Circuit Court for Anne Arundel County
Case Nos. 09-IN-OO-0148 & 09-IN-OO-0149

UNREPORTED

IN THE COURT OF SPECIAL APPEALS

OF MARYLAND

No. 2597

September Term, 2016

STAPLES, INC., et al.

v.

COMPTROLLER OF THE TREASURY

Friedman,
Shaw Geter,
Raker, Irma,
(Senior Judge, Specially Assigned),

JJ.

Opinion by Shaw Geter, J.

Filed: August 9, 2018

This case arises from the assessment of state taxes against appellants Staples, Inc. ("Staples, Inc.") and Staples the Office Superstore, Inc.[1] for tax years 1999 through 2004. The Comptroller issued Notices of Final Determination declaring tax, interest, and penalties due to the State of Maryland in the amount of $13,894,252 and $498,112 respectively. Appellants timely appealed to the State Tax Court, and the Tax Court affirmed the Comptroller's assessment but waived all penalties and interest accruing from February 20, 2009 through May 28, 2015. Appellants then filed a Petition for Judicial Review in the Circuit Court for Anne Arundel County, and the Comptroller filed a Cross-Petition regarding the partial waiver of interest. The circuit court vacated the partial waiver of interest, but otherwise affirmed the decision.

We have combined and reordered appellants'[2] questions presented as follows:

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[1] Now Staples the Office Superstore, LLC.

[2] Appellant presented the following questions for our review:

1. Did the Tax Court commit error when it failed to find that Superstore and Staples were separate business entities with economic substance?

2. Did the Tax Court commit error when it failed to find that the Notices improperly calculated the tax due?

3. Did the Tax Court commit error when it failed to find that the Notices violated Maryland law in that the Comptroller's apportionment methodology grossly distorted the income of Superstore and Staples attributable to Maryland?

4. Did the Tax Court commit error when it failed to find that the Notices violated the Due Process Clause and the Commerce Clause of the U.S. Constitution?

5. Did the Tax Court properly waive a portion of the interest?

1. Did the Tax Court commit error when it failed to find that Superstore and Staples, Inc. had economic substance as separate business entities?

2. Did the Tax Court commit error when it failed to find that the Notices improperly calculated the tax due, and therefore violated the Due Process Clause and Commerce Clause of the U.S. Constitution?

3. Did the Tax Court properly waive a portion of the interest?

For the reasons discussed below we shall affirm the findings of the Tax Court.

BACKGROUND

On January 28, 2008, appellee, the Comptroller, issued Notices of Assessment to Staples, Inc. ("Staples, Inc.") and Staples the Office Superstore, Inc. ("Superstore"), (collectively "appellant") for unpaid corporate income taxes from the years 1999 through 2004 (the "Audit Period"). Staples, Inc. and Superstore contested the amount, and, on January 26, 2009, the Comptroller issued Notices of Final Determination affirming the assessments. The Notices noted Superstore owed $6,340,835 in taxes, $1,585,210 in penalty, and $5,968,207 in interest. The Notices charged Staples, Inc. owed $213,325 in taxes, a $53,331 in penalty, and $231,456 in interest.

Appellants then appealed to the Maryland Tax Court to contest the Notices, arguing the Comptroller's apportionment method distorted the amount of their income attributable to Maryland, and that there was not sufficient nexus for Maryland to tax them. Later, in a Joint Stipulation of Facts with the Comptroller, however, appellants conceded there was sufficient nexus. The Tax Court trial was held August 24 - 25, 2011. In its Memorandum and Order, issued May 28, 2015, the Court affirmed the Comptroller's assessment of tax but waived all penalties and interest accruing from the date of the appeal to the Tax Court to the date of the Tax Court's decision.

Appellants, thereafter, filed a Petition for Judicial Review of the Decision in the Circuit Court for Anne Arundel County. The Comptroller filed a Cross-Petition, contesting the waiver of interest. The court vacated the Tax Court's waiver of interest, but otherwise affirmed the decision.

This appeal followed. Additional facts will be added as they become relevant to the issues below.

DISCUSSION

I. The Tax Court correctly found Superstore and Staples, Inc. did not have economic substance as separate business entities.

The Maryland Tax Court is "an adjudicatory administrative agency," and, thus, "decisions of the Tax Court receive the same judicial review as other administrative agencies." *Gore Enter. Holdings, Inc. v. Comptroller of Treasury*, 437 Md. 492, 503 (2014) (internal citations and quotations omitted). "In this context, our review looks through the circuit court's…decisions…and evaluates the decision of the agency." *Id.* (internal citations and quotations omitted). "A court's role in reviewing an administrative agency adjudicatory decision is narrow; it is limited to determining if there is substantial evidence in the record as a whole to support the agency's findings and conclusions, and to determine if the administrative decision is premised upon an erroneous conclusion of law." *Maryland Aviation Admin. v. Noland*, 386 Md. 556, 571 (2005) (internal citations and quotations omitted). "We cannot uphold the Tax Court's decision 'on grounds other than the findings and reasons set forth by [the Tax Court]." *Gore*, 437 Md. at 503.

Before this Court, appellants argue the Tax Court erred in "*sua sponte* rais[ing] as an issue and decid[ing] whether [appellants] ha[ve] sufficient contacts with Maryland in order to be subject to tax." Appellants contend that the Tax Court incorrectly ruled that in order to establish nexus, or sufficient contacts, a determination of whether the corporations had economic substance as separate business entities was required. They argue "[i]nasmuch as Superstore and Staples[, Inc.] had a physical presence in Maryland that was stipulated to by the Comptroller," they were "subject to tax in the State." Therefore, they contend the economic substance analysis under *Comptroller of the Treasury v. SYL, Inc.*, 375 Md. 78 (2003), is inapplicable. As addressed in appellants' second question presented, they argue that, in order to calculate the percentage of its income attributable to Maryland, the Comptroller was required to use the standard apportionment formula under § 10-402 of the Maryland Tax-General Code Annotated, which multiplies the taxable income of a corporation with economic substance by a specific apportionment formula, comprised of the taxpayer's property, payroll, and sales.

