No. 19-119

In The
Supreme Court of the United States

STAPLES, INC., *et al.*,

Petitioners,

v.

COMPTROLLER OF MARYLAND,

Respondent.

On Petition for Writ of Certiorari to the Court of Special Appeals of Maryland

BRIEF IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

Did the Maryland intermediate appellate court's unpublished decision properly affirm the state income tax assessment against petitioners, where petitioners conceded that they had sufficient economic nexus with Maryland to be subject to the State's taxing authority, the undisputed evidence showed that their royalty and interest income was earned from Staples affiliates in Maryland through the use of petitioners' intangible property and services within Maryland, petitioners were part of a unitary business with those same Staples affiliates, and the Comptroller's assessments reasonably reflected how the income was generated and fairly represented the income attributable to Maryland?

PARTIES TO THE PROCEEDINGS

The petitioners are Staples, Inc. and Staples the Office Superstore, Inc. Respondent is the Comptroller of Maryland.

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BRIEF IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI

STATEMENT

1. In this case, Maryland's intermediate appellate court, in an unpublished opinion, upheld the decision of the Maryland Tax Court, an administrative tribunal, which affirmed state income tax assessments against petitioners Staples, Inc. ("Staples") and Staples the Office Superstore, Inc. ("Superstore"). Before the Maryland Tax Court, petitioners conceded they had sufficient nexus with Maryland for the State to tax them, Pet. App. 4a; Br. Opp. App. 4a, and the undisputed evidence showed that (1) their royalty and interest income was earned from Maryland affiliates through the use of petitioners' intangible property and services within Maryland, Pet. App. 59a-60a, 61a-62a; (2) petitioners were part of a unitary business with those same Maryland affiliates, Pet. App. 59a-60a; and (3) the Comptroller's assessments reasonably reflected how the income was generated and fairly represented the income attributable to Maryland, Pet. App. 61a-62a.

Factual Background

2.a. Staples was organized in 1985. Before reorganizing in 1998, Staples owned and operated the company's retail stores and contract business, and its subsidiary Staples Properties, Inc. ("Staples Properties") owned the rights in and goodwill associated with the Staples brand trademarks and other intellectual property, which it licensed to Staples under an agreement requiring Staples to pay Staples Properties the greater of 3% of net sales or $5 million a quarter. Br. Opp. App. 11a.

b. In 1998, the company reorganized its corporate structure for the purpose of "minimiz[ing] or eliminat[ing] its state income tax liabilities in separate return states[[1]] like Maryland" by "creat[ing] a new scheme for shifting income using royalty and interest expenses," Pet. App. 59a; *see* Br. Opp. App. 9a-10a, paid by in-state operating entities to related, out-of-state entities, Pet. App. 59a. The reorganization resulted in four affiliated companies: petitioner Staples (the parent company) and three additional, affiliated companies: petitioner Superstore, Staples the Office Superstore East, Inc. ("Staples East") and Staples Contract & Commercial, Inc. ("Staples C&C"), and the elimination of Staples Properties, which merged into Superstore.[2] Pet. App. 59a; Br. Opp. App. 10a.

[1] 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*, 59 Md. App. 370, 379-80 (1984). A "combined return state" requires members of an affiliated or consolidated group of companies to file a combined or consolidated return, similar to a federal consolidated return. *Id*. Maryland is a separate return state. *See* Md. Code Ann., Tax-Gen. § 10-811 (LexisNexis 2016).

[2] The audit period at issue in this matter was years 1999 through 2004 ("Audit Period"). Pet. App. 55a. In the years preceding the Audit Period, Staples Properties held Staples' intellectual property and licensed that intellectual property back to Staples for use in Staples' retail operations. Pet. App. 58a. Staples paid

Superstore and Staples C&C were wholly owned subsidiaries of Staples, and Staples East was a wholly owned subsidiary of Superstore. Pet. App. 59a; Br. Opp. App. 12a. The four entities had common officers and directors. Pet. App. 8a, 14a; Br. Opp. App. 12a.

c. After the reorganization, Staples provided corporate necessities in the form of managerial and administrative services to Superstore, Staples East, and Staples C&C. These services included cash and credit; management; credit-support functions; paying all bills; strategic planning; and legal, accounting, financial, and payroll services. Pet. App. 59a-60a; Br. Opp. App. 21a. Staples also provided a cash-pooling service that included loans and banking services. Pet. App. 9a, 14a, 59a, 83a; Br. Opp. App. 23a. In exchange, Staples received management fees and interest income from Superstore, Staples East, and Staples C&C. Pet. App. 9a, 61a; Br. Opp. App. 23a-25a.

