

BRANCH BANKING & TRUST COMPANY *

IN THE

vs.

*
MARYLAND TAX COURT

COMPTROLLER OF THE TREASURY

*
No. 13-IN-OO-0076
*

REVISED ORDER

The above entitled case having come on for hearing, testimony having been taken and the matter considered, it is this *30th* day of *September*, 2016, by the Maryland Tax Court ORDERED, that the Respondent's denial of the refund claims for the tax years 2007 and 2008 is hereby **REVERSED**.

cc: James Dawson, Jr., Esq.
Kay Miller Hobart, Esq.
Joshua Madison Tyler Felder, Esq.
Brian L. Oliner, Esq.

CERTIFIED TRUE COPY
TEST: John T. Hearn, Clerk

NOTICE: You have the right of appeal from the above Order to the Circuit Court of any County or Baltimore City, wherein the property or subject of the assessment may be situated. The Petition for Judicial Review **MUST** be filed in the proper Court within thirty (30) days from the date of the above Order of the Maryland Tax Court. Please refer to Rule 7-200 et seq. of the Maryland Rules of Court, which can be found in most public libraries.

BRANCH BANKING AND TRUST COMPANY	*	
	*	IN THE
Petitioner	*	
	*	MARYLAND TAX COURT
vs.	*	
	*	
COMPTROLLER OF THE TREASURY	*	
	*	Case No. 13-IN-OO-0076
Respondent	*	
	*	
*	*	*
*	*	*
*	*	*
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REVISED MEMORANDUM OF GROUNDS FOR DECISION

Petitioner, Branch Banking and Trust Company, appeals from a final determination of the Respondent, Comptroller of the Treasury, affirming the disallowance of refunds of corporate income tax in the amount of \$2,623,240 for tax year 2007 and \$2,048,909 for tax year 2008.

Branch Banking and Trust Company (“BB&T” or “Petitioner”) is a North Carolina state chartered commercial bank that began doing business in Maryland and filing corporate income tax returns in Maryland in 1999. Between 1999 and 2008, BB&T’s federal taxable income as reported on its Maryland returns ranged from \$109,081,547 to 1,288,153,471. The federal taxable income, along with additions and subtractions, is the starting point in the calculation of Maryland’s modified income tax.

During the same years BB&T received interest income from federal and state obligations.¹ Federal interest is taxable for Federal purposes unless specific exemption applies. For Maryland purposes, a corporation must add back the income earned from federal obligation interest to their Maryland taxable income. However, there is no

¹ Federal and state obligations, for our purposes, are government bonds.

requirement to do so with earned Maryland obligation interest. Maryland then allows the federal obligation interest reported to be subtracted from Maryland taxable income up to the point that it creates or increases a net operating loss (“NOL”).

BB&T filed refund claims for tax years 2007 and 2008 attempting to subtract the federal obligation interest that was left unsubtracted in the years it was earned between 1999 and 2008 – which would create a “federal interest subtraction carryforward.” BB&T relied heavily on Administrative Release No. 18,² which allows subtraction carryforwards of foreign source dividends.

The Respondent, who claimed that there was no statutory provision that allows for a carryover of unsubtracted exempt federal obligation interest, denied the refund requests.

BB&T appealed the Respondent’s decision to the Hearings and Appeals Section where the refund denial was upheld. BB&T then appealed the decision to this Court.

Issues Involved

The issue to be resolved is whether the Respondent’s policy of denying the carry forward of previously unsubtracted tax exempt federal obligation interest violates the laws of the state of Maryland, the Federal Government, and/or the Supremacy Clause of the United States Constitution. Specifically, the Petitioner asserts that:

1. The Respondent violates MD. Code Ann. Tax-Gen. § 10-307 by denying a Federal Interest Subtraction Carryforward.

² Admin. Release No. 18 – Net Operating Losses and Associated Maryland Addition and Subtraction Modifications.

2. The Respondent's policy violates 31 U.S.C. § 3124 because (I) the policy taxes federal interest and (II) federal interest is "considered in computing a tax".
3. The Respondent's Policy is prohibited by the Supremacy Clause of the U.S. Constitution.

1. Md. Code Ann. Tax Gen. § 10-307(a) and 10-307(f)

This section of the Md. Code Ann. Tax Gen. reads:

(a) In *General* – To the extent included in Federal taxable income, the amounts under this section are subtracted from Federal taxable income of a corporation to determine Maryland Modified Income.

(f) Interest from United State Obligations – The subtraction under subsection (a) of this section includes interest attributable to an obligation of the United States or an instrumentality of the United States.

This section provides for the subtraction of exempt federal obligation interests, acquired through federal bonds, from Maryland income, which, unlike Maryland obligation interest, is included in federal taxable income – the starting point for the Maryland corporate income tax.

