic substance as separate business entities"

The Court recognized that prior Maryland case law, notably the 2003 *Comptroller of the Treasury v. SYL* Court of Appeals decision, supported the conclusion that a portion of an out-of-state subsidiary's income may be taxed in Maryland based upon its parent corporation's Maryland business when the entities have "no real economic substance as separate business entities." Another way of viewing this standard, according to the Court is the recognition that the parent's activity is what generates the subsidiary's income. In a tax case, a court can look to the realities of a parent/subsidiary relationship to determine the amount of income that is fairly traceable to Maryland.

Although the unitary business principle is an inquiry distinct from an economic substance inquiry, the Court determined that "there is no reason – based either in case law or logic – for holding that the factors that indicate a unitary business cannot also be relevant in determining whether subsidiaries have no real economic substance as separate business entities."

The Court approved the lower court's determination that GEH and FVI lacked substance apart from Gore based on facts that included the following:

- There were no outside Directors of GEH or FVI.
- FVI was simply a depository for assets built up through royalties paid to the patent company, GEH.
- GEH did not create, invent, or make anything and relied Gore employees to invent new processes or products.
- Although GEH had separate corporate status, the patent committee of GEH strongly considered Gore's interest in making its decisions.
- Gore and GEH had globally integrated goals and a synergy existed between Gore and GEH due to the relationship between patents and products.
- Nearly all third-party licenses came about in order to produce benefits for Gore.
- Inter-corporate transactions and the legal service agreement supported that GEH and FVI relied on Gore for revenues and services.

Accordingly, the Court determined that GEH and FVI had no real economic substance apart from Gore. This lack of substance "satisfied the constitutional requirements for taxation in Maryland" and therefore GEH and FVI were subject to Maryland tax.

Court rejects other taxpayer arguments

Gore argued that a finding of nexus was not appropriate because GEH and FVI: (1) were created for legitimate business reasons, (2) engaged in substantial activities, and (3) transacted with Gore at arm's length.

The Court rejected each of Gore's arguments, emphasizing that the relevant inquiry is whether the subsidiaries have economic substance as separate entities. As such, the motivation (i.e., legitimate business reasons) for creating the entities is not dispositive. Additionally, Gore argued that it engaged in more substantive activities than those in *SYL,* notably the acquisition of patents from third parties and the license of patents to third parties. However, the Court viewed the additional substance as 'window dressing' and found that these factors did not "imbue GEH and FVI with substance as separate entities."

Finally, arm's length transactions could not "dispel the inescapable conclusion" that GEH and FVI did not have economic substance as separate business entities.

Alternative apportionment allowed, authorized by the unitary business principle

Maryland provides that the Comptroller may alter apportionment methods when a formula does not 'fairly represent' the extent of a corporation's Maryland activity.

Applying Maryland's apportionment formula to GEH and FVI activities would have resulted in both entities having a zero apportionment factor, which the Court determined would not fairly represent their Maryland activity. The Court allowed the Comptroller to use Gore's property, payroll, and sales figures to apportion the income of GEH and FVI (for

example, GEH's liability was calculated by multiplying royalties paid by Gore times the Gore apportionment formula).

The Court found that using Gore's apportionment figures to calculate GEH and FVI's Maryland liability was fair and was "authorized by the unitary business principle." In other words, because GEH and FVI were engaged in a unitary business with Gore (as determined by the lower court), the Comptroller was justified in using a unitary apportionment factor measured by Gore's activities to calculate the Maryland tax liability of GEH and FVI.

The Court further held that the alternative apportionment formula satisfied constitutional concerns. Using Gore's apportionment factors was internally consistent because, if applied by every jurisdiction, the apportionment would result in no more than all of the unitary business' income being taxed. Additionally, the apportionment was externally consistent because the formula reflected a reasonable sense of how GEH and FVI's income was generated.

The takeaway

The opinion advances a nexus test relating to whether an out-of-state entity has "economic substance as a separate entity" from an in-state entity. The Court provides that factors indicating a unitary business can be used in determining whether entities have no real economic substance as separate business entities. At issue is whether the state or courts will continue to apply unitary factors in the context of seeking an economic substance determination, which, in turn, leads to nexus considerations. As a result, the concept of 'unitary nexus' may remain an issue in Maryland.

Let's talk

If you have any questions regarding the *Gore* decision, please contact:

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