In their separate Petitions of Appeal to the Tax Court, however, Superstore and Staples, Inc., argued in identical language that they did "not have sufficient nexus with the State to be subject to Maryland tax." The Petitions asserted neither company "own[ed] nor lease[d] any tangible personal property in Maryland," and "ha[d] no employees or bank accounts in Maryland." Subsequently, they conceded in a Joint Stipulation of Facts, filed in conjunction with the Comptroller, that there was, in fact, sufficient nexus.

The Tax Court's approach was nevertheless proper, explaining:

> The Court of Appeals of Maryland has consistently held certain constitutional principles must be satisfied before an entity is subject to Maryland income tax. "Under both the Due Process and the Commerce Clauses of the Constitution, a state may not, when imposing an income-based tax, 'tax value earned outside its borders…Both the Due Process and Commerce Clauses require that there be 'some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax.'
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> …
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> Maryland courts have consistently concluded that the basis of a nexus sufficient to justify taxation is the economic reality the parent's business in Maryland was what produced the income of the subsidiary. [Citing *Comptroller of the Treasury v. SYL, Inc.*, 375 Md. 78, cert. denied 540 U.S. 982 and 540 U.S. 1090 (2003).] Thus, the Court's initial inquiry is to examine the facts and determine whether the Petitioner had real economic substance as separate business entities.

The Tax Court ultimately held that the "facts support[ed] the Comptroller's position that enterprise dependency existed between [appellants] and the affiliated corporations," and therefore they lacked economic substance as separate business entities. Appellants argue this was error, given "Superstore's and Staples[, Inc.]'s numerous employees, substantial operations and interactions with third parties around the country. The Comptroller, conversely, argues that "no one entity under the Staples umbrella could operate independently from any of the others," and therefore, they were not separate business entities.

On review, we begin with an overview of Staples' operations during the years in question. In 1998, the Staples family of businesses underwent a reorganization, which culminated in the creation of four entities: Staples, Inc.; Superstore; Staples the Office Superstore East, Inc. ("Staples East"); and Staples Contract & Commercial, Inc. ("Staples C&C") (collectively "Staples"). Superstore and Staples C&C were wholly owned subsidiaries of Staples, Inc. Staples East was a wholly owned subsidiary of Superstore. Staples, Inc., Superstore, Staples East, and Staples C&C had common officers and directors. While appellants contend the reorganization was to facilitate an ultimately failed merger, they concede the reorganization mostly occurred to eliminate their tax liabilities in separate return states[3] like Maryland.[4]

Staples, Inc. was engaged in providing managerial and administrative services, including management; credit support functions; paying all obligations; strategic planning; and providing legal, accounting, financial, and payroll services, on behalf of Superstore, Staples East, and Staples C&C. Superstore, Staples East, and Staples C&C paid Staples, Inc. a fee for these services. Additionally, Staples, Inc. provided Superstore, Staples East, and Staples C&C a cash pooling service. "Under the cash pooling arrangement, if a company had a negative account balance, it would borrow funds from Staples[, Inc.]." "Conversely, if a company had excess cash, it would lend funds to Staples[, Inc.]." "At the end of each day, Staples[, Inc.] would invest any excess funds on behalf of Superstore, Staples East[,] and Staples C&C." This system, according to appellant, "allowed for efficient and effective management of the funds and reduced fees payable to third parties

[3] A "separate return state" is a state that requires each company with nexus in the state to file its own separate return, regardless of whether it is part of an affiliated or consolidated group of companies. *See Chesapeake Indus., Inc. v. Comptroller of the Treasury*, 59 Md. App. 370, 373 (1984). A "combined return state" requires members of an affiliated or consolidated group of companies to file a combined or consolidated return. *Id.*

[4] In their Joint Stipulation of Facts, filed in conjunction with the Comptroller before the Tax Court, appellants conceded they had requested representatives of Ernest & Young LLP to, amongst other things, "reduce its state tax rate to zero for all separate return states" in August of 1996. No mention was made of the possible merger with Office Depot at that time.

(such as banks)." It is not clear from the record what source of income, other than the fees paid by Superstore, Staples East, and Staples C&C for the managerial and administrative services it provided, and the interest it earned from the cash pooling system, Staples, Inc. may have had.

Superstore, as part of the reorganization, assumed ownership of the rights and the goodwill associated with the use of certain valuable trademarks and other intellectual property, which it licensed to Staples, Inc. pursuant to a Trademarks License Agreement. Superstore also provided the franchise system services to Staples East and Staples C&C, including the use of certain trademarks and other intellectual property; centralized purchasing; inventory control; lease and contract negotiations; advertising and marketing; research and development; store site selection and construction; store layout designs; equipment; and signage. These services accounted for one-third of Superstore's total income.

Staples East housed retail operations in separate reporting states, such as Maryland. Staples C&C housed Staples' catalog business. The services provided by Staples, Inc. and Superstore were necessary for the operations of Staples East and Staples C&C.

