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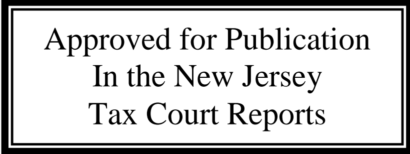
THE TAX COURT COMMITTEE ON OPINIONS

LORILLARD TOBACCO COMPANY, Plaintiff, v. DIRECTOR, DIVISION OF TAXATION, Defendant.	TAX COURT OF NEW JERSEY DOCKET NO. 008305-2007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In the New Jersey
Tax Court Reports

Decided: February 27, 2019

Craig B. Fields and Mitchell A. Newmark for plaintiff (Morrison & Foerster, L.L.P., attorneys).

Marlene G. Brown and Joseph Palumbo for defendant[1] (Gurbir S. Grewal, Attorney General of New Jersey, attorney).

SUNDAR, J.T.C.

This opinion decides plaintiff's summary judgment motion wherein plaintiff claims that defendant improperly and unconstitutionally granted only a partial deduction of royalty payments made by plaintiff to its subsidiary. Plaintiff argues that since its subsidiary reported those same royalties as income and paid corporation business tax ("CBT") on the allocated portion, plaintiff is entitled to a full refund of the CBT plaintiff paid when it had initially added back the royalty payments under N.J.S.A. 54:10A-4.4(b).

Defendant argues that its regulation, N.J.A.C. 18:7-5.18(b), which allows a refund to the royalty payor to the extent of the CBT paid by the royalty recipient, is a proper exercise of its

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[1] The matter was briefed and argued entirely by Senior Deputy Attorney General Marlene G. Brown, including the separate litigation involving defendant's imposition of CBT on the subsidiary in connection with the same royalty payments received by the subsidiary from plaintiff. After the case was re-assigned to the undersigned in January 2019, Deputy Attorney General Palumbo substituted in as attorney for defendant.

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discretion, and unless the expense (payor's deduction amount) matches the income (recipient's reported amount), the deduction can only be of a partial amount, to wit, the extent of the CBT paid by the royalty recipient on its New Jersey allocable royalty income.

The court finds in favor of plaintiff. Once the subsidiary, the royalty recipient, reported as its income the entire amount of the royalties paid to it by plaintiff, and paid the requisite CBT on its allocable share of such income to New Jersey, the legislative concerns of income shifting/exporting machinations, which caused the enactment of N.J.S.A. 54:10A-4.4(b), are allayed. That the subsidiary's New Jersey allocation factor was lower than plaintiff's, resulting in the subsidiary having to pay a lower amount of CBT does not, <u>without more</u>, establish that plaintiff proved only that a partial addback of the royalty payments is unreasonable, or is evidence of income shifting or tax avoidance. This is especially true since the subsidiary reported all of the royalties it received, and defendant accepted, without change, the subsidiary's and plaintiff's New Jersey allocation factor. Therefore, denying plaintiff a deduction for the full amount of royalties paid is not a reasonable exercise of defendant's discretion.

<u>**FACTS AND PROCEDURAL HISTORY**</u>

Plaintiff, Lorillard Tobacco Company ("Parent"), is a Delaware-incorporated entity, which manufactures, markets, distributes, and sells cigarettes throughout the United States, its territories, and possessions. It is headquartered in North Carolina.

Parent's wholly-owned subsidiary is Lorillard Subsidiary Co., LLC ("Subsidiary"), which was organized under the laws of North Carolina in November 1999. After it was created, Parent assigned all of its intellectual property (patents, trade secrets, trademarks, and know-how) to Subsidiary by agreements dated December 22, 1999. On the same date, Parent and Subsidiary entered into a Licensing Agreement, perpetual in term, and governed by the laws of North

Carolina. Therein, Subsidiary, as sole owner of the assigned intellectual property, granted Parent the right to use the same in Parent's nation-wide business.[2] Parent is obligated to pay Subsidiary a royalty of 13% of its monthly net sales (invoiced amount less certain separately stated expenses). Royalties accrue when Parent ships cigarettes to its customers, and are payable within 30 days after the end of each "Royalty Period" (defined as the end of each month). Along with the royalty payments, Parent is to provide monthly and year-to-date net sales of the "licensed products" (all cigarettes sold by Parent, bearing the licensed trade-marks, or cigarettes manufactured by Parent using the licensed patents, know-how, trade secrets), broken down by brand.

