MARYLAND COURT CASE UPDATE

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I. Maryland Income Tax Cases

a. Delaware Holding Company

i. Classics Chicago (Talbots), Inc. v. Comptroller of the Treasury, January 4, 2010, 189 Md. App. 593

Court of Special Appeals affirmed the decision of the Maryland Tax Court affirming the Comptroller's assessment.

Talbots was created in 1947. In 1973, Talbots was bought by General Mills. In 1988, General Mills sold Talbots to a Jusco, Inc., a wholly owned U.S. subsidiary of a Japanese company, Jusco Ltd. It was at this time that the trademarks were first separated from Talbots, placed in a Dutch subsidiary of Jusco Ltd. A significant factor in the separation was to obtain favorable tax treatment.

In 1993, Jusco Ltd. determined to do an IPO of Talbots. Investment advisors recommended that the ownership of the trademarks return to the U.S. within Talbots' corporate structure. On advice of in-house and third party advisors, it was recommended that Talbots set-up a Delaware holding company to take ownership of the trademarks and then lease those trademarks to Talbots. In exchange Talbots would pay a royalty to the DHC. Thus was Classics Chicago created. Classics "used" office space at a Talbots retail location in Chicago, for which it paid rent, had minimal employees, shared officers and directors with Talbots, had minimal expenses, and had significant, ever growing income from the royalties paid to it.

On these facts the Tax Court concluded that Classics lacked real economic substance as a separate business entity. "Thus, the activities of Classics must be viewed through the activities of its operating parent, Talbots, and, as such, there are substantial activities of the holding company, Classics, within Maryland. Therefore, Classics has constitutional nexus with Maryland and the assessments against both Classics and Talbots must be affirmed." On appeal to the Circuit Court, the decision of the Tax Court was affirmed.

The Court of Special Appeals ("COSA") rejected Classics' argument that the Court of Appeals in **SYL** had adopted a two prong sham transaction test. In so holding, the COSA stated that the Court of Appeals "consistent with the trend in caselaw, looked to the economic substance, in terms of the practical effect of the transaction in question. While relevant, the motivation behind the transaction is not necessarily dispositive…Thus, the SYL Court relied on cases upholding taxation of income received by holding companies of intellectual property when the intellectual property rights were used in the taxing state and produced income…As can be readily seen, the basis of a nexus sufficient to justify taxation,

in the above cases [cases cited in SYL and from other states], was the economic reality of the fact that the parent's business in the taxing state was what produced the income in the subsidiary."

ii. Nordstrom, Inc v. Comptroller of the Treasury
NIHC, Inc. v. Comptroller of the Treasury
N2HC, Inc. v. Comptroller of the Treasury

The Tax Court affirmed the assessments against Nordstrom's two subsidiaries, NIHC and N2HC. The alternative assessment against Nordstrom was rescinded. Nordstrom and NIHC noted appeals to the Circuit Court for Baltimore County. The Comptroller filed a cross-petition in the Nordstrom case. N2HC did not appeal.

In August, 2009, the Circuit Court issued an order and memorandum opinion remanding the cases back to the Tax Court. The Circuit Court directed the Tax Court to decide: 1) whether or not the IRC § 311(b) gain of NIHC, or any part thereof, constituted Maryland taxable income; 2) if so, whether the Maryland requirement of separate entity income tax returns prohibited taxing the § 311(b) deferred gain; and 3) whether Nordstrom's royalty payment deductions were ordinary and necessary business expenses.

The Tax Court initially affirmed the assessment against NIHC, but failed to answer the second question. On request of the Petitioner, the Tax Court revisited the matter and, on July 15, 2010, again affirmed the assessment. The Tax Court unequivocally determined that the income, characterized as § 311(b) gain was Maryland taxable income: "In the instant case, it is clear to this Court that but for the activities of Nordstrom and its use of the trademarks in Maryland, the gain of NIHC would not have been recognized…One cannot separate the value of the trademarks, the licensing of the trademarks and the gain recognized by NIHC from the Nordstrom activity in Maryland."

On the second question, the Court found that there is no prohibition arising from the separate reporting requirements when the income is attributed to the activity of the parent and its use of the marks in Maryland.

