

NORDSTROM, INC.
NIHC, INC.
N2HC, INC.

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MTC No. 07-**IN**-OO-0317
MTC No. 07-**IN**-OO-0318
MTC No. 07-**IN**-OO-0319

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

Petitioners, Nordstrom, Inc. (“Nordstrom”), NIHC, Inc. (“NIHC”) and N2HC, Inc. (“N2HC”) seek an Order reversing the assessment imposed by the Respondent, Comptroller of the Treasury. NIHC, a subsidiary of Nordstrom has appealed assessments for the tax years 2002 and 2003. N2HC, another subsidiary of Nordstrom, has appealed assessments for the tax years 2002 and 2003. Nordstrom has appealed assessments for the tax years 2002, 2003 and 2004. The assessments against Nordstrom were an alternative to the assessments against NIHC and N2HC, which will be rescinded by the Comptroller if the assessments against NIHC and N2HC are upheld.

This case concerns the liability for Maryland income taxes of two corporations that do no business in Maryland and own no tangible property in Maryland, but are subsidiaries of a parent that does business in Maryland. The dispositive issue is whether there is a sufficient nexus between the State of Maryland and each subsidiary corporation to impose Maryland income tax in accordance with the Commerce Clause of the United States Constitution or the principles of due process.

Nordstrom is a Washington corporation and a nationally known retailer with 150 stores in 27 states. Nordstrom operated four department stores, two discount

stores, and one distribution center in Maryland during the audit period.

Nordstrom was the owner of valuable trademarks (“Marks”), and in 1996 Nordstrom incorporated NIHC and NTN in Colorado and contributed to NIHC a license agreement authorizing NIHC to license the use of Nordstrom trademarks in exchange for 100 percent of NIHC stock. In January 1997, Nordstrom’s accountants, Deloitte & Touche (“D&T”), advised Nordstrom in a memorandum how Nordstrom should structure the transfer of the Nordstrom Marks approved by its Board so as to minimize potential state “Geoffrey” assessments of the proposed trademark protection company. In March 1997, Nordstrom caused the incorporation of N2HC in Nevada, contributing cash in exchange for all of the stock in N2HC. In March 1997, Nordstrom transferred its Marks to NTN. In April 1997, Nordstrom transferred its stock in NTN and NIHC to N2HC in exchange for cash. Following this April 1997 transfer, N2HC was the owner of all of the stock of NIHC, and NIHC had the right, pursuant to the license agreement conveyed to it upon its incorporation in 1996, to license the right to use the Nordstrom trademarks beginning February 1, 1999. In January 1999, NIHC distributed to N2HC, as a dividend, the license agreement which included the right to license the Nordstrom trademarks. In February 1999, D&T’s Valuation Group performed an appraisal of the Nordstrom Marks as of October 31, 1998 and estimated a reasonable royalty rate for the use of the Marks. On February 1, 1999, N2HC entered into a license agreement with Nordstrom, pursuant to which N2HC granted Nordstrom a license to use the Nordstrom trademarks, in exchange for royalty payments to be made by Nordstrom to N2HC. The license agreement with Nordstrom granted Nordstrom a non-exclusive license to use the Nordstrom Marks in return for an arm’s length royalty fee as

determined by the appraisal performed by the D&T Valuation Group.

Throughout the period in issue, N2HC maintained an office in Portland, Oregon staffed by a full-time intangible property specialist who interfaced with N2HC's outside trademark counsel in registering new Marks, giving notification of possible infringement and bringing actions to protect and enforce the Marks. Petitioner contends that these facts indicate that N2HC has substantial substance as a separate entity.

In addition to filing Maryland returns for Nordstrom, Maryland returns were filed by each member of the Nordstrom federal consolidated group, whether or not these companies conducted business in Maryland and had any Maryland tax liability. Nordstrom reported apportionable income to Maryland. The Maryland returns filed for Nordstrom affiliates, including NIHC and N2HC, listed the income reported on the federal consolidated return for each affiliate with a zero Maryland apportionment factor.

Petitioner contends that N2HC is not subject to Maryland Corporate Income Tax based in part on Comptroller v. SYL, Inc. and Crown Cork & Seal Co. (Delaware), Inc., 375 Md. 78, cert. denied, 504 U.S. 984 and 504 U.S. 1090 (2003). Unlike SYL, Inc., Petitioner contends N2HC was actively engaged in maintaining, managing, enforcing and protecting the Nordstrom Marks. The Court in SYL, Inc. found a number of facts which indicated SYL had no real economic substance as a separate business entity. SYL did not have a full-time employee and its part-time employees were officers or employees of a "nexus-service" company; the annual wages paid to employees were miniscule; the so-called office was a mail drop; and with respect to the protections of the trademarks, nothing changed after SYL, Inc. was created. In contrast, N2HC maintained its own office and employed a full-time experienced paralegal who was actively involved in managing the

Marks and registering new Marks and who worked closely with outside trademark counsel to protect and enforce the Nordstrom Marks.

