Maryland Comptroller “Offers a Deal” to Settle Delaware Holding Company Tax Cases

By Kenneth Silverberg
December 8, 2003

Is It A Deal You Ought To Accept?

The December 2, 2003, press release says:

Maryland Comptroller William Donald Schaefer today presented a one-time settlement offer to 70 holding companies in Delaware who owe more than $31.4 million in Maryland taxes, advising them to pay up soon to avoid heavy penalties. ‘If you notify us by December 31 and pay tax and interest by January 30, we will reduce the penalty to only 2% -- instead of the 25% penalty that we imposed originally,’ said Comptroller Schaefer.

And in a further spirit of generosity, the press release notes:

The Comptroller also extended the settlement offer to all other similar holding companies that are scheduled to be audited, as well as those not yet discovered, allowing them until March 1, 2004 to comply.

Why Is The Offer Being Made?

The Comptroller is both strapped for cash and flushed with the thrill of victory represented by the U.S. Supreme Court’s denial last month of the appeal petition of Syms, Inc., the clothing retailer. SYL, Inc. v. Comptroller of the Treasury, 825 A2d 399 (2003), cert. denied, U.S. S. Ct. Docket No. 03-335 (November 3, 2003). If all seventy companies to which Schaefer just mailed the offer were to accept it, he will have closed seventy messy, fact-intensive tax cases and picked up a cool $78 million in quick cash. How can you blame the guy for trying?

But is it a deal your Delaware holding company (“DHC”) should accept? Not unless your facts are as bad as those of Syms, Inc. or its litigation companion, Crown Cork & Seal Company, Inc.
Where Does Maryland Law Stand Now?

By refusing to hear an appeal of the Maryland high court’s decision, the U.S. Supreme Court has left standing a decision that on the surface seems to support the well-publicized South Carolina decision affecting Toys-R-Us, *Geoffrey, Inc. v. South Carolina Tax Comm'n*, 313 S.C. 15, 437 S.E.2d 13 (1993), *cert. denied* 510 U.S. 992, 114 S. Ct. 550, 126 L. Ed. 2d 451 (1993). Both *SYL* and *Geoffrey* conclude that the Commerce Clause of the U.S. Constitution does not require a DHC to have physical presence in-state before becoming subject to the corporate income tax of South Carolina or Maryland.

But tax law is rarely that black-and-white, and this is no exception. These cases do hold that South Carolina’s and Maryland’s tax authorities could tax these DHCs, but only because the facts of these taxpayers’ cases were extremely weak. In each of these cases, the courts examined substantial factual evidence and concluded that the DHCs were thinly constituted phantom corporations. Despite the fact that both Toys-R-Us and Syms used Delaware nexus service providers, neither company appeared able to have followed through on the many details that would have clearly indicated that their DHCs had economic substance.

All that can be said about these cases is that they stand for the proposition that taxpayers using DHCs without economic substance will get no protection from the Commerce Clause or the U.S. Supreme Court.

Is Your DHC A Sham?

This is the question corporate officers must ask themselves to decide whether Comptroller Schaefer’s “deal” is a good one.

Anyone who used a reputable tax advisor or nexus service provider in Delaware (or, for that matter, in Nevada or any other tax-friendly jurisdiction) probably got a lot of advice about the proper way to operate that corporation and what type of documentation would be required to demonstrate, if necessary, that the entity had economic substance and a substantial business purpose other than tax-savings. Did they follow that advice? If you were to evaluate the performance of your DHCs board and officers, and give them a letter grade on how well they followed that advice, what would it be? If it’s an A, B or C, you may have a DHC with economic substance and the ability to defend itself in a tax audit. If the grade is a D or an F, you might want to accept the “deal” from the Comptroller and from any other state tax auditor who pays you a visit in the future.

Good News For DHCs With A Passing Grade In Economic Substance

*Geoffrey* and *SYL* are not the law of the land. They only apply to similarly-situated DHCs being audited by South Carolina and Maryland. Other DHCs would do well to review the recent New Jersey Tax Court case involving Lane Bryant’s DHC, *Lanco, Inc. v. Director, Division of Taxation*, No. 005329-97 (Tax Court of New Jersey, October 23, 2003.)

Most tax experts expect that the *Lanco* reasoning will change the direction state income taxation has been taking since the *Geoffrey* decision. *Lanco* holds that New Jersey may not
impose its income tax on a corporation whose only contact with the state is that it receives license fees from a company using the licensed marks to conduct business in New Jersey.

