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APPENDIX A

State of New York
Court of Appeals

OPINION

This opinion is uncorrected
and subject to revision before
publication in the New York Reports.

No. 34
In the Matter of Walt Disney
Company and Consolidated
Subsidiaries,

Appellant,

v.

Tax Appeals Tribunal of the State
of New York et al.,

Respondents.

No. 35
In the Matter of International
Business Machines Corporation &
Combined Affiliates,

Appellant,

v.

Tax Appeals Tribunal of the State
of New York et al.,

Respondents.

Case No. 34:

Marc A. Simonetti, for appellant.

Frederick A. Brodie, for respondents.

Institute for Professionals in Taxation, amicus curiae.

Case No. 35:

Jeffrey A. Friedman, for appellant.

Frederick A. Brodie, for respondents.

CANNATARO, J.:

Under a taxation scheme in effect from 2003 through 2013, New York allowed corporations that paid franchise taxes in New York to deduct income received as royalty payments from members of the same corporate group, or family, in calculating their taxable income. The deduction was allowed only if the royalty payment came from a related entity that had already paid a New York tax on the same income through operation of another provision in the Tax Law that required companies to add back royalty payments made to related entities for the purposes of calculating their own taxable income.

In these cases, the state Department of Taxation and Finance determined that appellants improperly deducted royalty payments they received from affiliates in foreign countries that were not subject to New York franchise taxes and, so, were not required to add those payments back on a New York tax return. Appellants challenge the Tribunal's denial of the deduction as being contrary to the clear language of the statute and as violating the Commerce Clause's prohibition on discrimination against foreign commerce. Because the Appellate Division correctly interpreted the statutes as permitting a tax deduction only where a related subsidiary was subject to the add back requirement, and because any burden on interstate or foreign commerce created by this tax scheme was incidental and did not violate the dormant Commerce Clause, we affirm.[1]

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[1] We note that the subject tax scheme was repealed over a decade ago and so our holding today has no direct applicability to the

I.

Corporations that do business in New York must pay an annual franchise tax (Tax Law article 9-A). During the years in question, corporations reported their article 9-A tax liability based on the greatest of four alternative bases, the most common of which was "entire net income" (ENI) allocated to New York (former Tax Law § 210 [1] [a]). At that time, ENI generally consisted of the taxpayer's entire federal taxable income (FTI) with statutorily enumerated modifications that either added to or subtracted from the federal taxable income (*see id.* § 208 [9]). The portion of a company's ENI that was taxable in New York was determined using the business allocation percentage (BAP) (*id.* § 210 [3] [a], [b]). The BAP was determined by, among other things, comparing a taxpayer's business receipts from New York to its total business receipts from all sources (including related-member royalties) (*id.* § 210 [3] [a] [2]). For the purposes of BAP calculation, receipts from intangibles such as royalties on intellectual property (IP) were allocated to the jurisdiction in which the IP was used (*see id.* § 210 [3] [a] [2] [C]; *see also* former 20 NYCRR 4-4.6).

Prior to passage of the subject tax scheme in 2003, royalty receipts were included in all taxpayers' ENI. Large multinational conglomerates regularly avoided state taxes on income derived from intellectual property (IP). For example, a parent corporation [2]

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current scheme for taxing royalty payments between related entities.

[2] The terms "parent" and "subsidiary" are used throughout to describe related corporate entities for clarity and ease of

would transfer its IP assets to a subsidiary holding company located in a jurisdiction that had little or no tax on income from intangible assets. The subsidiary would, in turn, license the IP back to the parent in exchange for royalty payments, which were typically excluded from the parent company's FTI as deductible business expenses. The foreign subsidiary would not file a tax return in New York, and the royalty income would therefore not be included on any New York return.

Seeking to capture taxes on IP income, New York enacted former Tax Law § 208 (9) (o) which, among other things, created a process for taxing royalty payments between related entities. The express purpose of that process was to "eliminate tax loopholes concerning royalty payments" (Senate Introducer's Mem in Support, Bill Jacket, L 2003, ch 686 at 9). In furtherance of that purpose, subsection two provided that "[f]or the purpose of computing [ENI] or other applicable taxable basis, a taxpayer must add back royalty payments to a related member during the taxable year to the extent deductible in calculating federal taxable income" (former Tax Law § 208 [9] [o] [2] [A]).

Subparagraph (3) provided:

> "For the purpose of computing entire net income or other taxable basis, a taxpayer shall be allowed to deduct royalty payments

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description, however, for purposes of the Tax Law it is sufficient that the payor and payee entities are related through common ownership (see, former Tax Law § § 208 [9] [o] [1] [A]; 208 [9] [o] [1] [B]). The parent/subsidiary distinction is not essential to the statutory or constitutional analysis.

> directly or indirectly received from a related member during the taxable year to the extent included in the taxpayer's federal taxable income unless such royalty payments would not be required to be added back under subparagraph two of this paragraph or other similar provision in this chapter" (former Tax Law § 208 [9] [o] [3]).

These two provisions, working in concert, imposed a state tax on income used for royalty payments made to a related entity that might otherwise be tax deductible under the former taxing regime, but allowed the receiving entity to deduct those payments when calculating their New York State tax burden, thus avoiding companies including the same income on two different New York corporate tax returns.

The statute was further amended in 2007 to provide three exceptions to the add-back requirement (L 2007, ch 60, § 1, part J, § 4). First, no add back was required if the two companies were included in the same combined tax report[3] filed with New York State, as

[3] Under the then-existing law, any company that "own[ed] or control[led] either directly or indirectly substantially all the capital stock of one or more other corporations, or substantially all the capital stock of which is owned or controlled either directly or indirectly by one or more other corporations or by interests which owned or control either directly or indirectly substantially all the capital stock of one or more other corporations" were required to file a combined report covering those corporations if "there are substantial intercorporate transactions among the related corporations" (former Tax Law § 211 [4] [a]). It did not require a "corporation organized under the laws of a country other than the United States" to be included in a combined report *(id.* § 211 [4] [a] [5]).

there was no risk of evasion (former Tax Law § 208 [9] [o] [2] [A]). Similarly, no add back was required if the royalty was ultimately paid to a non-related company for a valid business purpose, as again there was no risk that such payments would be used to avoid taxation (*see id.* § 208 [9] [o] [2] [B] [i]). Finally, an add back was not required if the related member making the royalty payment was organized under the laws of a foreign country with which the United States had a tax treaty ensuring that the royalty payments would be taxed "at a rate at least equal to that imposed by" New York (*id.* § 208 [9] [2] [B] [ii]). If a company was exempted from the add back requirement due to an enumerated statutory exclusion "or other similar provision", it could not take advantage of the royalty tax exclusion contained in subparagraph (3) (former Tax Law § 208 [9] [o] [3]).

II.

A. *Walt Disney Company v Tax Appeals Tribunal*

The Walt Disney Company (Disney) is a multinational, diversified entertainment conglomerate organized under the laws of Delaware. Part of Disney's business includes the development, ownership, and exploitation of IP assets through licensing to subsidiaries both domestically and internationally. Within the United States, Disney and its related entities filed a combined tax return in New York which, as laid out above, is an enumerated exception to the "add back" requirements of former Tax Law § 208 (9) (o) (2). Internationally, Disney's foreign subsidiaries were each party to licensing agreements under which they were permitted to exploit Disney's IP in exchange for royalty payments.

The record contains no indication as to whether Disney or its subsidiaries paid any taxes on this income in these foreign jurisdictions.

From 2008 to 2010, Disney paid taxes on the portion of its income allocatable to New York business activity, which represented between 5% and 6% of its total taxable income for the years at issue.[4] During those years Disney received royalty payments totaling $5,440,787,188 from foreign affiliates. For the 2009 and 2010 tax years, Disney deducted royalty payments received from all its foreign subsidiaries from its taxable income. Thereafter it filed an amended tax return for 2008 seeking a refund for foreign royalty income. Disney was audited by the Tax Department, which denied its refund request and issued a notice of deficiency in the amount of $3,995,551.

B. *IBM v Tax Appeals Tribunal*

International Business Machines Corporation (IBM) is a multinational technology and consulting company organized under the laws of New York. IBM operates in more than 170 countries worldwide, primarily through locally incorporated subsidiaries. The subsidiary responsible for international operations is IBM World Trade Corporation (WTC), a Delaware corporation headquartered in New York. IBM transferred the entirety of its foreign assets to WTC and granted it a non-exclusive license to use certain IP.

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[4] Both Disney and IBM's corporate tax in New York were determined via an allocation formula. Effectively, a corporation's total receipts in New York were divided by their total receipts globally to determine how much business was fairly attributable to New York. A tax was then assessed on only that portion of the corporation's taxable income.

The various foreign subsidiaries paid royalties to either IBM or WTC for use and distribution rights to IBM's software, hardware, and for the right to provide services related to IBM products.

From 2007 to 2012, IBM and its US subsidiaries filed combined returns in New York, avoiding the need to add back any royalty payments. IBM paid the franchise tax on its New York-portion of its taxable income, which was about 5% of its total income for the years at issue. During that time, IBM received a total of $50,682,369,689 in royalty payments from its foreign subsidiaries. As with Disney, there is no indication in the record that any foreign taxing authority required any of IBM's foreign subsidiaries to add back the royalty payments made to either IBM or WTC, or any evidence as to any tax liabilities imposed on its subsidiaries. IBM took deductions for royalty payments received from its subsidiaries for the 2011 and 2012 tax years, and subsequently requested refunds for taxes paid on that income for the years 2007 through 2010. In response the Tax Department audited IBM, denied its refund requests, and issued a notice of deficiency for the 2010 to 2012 tax years, as well as interest charges and penalties.

