

MARYLAND TAX COURT

MICHIGAN HOST, INC.

Petitioner

v.

COMPTROLLER OF THE TREASURY

Respondent

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Appeal No. 12-IN-OO-1187

MEMORANDUM AND ORDER

In the present case, Michigan Host, Inc. (“Michigan Host” or “Petitioner”) appeals the assessment of corporate income taxes and penalties for the tax years 2000 through 2003 by the Comptroller of the Treasury (“Comptroller” or “Respondent”). Petitioner seeks a refund of these amounts totaling \$2,047,322.00 plus interest. Petitioner claims the amounts were erroneously assessed on interest income received by Michigan Host (a Delaware corporation with a principal place of business in Michigan), from Host International, Inc. (“Host International”) and other related entities. The interest income was apportioned to Maryland by the Maryland apportionment factor of Host International, Inc.

Respondent disputes the legal basis of the Petitioner’s argument and contends that the Maryland case law has consistently held that all of the inter-related companies must have economic substance as separate business entities. Moreover, nexus exists to impose the tax because the interest income received by Petitioner is derived, directly or indirectly, from its affiliate’s retail operations in Maryland.

The case arose when the Comptroller audited Host International and HMSHost Corp. (“HMSH”) for tax years including 2000-2003. The audit uncovered substantial interest payments paid by Host International to its affiliate, Michigan Host. Michigan Host did not file Maryland corporation income tax returns during the 2000-2003 tax years. Host International is based in Bethesda, Maryland, and through its subsidiaries, operates food, beverage and merchandise concessions at airports, on toll roads, and at other travel and entertainment venues in the United States. It operates gift and news retail outlets in off-airport locations, as well as manages toll road contracts.

Michigan Host operates restaurants and other retail stores at Detroit Metropolitan Airport as well as numerous other facilities. During the period of 2000-2003, Michigan Host operated between 8 and 35 restaurants at Detroit Metro, employing between 233 and 586 people. These employees were hired and trained in and around the Detroit metropolitan area. They operated all of the franchise restaurants and other retail businesses at the airport. None of Michigan Host’s airport operations are conducted in Maryland; no non-management employees are located in Maryland; and Michigan Host owns no real property or leases for real property in its own name in Maryland.

During the site audit of Host International, inter-company interest payments to its affiliate, Michigan Host, were found. The Comptroller sent an inquiry to Michigan Host on June 28, 2010, and on November 30, 2010, the Comptroller sent a notice and demand to Michigan Host, requiring it to file tax returns in Maryland. No Maryland returns were filed, and the Comptroller proceeded to issue tax assessments for the 2000-2003 tax years.

Michigan Host disputes the assessment and asserts that it has no sales, employees or property that produce income in Maryland. As a result, Michigan Host contends that it has no business in Maryland and was not required to file a Maryland corporation income tax return. The application of Maryland's apportionment formulas to Michigan Host results in a zero payroll factor, a zero property factor, and a zero sales factor. Therefore, according to Michigan Host, applying Maryland statutory apportionment provisions to Michigan Host results in Michigan Host having no Maryland corporate income tax liability. Neither Michigan Host nor its activities producing the interest income have a sufficient connection to Maryland for income tax purposes. Thus, again according to Michigan Host, the assessment violates Maryland statutes, its Constitution and Federal Due Process and Commerce Clause provisions.

In order to determine whether Michigan Host and its interest-producing activities had sufficient contact with Maryland under constitutional requirements, the threshold question must be answered. Did Michigan Host have economic substance separate from its parent, Host International for the years 2000 through 2003? The Court finds that Michigan Host is a resident of Maryland by virtue of its parent's offices and loan servicing operations in Bethesda. The offices of Michigan Host's directors and corporation-level officers were and are located in Bethesda, Maryland. All of the corporation's higher-level administrative functions were performed in Bethesda, Maryland. Moreover, the loan operations at issue in this case, which produced a third of Michigan Host's corporate revenues in each of tax years 2000 and 2001, and ballooned to three-fourths of its revenues in 2002 and 2003, were serviced in Bethesda, Maryland. The Court finds that the continuous and regular management of the corporation in

Maryland by its officers and directors in Bethesda and the loan servicing operations, taken together or independent of each other, are sufficient to create the necessary nexus for taxation.