The Tax Court, in addressing whether the Comptroller could tax appellants, noted it was first required to determine whether the four corporations had real economic substance as separate business entities. The court relied on the Court of Appeals' holding in *Gore Enterprise Holdings, Inc. v. Comptroller of the Treasury*, 437 Md. 492 (2014), to find appellants did not. In *Gore*, the Court reviewed the Tax Court's findings regarding whether the corporate subsidiaries in question were separate business entities. There, the

Comptroller attempted to tax two out of state subsidiaries based on their relationship with their Maryland parent, and their activities therein. One of the out of state subsidiaries managed the parent corporation's patent portfolio and had one employee, the other managed the parent's excess capital, and had three employees. "[T]he Tax Court highlighted the subsidiaries' dependence on [the parent company] for their income, the circular flow of money between the subsidiaries and [the parent company], the subsidiaries' reliance on [the parent company] for core functions and services, and the general absence of substantive activity from either subsidiary that was in any meaningful way separate from [the parent company]." *Id.* at 517.

Gore also examined *Comptroller of the Treasury v. SYL, Inc.*, which found the subsidiaries there were not separate business entities. In *SYL, Inc.,* the Court of Appeals examined what could be considered a business with no 'economic substance as a separate business entity,' and held the subsidiaries in question, though they did have some separate employees and expenses, did not have economic substance. 375 Md. 78 (2003). The *SYL* Court relied in part on this Court's opinion in *Comptroller of the Treasury v. Armco Export Sales Corp.*, 82 Md. App. 429 (1990). *Armco* involved three separate manufacturers doing business in Maryland that created wholly owned sales subsidiaries known as domestic international sales corporations ("DISCs"). "By definition, a sales DISC[,] earns income because it buys goods from its parent company and then resells the goods to an actual overseas customer; a commission DISC earns its income by a contractual agreement with its parent company giving it a percentage of each qualifying export sale made by the parent[.]" 82 Md. App. at 430-31. Regardless of type, "no activity is performed by the

DISC to earn the income." *Id.* at 431. The *Armco* Court found that, because the out of state DISCs were "phantom" corporations that could "only conduct its activity and do business through branches of its unitary affiliated parent," the activity of the DISCs that related to Maryland could be fairly apportioned and taxed by Maryland. *Id.* at 435. We explained:

> None of the [DISCs] has ever filed a Maryland corporation income tax return or paid corporate income taxes in this state; each is a wholly owned subsidiary of a multinational parent doing business in Maryland and filing a Maryland corporate tax return; each parent is a unitary business with a unitary relationship with its DISC; in all of the tax years at issue…each parent produced goods in this state that were exported outside the United States, generating taxable income for the DISC which, except for the DISC, would have accrued to the parent; none of the DISC[s] had any tangible assets or employees anywhere;…no DISC or parent was incorporated in Maryland and none of the parent companies had its headquarters in Maryland.

Id. at 431-32.

The Court in *SYL* found the reasoning in *Armco* applied to the subsidiaries at issue in *SYL*, despite their "'window dressing' [which was] designed to create an illusion of substance." 375 Md. at 106. The Court noted "[n]either subsidiary had a full time employee, and the ostensible part time 'employees' of each subsidiary were in reality officers or employees of independent 'nexus-service' companies[;]" "[t]he annual wages paid to these 'employees by the subsidiaries were minuscule[;]" and "[t]he so-called offices…were little more than mail drops." *Id.* "The subsidiary corporations did virtually nothing; whatever was done was performed by officers, employees, or counsel of the parent corporations." 375 Md. at 106. "Although officers of the parent corporations may have stated that tax avoidance was not the sole reason for the creation of the subsidiaries, the record demonstrates that sheltering income from state taxation was the predominant reason for the creation of" the subsidiaries. *Id.*

The Court in *Gore*, after discussing both *SYL* and *Armco*, held that, though "the subsidiaries here engaged in more substantive activities than those in *SYL*," "[i]n particular,…[one of the subsidiaries] acquired patents from third parties, licensed patents to third parties, and paid substantial fees for outside legal counsel and other services," these "trappings [did] not imbue [the subsidiaries] with substance as separate entities." 437 Md. at 519. The parent company, the Court found, "permeate[d] the substantive activities" of both subsidiaries, and are "so intertwined…as to be almost inseparable." *Id.*

In the instant case, after a discussion of the Staples reorganization and the functions assigned each entity within that, the Tax Court concluded:

> In reality, the activities of Staples[, Inc.] and Superstore permeate the activities of each other and Staples C&C and Staples East. As separate entities, [appellants] could not operate independently. The facts support the Comptroller's position that enterprise dependency existed between [appellants] and the affiliated corporations. Thus, [appellants] were not separate business entities[.]

We agree. Here, as in *Gore*, the subsidiaries Staples C&C and Staples East relied on the parent companies "for their income…and core functions and services." Moreover, as in *Gore,* there exists "the circular flow of money between the subsidiaries and [the parent company]…and the general absence of substantive activity from either subsidiary that was in any meaningful way separate from" Staples, Inc. or Superstore.

Appellants point to the Court's finding in *SYL*, that the subsidiaries meager expenses led to the conclusion that it had no economic substance, and argue that Staples, Inc. and

Superstore's various expenses differentiate them from those entities. The question in this case, however, contrary to appellant's allegation, is not Staples, Inc. and Superstore's expenses, but those of their subsidiaries – Staples East and Staples C&C. Those expenses, including payroll for their employees, were fully paid and handled by Staples, Inc. Superstore provided all of the merchandise both Staples East and Staples C&C sold, and dictated the manner in which it could be advertised and displayed. Staples, Inc., during the time in question, provided the loans and banking services to Staples East and Staples C&C. Finally, all four entities had common officers and directors. Given their total financial dependence on Staples, Inc., as well as their total administrative and managerial dependence on both Staples, Inc. and Superstore, we hold that, here, as in *Gore*, the additional "'window dressing[s]'…and trappings do not imbue" appellants with economic substance as separate business entities.

