

5/11/06

SCIENCE APPLICATIONS INTERNATIONAL *
CORPORATION *

IN THE *
MARYLAND TAX COURT *

V. *

COMPTROLLER OF THE TREASURY *

NO. 04-IN-OO-0632 *

* * * * *

MEMORANDUM OF GROUNDS FOR DECISION

Petitioner, Science Applications International Corporation, appeals from a final determination of the Respondent, Comptroller of the Treasury, denying a claim for refund of corporate income taxes paid in the amount of \$4,274,519 for the taxable period February 1, 1999 through January 31, 2000.

Stipulated Facts

The parties have stipulated to some of the facts. The more significant are:¹

3. Petitioner is a Delaware Corporation with its headquarters and commercial domicile located in San Diego, California.

4. Petitioner is an employee-owned research and engineering firm that primarily provides diversified and technical services involving the application of scientific expertise together with computer systems and technology to solve complex technical problems for a broad range of government and commercial customers both in the United States and abroad.

5. Petitioner conducts its business, in part, within Maryland.

¹ Paragraph numbers in this section reflect the number of the paragraph of the “Stipulation of Facts”.

6. In March 1995, Petitioner acquired 100% of the shares of stock of NSI (Network Solutions, Inc).

7. NSI was incorporated in the District of Columbia, but after its shares of stock were acquired by Petitioner in March, 1995, NSI was reincorporated in Delaware.

8. NSI's principal executive office was, and is, located in Herndon, Virginia

9. NSI's business is providing Internet domain registration services worldwide. NSI pioneered the development of registering Web addresses ending in .com, .net, .org, and .edu.

10. In 1992, NSI entered into a five-year cooperative agreement with the National Science Foundation giving NSI the right to act as a registry and the exclusive registrar for Internet domain names ending in .com, .net, .org and edu.

11. In October, 1997, there was an initial public offering of the NSI shares, and Petitioner sold 575,000 shares, thereby reducing its ownership interest to 76%.

12. On February 2, 1999, there was a second public offering of NSI shares, and Petitioner sold 9,000,000 shares, resulting in a \$715,850,753 capital gain and reducing Petitioner's ownership interest to 45%.

13. Petitioner reported the \$715,850,753 capital gain from the second public offering on a Maryland income tax return for the Taxable Period to the Respondent, and paid Maryland income tax on such income in the amount of \$4,274,519.

14. On October 14, 2003, Petitioner filed a 1999 MD Form 500X amended return seeking a complete refund of the \$4,274,519 paid to the Comptroller for the Taxable Period.

15. By letter dated December 18, 2003, the Respondent denied Petitioner's claim for refund.

16 & 17. Petitioner requested an informal hearing with the Respondent, which was held on July 13, 2004. On October 5, 2004, the Respondent issued a Notice of Final Determination, which denied in full Petitioner's claim for refund for the Taxable Period.

18. On November 3, 2004, Petitioner filed a Petition of Appeal in the Maryland Tax Court, which contested the Respondent's denial of Petitioner's claim for refund, for the Taxable Period in the amount of \$4,274,519.

19. The entire balance of the \$4,274,519 claim for refund appealed by Petitioner represents income tax paid by Petitioner to the Respondent for the Taxable Period relating to the capital gain of \$715,850,753 on the sale of stock by Petitioner in NSI.

Issues Involved

The issue in this case is whether the gain on Petitioner's sale of its interest in NSI is taxable in Maryland. Petitioner raises three Constitutional issues contesting the ability of Maryland to tax any of this gain:

- 1) Petitioner contends that there is no nexus linking the gain to Petitioner's activities in Maryland. Citing *Hercules v. Comptroller*, 351 Md. 101, 112 (1998), Petitioner asserts that the Respondent must establish a "nexus linking this income to activities within the taxing state."
- 2) Both parties agree that Maryland can tax the NSI gain if the investment in NSI served an "operational function", but not if it served an "investment" function, citing *Allied-Signal, Inc. v. Director, Div. Of Taxation*, 504 U.S. 768, 787 (1992) and *Hercules*, supra, at 109-114. The parties disagree, however, as to what function

NSI served for the Petitioner from its acquisition to the second public stock offering.