Superstore assumed ownership of the rights and goodwill associated with the Staples brand trademarks and other intellectual property. Pet. App. 9a, 61a, 67a; Br. Opp. App. 13a. Superstore also provided franchise system services to Staples East and Staples C&C; these services included the use of the Staples brand trademarks and intellectual property,

royalties to Staples Properties for this use. Pet. App. 58a. Maryland audited and assessed Staples Properties for income tax due to Maryland on the apportioned amount of this royalty income attributable to Maryland using the same apportionment formula used in the current case. Pet. App. 58a-59a. Staples Properties paid this assessment without objection. Pet. App. 58a, 61a.

centralized purchasing, inventory control, lease and contract negotiations, advertising and marketing, research and development, store site selection and construction, and equipment and signage. Pet. App. 59a-60a; Br. Opp. App. 13a.

The services provided to the Maryland affiliates by petitioners were necessary for the operation of the Maryland affiliates, and providing franchise system and administrative services to the Maryland affiliates generated income for both petitioners. Br. Opp. App. 14a. Through providing these services, Superstore dictated how Staples East and Staples C&C advertised, displayed merchandise, and otherwise operated. Pet. App. 14a, 61a. Superstore received royalty income from Staples East and Staples C&C for the use of the Staples brand trademarks and other intellectual property and receipt of the franchise system services. Pet. App. 10a, 29a, 59a, 66a; Br. Opp. App. 14a. Staples East took control over all retail operations in separate return states like Maryland. Pet. App. 10a; Br. Opp. App. 14a. Superstore, in addition to providing and administering the franchise system, took control over most retail operations in combined reporting states, Pet. App. 10a; Br. Opp. App. 14a, and Staples C&C housed the catalogue business, Pet. App. 10a; Br. Opp. App. 15a.

Administrative and Procedural History

3.a. The Comptroller conducted an audit of Maryland corporate income tax returns filed by petitioners' Maryland affiliates Staples East and Staples C&C. Pet.

App. 15a, 66a, 81a; Br. Opp. App. 5a. That audit confirmed that these two entities had properly allocated net income and expenses to Maryland to arrive at Maryland taxable income. Pet. App. 15a, 66a, 81a; Br. Opp. App. 5a-6a. The audit also revealed that Staples East and Staples C&C had been making intercompany interest and royalty expense payments to Staples and Superstore to reduce the Maryland affiliates' Maryland taxable income, and that neither petitioner had filed Maryland corporate income tax returns. Pet. App. 15a, 66a, 81a. Upon being contacted by the Comptroller, petitioners Staples and Superstore contended that they had no nexus with Maryland and, therefore, were not required to file Maryland returns or remit Maryland corporate income tax. Pet. App. 3a, 69a-70a, 82a-85a.

b. But, after appealing the Comptroller's assessments to the Maryland Tax Court and participating in substantial discovery, petitioners amended their appeal to concede that they had sufficient economic nexus with Maryland and therefore were required to file Maryland income tax returns, Pet. App. 4a, 16a; Br. Opp. App. 4a, and they filed Maryland state income tax returns for the Audit Period, Br. Opp. App. 5a. But, on those returns, petitioners apportioned to Maryland none of the millions of dollars of royalty and interest income they had earned during that period, Pet. App. 20a-21a, and instead claimed that the apportionment amount should be zero, Pet. App. 21a.

The Maryland Tax Court, the tribunal of record, on the evidence produced at trial, made the factual determination that "[i]n reality, the activities of Staples and Superstore permeate the activities of each other and Staples C&C and Staples East, and that as separate entities, petitioners could not operate independently." Pet. App. 60a. "'Substantial mutual interdependence' existed at all levels between Staples, Inc., Superstore, Staples C&C and Staples East. Staple 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." Pet. App. 20a; *see* Br. Opp. App. 12a-15a, 21a. The Maryland Tax Court, on this factual record, thus concluded that petitioners and their Maryland affiliates were part of "a unitary business enterprise." Pet. App. 60a. Consequently, the Tax Court held that Maryland could apportion that part of petitioners' income that was reasonably attributable to, and that reasonably reflected, their income generated in Maryland. Pet. App. 60a.