II. The Tax Court did not err in finding the Notices properly calculated the taxes due, nor do they violate the Due Process or the Commerce Clause of the U.S. Constitution.

Staples East and Staples C&C filed Maryland income tax returns during the years at issue. During an audit of these returns, auditors confirmed they had allocated the proper amount of net income from retail operations in the state to arrive at their Maryland taxable income. However, the auditors also noted the intercompany franchise fees and interest payments made by Staples East and Staples C&C to Staples, Inc. and Superstore. A review of the records showed neither Staples, Inc. nor Superstore had filed Maryland income tax returns during the audit period. It is the calculation of these taxes that we now review.

A. The Staples corporations are a unitary business, and, therefore, can be properly taxed under the Due Process and Commerce Clauses of the U.S. Constitution.

Appellant's brief is primarily focused on the Tax Court's finding that they lacked economic substance as separate business entities. They did, however, argue in a footnote the Tax Court erroneously relied on its finding that they were a unitary business to establish sufficient nexus to Maryland in order to be taxable. However, "the unitary business principle and economic substance inquiry under *SYL* are distinct inquiries with distinct purposes." *Gore Enterprise Holdings, Inc. v. Comptroller of Treasury*, 437 Md. 492, 518 (2014) (internal citations omitted). While the unitary business principle allows a state "to tax an apportioned sum" of a multistate corporation's business if it is unitary, it cannot be used to clear the constitutional hurdles of the Due Process and Commerce Clauses when the taxpayer disputes its nexus with the State. *Id.* at 509 (internal citations and quotations omitted). The economic substance inquiry is used to preliminarily establish nexus. Once determined, courts then focus on whether there is a unitary business, and thus whether it can be properly taxed. Contrary to appellant's contention, the Tax Court did not rely on the unitary business principle for nexus. Appellants conceded their nexus to Maryland, and we have also determined the Tax Court's finding of nexus, through the economic substance analysis, was not error. We therefore turn to the Tax Court's finding that Staples was a unitary business.

"Under both the Due Process and the Commerce Clauses of the Constitution, a state may not, when imposing an income-based tax, 'tax value earned outside its borders.'" *Id.* at 506-07 (internal citations omitted). The Due Process clause requires fairness of government activity, and is "preserved by requiring that an outside business have a 'minimal connection' between the interstate activities and the taxing State, and a rational relationship between the income attributed to the State and the intrastate values of enterprise.'" *Id.* (internal citations omitted). The Commerce Clause "is chiefly concerned with 'the effects of state regulation on the national economy.'" *Id.* It requires passing a four-part test: "that 'the tax is applied to an activity with a substantial nexus with the taxing State, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services provided by the State.'" *Id.* at 507-08 (internal citations omitted).

A unitary business exists "when the characteristics of 'functional integration, centralized management, and economies of scale' are present" throughout its operations. *Id.* at 508 (internal citations omitted). The unitary business principle "can be used to tax an apportioned sum" "that a [multistate] unitary business derived from its operation within the particular state." *Id.* at 508-09 (citing *MeadWestvaco Corp. ex rel. Mead Corp. v. Illinois Dep't of Revenue*, 553 U.S. 16, 24 (2008)).

The Constitutional test "is 'not the *potential* of unitary control, but rather the actual, in fact unitariness or separateness of the subsidiary enterprises." *Gore*, 437 Md. at 531 (internal citations omitted). "The prerequisite to a constitutionally acceptable finding of unitary business is a flow of *value*, not [just] a flow of goods." *Container Corp. of America v. Franchise Tax Bd.*, 463 U.S. 159, 178 (1983). It requires "that there be some bond of ownership or control uniting the purported 'unitary business.'" *Id*. at 166 (internal citations omitted). The "[s]ubstantial mutual interdependence" required "can arise in any number of ways; a substantial flow of goods is clearly one but just as clearly not the only one." *Id.* at 179 (internal citations omitted).

The U.S. Supreme Court, in *Container Corp. of America v. Franchise Tax Bd.*, found the corporations in question were a unitary business given the parent corporation's "assistance to its subsidiaries in obtaining used and new equipment and in filling personnel needs that could not be met locally, the substantial role played by [the parent corporation] in loaning funds to the subsidiaries and guaranteeing loans provided by others…the 'substantial' technical assistance provided by [the parent corporation]…and the supervisory role played by [the parent's] officers in providing general guidance to the subsidiaries." 463 U.S. 159, 179 (1983).

In comparison, the Supreme Court in *F.W. Woolworth Co. v. Taxation & Revenue Dept.*, found the corporations in question were not a unitary business because

> [t]here was little functional integration…With respect to who makes the decision for seeing to the merchandise, [store] site selection, advertising and accounting control,…[e]ach subsidiary performs these functions autonomously and independently of the parent company.…It further appears [the parent corporation] engaged in no centralized purchasing, manufacturing, or warehousing of merchandise…[E]ach subsidiary was responsible for obtaining its own financing from sources other than the parent. [As for economies of scale], [i]t appears that each subsidiary operated as a distinct business enterprise at the level of fulltime management. With one possible exception, none of the subsidiaries' officers during the year in question was a current or former employee of the parent…[The parent corporation] did not rotate personnel or train personnel to operate stores…There was no training program that is central to transmit the [parent corporation's] idea of merchandising[,]…to the foreign subsidiaries…This management decentralization was reflected in the fact that each subsidiary possessed autonomy to determine its own policies respecting its primary activity – retailing.…[The parent corporation] had no department or section, as such, devoted to overseeing the foreign subsidiary operations.

