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W. L. GORE & ASSOCIATES, INC.  
GORE ENTERPRISE HOLDINGS, INC.  
FUTURE VALUE, INC.

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No. 07-IN-OO-0084  
No. 07-IN-OO-0085  
No. 07-IN-OO-0086

vs.

IN THE

COMPTROLLER OF THE TREASURY

MARYLAND TAX COURT

**MEMORANDUM OF GROUNDS FOR DECISION**

Petitioners, Gore Enterprises, Inc. ("GEH"), and Future Value, Inc. ("FVI") are Delaware Holding Companies (DHC), which have appealed income tax assessments levied by the Comptroller of the Treasury, Respondent. These assessments are for the years 1983-1992 and 1993-2003 ("the taxable periods"). GEH and FVI are Delaware Holding Companies that have never filed Maryland tax returns and are wholly owned subsidiaries of Petitioner, W. L. Gore and Associates, Inc. ("W. L. Gore"). The case arises from three separate assessments against GEH, FVI and W. L. Gore. The assessments against GEH and FVI were made based on the Comptroller's contention that the companies were required to file Maryland income tax returns and pay tax on royalty and interest income on a modified apportionment formula. The assessments against W. L. Gore were based on the denial of the deduction for royalty and interest payments on the grounds that it had not sufficiently established these amounts as ordinary and necessary business expenses under I.R.C. Section 162. It should be noted that the assessment against W. L. Gore was expressly identified as an alternative assessment.

The Comptroller based its assessments against GEH and FVI due to their substantial connections and nexus to the State of Maryland under the unitary business

principles that determine the constitutional standard for State taxation. The Comptroller contends that neither company has an identity as a separate business entity and that the intangible income it receives is directly connected to Maryland activity through the unitary business conducted in Maryland. The license income earned by GEH is generated by the Maryland manufacture of products by W. L. Gore and the sale of goods to Maryland customers and the interest income earned by FVI is directly connected to the ordinary business operations of W. L. Gore conducted in Maryland. Under the unitary theory, both companies depend upon and are controlled by the operating company, W. L. Gore and rely on W. L. Gore employees and resources for any business activity it conducted.

The principle issue is whether GEH and FVI, wholly owned subsidiaries of W. L. Gore and which have no physical presence in Maryland, can be constitutionally required to pay State income taxes on its income when W. L. Gore maintains a physical presence in this State. An examination of the facts and relationship between these companies is necessary in order to determine whether a substantial nexus exists between GEH, FVI and Maryland so the imposition of income tax does not violate the Commerce Clause of the United States Constitution or principles of Due Process.

For the most part, the underlying facts in this case are not in dispute. The Petitioners presented testimony from numerous witnesses with extensive documentary evidence in an attempt to prove that GEH and FVI have economic substance as separate business entities. The witnesses were intimately involved in the operation of each company and made strategic decisions affecting how GEH and FVI carried out their business objectives. The Petitioners claim that the economic substance of both

companies was demonstrated through the employees and directors who actually engaged in the substantive activity of each company. In an attempt to prove that GEH and FVI have economic substance as separate business entities, Petitioners argue that the evidence proves the following:

(1) W. L. Gore's decision to create GEH was based on substantial business considerations, including (a) experiencing problems and delays obtaining patents for its revolutionary invention; (b) litigating "bet the company" patent infringement cases involving that invention in the U.S., the United Kingdom, Japan, and Sweden; (c) recognizing that its unique, decentralized, non-hierarchical organization posed barriers to protecting and enhancing the value of its revolutionary patents; and (d) responding to significant changes in Federal patent policy that led to the creation of the U.S. Court of Appeals for the Federal Circuit, which required increased focus on strategic management of patents.

(2) Patent strategy changed immediately after the creation of GEH.

(3) GEH engages in significant substantive activities, including investing in patent applications, deciding how broadly to draft patent claims; deciding where to file for patent protection throughout the world; pruning its patent portfolio to eliminate patents of little or no value; licensing, purchasing, selling, and donating patents to third-parties; enforcing its patents through litigation; and performing due diligence on patents offered for sale by others.

(4) GEH's operations and strategy have not been static but have evolved with changing circumstances and its evolution is consistent with the objectives and practices of other substantive entities that manage patents.

(5) W. L. Gore did not transfer its iconic trademarks to GEH because there was no business reason to do so, even though such a transfer would have provided substantial tax benefits.

(6) FVI was created to invest and manage excess funds not needed for working capital, which totaled approximately \$300 million at the time of FVI's creation and grew to over \$800 million as of 2008.

(7) FVI actively manages its investment portfolio and makes substantive decisions about its investment policy, how its advisors and managers are performing, how to invest its portfolio among asset classes, and how to maximize the return on its investments.