c. Given the Tax Court's factual finding that petitioners were part of a unitary business enterprise doing business in Maryland, and petitioners' concession that they had sufficient economic nexus with Maryland to be subject to the State's taxing authority, Pet. App. 4a, 60a; Br. Opp. App. 4a, the only remaining question before the Tax Court was what part of petitioners' income was reasonably attributable to Maryland and, consequently, taxable by Maryland. The Tax Court answered this question by accepting the assessments made by the Comptroller; those assessments captured the income of petitioners that had been simultaneously deducted by petitioners' Maryland affiliates, Staples East and Staples C&C, on their Maryland returns as an expense against income during the Audit Period. Pet. App. 61a.[3] That is, Staples East and Staples C&C themselves had identified this expense on their state tax returns and allocated it among the various states in which they operated to reflect the extent that the expense arose from the services and activities of Staples and Superstore provided in each state, including Maryland. Pet. App. 15a, 26a-27a, 34a, 61a.

d. Petitioners acknowledged to the Tax Court that the State's standard apportionment formula, Md. Code Ann., Tax-Gen. § 10-402(c) (LexisNexis Supp. 2018), would result in none of their income being apportioned to Maryland. Pet. App. 20a-21a. Nonetheless, petitioners contended that Maryland had to use this statutory formula, Pet. App. 20a-21a, even though Maryland law provides for alternative formulas under circumstances like these. Md. Code Ann., Tax-Gen. § 10-402(d) (LexisNexis Supp. 2018). Rejecting petitioners' interpretation of Maryland law, the Maryland Tax Court found that the Comptroller had appropriately used the alternative formula permitted by Tax-General § 10-402(d), Pet. App. 60a-61a, and approved by Maryland's highest court. *See Gore Enter. Holdings, Inc. v. Comptroller*, 437 Md. 492, 528-33 (2014) (holding that the Comptroller properly used the alternative

[3] Contrary to petitioners' implication, Pet. 25, the royalties and interest income was not double counted so as to be taxed as both the Maryland taxable income of petitioners and their affiliates Staples East and Staples C&C.

statutory method where the standard method "yielded an apportionment factor of zero, which did not fairly represent the subsidiaries' activity in Maryland"). The Tax Court found that the alternative formula captured and taxed only that part of petitioners' income that was reasonably attributable to Maryland. Pet. App. 61a.

The Tax Court rejected the testimony of petitioners' expert that the Comptroller's assessment grossly distorted petitioners' income attributable to Maryland. Pet. App. 62a-63a. As the trier of fact, the Tax Court found the expert's testimony unpersuasive because it was premised on a false assumption regarding how Staples was structured before its reorganization in 1998. Pet. App. 62a. Furthermore, the expert's credibility was compromised when he asserted that the assessments were distortive because they failed to take into account the expenses incurred by petitioners to generate their income, Pet. App. 26a, when the unrefuted evidence showed that the Comptroller requested from petitioners documentation of expenses directly related to the income earned in Maryland, but petitioners failed to provide any verifiable expenses. Pet. App. 33a.[4] When confronted with this fact, petitioners'

[4] In this Court, petitioners assert that they made a "proffer" of expenses in the form of their federal income tax returns. Pet. 12 n.1. But this is contrary to the record, because the lower courts found that petitioners had failed to provide any verifiable expenses, and therefore failed to provide "'clear and cogent evidence' of their expenses, nor did they 'make an affirmative demonstration that the expenses were directly related to the income' earned in Maryland." Pet. App. 33a (citing *Gore Enter.*

expert could not answer how the Comptroller was to take expenses into account if petitioners, who were the only source of the information, did not provide the information to the Comptroller. Pet. App. 33a.

4.a. On judicial review, in an unpublished decision, Maryland's intermediate appellate court held that substantial evidence supported the Tax Court's determination that the Comptroller had properly assessed petitioners' Maryland income tax liabilities for the audit years. Pet. App. 15a. As the parties appealing the assessments, petitioners had the burden of proving that the assessments were in error, *Frey v. Comptroller*, 422 Md. 111, 186 (2011), and the Court of Special Appeals upheld the Tax Court's determination that petitioners failed to present clear and cogent evidence that the Comptroller's assessments resulted in extraterritorial values being taxed. Pet. App. 34a-36a. To the contrary, the substantial evidence in the record, including

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Holdings, 437 Md. at 530; *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159, 169-70 (1983)).

