4/22/99

AMERICA'S MORTGAGE SERVICING, INC.	*	IN THE
vs.	*	MARYLAND TAX COURT
	*	No. C-95-0002-01
COMPTROLLER OF THE TREASURY COMPLIANCE DIVISION	*	and No. C-95-0108-01
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MEMORANDUM OF GROUNDS FOR DECISION

These appeals are from Final Determinations issued by the Comptroller of the Treasury on December 7, 1994 and November 22, 1995.

Petitioners contend that they are entitled to refunds due to overpayments of Maryland income tax. They argue that Maryland Code Tax-General §10-304 and I.R.C. §162 provide for an allocation of expense from a parent company to its subsidiaries in a manner as to decrease the reportable income and thus lower the Maryland income tax obligation for tax years 1989 to 1993.[1] In addition, the Petitioners believe that the Comptroller has erred by requiring the use of a single factor formula in apportioning America's Mortgage Servicing, Inc. ("AMSI") income. The Court will rule in favor of the Petitioners as to their first point, and affirm the Comptroller's requirement of the single factor formula for the apportionment of AMSI's income.

While the Comptroller agrees that federal tax principles are relevant, it is explained that §162(a) of the Internal Revenue Code allows this expense shifting only

[1]The tax years in question are the following: 1990-1992 for America's Mortgage Servicing, Inc. ("AMSI"); 1989-1992 for America's Trust Service, Inc. ("ATSI") and 1989-1993 for Stan Fed Financial Services, Inc. ("Financial Services").

when there are "ordinary and necessary expenses." It is his position that a study conducted by the accounting firm of Watkins, Meegan, Drury & Company ("Watkins Meegan"), and prepared at the direction of Petitioners, failed to demonstrate that the expenses in question were ordinary and necessary as used in Internal Revenue Code §162.

The Comptroller has required AMSI to use the single sales factor apportionment method based on the determination that AMSI was a service corporation. He contends that the Petitioner has failed to meet its burden of proof to show that it has a taxable nexus outside of Maryland, and that even if a nexus was proved, AMSI has not proved that the use of the cost of performance standard used in the single factor formula created an actionable distortion of its' income.

In addition, the Comptroller contends that the refund claims filed by ATSI and Financial Services for fiscal year 1989 were not timely filed and are barred by the statute of limitations pursuant to Md. Code Tax-Gen. §13-1104.

Petitioners AMSI, ATSI and Financial Services are wholly owned subsidiaries of Standard Federal Savings Bank ("Standard Bank"). Each subsidiary relates to the parent in such a way as to constitute a unitary business. AMSI was acquired by Standard Federal Savings Bank on August 31, 1988. AMSI's business involves servicing and subservicing mortgage loans. At the time of purchase, AMSI's "operations" were located in Illinois. However, effective November 1, 1989, the Illinois site was closed and moved to Frederick, Maryland where it was consolidated with the servicing operations of Standard Bank. In addition to its Frederick facility, AMSI maintained operations in Montana.

Another Standard Bank subsidiary, ATSI, "stored, maintained and tracked physical documents relating to loans processed by the Bank and its subsidiaries." Pet. Trial Memo at 4.

Financial Service's function was to provide services, such as insurance, that were related to the mortgage loans.

The loan servicing and subservicing operations of Standard Bank and its subsidiaries were conducted as one integrated business. Although the subsidiaries and Standard Bank shared several departments, Standard Bank, instead of sharing the expenses with the subsidiaries, assumed the expenses for these departments. The exception to this was the fact that AMSI was charged expenses relating to the residential loan servicing department. Petitioners explain that, due to circumstances surrounding heavy financial losses and a failure to allocate expenses to Petitioners on a full cost basis, reportable taxable income of the subsidiaries, was not consistent with the economic reality of their operations. It was only after Standard Bank and AMSI were placed in a Resolution Trust Company ("RTC") receivership pursuant to the Financial Institutions Recovery, Reform and Enforcement Act of 1989 ("FIRREA"), and the RTC requested that Watkins Meegan conduct the accounting study, that costs were allocated on a full cast basis.

Watkins Meegan determined that while Standard Bank and AMSI, ATSI and Financial services were sharing a number of operational departments, Standard Bank assumed most if not all of the costs attributed to such departments.[2] Watkins Meegan

[2]Watkins Meegan found that the following services and facilities were provided to Petitioners at no cost: audit department, human resource department, voice communication, mail services, word processing, insurance, occupancy (rent), electronic data processing, bank services, mortgage operations and overhead (including finance, accounting, legal and executive administration). In addition, Watkins Meegan discovered expenses allocated to

recommended that the estimated full costs should be charged to the respective subsidiaries in proportion to their use. It is this recommended allocation of expenses that gives rise to Petitioners' refund claims.

The second issue pertains to AMSI activities in 1990-1992. During that period, AMSI serviced and subserviced mortgage loans from its facilities in Maryland and Montana. The Montana facilities contained the employees' telephone banks and computer equipment used to process loans. The Montana operations had as a primary responsibility customer service activities related to customers in the western portion of the United States. The Montana facilities, by themselves, did not generate any income. Petitioner's claim that the application of the single factor formula by the Comptroller is an error since the formula does not take into account business activities outside of the State.