NIHC has again noted an appeal to the Circuit Court.

b. Non-resident

i. Frey, et al. v. Comptroller of the Treasury, 184 Md. App. 315 (2009), cert. granted June 17, 2009, CSA #62. Argument in the Court of Appeals – January 8, 2010. Decision pending

In Frey, et al., the Court of Special Appeals sustained the constitutionality of Tax-General Article § 10-106.1. The statute imposes a special state tax on non-residents equal to the lowest rate of tax set by any Maryland subdivision. Nonresidents are generally exempt from the local tax. The taxpayers (all out of state residents) argued that the tax was discriminatory and unconstitutional because it was not imposed on residents, but only on nonresidents. The Court of Special Appeals affirmed the lower courts and upheld the tax, reasoning that the

constitution does not look to labels such as “state” tax or “county” tax, but instead finds discrimination only if the actual dollars paid by a nonresident are greater than the amount paid by a resident. A second issue in the case is whether the Tax Court has discretionary authority to reduce an assessment of interest. The Comptroller argued (and the Tax Court agreed) that no such authority exists. The Court of Special Appeals held that the Tax Court does have authority to reduce the amount of interest, and remanded to the Tax Court for specific findings on this issue. On June 17, 2009, the Court of Appeals agreed to hear the case, and will decide both issues: the legality of the special nonresident tax, and the extent of the Tax Court's power over the interest due on a tax.

c. Credit for taxes paid

i. Brian and Karen Wynne v. Comptroller of the Treasury, MTC 08-IN-00-0791. Appealed to Circuit Court for Howard County. Argued July 7, 2010. Decision pending

Taxpayers, Maryland residents, appealed to the Maryland Tax Court from the Comptroller=s Notice of Final Determination affirming an assessment against them for income tax owed for the tax year 2006. In their appeal, the taxpayers raised two issues. First, they contested the applicability of Tax Gen. Art. § 10-703(c)(1) for calculating a credit for taxes paid by the taxpayers or an s-corporation, in which they owned shares to other states on the income earned by them as 2.4% shareholders of the Maryland S-corporation. The second issue, raised in an amended Petition of Appeal, argued that Tax Gen. Art., § 10-703 violates the Commerce Clause of the United States Constitution by “not allowing the credit against local income taxes.”

The S-corporation operated in 39 states, some of which recognized its status as an S-corporation and some which did not. Consequently, in some states the taxpayer paid a tax on his income, whereas in other states the corporation paid a tax on its income apportioned to that state. Recognizing this situation, Tax Gen. Art., § 10-703(c)(2) still allows a taxpayer to take a credit for taxes paid even though the tax was actually paid by the S-corporation in which he is a shareholder.

The taxpayers’ Commerce Clause argument asserts that the failure to allow a credit against the local (county) tax fails the fair apportionment prong (specifically the “internal consistency test”) of the *Complete Auto Transit* test.

Maryland Tax Court affirmed assessment on December 10, 2009. The taxpayers’ appealed. On appeal they are only pursuing the Commerce Clause issue.

d. Refunds

i. Robinson, James, et al. v. Comptroller of the Treasury, COSA 02486. Unreported Opinion, April 12, 2010 affirming decision of the Circuit Court.

In 1999, 2000, and 2006, the taxpayers filed three, successive claims for refund of a substantial portion of their 1995 Maryland income taxes. The Comptroller granted in part and denied in part the first claim, denied the second claim, and paid a substantial refund in response to the third claim. The taxpayers then requested an award of interest on the tax refunds paid to them, running from the date of their *first* claim for refund filed in 1999. The Comptroller denied the claim for payment of interest for the time between the filing of the first claim and the third claim.

On appeal from the Comptroller's decision, the Tax Court found that when the taxpayers filed their second and third claims for refund, they abandoned the first and second claims, respectively, and that having done so, they were entitled only to interest accruing 45 days after the filing of the third claim for refund. The taxpayers sought judicial review of the Tax Court's decision. After briefing and argument, the Circuit Court for Baltimore City affirmed the decision of the Tax Court.

Citing as precedent the prior cases of *Comptroller v. Fairchild Indus., Inc.*, 303 Md. 280 (1985) and *Hickey v. Comptroller*, 92 Md. App. 1 (1992), the Court of Special Appeals affirmed the decision of the Tax Court. Not only did the statute require the filing of the amended tax return, finality of the operative fact giving rise to the refund is required. For the taxpayers in this case, that operative fact was the federal settlement necessary to the determination of the federal adjusted gross income, which in turn was necessary for the calculations of Maryland income and tax liabilities.