(A) Parent's Income Tax Returns

For tax years 2002-2005, Parent filed CBT returns in New Jersey. As required by N.J.S.A. 54:10A-4(k), it reported its federal taxable income (Line 28 of the federal corporate income tax return, Form 1120) as its New Jersey entire net income ("ENI"). The Line 28 income is computed by deducting certain business expenses from income such as royalties. For tax years 2002-2005, Parent deducted the following royalty payments:

2002	$493,127,808
2003	$488,649,907
2004	$497,402,779
2005	$510,782,834

Thus, its Line 28 income, which is the starting point of its New Jersey ENI, was net of these deductions. Pursuant to N.J.S.A. 54:10A-4.4(b), which requires an addback of royalties paid by a taxpayer to one or more of its related member/s in computing the taxpayer's ENI, Parent added

[2] In February 2000, Subsidiary entered into an agreement with a third party, Schweitzer-Mauduit International, Inc. ("SMI"), which was located in Georgia, whereby Subsidiary granted SMI a non-exclusive license to use Subsidiary's patents and trade secret rights, and in return SMI agreed to pay royalty of 7.5% to 8.5% of the selling price. However, any sales made by SMI or its affiliate to Parent or Parent's affiliate would not require royalty payments.

back these payments to its ENI for each tax year. Parent then computed its CBT based on a percentage of its ENI allocable to New Jersey, which was based on the ratio of its property, payroll, and sales receipts in New Jersey to those same factors everywhere, and then averaged, thus:

Tax Year	Property (A)	Payroll (B)	Receipts (C)	Receipts[3] (D)	Average (A+B+C+D)÷4
2002	2.1616%	1.4583%	3.8196%	3.8196%	2.8148%[4]
2003	1.8330%	1.5005%	3.2877%	3.2877%	2.4772%
2004	1.4516%	1.4990%	2.8866%	2.8866%	2.1810%
2005	1.5068%	1.5741%	2.7347%	2.7347%	2.1376%

Although Parent allocated its income as above, it evidently paid more CBT due to the addback of the royalty deduction each year, since the addback effectively increased its taxable income base.

(B) CBT Assessment on Subsidiary

In 2006, and after Parent had filed its CBT returns, defendant ("Taxation"), assessed Subsidiary $18,405,410 in CBT (which, with interest and penalties, totaled $24,251,739), for tax years 1999-2004. For 2002-2004 (three of the years at issue here), Taxation deemed Subsidiary's federal Line 28 income as its New Jersey ENI, allocated 50% of it to New Jersey, and computed CBT on the same at 9%, reduced it by certain amounts of "maximum throw out" and Parent's "throw out." The allocated ENI was not further apportioned (i.e., was taxed 100% by New Jersey) since Taxation deemed almost 99% of Subsidiary's everywhere income as being "non-sourced."[5]

Subsidiary promptly, in 2006, appealed to the Tax Court claiming it received royalties from Parent "based on Parent's sales" nation-wide; it filed corporate income tax returns in six other

[3] The sales factor was double weighted or counted for the tax years at issue.

[4] On the worksheet for computing the "Throw-Out Tax Effect for Limitation," Parent computed its averaged allocation as 2.7907%. This was done by using the everywhere receipts without throwing out certain receipts, whereas on Schedule J, the everywhere income of $4,512,129,132 was reduced by $56,854,051 as non-sourced receipts. The change in the denominator resulted in the slightly differing receipts allocation percentages.

[5] In computing the allocation percentage of receipts, Taxation used Parent's reported allocable and everywhere receipts, since Subsidiary had not filed its own CBT returns.

states for tax years 2002-2004; and it "had no physical presence or employees in any state outside of North Carolina." See Lorillard Licensing Co., LLC v. Dir., Div. of Taxation, 28 N.J. Tax 590 (Tax 2014), aff'd, 29 N.J. Tax 275, 277-78 (App. Div. 2015), certif. denied, 226 N.J. 212 (2016).[6]

(C) Parent's Initial Refund Claim

After Taxation assessed Subsidiary, Parent promptly filed refund claims in 2007 for tax years 2002-2005 by filing amended CBT returns and including Schedule G-2 ("Exceptions to the Addback of Intangible Expenses and Costs"). Parent claimed "it would be improper, unreasonable and unconstitutional" to deny it a deduction if "at the same time," New Jersey subjected Subsidiary "to tax on such amounts."