Not only was petitioners' so-called "proffer" not "clear and cogent evidence," but the proffer had the added deficiency that any deductions listed on a tax return, even if they are assumed to be expenses, are aggregate figures. On their face, it is impossible for the factfinder to discern what, if any portion, of each aggregate figure is attributable to petitioners' earnings from the services provided to Staples C&C and Staples East. For example, assume there is an expense for salaries on Superstore's federal tax return. What that aggregate figure does not reveal to the factfinder is what, if any, part of that salary expense is for wages paid to those persons in Superstore's retail operations, for those persons that had anything to do with the oversight of the franchise system, or for those persons who administered the intellectual property. It is not enough to proffer an aggregate total.

the uncontested assessments made against, and paid by, Staple Properties, in the tax periods just prior to the years at issue, showed that the Comptroller's assessments against petitioners are reasonable and fairly represent the income of petitioners reasonably attributable to Maryland. Pet. App. 34a-35a, 61a-62a.

The Court of Appeals denied discretionary review. Pet. App. 93a.

Petitioners did not argue before the Tax Court or on judicial review in the Maryland courts that the Comptroller's alternative method of apportionment failed the internal consistency test of *Complete Auto Transit Inc. v. Brady*, 430 U.S. 274 (1977).

REASONS FOR DENYING REVIEW

I. There Is No Conflict Among the States on the Question of Whether a Physically Remote Corporation's Exploitation of a State's Markets Satisfies the Constitutional Requirements of Substantial Nexus for Purposes of Income Taxes on Business Activity.

Contrary to the argument of petitioners, there is no sharp division among the states' highest courts, Pet. 2, nor has Maryland, or any other state, taken an erroneously permissive view that the "mere receipt of royalties from businesses within the State is in-State activity that the State may constitutionally tax." Pet. 3. Maryland, like other states, has concluded that a physically remote corporation's exploitation of Maryland's markets, i.e., economic nexus, satisfies the constitutional requirements of substantial nexus for purposes of income taxes on business activity. These decisions are consistent with this Court's jurisprudence. *See South Dakota v. Wayfair, Inc.*, 585 U.S. ___, 138 S. Ct. 2080, 2093 (2018) ("Physical presence is not necessary to create a substantial nexus."); *Mobil Oil Corp. v. Commissioner of Taxes of Vt.*, 445 U.S. 425, 436-37 (1980) ("[T]hat a tax is contingent upon events brought to pass without a state does not destroy the nexus between such a tax and transactions within a state for which the tax is an exaction.") (citing *Wisconsin v. J.C. Penney Co.*, 311 U.S. 435, 445 (1940)).

Petitioners rely on cases from West Virginia and Oklahoma to support their argument that some states have held that out-of-state entities' royalty income cannot be taxed. Pet. 18-20. But the outcome in these cases turned on the factual records before the courts and not on any different legal standards for assessing whether an entity has sufficient nexus to be subject to a state's taxing authority.

In the West Virginia case cited by petitioners for the proposition that there is a split among the states, *Griffith v. Conagra Brands, Inc.*, 229 W. Va. 190 (2012), the court reiterated its view that physical presence is not a requirement in West Virginia. *Id*. at 199 (citing *Tax Comm'r v. MBNA Am. Bank, N.A.*, 220 W. Va. 163, 172 (2006) (holding that "[r]ather than a physical presence standard, this Court believes that a significant economic presence test is a better indicator of whether substantial nexus exists for Commerce Clause purposes.")). In MBNA, the court had upheld an assessment against MBNA, even though MBNA had no employees or property in West Virginia, because MBNA continuously and systematically engaged in promoting its business in West Virginia via mail and telephone. *Id*. at 164, 171. The court held that these activities created a substantial economic nexus with the state to tax the significant gross receipts attributable to West Virginia customers. *Id*. at 172-73.

In *Griffith*, the West Virginia case on which petitioners rely, in reversing the assessment at issue against ConAgra Brands, Inc., the court relied on the many factual stipulations favorable to the taxpayer that showed that it did not purposefully direct its business or otherwise have a significant economic presence in West Virginia. 229 W. Va. at 198, 200-01.[5] Thus, the West Virginia case is based on the facts of that case and is limited accordingly.