The basic Lane Bryant facts at first seem indistinguishable from those of Toys-R-Us, Syms and Crown Cork & Seal. All the parent companies used DHCs to hold their trademarks and other intellectual property (“IP”). All the DHCs licensed their IP to retail stores or related entities operating as separate corporations in other states. All the DHCs received royalties from the operating retail units, free of Delaware income tax under §1902(b)(8) of the Delaware Code. The operating units of all the companies deducted the royalties they paid to their Delaware sister companies. The South Carolina, Maryland and New Jersey departments of taxation all tried to assess their state income tax on the royalty income received by the Delaware holding companies.

In *Geoffrey* and *SYL*, and on the facts of *Crown Cork & Seal*, the DHCs were held to have sufficient economic nexus in South Carolina and Maryland to be subjected to their respective income tax, principally because the operations of those companies disclosed that the DHCs had no economic substance in Delaware. By contrast, Lane Bryant apparently earned a passing grade in economic substance, and the New Jersey Tax Court never had to deal with that issue.

Although many tax experts believe that *Geoffrey* and *SYL* would have been unconstitutional if their DHCs’ facts had been better, this had merely been a theory until the *Lanco* case. In *Lanco*, the New Jersey Tax Court directly considered the *Geoffrey* approach. The New Jersey decision thoroughly and convincingly traces the development of the Commerce Clause and explains: (1) why *Geoffrey* reaches an unconstitutional result, and (2) that *SYL* was decided on the basis of economic substance. *Lanco* concludes that a company must have substantial physical presence in a state in order to be subject to income tax liability there, and concludes that Lane Bryant’s DHC did not have the necessary physical presence in New Jersey.

**Where Does The Law Stand Now?**

The *Lanco* decision does not over-rule *Geoffrey* or *SYL*, since the decisions are from different state courts. However, the compelling logic of the *Lanco* decision is sure to be followed whenever the same issue is litigated by companies with a passing grade in economic substance. Although it will take a few years, the economic nexus theory of *Geoffrey* and *SYL* has been cut off at its roots, and will certainly die on the vine. Future cases will make it clear that the Commerce Clause does require physical presence for a state to tax a *bona fide* nonresident corporation.

Recognizing this, New Jersey and several other states have already changed their tax approach to one that really does work – expense disallowance. By virtue of a 2002 amendment to its income tax law, New Jersey has joined eight other separate-return states (Alabama, Arkansas, Connecticut, Massachusetts, Mississippi, New York, North Carolina and Ohio) during the past two years in disallowing deductions for royalties and interest paid to related parties. This tactic closes the loophole for most DHCs without raising constitutional questions.

The new expense disallowance provisions are slightly different in each state, which will make for some state-by-state inconsistencies for taxpayers that continue to use DHCs to reduce
their state income taxes. But their general design is similar, in that the in-state operating company is prevented from deducting most interest or royalty expense paid to a related party. The disallowance is triggered by the relationship between the payor and the payee, normally the red flag used by state tax departments to distinguish bona fide business arrangements from tax loopholes. These expense disallowance rules will usually not apply in the case of IP which is licensed to unrelated businesses, such as in the case of many franchisors. The absence of an ownership relationship will make all the difference.

You can expect that states will now stop asserting that the in-state use of IP creates income tax nexus. Instead, their efforts will be focused on adopting and harmonizing their various expense disallowance laws. Unfortunately, the news is still bad for most DHCs in the nine states with expense disallowance rules. Other states can be expected to join this list.

Proper Tax Planning Is Once Again Legitimate in Other States

DHCs will generally produce no tax advantage in the nine states with expense disallowance rules. And, they have never reduced the overall liability in states that require combined or unitary returns. However, companies that pay substantial state income taxes in other separate-return states can once again safely realize substantial tax advantages from the use of DHCs. The Lanco case, by virtue of its clear and correct analysis of the Commerce Clause, will eventually become the basis of our constitutional law.

The economic substance rules are clear. Many recent court cases have established what a DHC should do in order to earn a passing grade in economic substance, and to avoid being accused of operating as a sham or a phantom. The industry of so-called “nexus service providers” in Wilmington and Reno is sophisticated and provides good value to its customers.

There will still be ways for inattentive DHCs to get this wrong. For example, if your IP is currently located in another state, it will be just as important to have evidence you effectively removed it from that state, as it will be important to have evidence of economic substance in Delaware or Nevada. And you can still jeopardize the value of your IP by failing to exert sufficient quality control. The devil will always be in the details!
If you have any questions or require further information regarding these or other matters, please call your regular Nixon Peabody contact or feel free to contact one of the attorneys listed below:

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