6/8/01

KRAFT GENERAL FOODS, INC.	*	IN THE
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	*	MARYLAND TAX COURT
	*	
V.	*	
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COMPTROLLER OF THE TREASURY	*	NO. 98-IN-OO-0353
	*	
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MEMORANDUM OF GROUNDS FOR DECISION

Petitioner, Kraft General Foods, Inc., appeals from a final determination of the Respondent, Comptroller of the Treasury, assessing $300,800, plus interest for the tax year 1992. The issue to be resolved is whether the Respondent's calculation of Petitioner's net operating loss by disallowing the accumulated Maryland deductions for dividends from foreign corporations to be a part of the balance carried forward is constitutionally permitted.

Stipulated Facts

The parties have stipulated to all of the facts. The more significant are:[1]

1. Petitioner, a corporation organized under the laws of the State of Delaware, maintains its commercial domicile in the State of Illinois. Petitioner is a multinational food company totally committed to the production, marketing and distributing of food products.

2. In 1985, General Foods Corporation ("General Foods") was a Delaware corporation with its principal place of business in the State of New York when Philip Morris Companies Inc.

[1] Paragraph numbers in this section reflect the number of the paragraph of the "Stipulation".

("Philip Morris") acquired all of its outstanding common stock. Like Petitioner, General Foods was involved in the production, marketing and distribution of food products. In 1988, Philip Morris purchased all of the issued and outstanding shares of common stock of Kraft, Inc. predecessor to Petitioner. On December 29, 1989, General Foods was merged into Kraft, Inc., and the name of the surviving corporation was changed to Kraft General Foods, Inc. (Petitioner herein).

3. Petitioner timely filed Maryland corporate income tax returns for the calendar years 1990, 1991 and 1992. On July 27, 1994, Petitioner filed amended returns with Respondent for the years 1990 through 1992 (the "Amended Returns") as a result of adjustments made to the 1985 and 1986 federal income tax returns of General Foods. The federal adjustments to the General Foods returns resulted in changes to the net operating loss carryforward flowing to Petitioner. On November 7, 1994, the Respondent refunded $183,171 based on the Amended Returns.

4. The 1990 Amended Return reported a net operating loss in the amount of $1,142,153,703 attributable to i) the accumulated operating losses of General Foods dating back to 1985 as adjusted by the Internal Revenue Service and (ii) the accumulated Maryland deductions for dividends from foreign corporations. The 1991 Amended Return reported a net operating loss in the amount of $939,841,550 consisting of (i) federal carryforward of $694,542,136 for 1990 and (ii) the 1990 Maryland deductions for dividends from foreign corporations in the amount of $245,299,414. The 1992 Amended Return reported a net operation loss in the amount of $418,695,288 consisting of (i) federal carryforward of $409,583,987 from 1991, and (ii) the 1991 Maryland deductions for dividends from foreign corporations in the amount of $9,111,301. Each of the foreign corporations that paid a dividend to General Foods and to Petitioner was owned 50% or more by General Foods or Petitioner, as the case may be, and was organized under the laws of foreign government.

5. Respondent's Compliance Division (the "Division") conducted an audit of the Amended Returns and reduced the amount of General Foods' loss carryforward from

$1,142,153,703 to $907,866,626. The Division disallowed the balance attributable to the accumulated Maryland deductions for dividends from foreign corporations. The Division also disallowed the carryforward of those Maryland deductions from 1990 to 1991 and 1991 to 1992.

6. It is Respondent's consistent, long standing, unbroken policy that a corporation is not permitted to utilize a subtraction modification to increase its net operating loss carry forward to an amount in excess of its federal net operating loss. Further, it is Respondent's policy that a subtraction modification can be used to reduce a corporation's taxable income, but if the corporation has a net operating loss, the subtraction modification may not be used to increase the amount of that loss to be carried forward.

7. On February 25, 1997, the Division assessed additional taxes for the 1991 and 1992 years in the amounts of $50,885 and $376,821, respectively, together with interest and penalty. Kraft protested the assessment on March 18, 1997.