The same is true of the Oklahoma case on which petitioners rely. *Scioto Ins. Co. v. Oklahoma Tax Comm'n*, 279 P.3d 783 (Okla. 2012). Again, the outcome turned on the factual record before the court. Unlike here, where petitioners conceded enough nexus to be taxed, the taxpayer in *Scioto* proved that it had no

[5] Unlike in the West Virginia case, the factual record in the Maryland ConAgra Foods case, *ConAgra Foods RDM, Inc. v. Comptroller*, 241 Md. App. 547 (2019), contained factual findings based on substantial evidence of the company's economic presence in Maryland and purposeful direction of business activity into the Maryland market. ConAgra Foods RDM, Inc. did not seek further appellate review of this decision.

direct connection to the business operating in the taxing state. Scioto Insurance Co. ("Scioto") had its contractual arrangements for the licensing of intellectual property with Wendy's International, Inc., not with the Wendy's restaurants operating in Oklahoma. *Id.* at 783. Furthermore, Scioto was not involved in the restaurant business and had no say on where a Wendy's restaurant business was located. *Id*. Unlike here, Scioto had not been formed to avoid state income taxes by shifting income out-of-state through royalty payments but was formed to insure the various risks of Wendy's International Inc.; the transfer of the intellectual property from Wendy's International, Inc. to Scioto was to meet the capitalization requirements of the State of Vermont, the state of incorporation, for an insurance business. *Id*. It was Wendy's International, Inc. who, independent of Scioto, would sub-license the intellectual property to the restaurants. *Id.* Finally, the obligation of Wendy's International, Inc. to pay Scioto was not dependent upon the Wendy's restaurants paying Wendy's International, Inc. *Id.*

On these facts, the Oklahoma appellate court held that "there is no question that Oklahoma can tax the value received by Wendy's International in contracting with individual Wendy's restaurants in Oklahoma to use the intellectual property." *Id*. This holding is consistent with the earlier decision of the Oklahoma Court of Civil Appeals in *Geoffrey, Inc. v. Oklahoma Tax Commission*, 132 P.3d 632 (Okla. Civ. App. 2005), a decision that the *Scioto* court never questioned. On Due Process, not Commerce Clause, grounds, the Supreme

Court of Oklahoma could not find a "basis for Oklahoma to tax the value received by Scioto from Wendy's International under a licensing contract that was not made in the State of Oklahoma and no part of which was to be performed in Oklahoma." Thus, on the specific facts of the case, there was not enough physical or economic presence of Scioto in, or to, Oklahoma to satisfy due process. *Scioto*, 79 P.3d at 784.

Neither of petitioners' cited cases show any division among the states' highest courts. Pet. 2. Nor have petitioners established that any state, including Maryland, has held that "mere receipt of royalties from businesses within the State is in-State activity that the State may constitutionally tax." Pet. 3. Maryland's economic nexus standard is a permissible approach for ascertaining whether the facts in a case support a finding that a taxpayer has sufficient economic nexus with the taxing state to subject the taxpayer's income to the state's taxing authority. It satisfies the substantial nexus required under the Constitution and is neither unusual, novel, nor far reaching.

II. The Question of Apportionment Is a Fact-Based Issue That Does Not Warrant this Court's Review.

As with economic nexus, which they conceded below, petitioners have never disputed they were part of a unitary business with Staples East and Staples C&C (the Staples affiliates that operated in Maryland) and that some portion of petitioners' income should be apportioned to Maryland. The petitioners simply believe that the Comptroller should have accepted their factually unsupported argument that the apportioned amount should be zero. But as the Court of Special Appeals held, substantial evidence supported the Maryland Tax Court's determination that petitioners failed to sustain their burden of proof on the apportionment issue. And petitioners' argument that the Comptroller's alternative apportionment formula fails the internal consistency test of *Complete Auto Transit Inc. v. Brady*, Pet. 27-28, is both contrary to the factual record and unpreserved for review.

A. Given Petitioners' Conceded Economic Nexus to Maryland, the Comptroller Properly Applied an Alternative Statutory Apportionment Formula to Petitioners' Income.

It is beyond dispute that a state can constitutionally apply an apportionment formula to a company's income to establish taxable income. *Exxon Corp. v. Wisconsin Dep't of Revenue*, 447 U.S. 207, 221 (1980). "The 'linchpin of apportionability' for state income taxation of an interstate enterprise is the 'unitary-business principal.'" *Id*. at 223. And, if a company is a unitary business, then a state may apply an apportionment formula that produces a "rough approximation of a corporation's income that is reasonably related to the activities conducted within the taxing State." *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 273 (1978). Such apportionment formulas are a recognized and accepted method of accounting for the contributions made to a multistate company's income that result from the functional integration, centralized management, and economies of scale present in a unitary business. *Mobil Oil Corp.*, 445 U.S. at 438.