C. *Administrative Proceedings*

After deficiencies were assessed, both corporations challenged the denial of their royalty tax deductions and the notices of deficiency with the New York State Division of Tax Appeals. In each case, following a hearing, an Administrative Law Judge (ALJ) determined that, under the plain meaning of the statute, the deduction authorized under former Tax Law § 208 (9) (o) (3) only applied where the royalty

came from a subsidiary that had been subjected to the add back requirement contained in subsection two. The ALJs opined that the deduction did not discriminate against out-of-state interests as it was only permitted after a related company had already paid an in-state tax. Thus, the ALJs denied the petitions and sustained the notices of deficiency. The Tax Appeals Tribunal (Tribunal) subsequently affirmed both decisions.

Appellants challenged these determinations by commencing CPLR article 78 proceedings in the Appellate Division. The Appellate Division affirmed the determinations and dismissed the petitions, holding in separate decisions that the plain meaning of the statute supported the Tribunal's decision and that there was no differential treatment between in-state and out-of-state commerce (*see Matter of Walt Disney Co. & Consol. Subsidiaries v Tax Appeals Trib. of the State of N.Y.*, 210 AD3d 86, 89-92 [3d Dept 2022]; *Matter of International Bus. Machs. Corp. & Combined Affiliates v Tax Appeals Trib. of the State of N.Y.*, 214 AD3d 1125, 1126 [3d Dept 2023]). Appellants appealed to this Court as of right pursuant to CPLR 5601 (b) (1).

III.

Contrary to appellants' contentions, the Tribunal properly interpreted the statute. This Court's "cardinal function in interpreting any statute should be to attempt to effectuate the intent of the Legislature, and where the statutory language is clear and unambiguous, the court should construe it so as to give effect to the plain meaning of the words used" (*Matter of 1605 Book Ctr. v Tax Appeals Trib. of State of N.Y.*,

83 NY2d 240, 244 [1994], *quoting Doctors Council v New York City Employees' Retirement Sys.*, 71 NY2d 669, 674-675 [1988]). The plain meaning of the statutory language is clear: "[A] taxpayer shall be allowed to deduct royalty payments directly or indirectly received from a related member during the taxable year to the extent included in the taxpayer's federal taxable income unless such royalty payments would not be required to be added back under subparagraph two of this *paragraph or other similar provision in this chapter*" (former Tax Law § 208 [9] [o] [3] [emphasis added]). By its plain terms, the statute allows parent taxpayers to deduct royalty income only if that money had already been included on a New York tax return through an add back to the subsidiary's income.

Although the statute provides that a deduction will not be granted if one of the statutory exceptions to the add back requirement applies, it goes on to state that the deduction will not be permitted if an add back is not required under a "similar provision" in the chapter. Given that the operative language applies only to "corporations subject to tax under this article," i.e., corporations subject to tax in New York, the deduction was clearly only available to corporations receiving royalties from related entities who were subject to the add back, not those that would be subject to the addback if they were they subject to New York taxes, as appellants suggest.

Even if the statute were not clear on its face, which it is, we consider the objectives sought to be achieved by the legislature (*see Matter of Petterson v Daystrom Corp.*, 17 NY2d 32, 38 [1966]). Notwithstanding that ambiguities in tax statutes should "be construed in

favor of the taxpayer and against the taxing authority" (*Quotron Sys. v Gallman*, 39 NY2d 428, 431 [1976]), our main goal is to "give a correct, fair and practical construction that properly accords with the discernible intention and expression of the Legislature" (*1605 Book Ctr.* 83 NY2d at 244-245). In enacting the deduction and add back scheme at issue here, the legislature was attempting to close a loophole by which international corporate groups avoided paying state taxes on royalty payments between related members of the corporate group (*see* Senate Introducer's Mem in Support at 5, Bill Jacket, L 2003, ch 686 at 9).

Appellants' proposed interpretation of the law would not accomplish this goal, and in fact would result in the opposite outcome. Corporate families with subsidiaries out of state would be permitted to take a tax deduction without first paying a New York tax on the royalty money. By simply domiciling their subsidiaries outside New York, corporate groups would be able to perpetuate the very same tax loophole the challenged legislation seeks to avoid. Although counsel for Disney suggests that the legislature actually intended this incongruous result, neither appellant points to any authority supporting this interpretation. As both the plain language and the explicit legislative purpose behind the statute support the Tribunal's interpretation, we see no reason to disturb that determination.

IV.

Appellants argue that this construction of former Tax Law § 208 (9) (o) facially violates the dormant Commerce Clause. They must therefore "surmount the presumption of constitutionality accorded to

legislative enactments by proof beyond a reasonable doubt" (*Matter of Moran Towing Corp. v Urbach*, 99 NY2d 443, 448 [2003] [internal quotation marks omitted]). To do so, they bear "the substantial burden of demonstrating that in any degree and in every conceivable application, the law suffers wholesale constitutional impairment. In other words, [appellants] must establish that no set of circumstances exists under which the [law] would be valid" (*id.* [internal quotation marks and citation omitted]). The Commerce Clause of the United States Constitution provides that "Congress shall have Power . . . [t]o regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes" (US Const, art I, § 8 [3]). Although "phrased as a grant of regulatory power to Congress," the Commerce Clause "has also been interpreted as effecting a 'negative aspect that denies the States the power unjustifiably to discriminate against or burden the interstate flow of articles of commerce' " (*American Tel. & Tel. Co. v New York State Dept. of Taxation & Fin.*, 84 NY2d 31, 34 [1994] [internal quotation marks omitted], quoting *Oregon Waste Systems, Inc. v Department of Environmental Quality of Ore.*, 511 US 93, 98 [1994]), including "prohibiting certain state taxation even when Congress has failed to legislate on the subject" (*Oklahoma Tax Commn v Jefferson Lines, Inc.*, 514 US 175, 179 [1995]). Indeed, the dormant Commerce Clause precludes states from "discriminating between transactions on the basis of some interstate element" (*Boston Stock Exchange v State Tax Commn,* 429 US 318, 332 n 12 [1977]), meaning that states "may not tax a transaction or incident more heavily when it crosses state lines than

when it occurs entirely within the state" (*Armco Inc. v Hardesty*, 467 US 638, 642 [1984]) or "impose a tax which . . . provid[es] a direct commercial advantage to local business, or . . . subject[s] interstate commerce to the burden of 'multiple taxation' " (*Northwestern States Portland Cement Co. v Minnesota*, 358 US 450, 458 [1959]).

Generally, to withstand a challenge under the so-called dormant Commerce Clause, a state tax (1) must be "applied to an activity with a substantial nexus with the taxing State," (2) must be "fairly apportioned," meaning internally and externally consistent, (3) may not discriminate against cross-border commerce and (4) must be "fairly related to the services provided by the State" (*Complete Auto Transit, Inc. v Brady*, 430 US 274, 279 [1977]; *see e.g. Westinghouse Elec. Corp. v Tully*, 466 US 388, 402 [1984]; *Matter of Zelinsky v Tax Appeals Trib. of State of N.Y.*, 1 NY3d 85, 90 [2003], *cert denied* 541 US 1009 [2004]). With regard to foreign commerce, the United States Supreme Court has identified two additional prongs: "first, whether the tax, notwithstanding apportionment, creates a substantial risk of international multiple taxation, and, second, whether the tax prevents the Federal Government from speaking with one voice when regulating commercial relations with foreign governments" (*Japan Line, Ltd. v County of Los Angeles*, 441 US 434, 451 [1979] [internal quotation marks omitted]). "[A] proper [dormant Commerce Clause] analysis must take the whole scheme of taxation into account" (*Halliburton Oil Well Cementing Co. v Reily*, 373 US 64, 69 [1963]). Appellants' narrow argument is that former Tax Law § 208 (9) (o) fails the discrimination prong, because it

facially discriminates against out-of-state commerce, and does not pass the internal consistency test. Appellants have failed to meet their high burden to demonstrate such discrimination.

A.

With respect to the discrimination prong appellants have failed to show that the subject tax scheme is facially discriminatory against out-of-state commerce, that it in any way mandated "economic protectionism", or that it was a "regulatory measure[] designed to benefit in-state economic interests by burdening out-of-state competitors" (*National Pork Producers Council v Ross*, 548 US 356, 370 [2023]). At the corporate group level, Tax Law former § 208 (9) (o) treated groups with related members who did not pay taxes in New York the same as those with related members who did. The scheme (1) required payors of dividends to add back to their taxable income royalty payments to related corporate members that were deductible under federal law and (2) allowed recipients of royalty payments to deduct them from their taxable income unless the payor was not required to add them back to their taxable income. The result was a scheme where, if the payor was a New York taxpayer and no exceptions applied, the income used to make royalty payments only had to be included in the payor's taxable income. When a non-New York taxpayer made royalty payments to a New York taxpayer, that income had to be included in the payee's taxable income. In each case, the income only had to be included on a New York tax return once, resulting in a neutral economic impact on the corporate group as a whole. As is astutely noted by the concurrence, Tax Law former § 208 (9) (o) is not discriminatory

inasmuch as it "is not a measure that imposes benefits or burdens depending upon where a business is located, where goods are produced, or where payments are made" (concurring op at 2). Rather, "it is fundamentally a tax filing requirement (*id.*).

This case is distinguishable from cases in which the United States Supreme Court has found facial discrimination in a taxation scheme. In *Kraft*, the Court invalidated a tax scheme that allowed Iowa corporations to take a deduction from taxable income for dividends received from subsidiaries incorporated in Iowa, but not those incorporated elsewhere (*see* 505 US at 77). Unlike here, the *Iowa* scheme contained no add-back requirement. This meant that if the subsidiary paying the dividend was in Iowa, the corporate group faced no tax liability for the dividend, whereas if the subsidiary was incorporated abroad, the entire dividend was treated as income and taxable (*see id.*at 77-78). Similarly, in *Westinghouse*, the Supreme Court found a violation where a tax credit for a corporate parent increased when its subsidiary shipped goods from within New York and decreased when the subsidiary shipped goods outside the state (*see* 466 US at 400-01). By predicating the tax credit on the extent of a subsidiary's in-state export activities, it created a direct incentive to move business into New York, and therefore violated the dormant Commerce Clause by imposing a discriminatory burden on other states' commerce.