10. On April 21, 1998, the Hearing Officer issued his Final Determination which (i) upheld the Notice of Assessment in the amount of $347,973, plus interest, with respect to Kraft's 1992 taxable year, (ii) abated all penalties assessed…

11. Due to errors in both the Final Determination and Petitioner's 1993 claim for refund, the amount in controversy set forth in Petitioner's Petition is incorrect. The amount of additional tax liability which should have been stated in the Final Determination is $300,800, plus statutory interest.

12. Petitioner agrees that a refund is not due with respect to the 1993 tax year and believes that, at most, the revised tax liability owed for the 1992 tax year is $50,452. Thus, the correct amount in controversy is $250,347, plus statutory interest.

13. The amount of the accumulated operating losses of General Foods for the years 1985 through 1989, as adjusted by the Internal Revenue Service, to be carried forward to Petitioner's 1990 tax year is $964,503,048.

14. The amount of accumulated dividends from foreign corporations of General Foods for the years 1985 through 1989, as adjusted by the Internal Revenue Service, is $121,592,455.

15. The amount of accumulated dividends from foreign corporations of Petitioner for the years 1990 through 1992 is $286,639,333.

Issues Involved

Petitioner brings this appeal contending that the taxing statutes enacted by the Maryland General Assembly impermissibly discriminates against foreign commerce and denies Petitioner equal protection. The Commerce Clause of the United States Constitution (Art. 1, Sec. 8) provides: The Congress shall have the power "[t] o regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes." The Equal Protection Clause (Amend. XIV, Sec. 1) provides that: "No state shall…deny any person within its jurisdiction the equal protection of the laws."

The relevant Maryland statutes can be found in the Tax-General Article of the Annotated Code of Maryland. §10-304(1) provides that the Maryland modified income of a corporation is "the corporation's federal taxable income for the taxable year as determined under the Internal Revenue Code and as adjusted under this Part II of this subtitle".

The adjustment at issue presently can be found in §10-307(d), which provides that amounts which may be subtracted from the federal taxable income of a corporation includes "dividends received from a corporation if: (1) the receiving corporation owns, directly or indirectly, 50% or more of the paying corporation's shares of capital stock; and (2) the paying corporation is organized under the laws of a foreign government". This subtraction emanates from the treatment, under federal law, of foreign subsidiary dividends. Federal law includes

dividends from foreign subsidiaries in taxable income because the underlying income of those affiliates is not subject to federal tax. Domestic subsidiary dividends are excluded from United States tax because their inclusion results in U.S. double taxation of income (i.e. the underlying income of the subsidiaries is already included). The General Assembly enacted §10-307(d) to provide for the exclusion from Maryland tax of those foreign source dividends that, unlike domestic source dividends, are included in federal taxable income; i.e. the starting point for Maryland income calculations.

Petitioner contends that the Respondent's policy of not allowing a subtraction modification to increase a taxpayer's net operating loss (as stated in Paragraph 6 of the Stipulation above), on its face unconstitutionally favors domestic commerce because the subtraction can only be utilized if there are foreign source dividends. Respondent counters that the Maryland statute, which benefits entities with income from foreign subsidiaries by granting a subtraction, does not discriminate in the way that the law prohibits.

Commerce Clause

The United States Supreme Court has provided the test for determining whether a state taxing statute violates the Foreign Commerce Clause. Through the decisions rendered in *Complete Auto Transit, Inc. v. Brady,* 430 U.S. 274, 279 (1977) and *Japan Line, Ltd. v. County of Los Angeles,* 441 U.S. 434, 451 (1979), a six-prong test was developed. In analyzing a statute, a reviewing Court must ask whether the tax:

1) is applied to an activity with a substantial nexus with the taxing state;
2) is fairly apportioned;
3) is non-discriminatory;
4) is fairly related to the services provided;
5) creates a substantial risk of international multiple taxation; and
6) prevents the federal government from speaking with one voice when regulation commercial relations with foreign governments.

Petitioner, in its challenge to the Maryland taxing scheme, relies on the "discrimination" prong and the more recent Supreme Court ruling in *Kraft General Foods, Inc. v. Iowa Department of Revenue and Finance,* 505 U.S. 71 (1992). The issue in that case was the effect of an Iowa statute providing for the taxing of dividends that a corporation received from its foreign subsidiaries, yet not those dividends received from domestic subsidiaries. The Court, reiterating its *Japan Line* holding that "the constitutional prohibition against state taxation of foreign commerce is broader than the protection afforded to interstate commerce", 505 U.S. at 79, found that "[t]he Iowa statute cannot withstand this scrutiny, for it facially discriminates against foreign commerce and therefore violates the Foreign Commerce Clause", 505 U.S. at 81.