Where a company challenges an apportionment formula that a state has applied to the company's income, the burden of proof is on the company to demonstrate that "there is no rational relationship between the income attributed to the State and the intrastate values of the enterprise . . . proving that the income apportioned to [the State] under the statute is 'out of all appropriate proportion to the business transacted in that State.'" *Container Corp. of Am.*, 463 U.S. at 180-81 (internal citations omitted). And the company must satisfy this burden by presenting "clear and cogent" evidence that the state's formula results in extraterritorial values being taxed. *Exxon Corp.*, 447 U.S. at 221.

"This burden is never met merely by showing a fair difference of opinion which as an original matter might be decided differently." *Norton Co. v. Department of Revenue*, 340 U.S. 534, 537-38 (1951). This Court "will not re-examine, as a court of first instance, findings of fact supported by substantial evidence." *Id*. Furthermore, as "this Court has on several occasions recognized, a company's internal accounting techniques are not binding on a State for tax purposes." *Id*.

As explained below, in this case, the Maryland courts on judicial review properly upheld the Tax

Court's determination that petitioners had failed to sustain their burden of proof.

B. The Assessments Reasonably Reflected How the Income Was Generated and Fairly Represented the Income Attributable to Maryland.

The Maryland Tax Court and Maryland's intermediate appellate court both found that there was substantial evidence in the record that the Comptroller's apportionment formula captured only that income of petitioners that was reasonably attributable to Maryland and reflected a reasonable sense of how petitioners' income is generated. Pet. App. 30a, 62a. The record evidence established that the income captured by Maryland was limited to that deducted as expenses against income by petitioners' Maryland affiliates Staples East and Staples C&C on their Maryland corporate returns for the Audit Period.

Petitioners contend here, as they did below, that Maryland's formula and result distorted their Maryland taxable income because it fails to account for the activities occurring outside Maryland that contributed to the production of that income. Pet. 25. Citing an unpublished Colorado trial court decision, petitioners continue to base this claim of distortion on the alleged failure of the Comptroller to account for the expenses generated outside Maryland to generate the income attributable to Maryland. Pet. 27. But the Comptroller repeatedly requested petitioners to provide evidence of the costs associated with creation, enhancement, and preservation of the income that the Comptroller proposed to tax. Pet. App. 27a, 32a-33a. And petitioners consistently refused to provide that evidence; they instead chose to focus on attacking the Comptroller's use of the alternative statutory formula.[6] Pet. App. 27a, 32a-33a. Again, neither the Comptroller nor the Maryland courts have taken any novel, unusual, or far reaching position. Petitioners simply failed to satisfy their burden to present clear and cogent evidence that the alternative statutory formula resulted in extraterritorial values being taxed. *Exxon Corp.*, 447 U.S. at 221.

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[6] Moreover, the unpublished Colorado case, *Target Brands v. Department of Revenue of Colorado* (Colo. 2d Judicial Dist. Ct.) (CCH) ¶¶ 201-367 (Jan. 27, 2017), on which petitioners rely, supports the result below. In *Target Brands*, the court found that the company had economic nexus with Colorado; here, petitioners conceded that nexus. Like here, the Colorado court held that the state had shown that the "standard [3-factor payroll, property and sales] apportionment formulas do not fairly reflect [the company's] business activity" in the state "because they do not account for the manner in which [the company's] income is generated and where the income-generating activity occurs," *id*. at 38, and rejected the company's argument that not taking into consideration brand-related and product-sourcing activities led to a grossly distorted result without there also being sufficient evidence in the record from the taxpayer to support such an assertion. *Id*. at 34. But unlike here, the company in *Target Brands* adduced evidence of the "material contributions made by [its] employees and property toward creating, enhancing, and preserving the income" that the state sought to tax. *Id*. at 39. Because the case in *Target Brands* was "replete" with such evidence, the court ordered Colorado to include the company's payroll and property factors in the apportionment formula. *Id*.

Furthermore, as the Maryland Tax Court observed, there did exist a credible benchmark against which to evaluate the assessments for the Audit Period: the assessments against the company in the years preceding the reorganization. During that period, the Comptroller made assessments using the same apportionment formula as employed in this case, and these assessments were paid without objection. In addition, the Comptroller's alternative formula is mathematically consistent with the formula used by petitioners' outside consultants at the time of the reorganization to predict petitioners' tax savings from the reorganization.