Helpful to our analysis is the New Hampshire Supreme Court's consideration of a virtually identical taxing scheme in *General Elec. Co., Inc. v Commissioner, N. H. Dept. of Revenue Admin.* (154 NH 457, 914 A2d 246 [2006], *cert denied* 552 US 989

[2007]). That Court rejected a constitutional challenge to New Hampshire's similar tax scheme because, viewed as a whole, the tax did not discriminate against commerce but rather sought to tax each corporate group one time. This "taxing symmetry" ensured that corporations were only paying state tax on subsidiary income once and, as such, there was no differential treatment between companies that received the deduction and those that did not. So too here, there is no differential treatment on the corporate group level and the challenged taxing scheme is thus not facially discriminatory.

B.

Nor does the challenged scheme violate the United States Supreme Court's internal consistency test, which instructs courts to assume the challenged tax scheme applies in every jurisdiction in order to determine if such application would inherently result in impermissible interference with the flow of commerce (*see Container Corp. of America v Franchise Tax Bd.*, 463 US 159, 169 [1983]).

> "By hypothetically assuming that every State has the same tax structure, the internal consistency test allows courts to isolate the effect of a defendant State's tax scheme. This is a virtue of the test because it allows courts to distinguish between (1) tax schemes that inherently discriminate against interstate commerce without regard to the tax policies of other States, and (2) tax schemes that create disparate incentives to engage in interstate commerce (and sometimes result in double taxation) only as

> a result of the interaction of two different but nondiscriminatory and internally consistent schemes. The first category of taxes is typically unconstitutional; the second is not" (*Comptroller of Treasury of Md. v Wynne*, 575 US 542, 562 [2015] [citations omitted]).

The tax here falls within the latter *Wynne* category. Even if every other jurisdiction applied the same tax scheme found in former Tax Law § 208 (9) (o), there would be no impermissible burden on interstate commerce. Subsidiaries that did not pay taxes in New York would be subject to a hypothetical foreign add-back requirement when making royalty payments and their New York taxpayer corporate parents would be entitled to a hypothetical deduction for the portion of taxes apportioned to that jurisdiction, but not a deduction in New York. In this scenario, because the intellectual property is being used in the foreign country, that income would not constitute New York business receipts, and therefore would not be allocated to New York for purposes of calculating the parent company's BAP. In other words, although the income would be added to the parent's total taxable income, it would result in a lower percentage of that total income subject to New York corporate tax.[5]

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[5] The reverse, of course, would be true for calculating a parent's franchise tax in a foreign jurisdiction. Any royalty payments received from New York subsidiaries would not be deductible from total income when calculating the foreign tax burden as the subsidiary would not have added back its income in the foreign jurisdiction. However, the addition of such income from IP used in New York would also necessarily reduce the corporation's income attributable to that jurisdiction.

Indeed, it appears that appellants' true objection is to the system of income apportionment itself, and that their objection to "double taxation" here is more properly viewed as a repackaged challenge to that method of taxation. They argue that because royalty payments from foreign subsidiaries were taxed by New York (in that they were added to the total taxable income for the corporate parent), the corporate group would suffer a "double tax" if a foreign jurisdiction also taxed the payment through an add back. But the central premise of this argument is flawed. Because the internal consistency test requires us to evaluate the "tax scheme as a whole," we must also take into account New York's aforementioned system of calculating the portion of total income taxable in New York. Under that system, the addition of foreign income to a corporate parent's total income is not equivalent to subjecting it to corporate taxation in New York.

In the realm of internal consistency, because of the system of allocation, relocating intellectual property to New York could increase, decrease, or have no effect on a company' total taxable income depending on factors entirely independent of the add back scheme. Rather, whether a corporate group faces a greater or lesser tax burden as a result of receiving foreign royalty payments will depend on the amount of such payments received as well as the percentage of their total income attributable to such receipts. "[T]he appropriate measure of discrimination is comparison of similar circumstances, and the circumstances chosen to illustrate [the discrimination] seem ordinary rather than extraordinary and likely rather than unlikely" (*Appeal of Morton Thiokol, inc.*, 254 Kan. 23,

37 [Kansas 1993]). Appellants have failed to show that, under the internal consistency test, the challenged tax necessarily discriminates against interstate commerce in its ordinary application. It is simply not sufficient to show that sometimes, in some situations, the conflicting laws may result in a greater tax (*see Moran Towing Corp*, 99 NY2d at 448).

On the contrary, it is well settled that, while not perfect, the apportionment of taxes does not violate the Commerce Clause (*see Shell Oil Co. v Iowa Dept. of Revenue*, 488 US 19, 30 [1988]; *Matter of Disney Enters. Inc. v Tax Appeals Trib. of State of N.Y.*, 10 NY3d 392, 400-401 [2008]; *Brady v State of New York*, 80 NY2d 596, 603 [1992]). "[W]hen apportioning a [corporate] group's in-state taxable income, a state may look beyond its borders and take into account income of companies not subject to its jurisdiction. . . In doing so, the state is not deemed to have taxed that income but instead to have used it to determine the tax base fairly attributable to the group as a whole" (*Matter of Disney Enters.*, 10 NY3d at 400 [citations omitted]). Regardless of what tax may be applied to royalty payments in a foreign jurisdiction, the mere inclusion of such payments to a parent company's total taxable income does not result in an unconstitutional burden on interstate commerce as with each additional foreign dollar added, the portion of that company's income attributable to New York State will decrease. And "although the total tax assessed in the end may not be exactly equal. . . the state's taxation methods need not apportion income perfectly; the Federal Constitution does not require mathematical exactitude, only a rough approximation" (*General Electric Co.*, 154 NH at 470 [internal quotation marks

and brackets omitted]; *accord Illinois Central R. Co. v Minnesota*, 309 US 157, 161 [1940]).

As New York's tax scheme would not result in duplicative taxation in all (or even most) situations, it is not inherently discriminatory. To the extent that duplicative taxation may sometimes occur, it is the incidental result of "the interaction of two different but nondiscriminatory and internally consistent schemes" (*Wynne*, 575 US at 562).

Accordingly, in each case, the judgment of the Appellate Division should be affirmed, with costs.

WILSON, Chief Judge (concurring):

Disney and IBM, petitioners here, have advanced two arguments: first, that former Tax Law section 208 (9) (o) (3) should not be interpreted as the Department of Taxation and Finance has interpreted it; and second, that under the Department's interpretation, the statute violated the Commerce Clause of the United States Constitution. I agree with the majority's (and the Department's) reading of the statute. I also agree that the statute does not violate the Commerce Clause, though for different reasons than those relied on by the majority.

The key to explaining why former Tax Law section 208 (9) (o) (3) does not offend the dormant Commerce Clause is to understand it for what it is and what it is not. It is not a measure that imposes benefits or burdens depending upon where a business is located, where goods are produced, or where payments are made. Instead, it is fundamentally a tax filing provision. The availability of the deduction depends on whether the subsidiary is a "New York taxpayer," not on whether the royalty payment or any aspect of the corporate group's business crosses jurisdictional lines (*Walt Disney Co. and Consol. Subsidiaries v Tax Appeals Trib.*, 210 AD3d 86, 90 [3d Dept 2022]). A transaction between two New York taxpayers, which petitioners label an "intrastate" transaction, may be between a French corporation and a Chinese subsidiary, so long as both related members file taxes in New York. A transaction between a New York taxpayer and a non-New York taxpayer, which petitioners label an "interstate" transaction, may be

between two Delaware entities, only one of which files taxes in New York.

As these examples illustrate, because former Tax Law section 208 (9) (o) (3) is purely a tax filing provision, it does not necessarily tax "a transaction or incident more heavily when it crosses state lines than when it occurs entirely within the State" (*Armco Inc. v Hardesty*, 467 US 638, 642 [1984]). Rather, it creates complex second-order incentives that sometimes favor and sometimes disfavor interstate business operations. By conflating the requirement that the subsidiary file tax in New York with a requirement that the subsidiary be incorporated in New York or make royalty payments here, petitioners fail to properly account for those incentives. When the statute is understood for what it is, "[n]either record evidence nor abstract logic makes clear whether the overall effect...would be to increase or to reduce existing financial disincentives to interstate travel" (*Comptroller of Treasury of Maryland v Wynne*, 575 US 542, 563 n 7 [2016] [citation omitted]). Therefore, petitioners have not shown that the statute violates the dormant Commerce Clause.

I.

Former Tax Law section 208 (9) (o) (3) states that:

> "For the purpose of computing entire net income or other taxable basis, a taxpayer shall be allowed to deduct royalty payments directly or indirectly received from a related member during the taxable year to the extent included in the taxpayer's federal taxable income unless such royalty payments would not be required to be added back under subparagraph two of this

paragraph or other similar provision in this chapter."

A royalty payment is "required to be added back under subparagraph two of this paragraph or other similar provision of this chapter" only if the payor is a New York taxpayer. If a payor corporation does not file a New York corporation franchise tax return, it is not required to do anything under subparagraph two or any provision of the chapter governing New York corporation franchise tax. And because such a payor would not be required to take the add-back, the recipient may not take the deduction.

