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# State Tax Return

## U.S. Constitution Prevails As Supreme Law Of The Land – Maryland Tax Court Finds Taxation Of Gain From The Sale Of Subsidiary Stock Unconstitutional

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The Maryland Tax Court recently issued an opinion denying the state's ability to tax the gain associated with the sale of a subsidiary that lacked nexus in Maryland. In *Science Applications International Corporation v. Comptroller*,[1] the Maryland Tax Court cited the Court of Appeals' 1998 taxpayer-friendly decision in *Hercules*[2] for the proposition that income must have some link to the activities in the state before it can be taxed. Relying on *Hercules*, the Tax Court concluded that the capital gain from the sale of a subsidiary's stock could not constitutionally be taxed by Maryland where such link was not present.

### Background

Science Applications International Corporation ("SAIC") is a California-based research and engineering firm that provides technical services to customers located throughout the United States, including Maryland. In 1995, SAIC purchased 100% of the shares of stock in Network Solutions, Inc. ("NSI"), a Virginia based company providing Internet domain registration services worldwide. Several years later, SAIC reduced its share of NSI to 76%, then 45% through a series of public offerings.

The second public offering in 1999 resulted in a significant capital gain. SAIC reported the gain as income on its 1999 Maryland corporate income tax return and paid the applicable tax. After further review, SAIC filed an amended return and requested a refund of the tax paid relating to the capital gain income. The Comptroller denied SAIC's refund claim and SAIC appealed to the Maryland Tax Court. SAIC raised three primary arguments in support of its appeal:

(1) There was no nexus linking the gain from the sale of NSI shares to SAIC's activities in Maryland as required by the U.S. Constitution and the Maryland Court of Appeals in *Hercules*;

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[1] *Science Applications Int'l Corp. v. Comptroller*, No. 04-IN-OO-0632 (Md. Tax Ct. May 11, 2006).

[2] *Hercules, Inc. v. Comptroller*, 716 A.2d 276 (Md. 1998).

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(2) NSI served an investment function, rather than an operational function, and thus the companies lacked the requisite unitary relationship for Maryland to impose a tax; and

(3) Taxation by Maryland of the NSI gain leads to a disproportionate amount of income being taxed as compared to activity in the state, leading to a grossly distorted result.

The court agreed with each of the taxpayer's contentions, concluding that the gain on the sale of NSI could not constitutionally be taxed by Maryland.

### No Nexus Linking The Gain

The court cited the 1998 Maryland Court of Appeals decision in *Hercules* as the prevailing law with respect to gains from the sale of a subsidiary. The *Hercules* court found that a rational relationship must exist between the income attributed to the state and the intrastate values of the enterprise before Maryland may tax income earned outside its borders – even on a proportional basis. To levy a tax there must be some nexus linking the gain to the activities in the state. Because SAIC's Maryland operations had no involvement with NSI, and NSI had no facilities, employees or operations in Maryland, the court concluded that there was clearly no nexus linking the gain to the state.

### Investment v. Operational Function

The Comptroller argued that nexus was established not directly through the activities of NSI, but rather through the unitary relationship that existed between SAIC and NSI. The Comptroller conceded that this argument was contingent upon the finding that NSI served an operational function, rather than an investment function as held by SAIC. Based on the U.S. Supreme Court's opinion in *Allied Signal*,[3] the court concluded that SAIC's investment in NSI did not serve an operational function as the stock was not acquired as a short-term investment of working capital analogous to a bank account or certificate of deposit, but rather it was acquired, maintained and sold singularly as an investment with the goal of selling it for profit at a public auction. The court clarified that the relevant inquiry is not how the parent intends to use the income from the investment, but rather the nature of the actual connection between the subsidiary investment and its parent.

### Distortive Result

The court also concluded that the tax could not be upheld because taxation of the gain in Maryland would produce a tax that is disproportionate to SAIC's activities within the state and would lead to a grossly distorted result. The court noted that the taxpayer's liability in Maryland increased by almost 2000% from $229,217 in 1998 to $4,274,519 in 1999 (the year the gain was reported) and summarily concluded that the taxation of such gain by the State of Maryland would be distortive.

[3] *Allied Signal v. Director, Div. of Taxation*, 504 U.S. 768 (1992).

## What This Means For Taxpayers

This is clearly good news for taxpayers who invest in other businesses. The Tax Court has reiterated, once again, that the Comptroller cannot constitutionally tax the gain associated with the sale of a subsidiary where nexus is lacking between the gain and the activities in the state, the subsidiary serves an investment rather than an operational function, and the gain is distortive in nature. The challenge for taxpayers going forward will continue to be the application of these rules to other sets of facts, as the court's analysis calls for a very fact-specific inquiry.

Indeed, SAIC was able to present evidence that NSI was purchased and maintained for the purpose of generating additional income through a public offering. The court noted that this was a significant consideration in determining the investment nature of the business. It is unclear whether a similar conclusion would be reached where the subsidiary is purchased with no plans to sell. Considering the facts in the *Hercules* case, it seems likely that a court could conclude that such a subsidiary serves an investment function. Adding one or two additional facts (*e.g.*, the companies are in the same line of business or the companies share the same officers and directors) could change the result.

This is not to say that the court's decision extends only to diverse, separate businesses that can produce significant evidence of the investment nature of their relationship. Although there was some overlap between SAIC and NSI, the court was willing to dismiss these facts as *de minimis*. For example, the companies shared a few employees (including a Vice President) and had some arm's-length intercompany sales. In addition, during the transitory period after the acquisition, SAIC temporarily provided certain administrative services and some intercompany loans to NSI. The court should be commended for recognizing that despite of these contacts, the overall relationship was that of an investment function rather than an operational function.

## Conclusion

In the post-Enron tax environment in which we now live, companies often err on the side of paying additional tax when there is a lack of specific statutory guidance to the contrary. Despite aggressive states that attempt to apportion virtually all income, taxpayers should maintain protection from the U.S. Constitution, which requires transactional nexus between the activity being taxed and the taxing state. We are pleased to see another well-reasoned case that addresses the unitary and operational tests of apportionment and recognizes these constitutional limits.■

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