Exception 2 in Schedule G-2 provides the computation for determining whether and how much an exception will be permitted for intangible expenses such as royalties. The computation compares the CBT on the allocated amount of royalties paid (using the taxpayer's New Jersey allocation percentage) with the CBT on the related member's allocated income (lower of the royalty payment or its ENI using the related member's New Jersey allocation percentage). If the CBT on the related member's allocated income is more than the CBT on the allocated royalty payments by the taxpayer, then the taxpayer is permitted to deduct the entire royalty payment amounts (i.e. it does not have to addback the deducted amount). If not, the taxpayer is only allowed a partial exception from the addback. That amount is computed by dividing the lower CBT by the 9% CBT rate (which converts the tax to the related member's New Jersey allocated income), and dividing that result by the taxpayer's allocation factor (see infra p.7 for such a

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[6] Subsidiary had filed returns in North Carolina and Iowa (tax year 2002); North Carolina, Iowa, Oklahoma and South Carolina (tax year 2003); North Carolina, Iowa, Oklahoma, South Carolina, Florida and Massachusetts (tax year 2004). Subsidiary stipulated to its nexus to New Jersey, thus, the sole issue was the Throw-Out Rule, which the court held "did not apply" as Subsidiary "had a Subsidiary agreement with Parent in every state." Lorillard, 29 N.J. Tax at 283.

computation). No exception is provided if (1) the related member did not include the royalty payments as income on a CBT return; or, (2) the related member included the royalty payments as income but its "tax liability" was not "greater than the statutory minimum tax;" or (3) the related member's ENI as reported on its CBT return was "zero or less."

Parent used the 50% allocation percentage determined by Taxation on its 2006 assessment notice to Subsidiary (including for 2005, assuming Taxation "would take a similar position"), and since it was larger than Parent's allocation percentages, the resultant CBT of Subsidiary was also larger. Therefore the entire amount of the royalty payment for each year was excepted from the addback, which then reduced Parent's ENI and CBT, thus, providing for a refund as follows:

Tax Year	CBT w/Addback	CBT w/o Addback	Refund Claimed
2002	$3,164,380	$1,915,129	$1,249,251
2003	$1,982,269	$ 892,834	$1,089,435
2004	$1,980,697	$1,004,346	$ 976,351
2005	$2,161,519	$1,178,855	$ 982,664
TOTAL			$ 4,297,701

Taxation denied the claims as they were "protective." It stated that Parent could file a new claim after Subsidiary's litigation ended, although the four-year limitation period for refunds would apply. Parent timely appealed the denial directly to this court, and in 2008 filed the instant summary judgment motion.

(D) Parent's Expedited Refund Claim

While Subsidiary's appeal of Taxation's CBT assessment for 1999-2004 was pending, it filed CBT returns under then 2009 Tax Amnesty program and paid $5,859,359 for all tax years "pursuant to its interpretation of . . . the Throw-Out Rule." Lorillard, 28 N.J. Tax at 594-95.

Promptly thereafter, Parent sought an "expedited payment of a portion of the CBT refunds because [Subsidiary] recently paid CBT and the payments result in an allowed expense deduction for [Parent]." Parent noted that it nonetheless "continue[d] to challenge the remainder of the

royalty add back." This meant that Parent would continue its appeal in Tax Court on the remainder of its refund claims originally made in 2007. The partial refund immediately sought totaled $2,786,860, with the Schedule G-2 now using Subsidiary's reported (as opposed to audited) allocation factors and ENI as follows:

Tax Year	Royalty Amount	ENI	Allocation	CBT	Excepted From Addback
2002	$493,127,808	$510,534,251	1.8659%	$828,114	$326,888,826
2003	$488,649,907	$491,752,373	1.6111%	$708,538	$317,804,152
2004	$497,402,778	$498,730,036	1.4358%	$642,754	$327,451,220
2005	$510,782,834	$515,938,340	1.3214%	$607,454	$315,750,790

Computation of the partial (expedited) refund claim is exemplified here for tax year 2002:

A. $493,127,808 royalty payment times **Parent**'s allocation factor (2.8148%) = $13,880,562, times the 9% tax rate = $1,249,251 CBT.

B. $493,127,808 royalty payment times **Subsidiary**'s allocation factor (1.8659%) = $9,201,272, times 9% tax rate = $828,114 CBT.

C. Since the CBT in (A) is less than the CBT in (B), the lower amount of $828,114 is divided by the 9% tax rate. The result ($9,201,272, Subsidiary's allocated income in Step B) is divided by Parent's allocation factor (2.8148%) = $326,888,826, the allowed exception to addback amount.

D. Expedited refund sought was 9% of $326,888,826 = $828,114.[7]

In 2010, Taxation issued refunds to Parent for tax years 2002-2005 totaling $2,802,277 ($829,654; $711,866; $656,009; and $604,748 respectively) with interest. Taxation did not pay any further amounts, which is the issue presented in this summary judgment motion.

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[7] Parent's CBT on the royalty payments was greater since its allocation percentage was greater than Subsidiary's allocation percentage for each year.