Setting constitutional concerns aside, I agree with the majority that this is the most straightforward interpretation of the statute. The statutory scheme was enacted to address a tax loophole when royalties were paid by a NY-taxpaying parent to a subsidiary[1] in another jurisdiction which did not tax royalty income, thereby insulating the income from taxation. However, the reading advanced by petitioners would create a concomitant loophole when royalties are paid by a non-NY taxpaying subsidiary in a jurisdiction with no add-back to a NY-taxpaying parent. This is not what the legislature intended. Indeed, petitioners do not claim that the legislature intended to create the exemption conferred by the reading they offer.

Instead, they argue that the Tax Department's interpretation would facially discriminate against

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[1] Although I use "parent" and "subsidiary" because the parties here fit these labels, nothing turns on them. The scheme of deductions and addbacks in former Tax Law § 208 (9) (o) covered all "related members" without regard to parent or subsidiary status.

interstate commerce in violation of the dormant Commerce Clause of the United States Constitution (US Const, art I, § 8, cl 3). Therefore, petitioners contend that we should construe former Tax Law section 208 (9) (o) (3) as they propose, to avoid the proffered constitutional infirmity (*see Overstock.com, Inc. v New York State Dept. of Taxation and Fin.*, 20 NY3d 586, 593 [2013]; *H. Kauffman & Sons Saddlery Co. v Miller*, 298 NY 38, 44 [1948]). As explained below, I conclude that former Tax Law section 208 (9) (o) (3) does not violate the dormant Commerce Clause, and therefore I have no basis to construe the statute other than the way in which it plainly reads, just as the majority and the Department have read it.

II.

At issue in these appeals are royalty payments made by affiliates to their ultimate corporate parents for use of intellectual property owned by the parent. As the Tax Department has consistently maintained and the Third Department reaffirmed, the availability of the deduction for such payments turns on whether the royalty payor (affiliate) is a "New York taxpayer[]" (*Walt Disney Co.*, 210 AD3d at 90). If the royalty payor files a New York corporation franchise tax return (regardless of where the payor is located), it is required to take the add-back and therefore the deduction becomes available to the recipient (parent). If the royalty payor does not file such a return, it is not required to take the add-back and therefore no deduction is available to the recipient.

Although that rule is quite clear, petitioners have misapprehended it. A "New York taxpayer" is not the same as a corporation domiciled in New York, nor is it

the same as a company that receives royalty payments in New York or does business in New York. It is merely a corporation that files a tax return in New York.

Thus, for a parent corporation to receive the deduction, the subsidiary need only file a New York tax return. Because petitioners have brought a facial challenge, they bear the burden to "establish that no set of circumstances exists under which the Act would be valid" (*United States v Salerno*, 481 US 739, 745 [1987]). However, the record here fails to show that IBM and Disney could not have obtained the deduction they seek, because the record does not contain any indication of whether their foreign payor subsidiaries filed or attempted to file New York tax returns. Petitioners have never even asserted that their foreign payor subsidiaries could not have filed tax returns in New York, or that some untoward consequence would befall them if they had done so. If their subsidiaries had taken the add-back on New York tax returns, each parent could have claimed the deduction without changing anything about the corporate group's business operations. Although almost all would agree that filing tax returns is burdensome, it is not the sort of burden that violates the Commerce Clause—and no party contends that it would.

The statutory provisions discussed by petitioners do not suggest that the payor subsidiaries were barred from filing their own New York tax returns. Even were we to examine provisions never mentioned by petitioners, the issue is not obviously resolved. The statute governing corporate taxation does not speak in terms of which corporations are permitted to file tax returns, but rather in terms of which corporations are

required to do so (*see* former Tax Law § 209). In the most general possible terms, a corporation is required to pay franchise tax if it is "doing business" in New York state (*see id.* [1] [requiring a corporation to file a tax return "[f]or the privilege of exercising its corporate franchise, or of doing business, or of employing capital, or of owning or leasing property in this state in a corporate or organized capacity, or of maintaining an office in this state"]); *Wurlitzer Co. v State Tax Commn.*, 35 NY2d 100, 104 [1974]). The record at least implies that Disney and IBM's foreign payor subsidiaries did not do business in New York during the relevant period, and therefore were not required to file a corporate tax return.

However, that does not mean that they were not *allowed* to file such a return. Whether a company that does no business in New York could file a corporate franchise tax return in order to achieve a tax deduction for a related member is a novel question, but nothing in the record suggests that any payor affiliate of Disney or IBM ever sought to do so or even inquired about doing so as a way to permit the corporate parent to take the deduction. Although we can imagine arguments against a subsidiary's ability to claim the add-back on a New York franchise tax return, [2] petitioners have not raised any such arguments or

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[2] Former Tax Law § 208 (3) defines "taxpayer as "any corporation subject to tax under this article." Tax Law § 209 at some points uses "subject to tax" as a synonym for "required to pay tax" (*see* former Tax Law § 209 [4] [certain corporations liable to tax under other sections are not "subject to tax under this article"]). It is possible that a corporation that is not "subject to tax" would not be a "New York taxpayer" able to claim the royalty addback under former Tax Law § 208 (9) (o) (3).

shown on this record that former Tax Law section 208 (9) (o) (3) created anything more than an administrative burden.

For that reason, both appeals fail. If the payor subsidiaries could have filed New York corporate tax returns, which would have required those subsidiaries to "add back royalty payments to a related member" (former Tax Law § 208 [9] [o] [2]), petitioners have no case, because the parents could have then taken the deduction on their tax returns and would have been treated exactly the same as a New York parent corporation with a New York subsidiary. Because petitioners have not even attempted to demonstrate that they could not have obtained the deduction they seek by merely having their affiliated foreign payors file a New York tax return, there is no basis on which to hold former Tax Law section 208 (9) (o) unconstitutional.

III.

For the sake of argument, though, let us assume that the Department would not have allowed Disney and IBM's foreign payor subsidiaries to file New York tax returns even if they had tried, presumably because they do not do business here. On that assumption, Disney and IBM's Commerce Clause arguments still fail.

Disney and IBM have often conflated the "New York taxpayer" requirement with a requirement that the subsidiary be domiciled here or receive royalty payments here. However, there is plainly no requirement that a corporation must be domiciled in New York or make or receive royalty payments from or in New York to be required to file a New York

corporate tax return. A corporation that transacts business in New York is required to file a New York tax return, even if it is not incorporated in New York and its business has nothing to do with royalty payments.

Notably, a corporation may file a franchise tax return in many jurisdictions, even if it is incorporated in or allocates royalty payments to relatively few of those jurisdictions.[3] When a corporation is taxed in multiple jurisdictions, its net income is allocated to each jurisdiction for tax purposes depending on the portion of taxable value created in that state (*see* former Tax Law § 210 [3]; *see generally Oklahoma Tax Commn. v Jefferson Lines, Inc.*, 514 US 175, 186 [1995] [describing the constitutional requirement that no state tax more than its fair share of interstate commerce and discussing possible methods of apportionment]).

When we remember that the deduction at issue is based on the location of tax filings, not the location of incorporation or royalty payment, Disney and IBM's characterization of "intrastate" and "interstate" transactions falls apart. Disney and IBM often refer to New York related members as if they operate solely in New York and receive royalty payments in New York.[4] But a "New York taxpayer" for purposes of this

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[3] The parties agree that at the relevant time, receipts from royalty payments for intellectual property were allocated to the jurisdiction in which the intellectual property was used.

[4] At certain points, Disney acknowledges that the tax is not related to the transaction but to the subsidiary's presence in the state. However, Disney also conflates this understanding with understandings of the tax based on the location of payments or of incorporation, and significant portions of its argument rely on

deduction is simply a corporation, wherever located and receiving payments, that does sufficient business in New York to require it to file a franchise tax return. A payment from a "New York" subsidiary to a "New York" parent, which the petitioners describe as "in-state" or "intrastate," is simply a royalty payment between two companies that both file returns in New York, regardless of where the companies are based and where the intellectual property and royalty payments are used. Although petitioners' definition of "intrastate" does cover payments between New York related members (as long as they both pay New York tax), it also covers a royalty payment from France to China as long as it is between two New York taxpayers. Conversely, a payment from a "Foreign" payor to a "New York" recipient, which petitioners describe as "interstate," is a payment from a company that does not pay tax in New York to a company that does, regardless of the location of the companies and where the payments are made. Petitioners' definition of "interstate" covers a transaction between a Delaware payor and a Delaware recipient, so long as only the former pays corporate franchise tax in New York.

An example makes the error in petitioners' definition transparent. Petitioners suggest that the availability of the deduction turns on whether the corporate group participates in interstate or intrastate commerce. But consider a situation in which Disney, a Delaware corporation, receives a royalty payment

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that conflation. To the extent that Disney argues that merely distinguishing between New York taxpayers and other subsidiaries violates the dormant Commerce Clause, I address that argument in Part V *infra*.

from Magical Cruise Co. Ltd., which is incorporated in the United Kingdom. Disney files a corporate franchise tax return in New York, but Magical Cruise does not. For Disney to take the royalty deduction, Magical Cruise must file a tax return in New York. That is the only requirement. If Magical Cruise begins doing business, totally unrelated to any royalties, that requires it to file a corporate franchise tax return in New York, Disney may take the deduction. But if Magical Cruise reincorporates in Delaware and moves all its business there, Disney still may not take the deduction, because Magical Cruise still does not file a New York tax return. It is irrelevant that the entire royalty transaction is now intrastate (Delaware to Delaware). Conversely, if Magical Cruise files a New York tax return, it is irrelevant to Disney's deduction status that the royalty payment is still transmitted from the United Kingdom to Delaware. The issue is only whether the payor is a "New York taxpayer."