- 3) Petitioner asserts that the Respondent's taxation of the NSI gain leads to income being attributed to Maryland that is out of the appropriate proportions to the business transacted in Maryland, and that the taxation of this gain has led to a grossly distorted result. Petitioner directs us to the fact that the taxation of this gain resulted in a nearly 2000% increase in tax from 1/31/99 to 1/31/00 with almost no corresponding change in Petitioner's activities.

At the conclusion of the hearing, the Court determined that the resolution of the appeal was primarily a determination of the facts and the parties were directed to each file Proposed Findings of Fact based on the testimony and documentation submitted at the hearing.

Additional Findings Of Fact

1. Petitioner's employee, Michael A. Daniels, Sector Vice-President, initially identified NSI as a possible acquisition for Petitioner in 1992-1993, based on his prior knowledge of the internet, its commercial potential and NSI's recently awarded internet services contract for the exclusive worldwide domain name registrar.

2. Mr. Daniels contacted the owners of NSI after NSI was awarded the National Science Foundation contract in 1992. By the end of 1993 or early 1994, Mr. Daniels had decided that NSI would make a good acquisition for Petitioner.

3. Prior to its acquisition in 1995, testimony and documents (the November 15, 1994 acquisition letter and the minutes of Petitioner's Executive Committee meeting of December 8, 1994) indicate that taking NSI public through an Initial Public Offering (IPO) was contemplated by Petitioner.

4. Subsequent to NSI's acquisition, minutes of the Board of Director's meetings in April and July, 1996 indicate that Petitioner was kept informed of the status of Mr. Daniel's efforts in completing the IPO.

5. At the time of acquisition in 1995, NSI's business had three components: federal government contracting, commercial consulting, and domain name registration. Petitioner's business was primarily government contracting.

6. After the acquisition of NSI, its federal government contracting business was transferred out of NSI to Petitioner. The small commercial consulting unit and the domain name registration business was left at NSI. The transfer of the government contracting business served the purpose of keeping the activities of NSI and Petitioner separate in preparation for the IPO.

7. Unlike NSI (see Stipulated Fact #9, above), Petitioner was never and has never been in the internet domain registration business.

8. After the acquisition of NSI in 1995 until the second IPO in 1999, it was managed independent of and separate from Petitioner. Approximately 5 of the 385 NSI employees, including Mr. Daniels, came from Petitioner. Mr. Daniels hired a separate management team from outside Petitioner, including technical, sales and marketing personnel. NSI had a separate Board of Directors. NSI had its own Human Resources Director and made its own decisions as to whom to hire and fire. Its first post-acquisition CEO was recruited through a national search campaign.

9. In addition to providing personnel to NSI during the transition period after the acquisition, Petitioner also initially provided administrative services for NSI for which Petitioner was reimbursed based on arms-length service contracts with NSI.

10. Beginning in 1997, NSI had both its own cash management system and its own treasury function. NSI's employees participated in some of Petitioner's benefit plans and NSI paid Petitioner directly for their costs.

11. Other than the transfer of NSI's government contracting business to Petitioner, during the period 1995 through 1999, there were no efforts to consolidate the business operations of NSI within Petitioner. NSI's headquarters remained in Virginia. In addition, because of the uniqueness of its business, NSI did not work together with either of Petitioner's subsidiaries, Global Integrity and Bellcore on any project.

12. Other than during the transition period after the acquisition of NSI, there were no loans by Petitioner to NSI during 1995 through 1999. There were minimal intercompany sales between Petitioner and NSI and they represented less than one-tenth of one percent of Petitioner's total revenues during 1996 through 1998.

13. Petitioner made no acquisitions on behalf of NSI. NSI made its own acquisition efforts during the period.

14. During the period 1995 through 1999, Petitioner would average four to six acquisitions of companies. Only one, the acquisition of NSI, resulted in an IPO.

15. During 1995 through 1999, NSI did not have any operations, office or facilities in Maryland.

16. Due to the strong market for internet stocks, both the initial and second IPOs resulted in significant capital gains for the Petitioner.