Michigan Host assumed the role of corporate financier and was functionally and economically dependent upon Host International and HMSH, its direct and indirect corporate parents, for its existence. Michigan Host relied upon HMSHost Corp. and Host International for all of its non-operational corporate functions, including tax services, legal services, accounting services, payroll administration, procurement, treasury functions and cash management, and human resource policies. Michigan Host's corporate funds, which were not limited to just the interest revenue from Host International, flowed in a circular manner between MHI and Host International. MHI's airport operations cash was "swept" by Host International into corporate coffers in Bethesda. Host International levied general and administrative charges against Michigan Host's corporate cash accounts. Host International made the substantial interest payments at issue in this case to Michigan Host and concomitantly with the interest payments, MHI paid dividends to Host International. This circular movement of funds, in an integrated corporate system, is the central and predominant legal justification of the Comptroller's assessment.

The legal basis for taxation of intangible property holding companies was explained in *Comptroller v. SYL, Inc.*, 375 Md. 78 (2003) and reiterated in *Gore Enterprise Holdings, Inc. v. Comptroller*, 437 Md. 492 (2014). Under the *SYH/GEH* analytical framework, an inter-company banker, such as MHI, is taxable by Maryland if it is an entity that earns intangible income from activities of its controlling parent and has no operational existence as a separate entity

independent from its parent. *SYL*, 375 Md. At 106; *Gore Enterprise Holdings*, 437 Md. At 513-514.

The Court of Appeals opined in *SYL* that the constitutional requirements for state taxation were satisfied by virtue of the fact that the nexus-service companies “had no real economic substance as separate business entities.” *SYL*, 375 Md. At 106. The Court applied the exact same legal reasoning in *Gore Enterprise Holdings*, concluding that the intangibles holding companies “were subsidiaries with ‘no real economic substance as separate business entities.’” *Gore Enterprise Holdings*, 437 Md. At 515-516. In the present case, Michigan Host’s interest income has a direct and substantial connection to Maryland because the income is paid on loans made to Michigan Host’s Maryland parent that are serviced in Maryland. Host International’s business in Maryland is what produced the interest income of Michigan Host. This is a nexus sufficient to support taxation of Michigan Host’s Maryland income.

The Court finds that Michigan Host could not have functioned as a corporate entity without the support services, ranging from its physical housing to payroll, accounting, cash management, tax services, funding of legal services, capital requirements, financing, executive staffing, and purchasing, which were supplied by its corporate parent. Thus, Michigan Host lacked economic substance separate from its parents.

Having determined that Michigan Host had sufficient minimum contacts with Maryland to require it to file returns and pay income taxes, did the Comptroller fairly apportion income to the taxpayer’s Maryland related income-producing activities? The Comptroller’s auditors examined Host International’s books and records in Bethesda and found that with respect to Michigan Host, there were no recorded Maryland sales, no recorded Maryland payroll, and no

recorded Maryland property. As a result, application of the statutory 3-factor apportionment formula would have yielded an apportionment factor of zero. Since a zero apportionment factor would not have reflected the income allocable to Maryland, the Comptroller's agents formulated an apportionment factor. The apportionment factor utilized by the Comptroller in allocating Michigan Host's income was derived directly from the income tax returns of Host International that were filed in Maryland. Petitioner claims that the apportionment rates used by the Comptroller distorts the Maryland income attributable to Petitioner. The Court has examined Petitioner's proposed apportionment calculations and cannot conclude that Comptroller's formula is unreasonable or distorted Michigan Host's income. There is no clear and convincing evidence that the Comptroller's blended apportionment factor is unfair. Accordingly the Court sustains Comptroller's apportionment formula.

Finally, The Court must determine whether interest and penalties should be waived. The Court has consistently held that the state of the law in regard to the economic substance cases relied upon by the Comptroller was not clear and has evolved since the filing of the returns for tax years 2000 through 2003. The Court finds that the Petitioner had reasonable cause and acted in good faith in not remitting income tax on its interest income. However, Petitioner maintained an office in Maryland and should have filed Maryland corporate income tax returns.

Accordingly, this 1st day of February, 2017, it is hereby ORDERED by the Maryland Tax Court that the denial of the refund claim as it pertains to the income taxes paid is hereby AFFIRMED and that the denial of the refund claim as it pertains to penalty and 50% of the interest is hereby REVERSED.