This is not a mistake or even an unintended consequence of the Department's position, but the straightforward result of the Department's view of the statutory policy. The Department's view is that the legislative intent of the deduction was to counteract double taxation that the legislature had caused via the add-back requirement in Tax Law former section 208 (9) (o) (2), and that it was not intended to be available in other situations. As to that proposition, the majority and I are completely in agreement. This is entirely consistent with the view that the deduction would be available when the add-back provision is invoked and unavailable when it is not, regardless of the location of the payments or corporations. There is no reason the Department should object to Delaware-

based Disney taking a deduction on a royalty payment from a United Kingdom subsidiary, so long as that subsidiary adds back the payment under section 208 (9) (o) (2).

To summarize, the Department's interpretation of former Tax Law section 208 (9) (o) (3) does not disallow the deduction when a royalty payment is interstate. Rather (still holding to the untested assumption that a corporation that does no business in New York could not file a New York tax return), it disallows a deduction for royalty payments from a corporation that does not do business in New York, regardless of the locations of the payor or recipient. The question is whether that violates the dormant Commerce Clause.

IV.

Petitioners allege that the Department's interpretation facially violates the dormant Commerce Clause, meaning that it "inherently" discriminates against interstate commerce (*Wynne*, 575 US at 562) and is "unconstitutional in all applications" (*City of Los Angeles, Calif. v Patel*, 576 US 409, 418 [2015]).

Under the *Complete Auto* test, a tax is constitutional if it:

(1) "is applied to an activity with a substantial nexus with the taxing State";

(2) "is fairly apportioned";

(3) "does not discriminate against interstate commerce";

(4) "is fairly related to the services provided by the State" (*Complete Auto Tr., Inc. v Brady*, 430 US 274, 279 [1977]).

Here, the issue is whether the scheme of royalty deductions and add-backs set out in former Tax Law section 208 (9) (o) discriminates against interstate commerce. *Comptroller of Treasury of Maryland v Wynne*, the most recent Supreme Court case to address this issue, suggests that whether a scheme of taxation discriminates against interstate commerce depends on application of the internal consistency test (*see* 575 US at 562).

The internal consistency test "looks to the structure of the tax at issue to see whether its identical application by every State in the Union would place interstate commerce at a disadvantage as compared with commerce intrastate" (*id.*, quoting *Jefferson Lines*, 514 US at 185). A tax that fails the test is "typically unconstitutional;" a tax that passes is typically not (*Wynne*, 575 US at 562-563). A primary contention of petitioners, especially petitioner IBM, is that former Tax Law section 208 (9) (o) is unconstitutional because it violates the internal consistency test.

The internal consistency test requires the hypothetical application of New York's tax scheme to every jurisdiction. [5] In that hypothetical, every jurisdiction would follow the related member add-back provision in former section 208 (9) (o) (2). Thus the

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[5] Although *Wynne* refers to the test in the context of interstate commerce, it also traces the use of test to *Container Corp. of Am. v Franchise Tax Bd.*, 463 US 159, 169 [1983], which dealt with foreign commerce. Petitioners contend that the internal consistency test applies to international commerce and the Tax Department does not dispute that proposition. Therefore, we assume that the internal consistency test applies here.

royalty-paying subsidiary would have the payment added back to its income no matter where it files tax,[6] and will always be taxed on that money. Therefore, whenever the royalty recipient does not receive the deduction and is required to pay tax on the same money, there would be some level of multiple taxation. The multiple taxation would be avoided when the payor files in the same jurisdiction as the recipient. Just as New York permits an income deduction when the royalty payor files in New York, Delaware would permit an income deduction when the payor files in Delaware, and the United Kingdom would permit an income deduction which the payor files in the United Kingdom. Under that regime, the incentive is for the royalty payor to file a corporate franchise return in every jurisdiction where the recipient does so.

The internal consistency text asks whether application of that regime "would place interstate commerce at a disadvantage as compared with commerce intrastate" (*id.* at 562, quoting *Jefferson Lines, Inc.*, 514 US at 185). Disney and IBM argue that it would. If a New York company receives a royalty payment from a New York subsidiary, both taxpayers will file in the same jurisdiction and the money will only be taxed once. However, if a New York company receives a royalty payment from a foreign subsidiary, the foreign subsidiary will be required to add the money back, the New York company will not receive the deduction, and the money will be taxed twice.

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[6] The payor would not receive the add-back if the transaction implicated the exclusions in former Tax Law § 208 (9) (o) (2), but the parties agree that these exclusions are not relevant here.

In analyzing that argument, we must first remember that what petitioners describe as a "New York" company is merely a company that does business in New York. For example, petitioner Disney is a Delaware corporation—even if the tax regime incentivizes Disney to do business in New York, this seems to favor interstate commerce, not intrastate commerce. Similarly, it is not true that Disney is necessarily disincentivized to receive royalty payments from foreign corporations—if the foreign corporation pays New York tax, such a payment is favored.

More directly, because the tax is not on interstate transactions but rather relates to the location of filing, it is not difficult to find situations where a corporation would benefit from receiving a foreign royalty payment rather than an intrastate one. For example, consider a New York corporation that does business in both New York and the United Kingdom, with 90% of its receipts in the United Kingdom and 10% in New York.[7] The corporation has a subsidiary solely operating in New York and a subsidiary solely operating in the United Kingdom. If the corporation receives a royalty payment from the subsidiary in New York, it will be able to take the royalty deduction in New York but will not be able to take the deduction in the United Kingdom. If the corporation receives a royalty payment from the subsidiary in the United Kingdom, it will be able to take the deduction in the United Kingdom but not New York.

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[7] The allocation of net income to different jurisdictions in which a corporation does business is based on receipts, not profit (*see* former Tax Law § 210 [3] [a]).

Faced with that choice, the corporation is better off receiving the royalty payment from (and taking the deduction in) the United Kingdom, because it has a higher allocation percentage in that jurisdiction. After the deduction is taken, the net income of the corporation is multiplied by the allocation percentage (which at the time in New York was based on receipts) to determine taxable income in that jurisdiction. In this example, the allocation percentage would be 90% in the United Kingdom and 10% in New York. Therefore, if the deduction is taken in the United Kingdom it will be multiplied by 90%, but if it is taken in New York it will only be multiplied by 10%.[8] In general, whenever a business has a higher allocation percentage in a foreign jurisdiction than in New York, it will be preferable for the taxpayer to deal with a corporation that pays tax in that jurisdiction. Therefore, under the internal consistency test, the taxation scheme will tend to favor payments from a subsidiary located in a jurisdiction where the

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[8] For a numerical example, we can imagine that both jurisdictions calculate the net income of the corporation to be $500. The United Kingdom will tax $450 and New York will tax $50.

If the corporation is receiving a royalty of $100 from a subsidiary, it can get a deduction of $100 in the jurisdiction where that subsidiary files tax. If it receives the royalty from a subsidiary filing in the United Kingdom, the United Kingdom will calculate the corporation's net income at $400 and tax $360. New York will still calculate net income at $500 and tax $50. The total taxable income in both jurisdictions is $360 + $50, or $410.

If it instead receives the royalty from a subsidiary filing in New York, New York will calculate the corporation's net income at $400 and tax $40. The United Kingdom will still calculate the corporation's net income at $500 and tax $450. The total taxable income in both jurisdictions is $450 + $40, or $490.

recipient's allocation percentage is the greatest—which could either be an interstate or an intrastate transaction. Because under some circumstances the tax favors foreign commerce, petitioners cannot show that it facially discriminates against foreign commerce (*see Patel*, 576 US at 418; *Wynne* 575 US at 563 n 7).

Petitioners fail to address that issue, which is especially concerning because the scheme of taxation plausibly favors foreign commerce even as applied to them. IBM urged at argument that the correct application of the internal consistency test holds the plaintiffs constant and changes only the taxation schemes of the relevant jurisdictions (*see* Hellerstein and Hellerstein, State Taxation § 4.16 [1] [c]; *In re Alternative Minimum Tax Refund Cases*, 546 NW2d 285, 290 [Minn 1996]). But it appears that if we do so, Disney and IBM would benefit from engaging in additional foreign or interstate commerce, not additional intrastate commerce.

IBM is a New York corporation with numerous subsidiaries throughout the United States and foreign jurisdictions. During the years in question, about 5% of IBM's net income was allocated to New York. That means that 95% of IBM's net income was allocated to other jurisdictions. Essentially the same facts are true of Disney.[9]

If there is any jurisdiction where IBM has a higher allocation percentage than in New York, IBM would benefit from receiving the royalty payment from that

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[9] Disney is a Delaware corporation, but assuming internal consistency the exact same analysis can be repeated with regard to Delaware. Disney's allocation percentage in New York during the years in question was also approximately 5%.

jurisdiction rather than from New York. Given that IBM's income is only allocated 5% to New York, this could plausibly be the case. For example, if 10% of IBM's income is allocated to Canada, under internal consistency IBM would be tax-advantaged by receiving a royalty payment from a Canadian taxpayer, in which case its deduction is multiplied by 10%, rather than receiving a payment from an in-state New York taxpayer and having the deduction multiplied by 5%. Therefore, for a corporation like IBM for which New York is only one of many relevant tax jurisdictions, it is not at all clear that intrastate royalty payments are tax-advantaged.

Taking this line of reasoning further, the internal consistency test does not require that we assume each subsidiary does business in only a single jurisdiction. IBM would be best off if it received the payment from a subsidiary that did business not only in Canada, but also in New York and all other jurisdictions where it does business, because then it would benefit from a deduction in every place it is subject to an add-back. That even higher level of interstate business would advantage the corporation even further.

In short, although it is theoretically possible (again, assuming under internal consistency that every jurisdiction requires an add-back) that the former tax regime could create double taxation despite the clear legislative intent to avoid this, for petitioners and those similarly situated any double taxation would operate as a penalty for corporate groups that do not conduct sufficient interstate business, rather than a penalty for those who conduct too much. This is demonstrated by the fact that the action which petitioners portray as tax-advantaged, receiving all

royalties from related members within New York, would not in fact eliminate double taxation for them assuming internal consistency. Rather, petitioners would need to ensure that the related members file franchise tax returns in each of the numerous jurisdictions in which petitioners do business. I do not read any of the Supreme Court's Commerce Clause jurisprudence to suggest that a state may not enact a law that tends to favor interstate or foreign commerce over intrastate.