Note that Subsidiary's North Carolina returns showed its federal taxable income as $508,108,726; $489,111,363; $496,053,502; and $513,336,757; which included income from royalties, interest and capital gains. Receipts from royalties were reported as $493,127,808; $488,723,240; $497,526,405; and $510,940,442; almost similar to Parent's deduction amounts ($493,127,808; $488,649,907; $497,402,779; $510,782,834). The excess is possibly royalties received from an unrelated third-party. <u>See supra</u> n.2. In North Carolina also, the federal taxable income is the starting point to which adjustments are made, and then North Carolina imposes tax on the allocated portion of such income.

ANALYSIS

(*A*) *Appropriateness of Summary Judgment*

Summary judgment will be granted "if the pleadings, depositions, answers to interrogatories and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact challenged and that the moving party is entitled to a judgment or order as a matter of law." R. 4:46-2(c); Brill v. Guardian Life Ins. Co. of Am., 142 N.J. 520, 523 (1995). The only issue is whether Parent is entitled to the balance of its refund claims made in 2007, or in other words, whether Parent is entitled to deduct the full amount of royalty fees paid to Subsidiary. There being no material facts in dispute, summary judgment is appropriate.

(*B*) *Addback Provisions and its Exceptions*

In 2002, the Legislature amended the CBT law by enacting the Business Tax Reform Act ("BTRA"), L. 2002, c. 40. One reason was to address declining revenues due to "proliferating loopholes that have permitted many profitable companies to avoid paying virtually any" CBT by "allow[ing] multi-state corporations to transfer their profits to related out-of-State . . . companies," and "reduc[ing]" their corporate "net income to little or nothing," an unfair and inequitable result. See Statement to Assembly 2501 51 (June 2002). See also Assembly Budget Comm. Statement to Assembly No. 2501 1 (June 27, 2002) (". . . large corporations with apparently substantial economic activity in this State and substantial profit have managed to avoid having any of this income become taxable by New Jersey," a "trend . . . in "separate entity" states like New Jersey, due to inter-company transactions "to avoid tax . . . ").

One such "loophole closer" was the "disallowance of deduction of intangible expenses paid to a related party." This was to be achieved by:

> limit[ing] the ability of a taxpayer to deduct royalties . . . when paid to affiliates. The provision addresses, but does not solely apply to, a

> tax avoidance device that allows a multicorporate structure to export income from a state where the income is generated as a form of expense (for example, as a royalty payment to an out-of-state affiliate that the paying corporation deducts from its income) and then import the income back (for example as a tax-free dividend or as a loan).
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> [Ibid.]

See also Senate Budget & Approp. Comm. Statement to Senate No. 1556 2 (June 27, 2002). Nonetheless, "such deductions in areas that are established as 'non-tax avoidance' situations" would be allowed. Assembly Budget Comm. Statement to Assembly No. 2501 at 2. In this regard, Taxation would have the "authority to determine: (1) whether a taxpayer has met its evidentiary burden of establishing by clear and convincing evidence that the addback of an expense is unreasonable, or (2) that it is appropriate to enter into agreements or compromises with the taxpayer to produce an equitable level of taxation." Ibid.

Accordingly, N.J.S.A. 54:10A-4.4(a) initially defines "intangible expenses" as including "royalty . . . fees." Subsection (b) then provides that:

> For purposes of computing its [ENI] . . . a taxpayer shall add back otherwise deductible . . . intangible expenses and costs directly or indirectly paid, accrued or incurred to, or in connection directly or indirectly with one or more direct or indirect transactions with, one or more related members.
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> [N.J.S.A. 54:10A-4.4(b).] (hereinafter "Royalty Addback statute").

However, the addback "adjustments . . . shall not apply if . . . the taxpayer establishes by clear and convincing evidence, as determined by [Taxation], that the adjustments are unreasonable . . . ." N.J.S.A. 54:10A-4.4(c)(1)(b) (hereinafter the "Royalty U-E-T-A statute," the U-E-T-A standing for "Unreasonableness-Exceptions-To-Addback").

Taxation's regulations reiterate the Royalty Addback statute. Thus, N.J.A.C. 18:7-5.18(b) provides that "intangible expenses and costs directly or indirectly paid . . . in connection with a

transaction with one or more related members shall not be deducted in calculating [ENI]." However, "a deduction shall be permitted . . . [i]f the taxpayer establishes that the adjustments are unreasonable by showing the extent that the payee pays tax to New Jersey on the income stream." N.J.A.C. 18:7-5.18(b)(3) (hereinafter the "Royalty U-E-T-A regulation.").[8]

C. Validity of Providing a Partial Addback Exception

Parent argues that the Royalty Addback statute, together with the Royalty U-E-T-A statute, shows that the exception to the addback is an all-or-nothing situation. It argues that as a matter of pure statutory interpretation no deference is required to Taxation's determination.