458 U.S. 354, 364-67 (1982) (internal citations and quotations omitted).

The *Gore* Court found the subsidiaries in that case "demonstrated integration of business functions and personnel, centralized management through the inclusion of [the parent company's] employees on the subsidiaries' boards, and reliance on [the parent company] for everything from furniture to legal services." *Gore*, 437 Md. at 531. "Based on these findings," then, the Court found the Tax Court did not err in concluding the businesses were unitary. *Id.*

The Tax Court in the instant case, after a discussion of the Staples reorganization and the functions assigned each entity therein, concluded the activities of Staples[, Inc.] and Superstore permeate[d] the activities of each other and Staples C&C and Staples East." "As separate entities, [appellants] could not operate independently." "Thus, [appellants] were…part of a unitary business enterprise."

We agree. "[S]ubstantial mutual interdependence" existed at all levels between Staples, Inc., Superstore, Staples C&C, and Staples East. Staples East and Staples C&C were wholly dependent upon Staples, Inc.'s and Superstore's services for their income, from their management to their merchandise. As the Supreme Court held in *Container Corp.*, "[w]e need not decide whether any one [factor] would be sufficient as a constitutional matter to prove the existence of a unitary business." *Container Corp.*, 463 U.S. 179-80. "Taken in combination, at least, they clearly demonstrate that the [Tax Court] reached a conclusion 'within the realm of permissible judgment.'" *Id.* at 180.

B. The Tax Court did not err in finding the Notices properly calculated the taxes due, and they do not violate the Due Process or Commerce Clauses of the U.S. Constitution.

Appellants argue the Comptroller erred in failing to use the standard apportionment formula to calculate the income attributable to Maryland. They contend, under § 10-402 of the Maryland Tax-General Code Annotated, the Comptroller was required to multiply the taxable income of a corporation with economic substance by a specific apportionment formula, comprised of the taxpayer's property, payroll, and sales, in order to calculate the percentage of its income attributable to Maryland. They argue the Comptroller "[i]gnor[ed] the substantial property, payroll and sales of Superstore and Staples[, Inc.]," and instead "used the apportionment factors of Staples East and Staples C&C to apportion Superstore's franchise fee receipts and Staples[, Inc.'s] interest income to Maryland." While acknowledging that, under § 10-402(d) the Comptroller may, if circumstances warrant, alter the apportionment formula to clearly reflect the income apportionable to Maryland, appellants argue that any "alternative formula for corporations with economic substance should include the corporation's own property, payroll and sales."

The Comptroller, conversely, argues its assessments against Staples, Inc. and Superstore complied with the law and reasonably reflected the amount of income appellants earned in Maryland. "[T]he apportionment formula provided for in § 10-402(c) was not appropriate to judge the Maryland income for Staples[, Inc.] and Superstore[,]" as that apportionment formula resulted in a zero apportionment factor and, thus, zero income attributable to Maryland. This "would not have been representative of the economic reality, namely, that the use of the franchise system and cash pooling system in the retail operations of Staples East and Staples C&C in Maryland are what produced income for Superstore and Staples[, Inc.]." "To reflect the income actually attributable to Maryland, the auditors thus needed to use an alternative method to allocate taxable income," as allowed under § 10-402(d).

Section 10-402 of the Maryland Tax-General Code Annotated states in relevant part:

> (a) In computing Maryland taxable income, a corporation shall allocate Maryland modified income derived from or reasonably attributable to its trade or business in this State in the following manner:
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> …
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> (2) if a corporation carries on its trade or business in and out of the State, the corporation shall allocate to the State the part of the corporation's Maryland modified income that is derived or reasonably attributable to the part of its trade or business carried on in the State, in the manner required in subsection (b), (c), or (d) of this section.
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> …
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> (c)(1) Except as provided in paragraph (2) of this subsection, if the trade or business is a unitary business, the part of the corporation's Maryland modified income derived from or reasonably attributable to trade or business carried on in the State shall be determined using a 3-factor apportionment fraction:
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> > 1. the numerator of which is the sum of the property factor, the payroll factor, and twice the sales factor; and
> >
> > 2. the denominator of which is 4.
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> …
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> (d) To reflect clearly the income allocable to Maryland, the Comptroller may alter, if circumstances warrant, the methods under subsections (b) and (c) of this section, including:
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> …
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> (2) the use of the 3-factor double weighted sales factor formula method or the single sales factor formula method;
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> (3) the weight of any factor in the 3-factor formula;

§ 10-402 Md. Tax-General Ann. (West 2003 Supp.).[5]

COMAR 03.04.03.08 details roughly the same system, including the three-factor formula, for apportionment of income for corporations. COMAR 03.04.03.08(F)(1), however, states:

> (1) If an apportionment formula does not fairly represent the extent of a corporation's activity in the State, the Comptroller may alter the formula or its components.

COMAR 03.04.03.08(F)(1) (2002).

In their joint stipulations of fact, the parties agreed that the assessments were calculated as follows:

> 16. For the Years in Issue, pursuant to the audit narrative, the auditors assessed Superstore by starting with Superstore's total franchise fee receipts received from both Staples East and Staples C&C. Then the auditor determined the percentage of the total franchise fee receipts that were attributable to Staples C&C. Next, the auditor (1) multiplied the percentage of franchise fee receipts received from Staples East by Staples East's Maryland apportionment factor as reported by Staples East on its Maryland income tax return, and (2) multiplied the percentage of franchise fee receipts received from Staples C&C by Staples C&C's Maryland apportionment factor as reported by Staples C&C on its Maryland income tax return. These two apportionment factors were added together to arrive at a blended apportionment factor. This blended apportionment factor was then multiplied by the total franchise fee receipts received from both Staples East and Staples C&C to determine Superstore's purported Maryland taxable income.
> 17. For the fiscal years ended January 30, 1999 through February 1, 2003, pursuant to the audit narrative, the auditors assessed Staples[, Inc.] by first netting the interest income received from and/or paid by Staples East and Staples C&C to Staples[, Inc.] (the "Net Interest Income")[.] Then the auditor determined the percentage of the Net Interest Income that was