I do not suggest that the short-lived scheme of taxation created by former Tax Law section 208 (9) (o) (3) is necessarily fair or sensible—the risk of double taxation in jurisdictions where payors (for whatever reason) do not file is unnecessary and could have been easily been eliminated, for example by a credit for taxes paid in the foreign jurisdiction. However, given that "[n]either record evidence nor abstract logic makes clear whether the overall effect of such a system would be to increase or to reduce existing financial disincentives to interstate" business transactions," it does not violate the internal consistency test (*Wynne*, 575 US at 563 n 7 [citation omitted]).

V.

Disney also argues, independently of the internal consistency test, that former Tax Law section 208 (9) (o) is unconstitutional because it premises a tax deduction on a geographic determinant. However, the presence of a geographic determinant is not sufficient to show that a tax facially discriminates against interstate commerce. For example, a tax that explicitly states that intrastate activity will be taxed more heavily than interstate activity is premised on a

geographic determinant. However, it does not "place burdens on the flow of commerce across [] borders that commerce wholly within those borders would not bear"—rather, it does the reverse (*Jefferson Lines*, 514 US at 180; *see American Trucking Associations, Inc. v Michigan Pub. Serv. Commn.*, 545 US 429, 434 [2005] [upholding such a tax]).

Here, the tax deduction does depend on a geographic distinction between New York and non-New York taxpayers. However, this does not violate the dormant Commerce Clause unless by operation of that geographic distinction, there is "incentive to engage in intrastate rather than interstate economic activity" (*Wynne*, 575 US at 561). Although it is possible to construct situations where the geographic distinction in former Tax Law section 208 (9) (o) (3) incentivizes intrastate commerce, in other situations, including quite plausibly petitioners' actual situations, the geographic distinction incentivizes interstate commerce. Therefore, we cannot say that the tax discriminates against interstate commerce merely because it speaks in geographic terms (*see Kraft*, 505 US at 80 n 23 [noting the need to evaluate comparators who are "most similarly situated" (citation omitted)]; *Wynne*, 575 US at 563 n 7 [stating that where the effects of a tax may cut in either direction, an "empirical showing" is needed to determine whether interstate commerce would be at a disadvantage]).

VI.

Understanding that the deduction in former Tax Law section 208 (9) (o) turns solely on tax filing status highlights several fatal flaws in petitioners' argument.

First, petitioners have not contended, much less shown, that their payor subsidiaries could not have filed New York tax returns, which would have obtained the exact deduction petitioners seek. Second, the tax burden has nothing to do with whether a royalty transaction is intrastate—an "intrastate" corporate group is simply one where the payor and recipient do some business in the same jurisdiction generally. Third, a corporate group may have the lowest possible tax burden if it operates in 1, 100, or 1000 jurisdictions, so long as there is operational symmetry between the payor and recipient. Fourth, if we assume internal consistency, the drive towards symmetry would tend to encourage petitioners and those similarly situated to increase the jurisdictions in which their subsidiaries do business rather than decreasing the jurisdictions in which the parent does business, favoring interstate commerce. For these reasons, petitioners have not shown that former Tax Law section 208 (9) (o) discriminates against interstate or foreign commerce in violation of the dormant Commerce Clause. I would therefore affirm the holding of the Appellate Division, though on these different grounds.

For No. 34: Judgment affirmed, with costs. Opinion by Judge Cannataro. Judges Rivera, Garcia, Singas and Troutman concur. Chief Judge Wilson concurs in result in an opinion, in which Judge Halligan concurs.

For No. 35: Judgment affirmed, with costs. Opinion by Judge Cannataro. Judges Rivera, Garcia, Singas

and Troutman concur. Chief Judge Wilson concurs in result in an opinion, in which Judge Halligan concurs.

Decided April 23, 2024

APPENDIX B

Memorandum and Judgment Appealed From, dated March 16, 2023 [pp. 913 - 918]

State of New York
Supreme Court, Appellate Division
Third Judicial Department

Decided and Entered: March 16, 2023 533572

In the Matter of INTERNATIONAL BUSINESS MACHINES CORPORATION & COMBINED AFFILIATES,

Petitioner,

v.

TAX APPEALS TRIBUNAL OF THE STATE OF NEW YORK et al.,

Respondents.

MEMORANDUM AND JUDGMENT

Calendar Date: January 13, 2023

Before: Egan Jr., J.P., Lynch, Clark, Ceresia and Fisher, JJ.

Baker & McKenzie LLP, New York City (*Jeffrey A. Friedman* of *Eversheds Sutherland (US) LLP*, Washington, DC, admitted pro hac vice and *Michael J. Hilkin* of *Eversheds Sutherland (US) LLP*, New York City, of counsel), for petitioner.

Letitia James, Attorney General, Albany (*Frederick A. Brodie* of counsel), for Commissioner of Taxation and Finance, respondent.

Fisher, J.

Proceeding pursuant to CPLR article 78 (initiated in this Court pursuant to Tax Law § 2016) to review a determination of respondent Tax Appeals Tribunal, among other things, sustaining a notice of deficiency of corporate franchise tax imposed under Tax Law article 9-A.

Petitioner, the legal owner of certain intangible property including the International Business Machines (hereinafter IBM) brand, is a technology and consulting corporation organized under the laws of New York that partly operates outside the United States through locally incorporated subsidiary companies (hereinafter foreign affiliates). IBM World Trade Corporation (hereinafter WTC), a wholly-owned subsidiary of petitioner which has its headquarters in New York, received certain assets and non-exclusive rights under certain patents to handle and develop the marketing of petitioner's products and equipment outside the United States. During the tax years ending in 2007 through 2012 (hereinafter the audit

period), the foreign affiliates paid royalty payments to petitioner and WTC in exchange for the right to, among other things, exploit intangible property relating to software, hardware and services under IBM's patents, trademarks, copyrights, mask works, knowledge and related technical expertise. Petitioner and WTC deducted royalty payments received from its foreign affiliates for the audit period under Tax Law § 208 (former [9] [o]).

The Division of Taxation conducted a series of audits of petitioner's corporation franchise tax returns filed during the audit period and determined that petitioner could not deduct the foreign royalty payments in computing its combined entire net income on any such tax return. As a result, the Division disallowed and denied petitioner's various requests for a refund or overpayment and issued petitioner notices of disallowance or a notice of deficiency, as appropriate for each return. Petitioner sought review with the Division of Tax Appeals and the parties submitted a joint stipulation of facts in lieu of hearing before an Administrative Law Judge (hereinafter ALJ), who ultimately sustained the notices of disallowance and notice of deficiency. Petitioner filed an exception with respondent Tax Appeals Tribunal, which upheld the ALJ's determination. Petitioner commenced this proceeding in this Court to challenge the Tribunal's determination.

Initially, the Tribunal expressly rejected petitioner's royalty income exclusion argument based on its prior decision in *Matter of Walt Disney Co. and Consolidated Subsidiaries* (2020 WL 4788011, 2020 NY Tax LEXIS 140 [NY St Tax Appeals Trib DTA No. 828304, Aug. 6, 2020]). While the current matter was

pending before us, this Court rendered a decision confirming the Tribunal's statutory interpretation of Tax Law § 208 (former [9] [o]) in that matter (*Matter of Walt Disney Co. & Consol. Subsidiaries v Tax Appeals Trib. of the State of N.Y.*, 210 AD3d 86 [3d Dept 2022]). In considering petitioner's contentions related to the royalty income exclusion raised herein, which are nearly identical to those raised and recently decided in *Walt Disney*, we find no reason to depart from our recent holding on this issue (*id.* at 89-92).

Although this Court also rejected the challenge under the dormant Commerce Clause in *Walt Disney* (*id.* at 92-93), petitioner's arguments herein are distinguishable from the arguments raised in *Walt Disney*. Specifically, petitioner contends that the Tribunal's interpretation of the royalty income exclusion (Tax Law § 208 [former (9) (o) (3)]) and the royalty expense addback (Tax Law § 208 [former (9) (o) (2)]) fail the internal and external consistency tests (*see generally Complete Auto Transit, Inc. v Brady*, 430 US 274, 279 [1977]), based on the combined impact of the royalty income exclusion and the royalty expense addback, which is both discriminatory and unfairly apportions taxes.

We disagree. The dormant Commerce Clause of the US Constitution "prohibits state taxation, or regulation, that discriminates against or unduly burdens interstate commerce and thereby impedes free private trade in the national marketplace" (*Matter of Huckaby v New York State Div. of Tax Appeals, Tax Appeals Trib.*, 4 NY3d 427, 436 [2005] [internal quotation marks, brackets and citations omitted], *cert denied* 546 US 976 [2005]; *see* US Const, art I, § 8; *Westinghouse Elec. Corp. v Tully*, 466 US 388, 403

[1984]). "Unconstitutional discrimination means differential treatment of in-state and out-of-state economic interests whereby the differential tax treatment of two entities results solely from the situs of their activities and provides a commercial advantage to local business" (*Matter of Walt Disney Co. & Consol. Subsidiaries v Tax Appeals Trib. of the State of N.Y.*, 210 AD3d at 92 [internal quotation marks, brackets, ellipsis and citations omitted]; *see Hunter v Warren County Bd. of Supervisors*, 21 AD3d 622, 626 [3d Dept 2005]). To this end, "[a] state tax on interstate commerce violates the dormant Commerce Clause unless it 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" (*Matter of Huckaby v New York State Div. of Tax Appeals, Tax Appeals Trib.*, 4 NY3d at 436 [internal quotation marks and citation omitted]; see *Matter of Zelinsky v Tax Appeals Trib. of State of N.Y.*, 1 NY3d 85, 90 [2003], *cert denied* 541 US 1009 [2004]). "Legislative enactments carry an exceedingly strong presumption of constitutionality, and while this presumption is rebuttable, one undertaking that task carries a heavy burden of demonstrating unconstitutionality beyond a reasonable doubt" (*Matter of Walt Disney Co. & Consol. Subsidiaries v Tax Appeals Trib. of the State of N.Y.*, 210 AD3d at 92 [internal quotation marks, brackets and citation omitted]).