(1) Standard of Review

Parent's instant summary judgment motion, filed in 2008, claimed that Taxation's "limited definition of when the Add Back adjustment is unreasonable is unconstitutional" and results in distorting its ENI since the same item was being taxed to Subsidiary, thus, the CBT being sought by Taxation was out of proportion to Parent's business in New Jersey. It also claimed Taxation was not turning square corners. Taxation filed its opposition in 2013. By this time, the basis for its refund denial (from which Parent filed the complaint) no longer existed since Taxation had paid the expedited refunds demanded. However, Parent expressly reserved its right to the entire refund amount. Additionally, Parent's motion attacked the constitutionality of the Royalty U-E-T-A

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[8] Another suspect item of deduction was expensing interest on loans between related members. N.J.S.A. 54:10A-4(k)(2)(I) ("Interest Addback statute") requires that ENI be computed without a deduction for interest paid to a related member. Similar but not identical exceptions apply. For instance, a deduction is allowed if, among other conditions, the related recipient member is subject to tax on the interest income. Ibid. A U-E-T-A exception is also allowed "to the extent that the" payor "establishes" unreasonableness. Ibid. (hereinafter "Interest U-E-T-A statute"). Taxation's regulation in this regard is identical to the Royalty U-E-T-A regulation, namely that the payor establish unreasonableness by showing "the extent the related party pays tax in New Jersey on the income stream." N.J.A.C. 18:7-5.18(a)(2) (hereinafter "Interest U-E-T-A regulation").

regulation and continued to do so in the back-and-forth sur-reply briefs. Thus, Parent's attack on the refund denial, is not moot, although Taxation refunded a portion of the refund claimed.

Initially, the court rejects Parent's argument that zero deference must be afforded to Taxation's actions. The issue before this is court the validity of the Royalty U-E-T-A regulation wherein Taxation has exercised its discretion by providing relief from double taxation. The standard of review is not devoid of deference. See GE Solid State, Inc. v. Dir., Div. of Taxation, 132 N.J. 298, 306 (1993) ("Agency regulations are presumptively valid . . . and should not be invalidated unless they violate the enabling act or its express or implied legislative policies . . . [however,] an administrative agency may not, under the guise of interpretation, extend a statute to give it a greater effect than its language permits."). Courts have also "recognized" Taxation as having "expertise, particularly in specialized and complex areas of" the tax laws, and while not a "total . . . deference," Taxation's "interpretation will prevail as long as it is not plainly unreasonable." Koch v. Dir., Div. of Taxation, 157 N.J. 1, 8 (1999) (citation and internal quotation marks omitted).

Zero deference is also inappropriate because the "shall not apply" language in the Royalty U-E-T-A statute is contingent upon Taxation's discretionary determination. See Kraft Foods Global, Inc. v. Dir., Div. of Taxation, 29 N.J. Tax 224, 239 (Tax 2016) (plain language of the Interest U-E-T-A statute shows that "the Legislature intended to delegate to [Taxation] . . . in the first instance the authority to evaluate the [taxpayer's] evidence . . . and to determine whether it would be unreasonable to deny an exception," therefore, Taxation's determinations are entitled to deference); Morgan Stanley & Co. Inc. v. Dir., Div. of Taxation, 28 N.J. Tax 197, 220 (Tax 2014) (providing, as non-exhaustive examples, circumstances likely to establish unreasonableness, some

if not many of which could involve a fact-sensitive inquiry and an exercise of Taxation's discretion).[9]

Parent's argument that the difference in wording of the Interest U-E-T-A statute and the Royalty U-E-T-A law (a "deduction is permitted" in the former, as opposed to an exception "shall not apply" in the latter) evidences lack of any discretion in the latter is unavailing. The legislative history shows that the proposed law intended to close a tax loophole by a "[d]isallowance of deduction for intangible expenses paid to a related party" and a "[d]isallowance of deduction for interest paid to a related party," unless such a "disallowance" would be unreasonable. See Assembly Budget Comm. Statement to Assembly No. 2501 at 2. Thus, there was no evidence of any legislative intent to deprive or limit Taxation's authority in exercising discretion in disallowing a royalty expense.

Consequently, the court rejects Parent's overly broad argument that an interpretation of the Royalty U-E-T-A statute is always a purely legal exercise and the court need not afford any deference to Taxation. Rather, Taxation is not limited in its authority to use discretion for achieving a fair measure of justice, and examination of the exercise of such discretion should be on a case-by-case basis.

