

11/22/99

THE SOUTHLAND CORPORATION \* IN THE  
vs. \* MARYLAND TAX COURT  
COMPTROLLER OF THE TREASURY \* Income Tax No. 5534  
\*

### MEMORANDUM OF GROUNDS FOR DECISION

Petitioner, Southland Corporation, seeks a refund of taxes paid as a result of a capital gain earned from a 1990 sale of 50 % interest in stock of Citgo Petroleum. Petitioner had previously sold a 50% interest in Citgo Petroleum in 1986. Respondent, the Comptroller of the Treasury, believes the capital gain should be apportioned. It is his position that after the 1986 sale of stock, Petitioner and Citgo were in a unitary relationship or that the ownership of Citgo stock by Southland was an operational function of that corporation.

This Court had previously found there was not a unitary relationship between Citgo and Southland. The matter was appealed to the Circuit Court of Baltimore City which determined that there had been no express finding as to “the very material argument of the operational functions test” and reversed the factual findings of this Agency. Southland appealed to the Court of Special Appeals. That court explained that the “weight to be given the facts concerning the operational function test [had] not yet been determined by the Tax Court,” therefore the circuit court could not “sit in review of a matter not addressed by the Tax Court.” *Southland v. Comptroller*, No. 1402, Sept. Term, 1996 (unreported). The circuit court’s decision was vacated and the matter remanded to that Court with directions

for further remand to the Tax Court for a “factual determination as to the operational functions test.” This Court finds that the capital transaction did not serve as an operational function; as such, Southland is entitled to a refund from the State of Maryland.

Under the Due Process and Commerce Clauses of the United States Constitution, Maryland is prohibited from taxing Southland’s gain from its 1990 sale of Citgo stock unless (1) Southland and Citgo constituted a unitary business, or (2) Southland’s sale of the Citgo stock served an operational function rather than an investment function. *Allied-Signal Inc. v. Director*, 504 U.S.768, 772, 787, 112 S.Ct. 2252, 2255, 2263 (1992).

This Court previously held that the requisites of the unitary business test had not been met by Southland and that it was entitled to a refund; however, “a state still may tax income derived from interstate activities if the activities serve an operational function.” *Southland*, supra, quoting *Hercules v Comptroller*, 117 Md.App. 29, 45 (1997) *rev’d in Hercules v Comptroller*, 351 Md. 101 (1998). In other words, although we found that Southland was not responsible to pay taxes under the unitary business test analysis, this finding does not alone allow for a ruling in favor of Southland if the corporation fails the operational function test. The burden of proof rests with Southland to prove by clear and cogent evidence that the income was unrelated to its operations. *Xerox Corp. v. Comptroller*, 290 Md. 126, 139 (1981).

Guidance for the operational function test can be found in the Supreme Court’s decision in *Allied-Signal*. Traditionally, non-domiciliary taxation required that a unitary relation exist between the non-domiciliary corporation and the in-state corporation.

*Allied-Signal*, 112 S.Ct at 2262-2263. However, the Supreme Court in *Allied-Signal* carved out a few exceptions to the traditional unitary rule. Those exceptions allow, in limited circumstances, income from investments in non-unitary corporations to be subject to apportionment. The Supreme Court stated that:

“We agree that payee and the payor need not be engaged in the same unitary business as a prerequisite to apportionment in all cases. *Container Corp.* says as much. What is required instead is that the capital transaction serve an operational rather than an investment function.” *Allied-Signal*, 112 S.Ct. at 2263.

Unfortunately, as Justice O’Conner wrote in her dissent, the Court left what an “operational function” was, largely undefined. However, Maryland has applied a similar test.

The operational function test set out in *Allied- Signal* is, for all practical purposes, the same test as Maryland’s multi-state taxation test, referred to as the dependency test, set forth in *Xerox Corp. v Comptroller*, supra. The Court of Special Appeals wrote “we see no practical difference between the ‘operational function’ test set forth in *Allied-Signal* and the dependency test recognized by Maryland.” *Hercules*, 117 Md.App. 29, 45, *rev’d for other reasons* in *Hercules*, 351 Md. 101. Thus, if the requirements of the unities test have not been met, a state may still tax income derived from interstate activities if the activities serve an operational function, rather than merely an investment function of the business that is taxes.

In *Xerox*, the Court of Special Appeals reviewed several definitions pertaining to the operational function. One definition, supported by the court, explained the dependency test as follows:

“whether a number of business operations having common ownership constitute a single or unitary business or several separate businesses for tax purposes depends upon whether they are of mutual benefit to one another and on whether each operation is dependent on or contributory to others.” *Xerox*, 290 Md. at 139.

To justify an exclusion of the income derived from the sale of its Citgo stock subject to apportionment in Maryland, Southland offers the following arguments. First, and most important to our analysis, Southland argues that the sale of Citgo stock was not derived from activities that serve an operational function. In support of this suggestion, Southland points to how *Allied-Signal* used both *Corn Products Refining Co. v Commissioner*, 350 U.S. 46 50-53 (1955) and *Container Corp. of America, Inc. v Franchise Tax Board*, 463 U.S. 159, 180 n.19 (1983) as examples of when capital transactions served operational functions. *Allied-Signal*, 112 S.Ct. at 2263-2264. According to these case examples, a capital transaction could serve an operational function if the transaction was an “interim use of idle funds” or a “short term bank deposit.” We find that Southland’s investment of six and one-half years is distinguished from these types of transactions. As the subject income was neither an “interim use of idle funds” nor a “short term deposit” of working capital, Southland’s purchase and disposal of Citgo stock were nothing more than investment-type transactions.

Similarly, the Court of Appeals in *Hercules* noted the decision of the Supreme Court of Minnesota, when it rejected the argument that the sale by Hercules of its Himont stock served an operational function. They pointed out that “Hercules had not ‘treated its investment in Himont as a repository for working capital like a bank account or certificate of deposit.” *Hercules*, 351 Md. 101 at 114.

The Comptroller argues that an investment can qualify as operational if the investment relates to the operations of the business being taxed. However, the investment's "relating to" Southland's business is not enough to make the income from the sale a taxable operational investment. The Supreme Court held as much in *ASARCO* when it rejected the "relating to" standard proposed by Idaho:

"We cannot accept, consistent with recognized due process, a definition of unitary business that would permit non-domiciliary states to apportion and tax [intangible income] "where the business activities of the [subsidiary] have nothing to do with the activities of the [parent company] in the taxing State. . . ." *ASARCO*, 458, U.S. 326-27.

In order for the transaction to be described as operational rather than an investment, we are looking for that transaction to be integral to the in-state operations of that unitary business. As this Court held prior, "Southland was not dependent on Citgo for gasoline, and its purchases were made at market prices without preferences as to supply. The evidence here indicates a customary contractual relationship without a showing of lack of arms-length participation." That integral quality is not captured in this case. The arm's length character of these transactions demonstrates that they do not embody the "requisite flow of value to create a unitary business relationship." *Hercules*, 351 Md. at 119. Their character also does not create an operational function. This was a passive investment. "The mere fact that an intangible asset was acquired pursuant to a long-term corporate strategy . . . does not convert an otherwise passive investment into an integral operational one. . . . If that distinction is to retain its vitality, then . . . the fact that a transaction was undertaken for a business purpose does not change its character." *Allied-Signal*, 112 S.Ct. at 2263-2264.

In conclusion of this matter, this Court will hold that Southland's gain on the sale of Citgo stock is not subject to apportionment to Maryland for income taxation. Accordingly, this Court will pass an order reversing the decision of the Comptroller.