Petitioners have taken the position that the Comptroller has violated §10-402(a)(2) of the Tax-General Article, with the treatment of AMSI as a service corporation requiring the use of the single sales factor formula. This Court discussed the issue at length in *Data General Services, Inc. v. Comptroller*, M.T.C. No. 2981 and 3108 (March 19, 1991), Aff'd. Court of Special Appeals of Maryland (Number 1208, September Term, 1992, March 12, 1993, Unreported), where we considered necessary evidentiary requirements. It is clear that the Comptroller has the authority to require the application of a single factor apportionment formula and that the Taxpayer must provide convincing evidence that the application is inappropriate. In this case, the Petitioners have not reached the required

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AMSI in regard to the residential loan servicing department did not fully reflect the costs attributable to AMSI.

level of “convincing” evidence. The assessment against AMSI, as it relates to this issue, shall be affirmed.

Section 10-304 of the Tax-General Article allows for the modification of Maryland income for State tax purposes to be based on provision in the Internal Revenue Code. Since a consolidated return was filed for federal taxation purposes, the redistribution of expenses will have no federal tax consequences. However, because each member of an affiliated group of corporations is required to file a separate Maryland return, expense shifting may and does effect the level of income taxes paid to this State.

Petitioner asserts that the expense shifting was allowed under I.R.C. §162. It is the Comptroller’s position that §162 is not applicable since the costs incurred were never a liability for the subsidiaries in question and case law does not allow for the spontaneous creation of liabilities where they did not otherwise exist. The Comptroller contends that since no liability arose for ATSI, AMSI and Financial Services for the years in question they were not entitled to retroactively account for such expenses. The Comptroller cites several United States Tax Court cases[3] for the proposition that a liability cannot become fixed for accounting purposes until there has at least been the assertion of the liability. Furthermore, *U.S. v. General Dynamics Corp.*, 481 U.S. 239, 243 (1987), is offered to show that a taxpayer cannot accrue an expense for tax purposes any earlier than the point that a liability is claimed. However, the facts are distinct. The issue here is not the springing of expenses where none existed, but the allocation of expenses that

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[3] *U.S. Projector & Electronics Corp. v. Comm.,* T.C. Memo 1969-102; *S. Loewenstein & Son v. Comm.,* 21 T.C. 648 (1954), *aff’d.,* 55-1 USTC §9477 (6th Cir. 1955); *Koppers Company, Inc. v. U.S.,* 64-1 USTC 9485 (D.C. 1961) and *The Sico Foundtion v. U.S.,* 61-2 USTC §9732 (Ct.Cl. 1961).

have already been documented. The three part test of 26 C.F.R. §§1.461-1(c)(1)(ii)(A)[4], used by Petitioners and rejected by the Comptroller to determine if the liabilities really existed, has been satisfied. The expenses did occur. Prohibiting ATSI, AMSI and Financial Services from claiming expenses in the years in question based on the theory that they were nonexistent would seem to ignore the fact that the expenses already existed in their parent company. The Court decisions relied on by the Comptroller, as to this issue, stand for the creation of liabilities where one did not exist, not for the proposition of identification and assignation of appropriate preexisting liabilities from one entity to another.

Since an expense did exist, a determination must be made as to whether the expenses were "ordinary and necessary" as defined with §162 of the Internal Revenue Code. The Comptroller seems to assert that the expenses were not ordinary and necessary since the original subsidiary agreement did not take into consideration the costs, and that the subsidiaries had no obligation to incur the costs. The Comptroller's reliance on *Polak's Frutal Works, Inc. v. U.S.,* 176 F.Supp. 521 (S.D.N.Y. 1959) is misplaced since *Polak* dealt with a situation where the Petitioner was involved in fictitious costs. The expenses here have not been shown to be fictitious. The evidence supports the Petitioners' assertion that the expenses were ordinary and necessary for the day to day functions of all three subsidiaries.

[4]The three factors satisfied were: 1) all events have occurred that establish the fact of liability; 2) the amount of the liability can be determined with reasonable accuracy and 3) economic performance has occurred with respect to the liability. 26 C.F.R. §§1.446-1(c)(1)(ii)(A).

Since ATSI, AMSI and Financial Services could have been allocated the expenses in question, the Comptroller argues that the degree of expense shifting should be disallowed on the basis that the transfer was not at arms-length. Based on available evidence, this Court must conclude that the transactions were made at arms-length. The allocation on a full-cost basis is proper. The Comptroller's decisions in this regard are reversed, and the Petitioner's claim for refund shall be granted.

It is the Comptroller's position that the 1989 refunds sought by ATSI and SFSI were not timely filed and therefore barred by the Statute of limitations as set forth in Md. Ann. Code Tax-Gen. §13-1104(c). *Comptroller v. Mack Truck*, 343 Md. 606 (1996) controls. The assertion that the agreement entered into by Petitioners with the Internal Revenue Service does not extend the Maryland Statute of limitations has been expressly denied in *Mack Truck*. Within the statutorily prescribed three year limitation, Petitioner entered into a Consent to Extend the Time to Assess Tax for fiscal year 1988 with the Internal Revenue Service. In accordance with that agreement, ATSI and Financial Services were allowed to file a claim for a refund within six months after the agreement ended. The effective expiration date of the agreement was April 15, 1994 and, as such, the Statute of limitations extended to October 14, 1994. Since ATSI and Financial Services filed their respective amended 1989 refund claims on March 7, 1994, there has been timely filing.

Accordingly, for the reasons stated, the Court will pass an Order granting Petitioner's claims for refund, with appropriate interest for the years in question. The Comptroller's assessment requiring the use of the single factor formula is affirmed.