(2) Application of the Royalty U-E-T-A Regulation to Parent

The purpose of the Royalty U-E-T-A regulation is avoidance of double taxation. See 35 N.J.R. 1573(a) (April 7, 2003) (proposed regulation allows a "deduction" of intangible costs or interest expenses paid to related members "if disallowance would be unreasonable since the payee

[9] Although the rulings in Morgan Stanley and Kraft Foods involved the Interest U-E-T-A statute, they apply here since that statute is almost identical to the Royalty U-E-T-A statute (except that in the former, a payor is permitted a deduction "to the extent" it establishes such unreasonableness), see N.J.S.A. 54:10A-4(k)(2)(I), and further because the BTRA's legislative history had the same underlying concerns of income shifting among related members in either expense scenario.

paid tax to New Jersey on the same income stream" and Taxation's regulations attempts to address equitable concerns of double taxation and income distortion); 35 N.J.R. 4310 (a) (Sep. 15, 2003) ("Exception 2" of Schedule G "implements a discretionary exception to prevent the double payment of tax"). It cannot be credibly argued that allowing relief from dual taxation is an invalid exercise of Taxation's discretion. See, e.g., Morgan Stanley, 28 N.J. Tax at 220 (one example of unreasonableness under the Interest U-E-T-A statute would be "unfair double taxation"). Parent also does not dispute that the basis for its expedited demand for a portion of the refund claimed, and its repayment by Taxation, was double payment of CBT on the royalty amount which Parent claimed as a deduction, and which Subsidiary included as its New Jersey allocated income.

The Royalty U-E-T-A regulation states that an addback is not required "to the extent that the payee pays tax to New Jersey on the income stream." While the phrase "on the income stream" is undefined, the allusion in the regulatory history to the terms "same income stream" and "corresponding deduction," would seemingly mean that the royalty expense deduction of the payor should generate a corresponding royalty income in the same amount to the payee, consequently, the deduction amount on the payor's CBT return would match the income amount on the payee's CBT return. This interpretation makes sense because the BTRA sought to deny a deduction for amounts which are exported to another related member as the latter's income, and which income was not being taxed by New Jersey although it was earned by employing the latter's assets in New Jersey, and by exploiting New Jersey markets.

However, there is nothing in the Royalty U-E-T-A regulation to indicate that even if the amounts reported by each the payor and the payee are identical, the addback would only be partial. Rather, the plain language of the Royalty U-E-T-A regulation indicates that as long as the royalty recipient pays CBT to New Jersey on the royalty income, an addback is not required for the royalty

payor. It is only after completion of the computation on Schedule G-2 (which is not incorporated into or referenced in the Royalty U-E-T-A regulation although alluded to in the regulatory history), is it known that unless the royalty recipient (related member) pays 9% CBT on the entire royalty deduction amount, the royalty payor will not receive a full deduction for the same. Taxation argues that this is reasonable because (1) the deduction amount must match the royalty income amount; (2) there is double taxation only if the CBT paid is on an amount that matches the deduction amount; (3) here, there is no expense-income matching because Parent's allocated royalty expense is greater than Subsidiary's allocated income; (4) Taxation refunded the amounts of dual tax to Parent; and (5) allowing a full deduction will frustrate the BTRA's intent.

Taxation is correct that the court must balance the regulatory relief from double taxation, with the legislative intent underlying the disallowance for royalty deduction by a related member entity. That intent was to prevent income shifting (or exporting income from New Jersey to elsewhere) and tax avoidance. As noted:

> The [CBT] does not reach some out-of-state companies that do business here. Instead, these companies are able to take advantage of the state's lucrative market, extensive infrastructure, and geographic prominence, while paying no corporate taxes to New Jersey . . . . [The BTRA] closes numerous loopholes that allow profitable companies to reduce their net New Jersey income on paper and avoid their true tax liability and avoid paying their fair share . . . .
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> [Statement to Assembly 2501.]

See also 35 N.J.R. 1573(a) (The BTRA "was designed to prevent income shifting by multi-state taxpayers," such as where intangibles owned by a "holding company in a low tax or no tax state, [are] license[d] . . . back to its New Jersey . . . subsidiary," which would deduct "royalty payments") (citing to certain cases from Massachusetts). To this extent then, an addback is required if the transaction generating the expense controvert the goals of the BTRA. See Senate

Budget & Approp. Comm. Statement to Senate No. 1556 at 3 (". . . [a]s with the similar provision for intangible costs, the disallowance [of an interest deduction] is unreasonable if it would violate the policy goals of the disallowance."). Thus, if a claimed deduction, or even a portion of the same, would frustrate or defeat the underlying goals and intent of the BTRA, then it could, and should be disallowed. Therefore, if there is evidence that the royalty payor is still exporting its income from New Jersey to an out-of-state related member which is in a zero or "low tax" state, with the related member (royalty recipient) claiming immunity from being subject to the CBT, then, exceptions from the addback need not automatically be permitted.

