

4/11/2008

THE CLASSIC CHICAGO, INC.

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IN THE

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MARYLAND TAX COURT

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v.

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APPEAL NO. 06-IN-OO-0226

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COMPTROLLER OF THE TREASURY

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THE TALBOTS, INC.

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IN THE

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MARYLAND TAX COURT

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v.

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APPEAL NO. 06-IN-OO-0227

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COMPTROLLER OF THE TREASURY

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MEMORANDUM OF GROUNDS FOR DECISION

Petitioners, The Classics Chicago, Inc. (“Chicago”) and The Talbots. Inc. (“Talbots”) seek an Order reversing the assessments imposed by the Respondent, Comptroller of the Treasury. Classics has appealed tax assessments for the years 1993 through 2003, inclusive in the amount of \$1,092,336 with additional interest and penalty increasing the amount to a total of \$2,102, 100. Talbots, the parent corporation of Classics, has appealed tax assessments for the years 2001 and 2002 with a total assessment figure (tax, interest and penalty) of \$515,602.

The assessments against Classics are based on royalty income received by Classics from its parent, Talbots. Classics asserts that Maryland has no right to tax this income in that Classics had no constitutional nexus with Maryland. The assessments against Talbots result from the Respondent’s disallowance of the deductions claimed by Talbots for the royalty and interest payments made to Classics, as the Respondent refutes Talbots’ claims that these payments were “ordinary and necessary” business expenses.

The facts have been stipulated. The corporate relationships and transactions are very similar to those found in *Comptroller of the Treasury v. SYL, Inc.*, 375 Md. 78, cert. denied,

540 U.S. 984 and 540 U.S. 1090 (2003), (“*SYL, Inc.*”) wherein the Court found nexus existed with the subsidiary holding corporation based on the existence of the parent within Maryland and the fact that the subsidiary had no economic substance.

There are factual differences however, which Petitioners assert supports their claim of no nexus between Classics and Maryland. Specifically, the factual differences lie in the history of Classics and its creation. Citing the Stipulation and the pertinent numbered paragraphs, therein:

2. Talbots is a Delaware corporation with its principal place of business and commercial domicile during the Taxable Period in Hingham, Massachusetts.

3. ...Talbots conducted a specialty women’s retail clothing business by catalog... and through retail stores in numerous state, including stores in Maryland.

4. In 1973, Talbots was acquired by General Mills, Inc.

5. In 1988, General Mills sold its interest in Talbots to Jusco (USA), Inc. (“Jusco USA”), a wholly owned subsidiary of a Japanese corporation, Jusco Co. Ltd. (“Jusco”).

6. At the time of the 1988 acquisition of Talbots by Jusco USA, Talbots sold all of its trademarks, tradenames and related intellectual property (the “Talbots trademarks”) to Jusco (Europe) BV (“Jusco BV”), a Dutch subsidiary of Jusco, for \$100,000,000.

7. Jusco BV financed the purchase of the Talbots trademarks primarily through a loan from its parent company, Jusco.

8. Jusco BV and Talbots entered into a license agreement, dated June 26, 1988, pursuant to which Jusco BV licensed to Talbots the right to use the Talbots trademarks (except in Japan) in exchange for a royalty to be paid by Talbots in amounts decreasing from 2% to 1.6% of Talbots’ net sales, subject to an adjustment of the rate if Talbots’ sales materially varied from certain projections contained in the license agreement.

9. During the time period Talbots licensed the rights to use the Talbots trademarks from Jusco BV, Talbots deducted its royalty payments to Jusco BV on its federal tax returns; the Internal Revenue Service audited Talbots’ corporate income tax returns for those years without disallowing those deductions or otherwise adjusting Talbots’ income tax returns based on those deductions.

10. In November 1993, Jusco (USA) implemented an initial public offering of a minority portion of its interest in Talbots.

11. Incident to the initial public offering, Classics was incorporated in Delaware on October 20, 1993; Classics has maintained its principal place of business and commercial domicile in Chicago, Illinois throughout the Taxable Period.

12. Classics is a wholly owned subsidiary of Talbots.

13. Also incident to the initial public offering, Talbots loaned Classic \$102 million and Classics purchased from Jusco BV all of the Talbots trademarks (except for the rights to use the Talbots trademarks in certain parts of Asia) for \$103 million.

14. Classics and Talbots then entered into a license agreement, dated November 26, 1993, pursuant to which Classics licensed to Talbots the right to use the Talbots trademarks in exchange for a royalty to be paid by Talbots in an amount set at 1.8% of Talbots' net sales for the first five years of the licensing agreement.

15. Effective February 4, 1996, pursuant to a license agreement amendment, the royalty rate was increased to 6% of Talbots' net sales based on a royalty rate analysis performed by a valuation expert, Robert Reilly, of Willamette Management Associates.

17. On July 3, 1997, Talbots executed an assignment pursuant to which all of Talbots' rights, title, and interest in three trademarks, previously registered with the Secretary of State of Maryland, were assigned to Classics....On September 4, 1997, the Secretary of State of Maryland issued his certification that the trademark for the name "Talbots" had been assigned to Classics...Also on September 4, 1997, the Secretary of State of Maryland issued his certification that the trademark for the name "The Talbots" had been assigned to Classics.

18. ...On October 6, 1997, the Secretary of State of Maryland issued his certification that Classics' trademark for "Talbots had been renewed by Classics for a period of ten years and would expire on September 15, 2007.

19. ...On March 3, 2000, the Secretary of State of Maryland issued his certification that Classics' trademark for "The Talbots" had been renewed by Classics for a period of ten years and would expire on February 26, 2010.