II. Sales and Use Tax Cases

a. Muhammad Tahir, Officer of Fatimano, Inc. v. Comptroller of the Treasury, Circuit Court for Wicomico County, Case No. 22-C-09-00630. Tax Court decision affirmed February 10, 2010.

This case arises out of the Comptroller's liquor project. Fatimano, Inc. was a convenience store operated in Salisbury, Maryland. Among the items it sold was beer. A comparison of its purchases for the audit period, $4.3 million, with its sales, $1.1 million, resulted in a sales tax assessment of over $200,000. The entity was also assessed a 100% fraud penalty. As the president of Fatimano, Inc., Mr. Tahir was also assessed the tax and penalty. The Maryland Tax Court and the Circuit Court for Wicomico County affirmed not only the assessment but the full 100% fraud penalty against both the entity and the officer.

III. Admissions and Amusement Tax Cases

a. Gaming – Over, approximately, the last 18 months there have been a number of criminal investigations by local police departments of establishments that provide the video game consuls, usually a poker-type game, on the bar or other seating areas. Per the various records that have been obtained, questions have arisen whether the establishments have

correctly reported and remitted the applicable admissions and amusement tax.

b. Hot Air Balllons – The Comptroller's Office had issued assessments against two companies that provided hot air balloon rides. The initial position taken by the Comptroller's Office was that these rides were taxable as recreation and that the dominant purpose was for recreation not travel. Subsequent documentation provided by one of the taxpayers, specifically an opinion from General Counsel to the U.S. Department of Transportation, supported the taxpayers' position that the balloon rides were exempt from the tax. The Anti-Head Tax Act, 49 U.S.C. § 40116 preempts state law imposing a tax on the gross receipts from hot air balloon rides. Though an untethered hot air balloon literally floats with the wind, such rides are, nonetheless, considered to be travel in air commerce under the statute.

IV. Criminal Matters

a. State v. Gerald Katz, Esq., Circuit Court for Anne Arundel County Case No. 02K10001113, Failure to File Maryland Income Tax Returns

On August 20, 2010, Mr. Katz pled guilty to two counts of Willfully Failing to File Maryland Income Tax Returns. Mr. Katz is a prominent Maryland attorney. Mr. Katz filed federal income tax returns for 2004 and 2005, reporting an adjusted gross income of $592,687 and $573,780 respectively. These figures were well above the minimum adjusted gross income level required to file a Maryland income tax return. No Maryland income tax returns were filed for the 2004 and 2005 tax years.

V. Other Matters

a. State of Maryland (Appellee) v. Denise Ciotti (Appellant), U.S. Court of Appeals for the 4th Circuit, Case No. 10-1083

This matters concerns whether or not a State income tax debt is discharged if the taxpayer fails to file a report with the State after the IRS has made a final determination adjusting the federal return.

In 1996 Mrs. Ciotti filed her 1992-1996 Maryland income tax returns. In 1998 the IRS issued a letter of determination adjusting the returns. The total adjustment for all years increased taxable income by more than $2.6 million. Mrs. Ciotti never reported the adjustments as required by Md. Ann. Code, Tax Gen. §13-409(b). Subsequently, the Comptroller adjusted the returns, resulting in an income tax liability, including interest and penalty, in excess of $500,000. In February 2006, the State filed a tax lien.

On April 9, 2007, Mrs. Ciotti filed Chapter 7 bankruptcy. She received her discharge on August 22, 2007. On February 27, 2008, the State attached Mrs. Ciotti's bank account. Though the funds in the account were ultimately applied to different tax years, Mrs. Ciotti filed an adversary action in the bankruptcy court asserting that the State income tax debt had been discharged. At issue is the application of 11 U.S.C. § 523(a)(1) which excepts from discharge "any debt…for a tax…with respect to which a return, *or equivalent*

report or notice, if required…was not filed *or given*." The highlighted language was added to the statute in 2005. Prior to the addition of this language it was clear, based on case law, that failure to file the report required by § 13-409 would not prevent discharge.

The Bankruptcy Court agreed with Mrs. Ciotti and concluded that, even with the amendments, a return was still required by the applicable state statute. The U.S. District Court for Maryland disagreed and reversed. It held that based on the prior case law and the intent of Congress as gleaned from the reports accompanying the changes to the Bankruptcy Code in 2005, the added language did expand the exception to include a report such as is required by § 13-409.