

NORDSTROM, INC.
NIHC, INC.

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MTC No. 07-IN-OO-0317
MTC No. 07-IN-OO-0318

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vs.

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IN THE

COMPTROLLER OF THE TREASURY

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MARYLAND TAX COURT

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MEMORANDUM OF GROUNDS FOR DECISION

These appeals come to the Court by way of a remand from the Circuit Court of Baltimore County (Nos. 03-C-08-012004 and 03-C-08-012005) with specific directions provided. The Circuit Court has remanded the appeals for the Maryland Tax Court's resolution of those issues referenced below.

The Tax Court found that, pursuant to the Court of Appeals decision in Comptroller v. SYL, Inc., et al, 375 Md. 78 (2003), hereinafter SYL, NIHC and N2HC lacked real economic substance as separate business entities and the Respondent could attribute nexus to them based on the activities in Maryland of its parent, Nordstrom. The income taxable by Maryland was the royalty income that circuitously traveled from parent to the subsidiaries and back. First, the Circuit Court has directed this Court to reexamine the source of particular income of NIHC to see if there is a relationship between that income and business activities in Maryland.

As specified in our decision, the income sought to be taxed by Maryland arose from a 1999 transaction, whereby NIHC distributed, as a dividend, a license agreement authorizing the right to license the use of Nordstrom trademarks, to its parent, N2HC. As a result of the dividend of the licensing agreement, NIHC recognized gain on the distribution of appreciated property pursuant to I.R.C. § 311 (b). Pursuant to Treasury

regulation, NIHC was required to defer the reporting of the gain over the fifteen year period in which N2HC amortized the value of the license agreement under I.R.C. § 197. Approximately \$185 million in deferred § 311 (b) gain was reported by NIHC each year in the 2002, 2003 and 2004 Nordstrom federal consolidated returns. It is those deferred amounts that the Respondent seeks to tax.

The Circuit Court stated:

“This case will be remanded to the Tax Court for an analysis of whether there is a constitutionally sufficient nexus for Maryland income tax based upon a review of the relationship, if any, between the § 311 (b) gain and business activities in Maryland. If on remand the Tax Court again finds that there is a sufficient nexus to satisfy the Due Process and Commerce Clauses of the U.S. Constitution, it should then proceed to decide the additional issues raised by NIHC:

- 1) Whether the § 311 (b) gain constitutes “Maryland taxable income” under Md. Tax-General Code Ann., § 10-402(a).
- 2) Whether Maryland’s requirement for separate entity income tax returns prohibits taxing the § 311 (b) deferred gain.”

§ 10-402 (a) of the Tax-General Article provides that: “In computing Maryland taxable income, a corporation shall allocate Maryland modified income derived from or reasonably attributable to its trade or business in this State”.

We previously ruled that, due to Nordstrom’s presence and the lack of economic substance of the affiliates, constitutional nexus existed based on the subsidiaries’ connection to activities in Maryland. We found that the licensing of intangible property rights to the parent corporation for use in products that were sold in Maryland resulted in income (the royalty income) attributable to activity in Maryland. Upon remand, we find no reason to alter that decision.

However, as the Circuit Court points out, the facts pertaining to NHIC are distinguishable from “SYL” type situations in that the only income realized by NIHC is the § 311 (b) gain. “Once the requisite nexus has been shown, the taxpayer then bears the burden of demonstrating that the income it seeks to exclude from taxation was derived from unrelated business activity that constituted a discrete business enterprise.” SYL, supra, 375 Md. at 101. The question becomes then whether this gain is connected to any activity in Maryland, including the use by Nordstrom of the trademarks in its Maryland stores.

For the reasons below, we shall find that the gain income is subject to Maryland taxation. The gain required to be reported by IRC is income based on a transaction seemingly unrelated to the royalty income stream and to Maryland. The purpose of I.R.C. § 311 (b) is to tax the distribution to shareholders of appreciated property to prevent a company from avoiding tax on the appreciation by distributing the property tax-free to its shareholders.

Even if the Respondent has jurisdiction to tax NIHC due to its lack of economic substance, Respondent must also have sufficient nexus over the transaction it is attempting to tax. “In the case of a tax on an activity, there must be a connection to the activity itself, rather than a connection only to the actor the State seeks to tax.”, Allied Signal, Inc. v. Director, Div. of Taxation, 504 U.S. 768 at 778 (1992). In addition, “the basis of a nexus sufficient to justify taxation... was the economic reality of the fact that the parent’s business in the taxing state was what produced the income of the subsidiary.” The Classics Chicago, Inc., et al v. Comptroller, Court of Special Appeals, No. 2047, Sept. Term, 2008 (2010) at p. 21.

In the instant case, it is clear to this Court that but for the activities of Nordstrom and its use of the trademarks in Maryland, the gain of NIHC would not have been recognized. Nordstrom's business activities and use of the intellectual property rights obtained through its agreement with N2HC in Maryland produced the gain income reported by NIHC. One cannot separate the value of the trademarks, the licensing of trademarks and the gain recognized by NIHC from the Nordstrom activity in Maryland. Despite the distinct entities involved, the ruling in SYL compels us to find that the income NIHC seeks to exclude was derived from the related business activity of Nordstrom in Maryland and when a non-substantive entity's income results from the activity of its parent, it is proper to attribute nexus in Maryland to that entity and that income. Applying the SYL analysis, the attribution of nexus to NIHC permits the Respondent to find that the gain is Maryland taxable income under § 10-402 (a) as a separate business entity.

Next, the Circuit Court remanded to the Tax Court to "decide whether Nordstrom claimed a deduction for any income reported by NIHC, and if so, whether Nordstrom's deduction is allowable as an ordinary and necessary business expense under I.R.C. § 162", (In the Circuit Court for Baltimore County, No. 03-C-08-012004, Memorandum and Order, August 19, 2009) . We find no evidence in the record that Nordstrom deducted any of the gain income of NIHC in its federal returns for the years in question. Thus, the second part of the remand instruction need not be addressed.

Accordingly, for the reasons stated, we shall again pass an Order affirming the assessments against NIHC, reducing the penalty to 10% and rescinding the assessment against Nordstrom.