20. Talbots timely filed Maryland corporate income tax returns for the Taxable Period.

21. Classics did not file Maryland income tax returns for the Taxable Period.

22. Classics did not own or lease tangible personal or real property in Maryland.

23. Classics did not have any employees in Maryland.

24. Classics did not have any bank accounts in Maryland.

25. Talbots billed Classics and Classics paid to Talbots, rent for sublease of office in Chicago, Illinois, in the amount of \$1,980 per month during the Taxable Period.

26. Bookkeeping services were provided to Classics by an independent contractor, Maureen Doyle. Ms. Doyle billed Classics for her accounting and bookkeeping services at the rate of \$200 per month...

The primary factual distinction from those presented in *SYL, Inc.* is that the trademarks first were transferred from the parent to a foreign holding company, Jusco BV, in order to take advantage of favorable accounting treatments in that country, according to the Petitioners. The ownership of the trademarks was then transferred to the domestic subsidiary Classics from Jusco BV and the Petitioners cite numerous business reasons: the transfer maximizes the value of Talbot's stock at the time of the IPO; a domestic subsidiary holding the trademarks gives Talbots greater growth flexibility in its business; Classics ownership of the Talbots trademarks allows Talbots to sell geographical rights to the trademarks to other business ventures, and; Talbots gets a captive revenue stream of royalty payments into the subsidiary that can be used as collateral for loans.

Petitioners argue that this factual distinction from the facts in *SYL, Inc.* evidences that there was no motivation on behalf of Talbots, at the time of entering into the transaction with Classics, of avoiding the payment of state taxes. On the contrary, Petitioners note that the transfer of the trademarks back to a domestic subsidiary subjected the holding company, Classics, to state tax liability in those states utilizing the unitary combined reporting approach, which liability Jusco BV, as a foreign entity did not have. Since there were no state tax advantages to the structuring of the trademark transactions and no subjective motivation to avoid taxes was apparent, based on the *SYL, Inc.* decision, Petitioners assert nexus does not exist and the assessments should be reversed.

Petitioners are asserting that the federal "sham doctrine" applies based on the holding in *SYL, Inc.* That doctrine examines the transactions involved and invalidates those designed solely to skirt income taxes. Petitioners claim the sham doctrine looks to the subjective

motivations of the transactions and if those motivations are for no other reasons than tax avoidance, than the transactions are voided. Petitioners point to the evidence in this case indicating the motivating factors behind and at the time of the creation of Classics, such as to protect the trademarks, to assure a protected revenue stream and provide potential collateral for Talbots, as proof that the transactions were not a sham. According to Petitioners, the *SYL, Inc.* transactions can be distinguished in that in that situation, the tax avoidance motivations were disclosed at the time the transactions were entered and were predominant.

While reference to the sham doctrine is made by the Court of Appeals in *SYL, Inc.* while citing a Massachusetts Supreme Judicial court decision, *SYL, Inc.* does not establish the sham doctrine as the standard to be applied when determining nexus of affiliated entities. Without specific direction from the Court of Appeals, this Court will not rely on the sham doctrine. Rather the test applied is whether the out-of-state affiliates had “real economic substance as separate business entities”, *SYL, Inc., supra at 106*.

Similar to the entities involved in *SYL, Inc.*, Talbots may have had legitimate business purposes, other than tax avoidance, to fund the payment from Classics to Jusco BV for the trademarks (rather than purchase them itself). However we are directed to examine the substance of the resulting subsidiary. The evidence indicates that Classics had minimal operating expenses during the eleven year period in question. There were little or no expenses for compensation for officers, salary, wages and cost of labor and minimum expenditures for travel, maintenance, professional services, service charges, directors’ fees and rent. The minimal expenses greatly contrasts with the significant amount of royalty income reported.

The transactions generating the income and deductions in question were all inter-company. Classics royalty income resulted from transactions by its parent Talbots and there was no other income generated. Classics relied entirely on its parent for performance of ordinary business operations. The transactions at issue were simply the payment of a significant royalty by a parent to its wholly owned subsidiary, followed by a substantial repayment by the subsidiary to the parent in the form of a dividend.

As this was essentially the fact scenario as that presented to the Court of Appeals in *SYL, Inc.*, we find that Classics lacks real economic substance as a separate business entity. Thus, the activities of Classics must be viewed through the activities of its operating parent,

Talbots, and, as such, there are substantial activities of the holding company, Classics, within Maryland. Therefore, Classics has constitutional nexus with Maryland and the assessments against both Classics and Talbots must be affirmed.

Petitioners argue that should the tax assessments be affirmed, the penalties (25%) should be abated. They reason that the penalties are unwarranted because the state of the law was in flux during the tax period in questions. The *SYL, Inc.* litigation lasted from approximately 1996 until 2003, when the Court of Appeals decision was issued. The Petitioners contend they acted consistent with the law as it existed prior to the 2003 decision and that after the assessments were issued, Petitioners based their protests on good faith arguments due to their factual difference between the *SYL, Inc.* case. Petitioners also direct us to the alternative assessment against Talbots by the Respondent as evidence that underscores the legal uncertainty in this area of law.

Respondent counters that Petitioners knew of the “bogus nature of the generation of a tax deduction by the payment of expenses to yourself”, Respondent’s Post-Trial Memorandum of Law, p. 8, and therefore should not be permitted to escape punishment. Respondent notes that penalties have been imposed because a taxpayer should have been suspicious about the propriety of certain tax deductions and in this case, there is evidence that Petitioners were well aware of the risks involved in the creation of Classics.

Based on the above, the Court shall issue an Order which affirms the assessments for taxes, interest and reduce the penalties imposed to ten percent of the due and owing taxes.