However, where, as here, Subsidiary, the out-of-State related member and royalty recipient, admits to New Jersey's jurisdiction, files CBT returns, and reports royalty income that corresponds to the amount claimed by Parent as a deduction, the loophole closure sought by the BTRA is achieved. It appears undisputed that Subsidiary reported as its ENI, all of the royalty payments claimed as a deduction by Parent for each tax year. See supra n.7 (Subsidiary's reported federal taxable income included royalty income which closely matched Parent's royalty deduction amounts). It is undisputed that Subsidiary paid CBT on the royalty income allocated to New Jersey. At this point, then, the legislative concerns of income shifting, or exporting income tax-free out of New Jersey, should conceivably be allayed.

It is true that Royalty Addback statute does not have the same subject-to-tax provision as the Interest Addback statute. See N.J.S.A. 54:10A-4(k)(2)(I) (allowing deduction of interest paid to a related member provided, among others, the related member have been subject to tax on that interest income, at an effective tax rate of at least 6%, which measure of tax includes the interest income). This however, does not automatically permit an inference that the 9% CBT must be collected on the entire amount of the royalty deduction claimed for the Royalty U-E-T-A statute

to apply. See, e.g., Senate Budget & Approp. Comm. Statement to Senate No. 1556 3 (Taxation can enter into agreements "with the taxpayer to produce an equitable level of taxation") (emphasis added).

What is of more concern to the court here is that the alleged mismatch of the allocated royalty expense versus royalty income arises solely due to differing allocation factors of Parent and Subsidiary respectively. The BTRA's concerns arose because New Jersey, as a separate reporting State, allowed members to move income earned in and allocable to New Jersey (by claiming deduction of certain expenses and reducing the ENI, thus, the CBT), to a state where that same New Jersey-sourced, but non-taxed income would also be non-taxed to the royalty recipient related member under that state's tax laws. Here, however, Subsidiary, the royalty recipient related member, complied with the requirements of separate reporting by filing its own CBT returns, and paying CBT, and using its own allocation factor.[10] Under such a circumstance, Taxation cannot, without more, credibly maintain that Parent and Subsidiary's allocation factor should be the same for Parent to obtain a deduction of the full amount of royalties paid.

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[10] "[S]eparate reporting states . . . calculate the taxable income and apportionment percentage of each corporate affiliate doing business within the state as if those affiliates were unrelated persons." Bret N. Bogenschneider & Ruth Heilmeier, Google's "Alphabet Soup" in Delaware, 16 Houston Bus. & Tax L.J. 1, 14-15 (2016). This is "[i]n contrast to a typical combined report, in which the business income of members of a unitary group is combined, intercompany transactions are eliminated, and the combined business income is apportioned among the states based on group-level apportionment percentages." Id. at 15, n.35. See also Marjorie Gell, How Should Business Income From Unitary Flow-Through Businesses Be Apportioned Under the Michigan Individual Income Tax Act?, 38 Mich. Tax L. 5, 5 (Winter 2013) (". . . separate reporting . . . would require applying apportionment factors at the entity level and then allocating the entity-level result to the taxpayer.").

Note that of the six states in which Subsidiary filed tax returns, see supra n.6, North Carolina, South Carolina, Florida, Iowa, and Massachusetts are separate reporting jurisdictions such as New Jersey. See Bogenschneider & Heilmeier, 16 Houston Bus. & Tax L.J. at 42-43 (providing a list of states which are separate reporting jurisdictions). Florida, Oklahoma, and South Carolina have no addback statutes. Ibid.

Moreover, the purpose of the allocation factor, utilizing a typically accepted three-factor formula using property, payroll and receipts/sales, is that it fairly reflects a corporation's "share of the activities by which value is generated" and avoids large income allocation "distortions." Container Corp. of Am. v. Franchise Tax Bd., 463 U.S. 159, 183 (1983); Metromedia, Inc. v. Dir., Div. of Taxation, 97 N.J. 313, 322-323 (1984) (noting that the three-factor allocation formula applicable to the "net income tax bases" ensures that "only those portions of . . . net income . . . that are fairly attributable to the corporation's activities in New Jersey are used in the measure of the tax" and as averaged are "applied to the taxpayer's . . . net income . . .to determine the . . . portion of . . . net income properly attributable, and thus taxable, to New Jersey."). Allocation of multi-state income is thus a legally required consequence of, and pre-requisite to, its taxability.