[5] We note, under *NCR Corp. v. Comptroller of the Treasury, Income Tax Div.*, 313 Md. 118, 125 (1988), we use the statutory and regulatory scheme as it was during the tax years in question. Except for minor changes in organization, the statute remained consistent through the years at issue.

attributable to Staples East and the percentage of the Net Income that was attributable to Staples C&C. Next, the auditor (1) multiplied the percentage of Net Interest Income received from or paid by Staples East by Staples East's Maryland apportionment factor as reported by Staples East on its Maryland income tax return, and (2) multiplied the percentage of Net Interest Income received from or paid by Staples C&C by Staples C&C's Maryland on its Maryland income tax return. These two apportionment factors were added together to arrive at a blended apportionment factor. This blended apportionment factor was then multiplied by the Net Interest Income to determine Staples[, Inc.'s] purported Maryland taxable income.

18. For the fiscal year ended January 31, 2004 pursuant to the audit narrative, the auditors assessed Staples[, Inc.] by starting with the interest income received from Staples C&C. The auditor then multiplied the interest income received from Staples C&C by Staples C&C's Maryland apportionment factor as reported by Staples C&C on its Maryland income tax return to determine [, Inc.'s] purported Maryland taxable income.

Reviewing the same apportionment method used in the case *sub judice*, the *Gore* Court, based on § 10-402(d) and COMAR 03.04.03.08(F)(1), held the Comptroller is allowed to use an alternative method when "the three-factor formula set forth by [§] 10-402(a)(2) would have yielded an apportionment factor of zero, which did not fairly represent the subsidiaries' activity in Maryland." 437 Md. at 529. Nevertheless, appellants argue the three-factor formula is more appropriate for corporations with economic substance. We disagree and find no reason in either statute or case law for the exception, nor would appellants qualify for such an exception, given the Tax Court's finding appellants did not have economic substance. As such, the Comptroller was duly authorized to use an alternative apportionment method.

Appellant next argues the Notices distorted the amount of income attributable to Maryland because the Comptroller ignored the expenses incurred by Superstore and Staples, Inc. to generate that income. They point to the testimony presented by their expert, Dr. Brian Cody, that the Comptroller's formula "simply look[ed] at the receipts, at the franchise revenue, and then appl[ied] a tax rate, which is meant to tax profits,…[which] produc[ed] a distorted result." They contend the Tax Court dismissed their expert's testimony based on an erroneous finding that the expert assumed Staples operated as a single entity prior to 1998, which they claim has no basis in the record. Furthermore, they contend the Comptroller erred in failing to start the calculation of the tax due with the federal taxable income of Superstore and Staples, Inc.

The Comptroller argues that here, as in *Gore*, the alternative apportionment method was proper. This formula used the franchise fees and interest payments that Staples East and Staples C&C made to Superstore and Staples, Inc. for activities in Maryland to determine the income attributable to Maryland for Superstore and Staples, Inc. Staples East's and Staples C&C's tax returns specifically identified the income earned by Staples, Inc. and Superstore through franchise fees and interest fees, and allocated their retail activities among different states, including Maryland. "This data made clear to the Comptroller how much of the appellants' income was related to activities in, and thus could be taxed by, Maryland." "Staples[, Inc.] and Superstore were then provided the opportunity to account for any expenses they incurred to generate this income" "[b]ut declined to do so." The Comptroller argues, under § 13-402(a)(3), it was thus required to use the "best information in the possession of the tax collector." They contend this method did so.

"Our review of apportionment [formulas] is guided by the Supreme Court's analysis in *Container Corp.*" *Gore*, 437 Md. at 532 (citing *Container Corp.*, 463 U.S. at 169-70 (internal citations and quotations omitted)).

> [A]n apportionment formula must, under both the Due Process and Commerce Clauses, be fair. The first, and again obvious, component of fairness in an apportionment formula is what might be called internal consistency – that is, the formula must be such that, if applied by every jurisdiction, it would result in no more than all of the unitary business's income being taxed. The second and more difficult requirement is what might be called external consistency – the factor or factors used in the apportionment formula must actually reflect a reasonable sense of how income is generated. The Constitution does not invalidat[e] an apportionment formula whenever it *may* result in taxation of some income that did not have its source in the taxing State…Nevertheless, we will strike down the application of an apportionment formula if the taxpayer can prove by clear and cogent evidence that the income attributed to the State is in fact out of all appropriate proportions to the business transacted in that State, or has led to a grossly distorted result[.]"

Gore, 437 Md. at 532 (citing Container Corp., 463 U.S. at 169-70 (internal citations and quotations omitted)).

Using the *Container Corp.* analysis, the *Gore* Court found the apportionment formula at issue was "internally consistent" because, "'if applied by every jurisdiction…[it] 'would result in no more than all of the unitary business' income being taxed.'" *Gore*, 437 Md. at 532 (internal citations omitted). "Regarding external consistency," "[t]he Comptroller's apportionment formula captured [the parent company's] expenses in Maryland – expenses that simultaneously constituted income" for the out of state subsidiaries. *Id.* at 533. "Thus, the formula reflects 'a reasonable sense of how [the out of state subsidiaries] income is generated." *Id.* The Court then concluded:

> [T]he Tax Court did not err in holding that the Comptroller had the authority to tax [the out of state subsidiaries]. [They] are subsidiaries with "no economic substance as separate business entities" from their parent, Gore. Therefore, these subsidiaries are taxable entities under *SYL*. We also conclude that the Tax Court did not err in upholding the apportionment formula used by the Comptroller. This apportionment formula passes

> constitutional muster through a justified application of the unitary business principle.