Although applying the internal consistency test is not the first step in the dormant Commerce Clause inquiry (*see Matter of Tamagni v Tax Appeals Trib. of State of N.Y.*, 91 NY2d 530, 540 [1998], *cert denied* 525

US 931 [1998]), in light of this Court's holding in *Walt Disney*, we find it necessary to focus our examination only on the "fairly apportioned" prong of the dormant Commerce Clause test, which implicates the internal and external consistency tests. Such tests are used to measure the "threat of misapportionment" of a tax (*Matter of Huckaby v New York State Div. of Tax Appeals, Tax Appeals Trib.*, 4 NY3d at 436 and n 5 [internal quotation marks omitted]; *see Matter of Zelinsky v Tax Appeals Trib. of State of N.Y.*, 1 NY3d at 91; *Tennessee Gas Pipeline Co. v Urbach*, 96 NY2d 124, 133 [2001]). "To be internally consistent, the tax must be structured so that if every state were to impose an identical tax, no multiple taxation would result" (*Matter of Zelinsky v Tax Appeals Trib. of State of N.Y.*, 1 NY3d at 91; *see Oklahoma Tax Comm'n v Jefferson Lines, Inc.*, 514 US 175, 185 [1995]).

Here, petitioner argues that the internal consistency test is violated because, if every state imposed the royalty expense addback and royalty income exclusion, licensing transactions with non-New York licensees would be subject to greater taxation than licensing transactions with New York licensees. However, this interpretation is too narrow. It neglects, as contended by the Division and as we recently emphasized, the fact that there are two taxable events occurring, one being the payment and the other being receipt of that payment (*see Matter of Walt Disney Co. & Consol. Subsidiaries v Tax Appeals Trib. of the State of N.Y.*, 210 AD3d at 89; *see generally Matter of Pepsico, Inc. v Bouchard*, 102 AD2d 1000, 1001 [3d Dept 1984]). Petitioner's interpretation further views these transactions in a vacuum, particularly ignoring other provisions of the Tax Law,

including Tax Law former § 211 (4),[1] which creates an offset. When these two actions are properly recognized and balanced based on the whole scheme of taxation, non-New York licensees would not be subject to greater taxation than those with New York licensees because non-New York licensees would be able to realize a deduction. To the extent that petitioner posits that there could still be instances of multiple taxation in different states due to the separate events of payment and of receiving such payment, " '[t]he multiple taxation placed upon interstate commerce by such a confluence of taxes is not a structural evil that flows from either tax individually, but it is rather the accidental incident of interstate commerce being subject to two different taxing jurisdictions' " (*Matter of Zelinsky v Tax Appeals Trib. of State of N.Y.*, 1 NY3d at 96, quoting *Oklahoma Tax Comm'n v Jefferson Lines, Inc.*, 514 US at 192). Accordingly, we cannot say the New York tax scheme offends the dormant Commerce Clause after applying the internal consistency test.

Petitioner's application of the external consistency test is equally flawed. The test for "[e]xternal consistency looks to 'the economic justification for the State's claim upon the value taxed, to discover whether a State's tax reaches beyond that portion of value that is fairly attributable to economic activity within the taxing State' " (*Matter of Huckaby v New York State Div. of Tax Appeals, Tax Appeals Trib.*, 4 NY3d at 436 n 5, quoting *Oklahoma Tax Comm'n v Jefferson Lines, Inc.*, 514 US at 185). "External consistency is essentially a practical inquiry for

[1] This has been recodified in Tax Law § 210-C.

determining whether the State has taxed only that portion of the revenues from the interstate activity which reasonably reflects the in-state component of the activity being taxed" (*Matter of Zelinsky v Tax Appeals Trib. of State of N.Y.*, 1 NY3d at 91 [internal quotation marks and citations omitted]). Here, petitioner specifically is challenging the royalty income exclusion as violating the external consistency test. Although petitioner argues that the extraterritorial economic activity is generated by intangible property like licenses and patents exploited outside the United States, this ignores the fact that petitioner is organized under the laws of New York and both petitioner and WTC have located their head offices in New York. As highlighted by the Division, petitioner has enjoyed rather significant tax credits under the New York tax scheme it now complains of; when measured against the challenged royalty income exclusion, it cannot be said that these benefits are unreasonable in comparison. As such, the tax scheme also passes the external consistency test.

Lastly, we reject petitioner's foreign Commerce Clause argument. Since WTC primarily transacts business outside of the United States, we must "determine if the challenged tax exposes [petitioner] to an enhanced risk of multiple taxation and impairs [f]ederal uniformity in an area where [f]ederal uniformity is essential" (*Ontario Trucking Assn. v New York State Dept. of Taxation & Fin.*, 236 AD2d 70, 72 [3d Dept 1997]). Petitioner's argument is largely based on its internal consistency test, which we have found to be without merit. Such contentions under both prongs of this evaluation are also speculative and conclusory, as petitioner points to no foreign policy

issues or federal directives that the New York tax scheme would violate (*compare id.* at 73-74). Accordingly, petitioner cannot carry its burden that the foreign Commerce Clause is offended by the New York tax scheme. We have considered the parties' remaining contentions, including those contained in the supplemental submission from petitioner following oral argument, and find such arguments to be distinguishable, academic or without merit.

Egan Jr., J.P., Lynch, Clark and Ceresia, JJ., concur.

ADJUDGED that the determination is confirmed, without costs, and petition dismissed.

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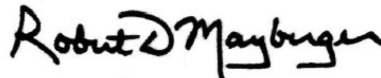


Robert D. Mayberger
Clerk of the Court

APPENDIX C

Decision of the Tax Appeals Tribunal, dated March 5, 2021 [pp. 883 - 908]

STATE OF NEW YORK

TAX APPEALS TRIBUNAL

In the Matter of the Petitions of **INTERNATIONAL BUSINESS MACHINES CORPORATION AND COMBINED AFFILIATES** for Redetermination of Deficiencies or for Refund of Corporation Franchise Taxes under Article 9-A of the Tax Law for the Periods January 1, 2007 through December 31, 2012.	:	DECISION DTA NOS. 827825, 827997 AND 827998

Petitioner, International Business Machines Corporation and Combined Affiliates, and the Division of Taxation each filed an exception to the determination of the Administrative Law Judge issued on December 19, 2019. Petitioner appeared by Baker & McKenzie LLP (Scott Brandman, Esq., and David Pope, Esq., of counsel). The Division of

Taxation appeared by Amanda Hiller, Esq. (Jennifer L. Baldwin, Esq., of counsel).

Petitioner filed a brief in support of its exception. The Division of Taxation filed a brief in support of its exception and in opposition to petitioner's exception. Petitioner filed a brief in opposition to the Division of Taxation's exception and in reply to the Division of Taxation's brief in opposition. The Division of Taxation did not file a brief in reply to petitioner's brief in opposition. Petitioner withdrew its request for oral argument on September 9, 2020, which date began the six-month period for the issuance of this decision.

After reviewing the entire record in this matter, the Tax Appeals Tribunal renders the following decision.

ISSUES

I. Whether petitioner may exclude royalties received from foreign affiliates in the computation of its entire net income pursuant to Tax Law former § 208 (9) (o).

II. If not, whether denying petitioner such an exclusion under the facts herein violates the dormant Commerce Clause of the United States Constitution.

FINDINGS OF FACT

We find the following facts as determined by the Administrative Law Judge.[1]

1. International Business Machines Corporation (IBM) is a New York corporation and the publicly-traded parent of a worldwide group of companies.

[1] We have corrected typographical errors in findings of fact 30 and 36 to conform with the parties' stipulated facts.

2. IBM World Trade Corporation (WTC) is a Delaware corporation headquartered in New York.

3. IBM owns 100 percent of the outstanding stock of WTC.

4. IBM and WTC filed as part of a federal consolidated return, along with numerous other domestic affiliates, for federal corporate income tax purposes during the periods at issue.

5. IBM and WTC filed as part of petitioner's New York State combined report, along with numerous other domestic affiliates, for New York State corporation franchise tax purposes for the tax years 2007 through 2012 (periods at issue).

6. IBM operates in over 170 countries, primarily through locally incorporated subsidiary companies (Alien Affiliates).

7. IBM is responsible for selling IBM products and services in the United States directly to third parties.

8. WTC serves several functions as IBM's principal entity to conduct offshore activities, including: (1) operates a network of branches in countries where IBM does not have full-fledged subsidiaries; (2) contracts directly with third-party customers to sell IBM products in certain countries; (3) sublicenses the right to distribute IBM products to IBM Alien Affiliates; and (4) serves as the holding company for IBM's Alien Affiliates.

9. WTC does not have any United States sales.

10. IBM and WTC indirectly own 100 percent of the outstanding stock of IBM's Alien Affiliates. The subset of affiliates that engage in sales to third-party

customers are commonly referred to within IBM as sales and distribution affiliates (Alien S&D Affiliates).

11. Since its incorporation in 1911, IBM's mode of operations has changed over time as the company has adapted to changes in the global economy.

12. IBM serves as the legal owner to all IBM intangible property, including the IBM brand.

13. IBM directs, controls, and funds all research and development activity (R&D) performed by IBM and its Alien Affiliates.