In 1993, Staples placed its Staples brand trademarks and other intellectual property in Staples Properties, and licensed the use of those intangibles back to Staples. Pet. App. 35a, 58a. Staples then reduced its state taxable income by shifting income to the out-of-state entity vis-à-vis the royalty expense payment it made to Staples Properties. Pet. App. 61a.

During the 1993-1997 period, Staples was experiencing tremendous growth and expansion. Md. Ct. Spec. App. Record Extract 266. Staples Properties experienced steady income growth and saw its royalty income, paid to it by Staples, rise from $18,884,807 in 1993 to $132,002,909 in 1997. Pet. App. 61a. The uncontested tax assessed by the Comptroller correspondingly rose from $64,894 in 1993 to $488,631 in 1997. This represented year-over-year increases ranging from a high of 162.5% to a low of 37.9%, averaging approximately 65.5%. *Id.* In 1997, the apportionment factor (i.e., the amount of business attributable to Maryland), as derived from Staples' own calculations, was .052881. *Id*.

By comparison, in 1998, the first year the reorganization took effect and the first year of the Audit Period, the petitioners reported royalty payments, now paid by Staples C&C and Staples East to Superstore, in the amount of $186,387,520. Pet. App. 62a. The apportionment factor, as derived from Staples C&C's and Staples East's own calculations, was .073377. *Id.* The tax assessed for 1998 was $957,358. These numbers are not out of line with the income and taxes paid by Staples Properties in the years before the Audit Period. Although the amount of tax due for 1997 increased more than the 65.5% average annual increase for prior period, it is substantially less than the highest year-over-year increase during the pre-audit period. The increase in that particular year is also not surprising taking into consideration the 38% increase in royalties paid ($132,002,909 vs. $186,387,520) and the 41% increase in the amount of business reported as attributable to Maryland (.052881 vs. .073377).

Ultimately, as the petitioners' expert witness stated, formula apportionments are a "short-cut" to get to "what is viewed as a measure of economic activity in a particular location." Md. Ct. Spec. App. Record Extract 165. Although there exists an "open debate about the factors that are used and it's a policy decision in many respects," Md. Ct. Spec. App. Record Extract 165-66, that policy decision should be left to the state and is generally not for the courts to decide. *See Moorman*

Mfg. Co., 437 U.S. at 277-81 (stating that states have the freedom to formulate independent policy in the tax area and one longstanding policy does not necessarily have to give way to a newer policy in and of itself).

Petitioners nonetheless objected that the Comptroller's assessments did not account for the "substantial" expenses incurred to produce the income Maryland has taxed. To support this argument, the petitioners employed "economic benchmarks" to calculate alleged distortions between what they assert are reasonable assessments and the Comptroller's assessments. These purported "benchmarks," however, are—as admitted by the petitioners' witness—merely their own alternative apportionment formulas. Md. Ct. Spec. App. Record Extract 142. These alternative formulas are not "clear and cogent evidence" that the income attributed to Maryland was "out of all appropriate proportion" to the petitioners' business activities in Maryland.

Even if the benchmarks were relevant, they failed to support the petitioners' argument that the Comptroller "grossly" distorted the income attributable to Maryland. The testimony of the only witness for the petitioners in support of this argument shows that, in fact, the petitioners made no attempt to allocate or otherwise identify any expenses or deductions that were attributable to the income from use of the franchise system or cash management system in Maryland.

The first alternative presented, for example, used Superstore's unmodified federal taxable income (which takes into account expenses) as a starting point for calculating apportionable income. But this starting point is proper only if one assumes that *all* of Superstore's income and expenses were related to activities conducted in Maryland. Yet, for good reason, neither of the petitioners ever implied that such an assumption would be accurate. This is because it is undisputed that, in addition to its franchising function, Superstore conducted retail activities that had no connection to Maryland and incurred expenses in conducting those retail activities. Superstore's first alternative never accounted for the fact that not all its expenses were attributable to the income it earned from business activities in Maryland. Therefore, even if the Comptroller's final assessments did not fairly reflect the income of petitioners attributable to Maryland, a measure that assumes 100% of the expenses are attributable to Maryland equally fails to fairly reflect such income.