Id. at 533.

The Tax Court in the instant case, noting *Gore*, held:

> The [*Gore*] Court stated that the apportionment formula used by the Comptroller should reflect a reasonable sense of how [the petitioner's] income is generated. The apportionment formula used by the Comptroller in [*Gore*] captured Gore's expenses in Maryland – expenses that simultaneously constituted income for its subsidiaries. The Comptroller's responsibility was to capture and tax only that income of the Petitioners that was reasonably attributable to Maryland.
>
> Superstore, in this case, received royalty income which has been taken as an expense by Staples C&C and Staples East. Staples[, Inc.] received interest income which has been taken as an expense by Staples C&C and Staples East. Using an apportionment methodology identical to that used in *Gore*, the Comptroller's assessments in this case have captured the royalty and interest expenses of Staples C&C and Staples East – expenses that simultaneously constituted the income for Superstore and Staples[, Inc.].

As in *Gore*, "[t]he Comptroller's apportionment formula captured [Staples East's and Staples C&C's] expenses in Maryland – expenses that simultaneously constituted income" for Staples, Inc. and Superstore. We find, then, the Tax Court did not err in holding "the formula reflects 'a reasonable sense of how [Staples, Inc.'s and Superstore's] income is generated,'" and "passes constitutional muster."

It, further, was not error for the Comptroller to base its calculations on income received by Staples, Inc. and Superstore, from Staples East and Staples C&C, instead of appellant's federal taxable income. Appellants cite *Comptroller of the Treasury v. Gannett Co., Inc.*, for the proposition that the Comptroller must accept the figure adopted as taxable income on the corporate taxpayer's consolidated federal return in calculating the taxpayer's Maryland modified income. *Gannett*, however, concerned discretionary federal taxable income of the taxpayer, and held the Comptroller did not have the authority under the Internal Revenue Code to impute interest income which was not reported on the taxpayer's federal income tax returns. 356 Md. 699 (1999). It is, therefore, clearly distinguishable. *Gore*, in which the Court of Appeals explicitly approved the method at issue, is indistinguishable. Moreover, § 10-402 does not require the Comptroller to "start" its calculations of the Maryland modified income with the corporation's federal taxable income. The use of an alternative method, when the method set "by [§] 10-402(a)(2) would have yielded an apportionment factor of zero, which did not fairly represent the subsidiaries' activity in Maryland" was appropriate. *Gore*, 437 Md. at 529.

Appellants, nevertheless, contend that the Comptroller's failure to take expenses into account ultimately led to a distortive calculation, and violates the Due Process and Commerce Clauses of the U.S. Constitution. The Comptroller argues they could not take expenses into account because neither Staples, Inc. nor Superstore provided any.

Gore is again instructive. There, the Court noted expenses "were deducted from the income if the [subsidiary] made an affirmative demonstration that the expenses were directly related to the income." *Gore*, 437 Md. at 530. The subsidiary, however "made no attempt to allocate" expenses to the income it derived from the Maryland based parent corporation. *Id.* "Consequently, [the out of state subsidiaries'] tax liability was calculated by multiplying royalties" or "interest paid by [the Maryland parent corporation] times [the Maryland parent corporation's] apportionment formula." *Id.*

In the present case, Mary Wood, the Manager of Business and Tax Audits for the Comptroller, had the following exchange during direct examination before the Tax Court:

> [Counsel for the Comptroller]: When using this apportionment formula and applying in a situation like this, is the taxpayer given any opportunity to present any numbers or items to adjust the income figures that were used on those?
>
> [Ms. Wood]: Yes, they are.
>
> [Counsel for the Comptroller]: And what are they allowed to provide, or what do we encourage them to provide?
>
> [Ms. Wood]: At the audit site, the Auditors inform the Taxpayers that if they have expenses that are attributable to the royalties or the interest, to give those to use, and they have to be verifiable amounts, of course, but then we would apply that accordingly.
>
> [Counsel for the Comptroller]: At the time of the audit, did either Petitioners, either Petitioner in this case provide any type of expenses to offset the income?
>
> [Ms. Wood]: No, they did not.
>
> [Counsel for the Comptroller]: Since the time of the audit to today's date, have they provided any such information?
>
> [Ms. Wood]: No, they have not.
>
> [The Court]: Do you believe there exists any expenses?
>
> [Ms. Wood]: I haven't seen anything that's verifiable, no. I, just personal, you just want as a…
>
> [The Court]: No, professionally. Do you believe, based upon your experience, whether there are any expenses that you could use to offset the income?
>
> [Ms. Wood]: I would say most likely not. And if there were any, I would say they would be minimal.

On cross, appellants did not refute that Staples, Inc. and Superstore had failed to provide any verifiable expenses, but instead questioned Ms. Wood's assertion that if any expenses did exist, they would be minimal. Dr. Brian Cody, appellants' expert witness, testified that the apportionment method used produced a "grossly distorted" outcome to fail to include the various expenses Staples, Inc. and Superstore incurred, but said he "did not know how to answer" when the Comptroller asked how they were supposed to determine those amounts.

In sum, appellants did not provide "clear and cogent evidence" of their expenses, nor did they "ma[k]e an affirmative demonstration that the expenses were directly related to the income" earned in Maryland. *Gore*, 437 Md. at 530; *Container Corp.*, 463 U.S. at 169-70 (internal citations and quotations omitted)). Therefore, the Comptroller acted properly in excluding any estimated expenses in its calculations.