According to Petitioner, the Maryland scheme of taxation is demonstrably unfair to companies engaged in foreign commerce. Because domestic source dividends are deducted from federal taxable income, the starting point in calculating Maryland taxable income will never include those dividends. Thus, if a taxpayer incurs a loss, the entire loss can be carried forward to future years for Maryland tax purposes. Alternatively, foreign source dividends are included in Federal taxable income. Unlike the Iowa statute, Maryland allows for those dividends to be deducted in the year the dividends are received. However, if a loss is incured, the amount subtracted cannot be utilized to increase the loss for the carryover year.[2] Petitioner contends that the different treatment results in a higher Maryland corporate income tax on the taxpayer with foreign subsidiary dividend income and the Supreme Court has found such treatment unconstitutional.

Respondent does not deny that "the 'benefit' a taxpayer derives from the non-taxability of domestic dividends will exceed the 'benefit' from the non-taxability of a foreign dividend", Respondent's Memorandum of Law, p. 6. However, the benefit, according to the Respondent, depends only upon the presence, if and when, of a net operating loss that is carried forward. The domestic source benefit is not inherent in the Maryland statute. Indeed, §10-307(d) confers a benefit to foreign source dividends that was meant to offset what occurred with the Iowa situation. The Supreme Court found that Iowa statute "facially" discriminated in violation of the Foreign Commerce Clause. The Respondent contends that facial discrimination cannot be

[2] This is true of all subtraction modifications, not solely the one at issue here.

found in the Maryland statute where, as here, the "presence of **potential** discrimination is speculative" Respondent's Memorandum, p. 6, (Emphasis in original).

Discrimination "on its face" usually occurs when the taxing statute is explicit in taxing out-of-state taxpayers at a higher rate or burden than competing in-state taxpayers. The Supreme Court has basically defined "facial discrimination: "It is not necessary to look beyond the text of this statute to determine that it discriminates against interstate commerce" *Camps Newfound/Owatonna, Inc v. Town of Harrison, Maine*, 520 U.S. 564, 581 (1997). Upon a finding of facial discrimination, the offending statute is "virtually per se invalid", *Camps Newfound*, supra at 581.

It is this narrow concept of facial discrimination to which the Respondent directs us in arguing that only the words of the statute should be examined when a foreign commerce clause challenge is made. We disagree. As stated above, the *Kraft* court confirmed that the protection afforded foreign commerce is broad and any attempt to tax requires a more extensive constitutional inquiry than that involving simply interstate commerce. The Supreme Court has even taken that broader view by looking outside the text of a statute in concluding facial discrimination exists in an enacted tax, *South Central Bell Telephone Co. v. Alabama*, 119 S. Ct. 1180 (1999).

Thus, this Court looks beyond the language of the subtraction modification (which does correct the unequal treatment of foreign source dividends caused by the federal tax code) to the Respondent's scheme of taxation as pertaining to net operating losses. That scheme treats two taxpayers (one receiving domestic source dividends and the other foreign source dividends) in identical situations (in the years following a loss year), differently. In every year following the loss year, a corporation will always get the benefit of the federal deduction for domestic source dividends received in the loss year while the Maryland subtraction modification for foreign source dividends received in the loss year will be lost. The benefit inuring to the domestic dividend recipient and the harm to the foreign dividend recipient is not speculative or uncertain. This disparate treatment discriminates against foreign commerce because it directly results in a higher Maryland corporation income tax on the taxpayer with the foreign source dividend income. By exposing foreign commerce to burdens that domestic commerce is not required to bear, the taxing scheme fails to meet Commerce Clause requirements and is invalid.

Equal Protection Clause

Having determined that the Commerce Clause of the U.S. Constitution has been violated by the Respondent's method of taxing foreign source dividends, it is not necessary for the Court to reach the equal protection argument.

Conclusion

For the above reasons, we shall pass an Order reversing the assessment imposed on Petitioner for the tax year 1992 and the tax liability shall be recalculated pursuant to the Stipulation as agreed to by the parties.