17. Due to the gain reported on Petitioner's 1999 Amended Maryland return, the Petitioner's tax increased from \$229, 217 in 1998 to \$4,274,519 in 1999, representing almost a 2000% increase. In the same period, Petitioner's Maryland apportionment, based on its sales, payroll and property situated within Maryland, factor increased approximately 5.5%.

Conclusions of Law

The decision in *Hercules*, supra, summarizes the legal principles that provide guidance for the instant appeal. As to the nexus issue, the Court has held that the State of Maryland “may not, when imposing an income-based tax, tax value earned outside its borders. In order to levy a tax, there must be some nexus linking this income to activities within the state. *Hercules*, supra at p.109. “Maryland may not tax income earned outside its borders, even on a proportional basis, unless there is ‘a rational relationship between the income attributed to the State and the intrastate values of the enterprise.’” *Hercules*, supra at p. 112.

Based on the facts as determined, it is clear that there was no nexus linking the gain realized through the sale of NSI stock to any of Petitioner’s activities in Maryland. NSI had no facilities, employees or operations in Maryland. Petitioner’s Maryland operations had no involvement with NSI. The two entities operated distinct businesses with minimal contacts between them. The evidence supports the conclusion that those contacts were at arms-length. Since NSI had nothing to do with Petitioner’s operations in Maryland, the necessary linkage of the income from the sale to activities within Maryland is absent.

The Respondent argues that NSI is a part of Petitioner’s unitary business and thus nexus can be established. “The necessary nexus usually is satisfied by demonstrating the existence of unitary business, part of which is carried on in the taxing state” *Hercules*, supra at p. 109. Relying on the Supreme Court’s decision in *Allied-Signal*, supra, Respondent asserts that Petitioner’s purchase and ultimate sale of NSI served an operational function of Petitioner and accordingly, as a unitary business, the resulting gain is apportionable to Maryland.

The Courts have provided some guidance as to the distinction between “operational” and “investment” functions. In *Allied Signal*, supra, the Supreme Court found that the investment in the subsidiary did not serve an operational function as the stock was not a “short-term investment of working capital analogous to a bank account or certificate of deposit.” *Id* at p. 789-790. The Court of Appeals stated: “The Supreme Court has made clear beyond any doubt that the proper level of inquiry under the Constitution depends upon the actual

connection between the subsidiary investment and its parent. How the parent intends to use the income derived from its investments is irrelevant. *Hercules, supra* at 114-115.

Again, based on the facts presented, it is evident that the acquisition of and ultimate sale of NSI stock served purely an investment function and there was no integration of the business of NSI into the regular business operations of Petitioner. The purchase of NSI was not a short-term investment of working capital analogous to a bank account or certificate of deposit. From the beginning, NSI was acquired, maintained and sold singularly as an investment. The acquisition of NSI by Petitioner was done with the goal of selling it for a profit in a public offering, which it did.

Respondent argues that certain documents in evidence (i.e. Annual Reports, financial statements, etc.) and the statements found within prove that NSI was to be and actually was a significant operational part of Petitioner's business. While those documents standing alone may lead one to that conclusion, when analyzed and reviewed together with the testimony of the witnesses and other documents presented, it is clear that those statements within those documents relied upon by Respondent are nothing more than standard marketing language and general references whose purpose was presenting Petitioner and its activities in the best possible light to its constituents. The whole of the evidence more than supports the conclusion that NSI was purchased for investment purposes.

Finally, the Respondent's taxation of the capital gain resulting from Petitioner's sale of NSI stock produces a tax that is disproportionate to Petitioner's business activities within Maryland and has led to a grossly distorted result. Under the rulings in *Moorman Manufacturing Co. v. Bair*, 437 U.S. 267 (1978) and *Comptroller v. ARMCO Export Holding Corp.*, 82 Md. App. 429 (1990), such taxation is unconstitutional.

Conclusion

Based on the above factual findings and the applicable case law, the gain on the shares of NSI stock sold cannot constitutionally be taxed by Maryland. Accordingly, the Court shall pass an Order reversing the decision of the Respondent in denying the refund claim of the Petitioner for the tax period in question.