The Tax Court found Dr. Cody's testimony about appellants' expenses "not persuasive" because his opinion "was premised on the assumption that Staples operated as a single entity prior to 1998." This, appellants contend, was in error. However, during his direct examination, Dr. Cody explicitly stated that "prior to the restructuring, we had the business in one company, in Staples." Dr. Cody further testified he did not take into account the royalty payments made before the restructuring by Staples, Inc. to Staples Properties, Inc. ("Staples Properties"), which was subsumed by Superstore in the reorganization, in doing an analysis of the distortedness of the Notices at issue. Additionally, Ms. Wood also testified Dr. Cody's analysis was flawed because of his failure to take the restructuring into account. On review, we give deference to the decisions of administrative agencies about the persuasiveness and weight of an expert witnesses' testimony. *Geier v. Maryland State Bd. of Physicians*, 223 Md. App. 404, 442 (2015) (internal citations omitted).

Appellants further argue the Comptroller's method "tax[ed]…income…that is not properly attributable to the State," ultimately violating the Due Process and Commerce Clauses of the U.S. Constitution. However, "the taxpayer always has the 'distinct burden of showing 'by clear and cogent evidence' that [the state tax] results in extraterritorial values being taxed.'" *Container Corp.*, 463 U.S. at 175 (internal citations omitted). Staples C&C and Staples East allocated their activities among the states they conducted business, which "made clear to the Comptroller how much of the appellants' income was related to activities in, and thus could be taxed by, Maryland." Moreover, Ms. Wood testified, that the royalties, franchise fees, and interest figures used were obtained from a worksheet provided by appellants.

In affirming the apportionment method used by the Comptroller, the Tax Court noted "[t]he reasonableness of these assessments is readily apparent when the uncontested assessments against [Staples Properties] for the [period prior to the reorganization is] considered." It found

> [I]n 1993, Staples placed its intellectual property in [Staples Properties], licensing the use of those intangibles back to Staples, Inc….
>
> Staples Properties' royalty income, paid to it by Staples, Inc….[was] $132,002,909 in 1997. The uncontested tax assessed by the Comptroller…[was] $488,631 in 1997, [with] an average annual increase of approximately 65.5%. In 1997, the apportionment factor, as derived from Staples, Inc.'s own calculations, was .052881.
>
> In 1998, the first year the reorganization took effect and the first year of the audit period, Petitioners reported royalty payments, now paid by Staples C&C and Staples East to Superstore, in the amount of $186,387,520. The apportionment factor, as derived from Staples C&C's and Staples East's own calculations, was .073377 and the tax assessed for 1998 was $957,358. Staples argues this was in error. We disagree.

Appellants argue this too was in error, as Staples Properties was not in existence during the audit period, and the apportionment factor used for Staples Properties included expenses. "With little or no analysis, the Tax Court stated that the Notices are not distortive because of taxes that Staples Properties paid." "[I]t is not 'readily apparent' how a comparison of the Notices to the tax assessed to Staples Properties justifies the Notices." The Comptroller, conversely, argues a comparison to Staples Properties is helpful in establishing the reasonableness of the apportionment method chosen.

We note initially the Tax Court clearly did not base its analysis of the appropriateness of Notices on a comparison of the taxes paid by Staples Properties, but rather, on the Court's opinion in *Gore*. It is "readily apparent" that a comparison of the royalty income paid to Staples Properties before the reorganization, and the royalties paid to Superstore, Properties' heir, after the reorganization, would be a helpful benchmark in analyzing the 'distortedness' of the Notices assessed. Nevertheless, we do not find it was error for the Tax Court to have included the comparison in further substantiating its analysis.

"A court's role in reviewing an administrative agency adjudicatory decision is narrow; it is limited to determining if there is substantial evidence in the record as a whole to support the agency's findings and conclusions, and to determine if the administrative decision is premised upon an erroneous conclusion of law." *Maryland Aviation Admin. v. Noland*, 386 Md. 556, 571 (2005) (internal citations and quotations omitted). We find the Tax Court's findings were fully supported by the record as a whole, and its conclusions were not premised upon any erroneous conclusions of law. We therefore affirm.

III. The Tax Court properly waived interest.

Our review of the factual determinations of the Tax Courts "is narrow," and "is 'limited to determining if there is substantial evidence in the record as a whole to support the agency's findings and conclusions." *Frey v. Comptroller of the Treasury*, 184 Md. App. 315 (2009), *aff'd*, 422 Md. 111, 181-85 ("*Frey I*"). "It is not our job to substitute our judgment for that of the Tax Court." *Id.* at 331.

In *Frey I*, this Court found the Tax Courts were statutorily authorized to waive the imposition of interest. 184 Md. App. at 422 (internal citations omitted). In *Frey v. Comptroller of Treasury* ("*Frey II*"), 422 Md. 111, 187 (2011), the Court of Appeals, in affirming this Court, further stated "a tax collector's assessment of interest will not be overturned unless the complaining party provides affirmative evidence demonstrating reasonable cause for the abatement or the tax collector has made an obvious error." *Id.* at 187.

Noting *Frey I*, the Tax Court in the instant case found that, given the evolution in the law through *SYL* and *Gore*, amongst others, appellants had a reasonable basis for challenging the law and acted in good faith.

We find nothing in the record to contradict the Tax Court's findings. We therefore affirm.

JUDGMENT OF THE CIRCUIT COURT FOR ANNE ARUNDEL COUNTY AFFIRMED IN PART (WITH RESPECT TO THE ASSESSMENT OF TAX) AND REVERSED IN PART (WITH RESPECT TO WAIVER OF PARTIAL INTEREST); COSTS TO BE EVENLY DIVIDED BETWEEN THE PARTIES.