The second economic benchmark was similarly flawed. This second proposed alternative looked to what the taxable income of the petitioners would have been had no reorganization occurred. Md. Ct. Spec. App. Record Extract 152. But this alternative suffers from the same flaw as the first, given that the hypothetical figures used by the petitioners included expenses and costs of goods sold. There is also no legal precedent to support the petitioners' suggested approach to gauge distortion with reference to a hypothetical course that the taxpayer specifically chose to abandon. To recognize that approach here would also be particularly problematic because petitioners undertook their reorganization with a primary goal of eliminating their state income tax liability. When the results are not what they anticipated, the lower courts rightfully rejected their attempt to undo that miscalculation by arguing what might have been had they done nothing.[7]

The Tax Court was thus correct in finding the expert's testimony unpersuasive. In addition to the flawed assumptions discussed above, he based his testimony on two other erroneous premises: that, if no restructuring occurred in 1998, the Maryland tax liability would be consistent with what it had been in the years leading up to 1998, Md. Ct. Spec. App. Record Extract 152-53, and that Staples operated as a single entity prior to 1998, Md. Ct. Spec. App. Record Extract 164.

But it was clear to the Maryland Tax Court and Maryland's intermediate appellate court that these assumptions at the foundation of the expert's opinion were false. First, Staples did not operate as a single entity prior to 1998. Rather, Staples served as the operating entity, while Staples Properties owned the intellectual property and received substantial royalty payments from Staples for the use of that intellectual property. Md. Ct. Spec. App. Record Extract 269,

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[7] If this second economic benchmark method were valid, then it would seemingly be necessary to consider what the taxable income calculation would be for all the various reorganization plans considered by Staples in 1998. The evidence suggests that several different structures were considered. Md. Ct. Spec. App. Record Extract 574-81; 1388-90; 1406-13; 1507-08; 2325.

2426-38. Petitioners' expert explicitly acknowledged that his analysis did not consider that this assumption was incorrect and that, prior to the restructuring, a 3% royalty fee was paid to Staples Properties. Md. Ct. Spec. App. Record Extract 242. Second, contrary to the expert's assumption that all required taxes had been remitted, the tax records show that Staples Properties owed and paid a substantial tax liability to Maryland for the tax years 1993 through 1997.

Further contradicting petitioners' expert's testimony are the predictions of Ernst & Young, the consultants retained by the petitioners to recommend ways for Staples to reduce its state income tax liabilities. Md. Ct. Spec. App. Record Extract 267. Using Ernst & Young's tax savings formula, the minimum tax savings that would have been realized in this first year of the reorganization would have been $689,945 ($186,387,520, the amount of royalty income reported by Superstore multiplied by .052881, Staples's apportionment factor prior to reorganization, multiplied by the 7% state tax rate). Md. Ct. Spec. App. Record Extract 574; 2995. The only difference between the predicative savings determined using Ernst & Young's model and the Comptroller's assessment is the Comptroller's use of the actual apportionment factors calculated by the petitioners.

Petitioners' attempt to discredit the Comptroller's apportionment formula through the testimony of an expert witness failed because the Maryland Tax Court rejected the witness's opinion. And given that petitioners would not provide expense information to the

Comptroller, Pet. App. 31a-32a, the intermediate appellate court properly rejected petitioners' argument that the Comptroller and Tax Court were at fault for not considering petitioners' expenses, *id.*

C. The Argument That the Comptroller's Alternative Apportionment Formula Fails the Internal Consistency Test Is Contrary to the Factual Record and Not Preserved for Review by this Court.

Finally, for the first time in the history of this case, petitioners assert the unpreserved argument that the Comptroller's alternative apportionment formula fails the internal consistency test of *Complete Auto Transit Inc. v. Brady*. Pet. 27-28. The crux of this argument is that the income of an in-state business would be allocated using a three-factor (property, payroll, and sales) formula. Thus, petitioners assert, "for in-State entities, Maryland deemed the creation of the franchise system, not just the ultimate sales by the franchisees, to have generated the taxable income." Pet. 27. On this basis, petitioners conclude that if every state took Maryland's approach, interstate business would be taxed twice on the same income.

Not only is there no evidence in the record that Maryland does this, petitioners' argument ignores the record evidence. First, Maryland did not tax the "ultimate sales by the franchisees" in this case. It sought to determine the income of the franchisors (petitioners) that was attributable to Maryland. Second, petitioners rebuffed the Comptroller's attempt to get from petitioners the costs for creation, enhancement, and preservation of the franchise system so as to take such costs into account. Petitioners refused to provide those costs.

Any determination of whether economic nexus exists in a specific case will turn on the facts of that case. Because they conceded nexus below, petitioners' real quarrel is with the factual conclusions reached by the Maryland Tax Court and upheld in the unpublished decision of the Maryland intermediate appellate court. That dispute does not warrant this Court's review.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted,

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