Petitioner further claims that NIHC is not subject to Maryland Corporate Income Tax. The NIHC income, which the Comptroller seeks to tax in 2002 and 2003, arose from the 1999 transfer by NIHC of the right to license the Marks to its parent, N2HC, resulting in a gain under I.R.C. Section 311(b) (the "I.R.C. Section 311(B) Gain"). NIHC's distribution of its right to license the use of the Nordstrom Marks to N2HC was treated as a distribution of appreciated property under I.R.C. Section 311(b). Approximately \$185 million in deferred I.R.C. Section 311(b) Gain was reported by NIHC each year in the 2002, 2003 and 2004 on Nordstrom federal consolidated returns. Petitioner contends that I.R.C. Section 311(b) required NIHC to report the gain from the distribution of the license agreement to N2HC and, under the Regulation 1.1502-13, intercompany transactions rules, the gain was required to be deferred and reported in the Nordstrom consolidated returns over fifteen years. The Comptroller seeks to tax these deferred amounts.

NIHC also relies on the Maryland Court of Appeals' decision in SYL to distinguish the facts in the present case. "Since SYL was found to be a phantom, it was clearly appropriate to look to the underlying source of its income. SYL's booked income was in reality generated from Syms' sales, property and payroll." SYL, 375 Md. at 84. Petitioner asserts that Nordstrom's activity in Maryland had nothing to do with the gain derived by NIHC in 1999. Petitioner claims that the Comptroller seeks to tax NIHC on income arising from a 1999 transaction which bears no relation to Nordstrom's use of Marks in its Maryland stores or any other activity conducted in Maryland.

Petitioner also challenges the Comptroller's Notice of Final Determination which affirmed the disallowance of the deductions taken by Nordstrom for royalties paid to N2HC on the basis that the expenses were not ordinary and necessary under I.R.C. Section 162. The Comptroller's Final Determination letter stated.

As an alternative to the assessment made against Nordstrom's affiliates, ... the Comptroller has denied royalty expense deductions taken in tax years 2002, 2003 and 2004 It is the Comptroller's position that the deduction should be denied, based on the fact that the expense was not ordinary and necessary (I.R.C. Section 162). It is expected that the Comptroller's primary basis for assessment should be upheld; therefore, it is not necessary to fully address the factual basis for denial of the royalty expense, except to note that facts supporting such are in part set forth in each of the affiliate's final determinations.

The Comptroller's Conclusion of Law stated:

The taxpayer has failed to meet its burden of proof with respect to the I.R.C. Section 162 royalty expenses and did not establish that they were ordinary and necessary. As a result, the tax, interest and penalty assessments are affirmed.

While reference to the sham doctrine is referred to by the Court of Appeals in SYL, Inc., this Court finds that SYL, Inc. does not establish the sham doctrine as the standard to be applied when determining nexus of affiliated entities. The test applied is whether the out-of-state affiliates had "real economic substance as separate business entities," SYL, Inc., *supra* at 106; The Classic Chicago, Inc. and The Talbots, Inc. v. Comptroller, 2008 WL 1724237 (April 11, 2008).

This test requires the Court to examine the economic substance of the resulting subsidiary, as well as the legitimate business activities (other than tax avoidance) of the subsidiary and its parent. A transparent consideration of the business activity of Nordstroms and its subsidiaries, as well as a review of the royalties

paid by Nordstrom and the financial statements of NIHC and N2HC is necessary to apply the test.

Nordstrom paid royalties to N2HC of approximately \$200,000,000 or more for the years 2002, 2003 and 2004. N2HC loaned back to Nordstrom substantial sums of money equal to approximately two-thirds (2/3) of the year's royalties. Nordstrom paid interest to N2HC, but Nordstrom repaid minimal principal amounts. This payment to N2HC and the subsequent loans to Nordstrom were not arm's length market transactions. The operating expenses of N2HC were minimal when compared with separate royalty income. NIHC's income, other than minimal interest, was the gain equal to the amount amortized and deducted by N2HC. NIHC had minimal expenses in years 2002 and 2003. The result of the assignment of the licensing agreement to NIHC together with the dividending of the licensing agreement to N2HC is a more complicated transaction but it is similar to SYL, Crown and Talbots. Fundamentally, the subsidiaries did not act independently, although the financial structure creates an illusion of substance.

The law on what constitutes nexus for purposes of state taxation has evolved from cases such as Ward Europa v. Comptroller, 66 Md.App. 300 (1986) and Comptroller v. Armco Export Corp., 82 Md.App. 429 (1990) and SYL. Nexus exists, independent of physical presence, because of interrelated activities of commonly owned and controlled corporations where a subsidiary corporation lacks economic substance as a separate business entity. The test suggested by this Court is a transparent consideration of the business activities of the parent and its subsidiaries in order to properly determine the economic substance of the out-of-state subsidiary.

The Court finds that NIHC and N2HC lack real economic substance as separate business entities. The activities of NIHC and N2HC must be considered as the activities of their parent, Nordstrom, and, as such, there are substantial activities in Maryland. Nordstrom has constitutional nexus with Maryland, and the assessments against both NIHC and N2HC must be affirmed as to principal and interest. However, the penalty assessment shall be reversed and reduced to ten percent.

Based on the Respondent's assertions, since the assessments against NIHC and N2HC are affirmed, the assessments against Nordstrom are to be rescinded.