However, "even the three-factor formula is necessarily imperfect," and income allocation is akin "to slicing a shadow," thus, "absolute consistency, even among taxing authorities whose basic approach to the task is quite similar" is impractical. Container Corp. of Am., 463 U.S. at 183, 192. See also Metromedia, 97 N.J. at 323 ("It is the implicit premise of the [CBT] Act that the statutory three-ply formula can only approximate the taxpayer's true net worth and income generated by its New Jersey activities."). Consequently, it is not necessarily surprising that related members will not have the same allocation factors.

Therefore, when parity in each entity's allocation factor is not realistic, and since the basis for allocation is to prevent unfair double taxation, Taxation cannot expect Parent and Subsidiary to have identical allocation factors when each is treated as a separate entity under the separate reporting regime. Consequently, Taxation's claim that the BTRA's goal is frustrated because Subsidiary's allocated royalty income does not match Parent's royalty deduction solely due to the

difference in their respective allocation factors, is not persuasive grounds for requiring a portion of the royalty deduction be added back.

Indeed, the BTRA recognized that the addback could cause economic distortion or other inequity in valid, non-tax avoidance situations. This is why it allowed for compromises or agreements as to apportionment, and also vested authority with Taxation to make adjustments under N.J.S.A. 54:10A-8 ("Section 8") to allow for equitable apportionment and consequent taxation. See N.J.S.A. 54:10A-4.4(c)(1)(c); 4.4(d). See also F.W. Woolworth Co. v. Dir., Div. of Taxation, 45 N.J. 466, 497, 499 (1965) (Taxation is obligated to consider Section 8 adjustments because "taxation of multi-state businesses should be administered on a basis which is equitable, and not merely constitutional, to the corporate taxpayer as well as to the State."). Nothing of that sort was even attempted here. To the contrary, Taxation accepted Subsidiary's allocation factor for each tax year. See Lorillard, 28 N.J. Tax at 596 (Taxation reviewed Subsidiary's CBT returns "for all other issues and elected to make no further adjustments to Subsidiary's CBT obligations.").

Absent from Taxation is any explanation why either Parent or Subsidiary's allocation factor is suspect vis-à-vis the concerns underlying the BTRA. Also absent is an allegation that Parent must provide some other "clear and convincing evidence" even if the Royalty U-E-T-A regulation deems unreasonableness of the addback as being established by proof of CBT payment on the royalty income by the Subsidiary royalty recipient. Also absent is a claim that Subsidiary's reporting and tax payments on the royalty deduction amounts in North Carolina and other States is not clear and convincing evidence. Equally absent is any argument that Subsidiary's CBT payments, and its reporting of the royalties as income to New Jersey and other states are facts which are completely irrelevant in the "unreasonableness" inquiry. Under all these circumstances, Taxation's determination to deny a portion of Parent's refund claims is not well-founded.

Through use of an addback, "though the taxing authority does not directly pursue the out-of-state [Intellectual Property] holding company, the result is the same: Apportioned royalty income is subject to state taxation**.**" Xuan-Thao N. Nguyen, Holding Intellectual Property, 39 Ga. L. Rev. 1155, 1192-1194 & n.198 (Summer 2005). Here, Subsidiary included in its income base, the royalty payments from Parent, and paid CBT to New Jersey under its allocation factor. In the absence of any allegations that Subsidiary's allocation factor does not properly represent its allocable income to New Jersey, the court is hard pressed to accept Taxation's argument that there was a mismatch of income and expense solely due to the difference in the unchallenged allocation factors of Parent and Subsidiary. Therefore, Taxation did not exercise its discretion fairly by deeming only a portion of the royalties paid by Parent to Subsidiary as excepted from addback.

CONCLUSION

For the aforementioned reasons, and under the facts presented here, the court grants summary judgment to Parent. Taxation should issue the remainder of Parent's refund claims for tax years 2002-2005, with the statutorily permitted interest. In light of this relief, the court finds it unnecessary to address Parent's constitutional attacks on the Royalty U-E-T-A regulation.[11]

[11] Parent filed another complaint, Docket No. 014043-2012, against Taxation's refund denial for 2008-2010, and on the same basis as here, namely, Parent could not file "protective refund claims" but could file claims after the court had decided Subsidiary's separate appeal. Parent left it to the "court's discretion whether" to consolidate the matters or deem the court's decision herein to be "the law of the case" for purposes of disposing the 2012 complaint. Taxation vehemently objected to this suggestion. The court did not consolidate the matters.