The Petitioner's argument is that the plain language of the above statute demonstrates that the Maryland Legislature intends to allow subtraction of all federal interest. The Petitioner also asserts that reading the statute as allowing a limitation on the subtraction of those interests creates unequal treatment between those that hold federal interest and those that hold similarly situated state interest. State interest, unlike federal

interest, is not included in federal taxable income and thus any loss can be carried forward to future years.

The Respondent's policy on assuring adherence to the statute is to allow corporations, such as the Petitioner, to deduct the exempt federal obligation interest, during the year that it was received, until the corporation has zero taxable income for that year. If the corporation has a NOL for the year, then no subtraction is permitted.

The Respondent's argument is that the language in the statute is unambiguous. He asserts that the statute clearly does not imply that federal obligation interest, that has never been taxed by Maryland and has already been subtracted on the Maryland return in the year it was earned, should be used to reduce future income that is taxable by Maryland. The Respondent contends that the federal obligation interest the Petitioner is seeking to subtract should only be that interest which is included in that year's reported state taxable income.

2. 31 U.S.C. § 3124

This section of the United States Code reads:

- (a) Stocks and obligations of the United States Government are exempt from taxation by a state or political subdivision of a state. The exemption applies to each form of taxation that would require the obligation, the interest on the obligation, or both, to be considered in computing a tax.

The Petitioner argues that the Comptroller's policy violates both parts of the statute. The policy directly taxes their federal obligation interest by not permitting net subtraction modification carryforwards because it imposes a greater income tax burden on earning exempt federal interest than on earning fully taxable income. The Petitioner also contends that the policy considers the interest on the obligation by starting the tax computation with federal taxable income and then failing to fully deduct the exempt federal interest, if doing so creates a negative number or increases a negative number, from the federal taxable income.

The Respondent argues that the Petitioner is attempting to create a tax shelter for their Maryland taxable assets out of the deduction provided to them by TG § 10-307 (f). The Respondent does not address the Petitioner's claim that he is directly taxing the obligation interest. He instead focuses on the consideration issue, citing *First Nat. Bank of Atlanta v. Bartow County Bd. Of Tax Assessments*, 470 U.S. 583, 597 (1985) as an example of how a state may "consider" a federal obligation, as the Court in that case agreed that U.S.C § 3701³ would be satisfied if the Bank was allowed to deduct a proportionate share of the federal obligations. The Respondent contends that they are justified in considering the obligation interest in determining taxable income because doing otherwise would inhibit his ability to raise revenue through taxes from corporations like the Petitioner.

³ U.S.C. § 3701 is the predecessor to U.S.C. § 3124.

3. The Supremacy Clause

The Petitioner maintains that if the Respondent's policy places a larger burden on holders of federal obligations than it does on similarly situated holders of state obligations then that policy is discriminatory and violates the Supremacy Clause.

The Respondent largely fails to reference the Petitioner's claim that his policy discriminates against holders of Federal obligations in favor of those who hold similar state property. He instead focuses in on whether or not the policy made the federal obligation interest's less attractive. The Respondent argues, citing testimony from a witness for the Petitioner, that the policy has not diminished the attractiveness of Federal obligation because the Petitioner has continued to purchase those obligations.⁴

Analysis

The Court has chosen to tackle the constitutionality question first. Since the issue is whether the Respondent's policy violates the Supremacy Clause and not whether or not the state and federal statutes violate the Supremacy Clause, we assume the legislature would not intend to pass a statute that violates the Constitution. Thus, if the Respondent's policy violates the Supremacy Clause of the Constitution, this Court is of the opinion that it then inherently violates both the state and federal statutes that are at issue here.

The Supreme Court has held that a state seeking to impose a tax on a party doing business with the United States must establish a tax "imposed equally on the other similarly situated constituents of the state." *United States v. County of Fresno*, 429 U.S. 452, 462 (1977). Further, the Supreme Court has held that "a state tax that imposes a

⁴ While the Court agrees that there would clearly still be a benefit to purchasing federal obligations despite the Comptroller's policy, the Respondents reply largely missed the mark regarding the Petitioner's argument on this issue.

greater burden on holders of federal property than on holders of similar state property impermissibly discriminates against federal obligations.” *Memphis Bank & Trust Co. v. Garner*, 459 U.S. 392, 397 (1983).

BB&T relies heavily on the decision by this Court in *Kraft General Foods, Inc. v. Comptroller of the Treasury*, No. 98-IN-OO-0353. 2001 WL 699558 (Md. Tax Ct. 2001). In that case the Petitioner, Kraft General Foods, Inc. argued that “the Respondent’s policy of not allowing a subtraction modification to increase a taxpayer’s net operating loss, on its face unconstitutionally favors domestic commerce because the subtraction can only be utilized if there are foreign source dividends”.⁵

Similar to the federal obligation interests in the instant case, foreign source dividends were added back into the income reported for state tax purposes. Maryland allowed for foreign source dividends to be subtracted from taxable income in the year it was received unless the subtraction created or increased a loss for the carryover year.⁶ That was not the case for domestic source dividends because they were not required to be added to the Maryland income tax returns, and thus were not considered in computing the Maryland income tax.

