Maryland: Who Needs Combined Reporting When You Have *Gore*?

by Brian Strahle


Brian Strahle

The SALT Effect is written by Brian Strahle, who provides state and local tax technical services to firms, businesses, and tax research organizations. He welcomes comments at strahle@leveragesalt.com.

Combined reporting proposals in Maryland, like a holiday or one of the four seasons, come around every year, and 2014 is no exception. Sen. Paul G. Pinsky (D) sponsored and introduced SB 395 on January 23. The bill would require affiliated corporations to compute Maryland taxable income using combined reporting and would take effect July 1, 2014, with the provisions being applicable to tax year 2015 and beyond.[1] Some of this year's gubernatorial candidates[2] are proposing combined reporting as a method to provide tax relief to small businesses and close tax avoidance loopholes as part of their campaigns. Despite the annual recurrence, combined reporting legislation never gets much traction. Deputy Comptroller David Roose said that it's improbable that 2014 will be any different, especially being an election year.[3]

Those in favor of combined reporting say that many large multistate corporations use aggressive accounting strategies to avoid paying tax in Maryland.[4] Supporters also say combined reporting would bring Maryland tens of millions of dollars a year and would level the playing field for local businesses. However, opponents believe that combined reporting would impose a multimillion-dollar tax increase on Maryland businesses and make Maryland less competitive with neighboring states that don't impose mandatory combined reporting. They also argue that combined reporting would create tax shifts among businesses, create additional compliance complexity and litigation, and increase the volatility of the amount of revenue the state receives from the corporate income tax.[5] The Council On State Taxation has provided testimony opposing Maryland mandatory combined reporting legislation each time (or nearly so) the legislation has been proposed throughout the last decade.

The reemergence of combined reporting legislation compelled me to revisit *Comptroller of the Treasury v. Gore Enterprise Holding Inc., Comptroller of Treasury v. Gore Enterprise Holdings Inc. et al.*, Md. Ct. of Spec. App., 1696, 1697 (2013). and raised the question: Does Maryland need mandatory combined reporting legislation if the comptroller ultimately wins *Gore*?

Unitary Relationship Creates Nexus?

Gore presented two questions:

- Can Maryland treat royalties and interest income claimed as expenses in Maryland and paid to wholly owned subsidiaries as a taxable part of a unitary business?
- Can Maryland apportion the subsidiaries' income based on the parent corporation's apportioned expenses?

The Maryland Court of Special Appeals said yes to both. The taxpayer has since appealed to the Maryland Court of Appeals, Maryland's highest court, and oral arguments were held on December 6, 2013, with the decision expected this spring.

An examination of the two questions made me conclude that related-party expense addback legislation would be a simple solution to each question. However, this case involved assessments for the years 1983 to 1992 and 1993 to 2003. Maryland adopted its related-party expense addback legislation in 2004.[6] Thus, without the ability to use that

---

[1] SB 395, *Fiscal and Policy Note*, Department of Legislative Services, Maryland General Assembly, 2014 Session.

[2] Democratic candidates Heather Mizeur and Doug Gansler.

[3] Jennifer DePaul, "Maryland Deputy Comptroller Predicts No Major Tax Legislation in 2014," *State Tax Notes*, Nov. 18, 2013, p. 412.

[4] Bryan P. Sears, "Pinsky Makes Another Stab at Combined Reporting," *The Daily Record*, Feb. 12, 2014.

[5] Maryland Chamber of Commerce, Legislative Position regarding SB 395 (Feb. 12, 2014).

[6] Md. Code Ann. Tax-Gen. section 10-306.1.

legislation, the comptroller and the court utilized the unitary principle to create nexus for two out-of-state subsidiaries based on the connection of the income they received, or the activities of the parent with the related expense. In brief, the court determined that a unitary business relationship creates nexus.

Right Conclusion, Wrong Reasoning?

According to the court, the resolution of *Gore* depends on whether the two out-of-state subsidiaries had real economic substance as business entities separate from the parent with nexus in Maryland. The court admitted that the test in any case is whether intrastate and extrastate activities form part of a single unitary business. If the extrastate activities constitute a discrete business enterprise, then a single unitary business would not exist. The court stated the "hallmarks" of a unitary relationship are functional integration, centralized management, and economies of scale.

Based on an analysis of the facts, the court concluded that the entities were functionally integrated, controlled through stock ownership, and had common employees, directors, and officers. Perhaps more importantly, there was a circular flow of funds through royalties, dividends, and loans between the entities. Thus, it is arguably easy to concede that the entities were unitary. However, the court used the conclusion that the entities are unitary to also deduce that the subsidiaries have substantial nexus with Maryland, which is arguably erroneous.

The reasoning and conclusions made by the court are focused on the connection between the in-state parent's expenses or deductions taken, and the corresponding income or gains by the out-of-state subsidiaries. Consequently, the focus is not on whether the out-of-state subsidiaries have nexus. Rather, the focus is on the fact that the parent is taking a deduction in Maryland while the corresponding income goes untaxed. The court contended that "it would defy logic to argue that expenses are incurred in Maryland and yet the corresponding gains are somehow not realized in Maryland as part of a unitary business." Those arguments and statements appear more appropriate to sustain the imposition of addback legislation, not to hold that out-of-state subsidiaries have nexus.