(8) GEH and FVI incur significant expenses to manage their patent and investment portfolios, respectively.

(9) GEH and FVI are separate business entities. They exercise independent business judgment in making decisions and are not dominated by W. L. Gore. GEH and FVI make the final call on every patent and investment decision. There is no evidence that W. L. Gore made any decisions involving the operations or strategy of GEH or FVI.

Petitioners' interpretation of the evidence is based on the premise that patent management is a substantive activity which should be distinguished from the manufacture or sale of products of the parent company, W. L. Gore.

However, an examination of GEH's Federal Tax Returns, the circular flow of money between GEH, FVI and W. L. Gore, as well as the other evidence in the case, do not support Petitioners' position.

The income and expenses of GEH and FVI, according to schedules and royalties and interest paid by W. L. Gore, indicate that the Delaware Holding Companies were passive, non-operational entities and did not have a business existence separate and apart from their parent company. For example, the GEH tax return for 1996 indicates a zero expense for salary and rent with a depreciation expense of \$1,583, and \$16,973,458 in royalty income received from W. L. Gore. Although the Petitioners introduced evidence of income from third party royalty transactions, the evidence also indicates that post-1996 third party royalties were not a separate business but were directly connected to W. L. Gore operations. Returns further show that most of the expenses of GEH were for services performed by W. L. Gore for GEH or for ordinary business fees required to maintain patents. It is significant that the lack of independent

expenditures reflect a passive activity in order to retain its favorable Delaware tax exempt status.

Miscellaneous corporate documents support Comptroller's position that GEH and FVI are passive entities inextricably connected to their parent company, W. L. Gore. It is clear that the holding companies for the patents resulted in substantial savings of Delaware state income tax with little or no effect on Federal income tax. The evidence further indicates that there were no outside Directors of GEH or FVI and prior to 1996 the W. L. Gore family dominated the Officer list. Corporate documents, minutes and actions of the Officers support Comptroller's position that the Delaware Holding Companies were part of the W. L. Gore unitary business. Moreover, FVI was simply an intentional depository for assets built up through royalties paid to the patent company, GEH.

Petitioners offer the third party License Agreements as support for the independence of the independent operations of the companies. However, none of the third party Agreements made royalties contingent on profits earned by the Delaware Holding Companies.

The Hopkins Research Agreement is an example of the direct connection between W. L. Gore and GEH in the State of Maryland. W. L. Gore invents and manufactures a medical device under a patent owned by GEH, which device must be subject to certain testing and research before it could be sold. That research and testing is sometimes conducted in Maryland and the product is then sold in Maryland and produces a royalty calculated as a percentage of Maryland sales income. This type

of activity directly establishes a connection or nexus between W. L. Gore, GEH and the State of Maryland.

In effect, GEH does not create, invent or make anything and must rely on W. L. Gore employees to invent the new process or product. Thus, an idea generated by a technologist with W. L. Gore is prepared by GEH through an application for filing with the patent office. In most cases, the employees of W. L. Gore review the patent application and determine whether it should be pursued.

The testimony in the case suggests that GEH relied on W. L. Gore for a continuing stream of inventions and discoveries as set forth in the materials that make up the patent application. The manufacture or sale of the product by W. L. Gore obligates the payment of royalties to GEH under the License Agreement. A review of the License Agreement indicates that W. L. Gore and GEH were inter-dependent. GEH as licensor to W. L. Gore, Inc., licensee, is dependent on the licensee's activities to obtain consideration for grants of the license. Although GEH has separate corporate status, the inter-dependence reflected in the third party License Agreements suggests that the patent committee of GEH strongly considers the interest of W. L. Gore in making its decisions.

Another contention made by the Petitioners through testimony was that GEH was established due to changes in the Federal court organization in which jurisdiction for appeals in patent cases was transferred from Federal Circuit Courts to a new U.S. Appellate Court. The expert witness of the Petitioners emphasized that the need for centralized management of W. L. Gore patents was the critical economic substance of GEH. However, she acknowledged that W. L. Gore and GEH were inter-

dependent, which suggests that GEH, a wholly owned subsidiary of W. L. Gore, could not control patent activities of W. L. Gore.