Any loss that resulted because domestic source dividends were not added to compute Maryland taxable income may be carried forward for future year. However any foreign source dividends that may have created a loss if they were permitted to be subtracted would be lost. In *Kraft*, the Court found that the Respondent’s policy treated “two tax payers (one receiving domestic source dividends and the other foreign source

⁵ *Kraft* at 5.

⁶ *Kraft* at 6.

dividends) in identical situations (in the years following a loss year), differently.”⁷ The Court stated that the policy “discriminates against foreign commerce because it directly results in a higher Maryland Corporation income tax on the taxpayer with the foreign source dividend income.”⁸

We find that we must echo the findings offered in *Kraft*. In this case the Respondent’s policy, of not allowing carryforwards of unsubtracted exempt federal obligation interest, discriminates against holders of federal obligations in favor of similarly situated holders of Maryland obligations, in the same way that the Respondent’s previously held policy on subtractions of foreign source dividends did.

The Maryland obligation interest is subtracted in its entirety when Maryland computes taxable income. Thus, when there is a NOL, the entirety of the loss can be carried forward regardless of whether or not the Maryland interest had a hand in creating that loss. That is not the case for federal obligation interest. Maryland allows the federal interest to be deducted until there is no taxable income. If the holder of the federal obligation has a NOL for the tax year in question, then the federal interest may not be used to increase that loss.

The Respondent’s policy clearly places a greater burden on holders of federal obligations. Maryland obligation interest is subtracted in its entirety and when a loss occurs that loss can be carried forward. That is not the situation for federal obligation interest, as it is not permitted to be subtracted in its entirety the year it is earned and no further loss amount can be carried forward. The disparate treatment between these two obligations and those similarly situated taxpayers who hold them creates a higher

⁷ *Kraft* at 7

⁸ *Kraft* at 7.

Maryland corporate income tax per non-exempt taxable dollar on those who have federal obligation interest than on those who hold state obligations.

4. Conclusion

The Court concludes that the Respondent's policy violates Md. Code Ann. Tax Gen. § 10-307(a) and 10-307(f) because if read so as to not violate the Supremacy Clause of the Constitution, the statute requires the full subtraction of exempt federal obligation interests.

The Court also finds that the Respondent's policy violates 31 U.S.C. § 3124 because it creates a higher corporate income tax on the taxpayer with federal obligation interest than would be created if no federal obligation interest were held, and thus directly taxes that interest. The policy also considers the interest in computing its Maryland Taxable Income. The interest that cannot be fully subtracted is a part of the formula for computing that tax. The interest left is used by the State to make sure no additional losses are acquired; prohibiting any carryforward that otherwise would exist.

The Court holds that the Respondent's policy violates the Supremacy Clause of the U.S. Constitution by discriminating against those who hold federal obligations in favor of those who hold state obligations.

The Court further finds that the amounts of the refunds claimed for the tax year 2007 (\$2,623,240) and for the tax year 2008 (\$2,048,909) are supported by the evidence offered by the Petitioner. BB&T's General Ledger contains the data used to financially account for federal obligations, and that data was relied upon to file federal and Maryland tax returns for 1999 through 2008. The same data was relied upon to file "Call Reports"

submitted to the Federal Institutions Examination Council with the Federal Deposit Insurance Corporation for 2002 through 2008.

Petitioner's expert, Eric Liou, reconciled the General Ledger to the federal and Maryland tax returns. His forensic accounting report confirms that the federal interest subtraction amounts on the Schedules are similar to the subtraction amounts used for federal interest on the tax returns.

Joe Flack, another expert for the Petitioner, computed the refund amounts by using the same subtraction amounts. Mr. Flack identifies bond interest as exempt from Maryland taxation consistent with the methodology utilized by Petitioner's Tax Director and Securities Manager.

For the above reasons, the Court shall pass an Order reversing the decision of the Comptroller and granting the Petitioner's refund claims in the amount of \$2,623,240.00 for tax year 2007 and \$2,048,909.00 for tax year 2008, with statutory interest. Interest is mandated by the MD. Code Ann, Tax- Gen. §13-603, unless the Petitioner's original return was mistakenly filed and the mistake or error was not attributable to the state. In the present case, Petitioner filed its original returns in accordance with the Comptroller's policy and tax forms which did not authorize a carry forward of federal interest. The Court finds that the Petitioner used reasonable judgment in filing the original returns, and interest should be computed upon the filing of the amended returns.