In a footnote to the case, the court explained that the taxpayer asserted that the unitary principle should only be applied "to apportion an out-of-state company's income among several states if and only if nexus has already been established between a taxpayer and a taxing jurisdiction."[7] That stance is one that most taxpayers have been operating under for years and is outlined by the U.S. Supreme Court.[8] Unfortunately, the court refuted that assertion by referencing Maryland cases that focus on "real economic substance" and a "sham transaction test."[9]

In the same footnote, the court stated, "where, as here, a parent company undoubtedly has a requisite nexus, the only question is whether the subsidiary partakes in the parent's unitary business; if so, it inherits the parent's nexus, and the tests are effectively merged." Previous Maryland cases have applied nexus to out-of-state intangible holding companies but without using the unitary principle to do so. If the court's position is ultimately upheld, the assertion that a "unitary relationship creates nexus" may be levied by the comptroller against parent-subsidiary relationships regardless of whether an entity is an intangible holding company.

Walter Hellerstein of the University of Georgia Law School has said that the unitary business principle "establishes the link between property or income that lies outside the state's jurisdiction in order to permit the state, through a reasonable apportionment formula, to determine the value of property or the amount of income that is fairly attributable to the state for tax purposes."[10] He added that the unitary principle is the "linchpin of apportionability," not the "linchpin of nexus."

Hellerstein maintained that the court errantly relied on the unitary business principle to attribute the activities of the in-state parent to the out-of-state subsidiaries and instead could have relied on nexus attribution as put forth in other Maryland cases. In other words, there is precedent for the conclusion the court reached, but there is no precedent for the reasoning it applied. The reasoning is just as important as the conclusion reached because of the potential impact on other taxpayers. Therefore, the court of appeals must consider this case with extreme diligence.

Unfortunately, a report regarding the oral arguments that were held on December 6 reflects that the court and those involved may not agree or understand the technical differences between the unitary principle and nexus.[11] According to the report, Maryland Assistant Attorney General Michael Salem argued that "the unitary business principle can be used to establish a state's jurisdiction to tax an entity." One judge expressed that he was having trouble understanding why the unitary business principle can't be part of a nexus analysis. The report also mentions that the bench was struggling with the concept of nexus in general — "the difference between substantial connection and minimum contact." The lack of knowledge or experience in those issues does not

---

[7] *See Gore*, at n.11.

[8] *Mobil Oil Corp. v. Commissioner of Taxes of Vermont*, 445 U.S. 425, 439 (1980).

[9] *Comptroller of the Treasury v. SYL Inc.*, 375 Md. (2003); *Classics Chi. Inc. v. Comptroller of the Treasury*, 189 Md. App. (2010).

[10] Hellerstein, "A Unitary Business Is the 'Linchpin of Apportionability,' Not Nexus," *State Tax Notes*, Mar. 18, 2013, p. 865; Jerome R. Hellerstein, Walter Hellerstein, and John Swain, *State Taxation*, at para. 6.13 (3rd ed. 2013 rev.).

[11] Jennifer Carr, "News Analysis: Cases to Watch in 2014," *State Tax Notes*, Jan. 6, 2014, p. 7.

invoke confidence that the proper reasoning will be exercised to reach the court's ultimate decision. A decision that could be justified by prior Maryland case law but which is based on incorrect assertions could lead to assessments on similarly situated taxpayers, or on out-of-state corporations that have unitary relationships with in-state corporations.

Other Revelations From *Gore*

After reaching its decision, the court addressed whether the statute of limitations had expired. As a result of establishing that the unitary relationship with the parent created nexus for the subsidiaries, the subsidiaries should have filed returns. Because they did not file returns, the statute of limitations never began. The taxpayer argued that the comptroller did not assess taxes in prior audits of the parent. Thus, the comptroller's ability to assess additional tax no longer exists. However, the court held that it is "not the comptroller's duty to investigate every expense" paid to related companies. The court asserted that it is the taxpayer's responsibility to timely address issues by seeking the comptroller's opinion. Therefore, the court held that the comptroller has the ability to assess additional tax on the parent or the subsidiaries.

Another noteworthy matter was affirmed by the court when it reiterated a 1964 precedent.[12] In brief, the court said, "The Comptroller is not bound by positions taken in its audits." That may not be earth-shattering news, but it should give taxpayers pause. Taxpayers presuming certainty or predictability from one audit to the next should review their facts and potential issues more closely to determine if any proactive action should be taken, such as a private letter ruling or other disclosure.

Conclusion

In his article, Hellerstein said, "Maryland could have achieved substantially the same result that the court sustained by adopting combined reporting." In other words, Maryland is achieving combined reporting by asserting that a unitary relationship creates nexus, without formally adopting combined reporting. Thus, if Maryland wins *Gore* based on the reasoning put forth by the court of special appeals, it would seem to render the enactment of combined reporting legislation unnecessary. ✩

---

[12] *Comptroller of Treasury, etc. v. Atlas General Industries*, 234 Md. 77, 86 (1964).