A reasonable and practical interpretation of the testimony of the Petitioners' witnesses suggests an economic inter-dependence of the W. L. Gore family of companies. One witness for GEH who described herself as a Patent Administrator confirmed that W. L. Gore employees would prepare patent applications at no cost to GEH and that payments were made for GEH in accordance with the Service Agreement with W. L. Gore. An economist for the Petitioners testified that the 7.5 royalty rate set in the W. L. Gore GEH License Agreement was reasonable and equivalent to an independent third party rate. He justified the rate on the grounds that the license was effectively exclusive and in the best interest of the W. L. Gore family of companies since it is the only firm allowed to use the vast majority of the GEH patents. The witness also suggested that W. L. Gore could sell GEH to another entity and that GEH qualified as a "virtual corporation" that had substance even though it received "the vast majority of its royalty income from Gore." However, he agreed that W. L. Gore and GEH had globally integrated goals and that a synergy existed between W. L. Gore and GEH due to the relationship between patents and products. Without such a relationship, there would be no reason for a license between the parties. Testimony from other Petitioners' witnesses consistently suggested that nearly all of the third party licenses came about in order to produce benefits for W. L. Gore or for the "W. L. Gore family of companies."

The testimony in this case also suggests that FVI was formed in 1996 to manage excess cash and capital of W. L. Gore according to a long term investment plan. In 1996, W. L. Gore was experiencing some negative cash flow when W. L. Gore

asked FVI for a line of credit to meet current operating needs which continued through 1999. The inter-company loans reflected the inter-company dependence of FVI. There was a stream of dividends from GEH to W. L. Gore after FVI was organized, which funds were then transferred to FVI to take advantage of the Delaware tax benefits of the Delaware Holding Company. The only reasonable conclusion from this testimony was that FVI was intended to be a passive, non-operational entity similar to GEH.

The only witness for the Comptroller testified that GEH and FVI were typical of hundreds of other Delaware Holding Companies that had been subject to audit by the Comptroller's Office. The audits reflected through the inter-corporate transactions and Service Agreement that the Delaware Holding Companies relied on W. L. Gore for revenues and services. The tax calculation utilized by the Comptroller was intended to apportion to Maryland only the Delaware Holding Company income connected to the operating transactions of W. L. Gore. Expenses were deducted from the income if the Delaware Holding Company made an affirmative demonstration that the expenses were directly related to the income. GEH made no attempt to allocate Delaware Holding Company expenses to the W. L. Gore connected income. Consequently, GEH's tax liability was calculated by multiplying royalties paid by W. L. Gore times the W. L. Gore apportionment formula. For FVI, the tax is calculated by multiplying interest paid by W. L. Gore times the W. L. Gore apportionment formula. There was no other evidence offered by the Petitioners that this formula method was unfair.

Under the Commerce Clause, an entity must have a substantial nexus, while Due Process requires minimal contacts with the State in order to subject the entity



to taxation within that State. Maryland Tax General, Section 10-402 permits the State of Maryland to tax multi-state corporations doing business in Maryland to the fullest extent permitted by the United States Constitution. In the present case, the Comptroller relies on Maryland's income tax laws to tax GEH and FVI to the extent permitted by the Commerce Clause.

Maryland courts have consistently concluded that the basis of a nexus sufficient to justify taxation is the economic reality of the fact that the parent's business in Maryland was what produced the income of the subsidiary. The Classics Chicago, Inc., et al vs. Comptroller of the Treasury, 189 Md.App. 593 (2010); Comptroller of the Treasury v. SYL, Inc., 375 Md. 78, cert. denied, 540 U.S. 984 and 540 U.S. 1090 (2003). Thus, the resolution of this case depends on whether GEH and FVI as out-of-state affiliates had real economic substance as business entities separate from W. L. Gore.

This Court's previous interpretation of the facts support the Comptroller's position that GEH and FVI were engaged in a unitary business with W. L. Gore and are not separate business entities. GEH and FVI depend on W. L. Gore for their existence. The facts indicate functional integration and control through stock ownership, as well as common employees, directors and officers of W. L. Gore and the Gore family. The functional source of GEH's income is derived from the ideas and discoveries generated by W. L. Gore employees. The circular flow of money is traced by and through W. L. Gore when GEH acquires a patent from the ideas and discoveries of W. L. Gore. The income of GEH is derived from a royalty paid by W. L. Gore under a license agreement on the patent.

In addition, the facts also indicate GEH's reliance on W. L. Gore personnel, office space and corporate services. The tax returns and other financial data reflect the lack of separate substantial activity of GEH or FVI. Moreover, the evidence also demonstrates that FVI is taxable by Maryland on its intercompany loan income. FVI is inextricably connected to the royalty income generated by W. L. Gore and paid to GEH. There is a circular flow of money through royalties, dividends and loans which support the unitary business of W. L. Gore and its wholly owned subsidiaries, GEH and FVI.

The Court finds that substantial nexus exists between GEH and FVI with the State of Maryland, and that the Comptroller has fairly apportioned the tax on income through its apportionment formula. Under the circumstances of this case, the Court will abate the penalty but affirm the assessments of tax and interest against GEH and FVI. The alternative assessment against W. L. Gore is dismissed.