14. IBM incurs globally-benefitting selling, general and administrative (SG&A) expenses, including worldwide marketing expenses related to the IBM brand.

15. IBM historically granted the economic right to exploit intangible property to WTC and the Alien Affiliates through a series of intercompany agreements.

16. IBM and WTC grant the Alien Affiliates the right to exploit IBM's intangible property relating to software, hardware, and services in a designated region in exchange for specified payments by the Alien S&D Affiliate.

17. During the periods at issue, IBM, WTC, and certain Alien S&D Affiliates were parties to a cost sharing arrangement whereby certain IBM costs, such as R&D, were borne by WTC and the Alien S&D Affiliates collectively with IBM.

18. The payments received by IBM from WTC and the Alien Affiliates as part of these cost sharing arrangements were not included as royalty payments and were not deducted on line 15, other subtractions,

of petitioner's original or amended forms CT-3-A for the periods at issue.

19. The Alien S&D Affiliates earn revenue by selling IBM hardware, sublicensing IBM software, and providing services to third-party customers.

20. During the periods at issue, the Alien S&D Affiliates paid IBM or WTC 60 percent of their revenue for the rights under IBM's patents, trademarks, copyrights, mask works, knowledge and technical know-how related thereto to use, distribute, and market IBM computer software programs. As part of a stipulation of facts, the parties submitted a copy of a sample software agreement (software agreement) in effect during the periods at issue between IBM and an Alien S&D Affiliate. The software agreement provided, in pertinent part as follows:

> "IBM . . . grants to [Alien S&D Affiliate] under IBM's Copyrights, Mask Work Rights and Patents the non-exclusive rights (i) to license and distribute copies of IBM programs for their ultimate use by customers, (ii) to use such IBM Programs in revenue producing activities, (iii) to use such IBM programs internally, (iv) to make or have made copies for the purposes described above, for distribution to affiliated companies, and for translation or modification of such IBM programs, and (v) to allow [Alien S&D Affiliate's] customers to use, make copies of and modify IBM Programs pursuant to the terms of [Alien S&D Affiliate's] agreements with its customers . . .
>
> IBM . . . grants [Alien Affiliate] . . . the right to use all of IBM's Trademarks on or in association with IBM Programs . . .

> IBM agrees . . . to allow [Alien S&D Affiliate] . . . access to and use of all knowledge and technical know-how, both confidential and other, that it may have available at any given time relating to the reproduction, use, modification, marketability, education of users, service and maintenance of IBM Programs and to make such knowledge and technical know-how available to [Alien S&D Affiliate] in the United States of America without separate charge . . . . "

Under the software agreement, "Programs" are defined as "instructions written, contained, or recorded on materials, documents or machine readable media capable of being executed on, or used in the operation of, a machine; and information, technology, or data related thereto." "IBM Programs" are defined as "Programs protected by IBM's Patents, Mask Work Rights or Copyrights."

In addition to the agreed upon monetary payments, the software agreement granted IBM the "non-exclusive, unrestricted license with respect to Programs now or hereafter existing under [the Alien S&D Affiliate's] Patents, Mask Work Rights and Copyrights, including the right to sublicense to others."

21. During the periods at issue, the Alien S&D Affiliates paid WTC a percentage (typically 5 to 10 %) of their gross charges, less returns and allowances, for the rights under IBM's patents and trademarks to manufacture and sell IBM computer hardware. The rate applied to the gross charges less returns and allowances varied by product family. As part of the stipulation of facts, the parties submitted a copy of a sample hardware agreement (hardware agreement) in

effect during the periods at issue between WTC and an Alien S&D Affiliate. The representative hardware agreement provided, in pertinent part as follows:

> "WTC . . . grants to [Alien S&D Affiliate] a non-exclusive, nontransferable license under IBM Technology to manufacture or have made (when [Alien S&D Affiliate] acts in its capacity as a manufacturer and not in its capacity as a distributor), for subsequent sale, lease, internal use, or other disposition, Products within Product Families specified [therein], and to practice any method or process used in such manufacture or internal use by [Alien S&D Affiliate].
>
> WTC . . . grants to [Alien S&D Affiliate] . . . a non-exclusive, nontransferable license to utilize the now and hereafter existing IBM Trademarks on or in association with Products produced under the grant [above] for the purpose of marketing, selling and leasing such Products and to use in its trade names the IBM Trademark 'IBM' . . . ."

The hardware agreement defines "Technology" as:

> "any and all technologies, procedures, processes, designs, inventions, discoveries, know-how and works of authorship, including without limitation, documentation and all (i) issued patents, utility models, and the like and applications therefor, (ii) copyrights, whether or not registered, and other rights in works of authorship, (iii) mask work rights, (iv) trade secrets, (v) confidential information, (vi) the right to extract data from databases under current and future laws and (vii) other intellectual property rights constituting, embodied in, or pertaining thereto.

> Technology shall not include trademarks or service marks."

In turn, "IBM Technology" is defined as "all Technology now or hereafter owned by or licensed to IBM, including Technology covered under an IBM Cost Sharing Agreement, for which IBM has the right to grant the licenses granted in [the Hardware Agreement]."

22. During the periods at issue, the Alien S&D Affiliates paid WTC for the right to provide services, including maintenance services, systems integration, outsourcing network services, consulting, and education services relating to IBM products. As part of the stipulation of facts, the parties submitted a copy of a sample service agreement in effect during the periods at issue between WTC and an Alien S&D Affiliate. This representative service agreement provided, in pertinent part as follows:

> "[WTC] . . . grants to [Alien S&D Affiliate] a non-exclusive, nontransferable license under IBM Intellectual Property, which is necessary to enable [Alien S&D Affiliate] to provide Services related to ITS products and Programs to Unaffiliated Customers. [WTC] . . . grants to [Alien S&D Affiliate] a non-exclusive, nontransferable license under IBM Intellectual Property necessary to enable [Alien S&D Affiliate] to manufacture and have made maintenance parts (other than hard disk drive maintenance parts) for ITS Products and to acquire hard disk maintenance parts for ITS Products from Subsidiaries in order to: (i) sell or lease such maintenance parts to Unaffiliated Customers;

> and, (ii) to use or otherwise dispose of such maintenance parts.
>
> [WTC] . . . grants to [Alien S&D Affiliate] a non-exclusive license and rights under IBM's Services Copyrights: (i) to license and distribute copies for their ultimate use by Unaffiliated Customers, (ii) to use in revenue producing activities, (iii) to use internally, (iv) to make or have made copies for the purposes described above, for distribution to Subsidiaries, and for translation or modification, and (v) to allow [Alien S&D Affiliate's] Unaffiliated Customers, for the customers' internal use only, to use, copy, and modify such licensed IBM Service Copyrights pursuant to the terms of [Alien S&D Affiliate's] agreements with customers.
>
> [WTC] . . . sublicenses [Alien S&D Affiliate] to have the right to use all IBM Trademarks on or in association with (i) Services; (ii) maintenance parts, and (iii) Vendor Developed Products, and to use in its trade names the IBM Trademark 'IBM.'
>
> In addition to the grant of the foregoing licenses and rights, [WTC] agrees . . . to allow [Alien S&D Affiliate] . . . access to all knowledge and technical know-how, both confidential and other, related to the grants [above] that [WTC] may have available at any given time, and to make such knowledge and technical know-how available to [Alien S&D Affiliate] in the form in which it exists and where it exists without separate charge . . . under Services Agreements."

23. During the periods at issue, the Alien S&D Affiliates paid IBM or WTC for the economic rights to

already existing intangible property for the purpose of creating cost-shared intangibles with IBM and distributing IBM products within their respective region. As part of a stipulation of facts, the parties submitted a copy of a sample platform contribution agreement between IBM and an Alien S&D Affiliate in effect during the periods at issue. A typical Platform Contribution Agreement provided for the following:

> "[IBM] . . . grants to [Alien Affiliate] . . . a terminable, sublicensable, non-exclusive license to [IBM's] interests to and under the PCT Assets to use such PCT Assets for purposes of creating Cost Shared Intangibles in accordance with the [Cost Sharing Agreement]; and . . . a terminable, sublicensable, non-exclusive license to [IBM's] interests to and under the IBM Products to exploit such IBM Products commercially within the [Alien S&D Affiliate's] Territory solely for purposes of engaging in transactions consisting of licensing, sublicensing and sales of IBM Products . . . ."
>
> "PCT Assets" is defined as:
>
> "(a) the Intangible Property owned, acquired by, licensed to, or developed by [IBM] on or prior to the Effective Date that is embodied or used in, or otherwise relates to, IBM Products *and* (ii) used in conducting intangible development under the [Cost Sharing Agreement]; and
>
> (b) any other Platform Contribution acquired by, licensed to, or developed by, [IBM] on or prior to the Effective Date and used in conducting

> intangible development under the [Cost Sharing Agreement] relating to IBM products . . . ."

Payments under the Platform Contribution Agreement (buy-in/other payments) are based on varying percentages of revenue from sales of IBM hardware products and IBM software products.

24. IBM and WTC did not file with any of its Alien S&D Affiliates as part of petitioner's federal consolidated return for federal income tax purposes during the periods at issue.

25. For federal income tax purposes, petitioner included the payments IBM and WTC received from the Alien S&D Affiliates pursuant to the hardware, software and services agreements (Alien Payments) on line 7, gross royalties, of its respective federal forms 1120 for all periods at issue. The remaining amounts petitioner reported on line 7 of its federal forms 1120 reflect amounts received directly from third parties in the United States (Third Party Payments).

26. The Alien Payments were neither directly nor indirectly paid to, nor incurred by, any unrelated parties during the periods at issue.

27. IBM and WTC did not file with the Alien S&D Affiliates as part of petitioner's combined report for New York State corporation franchise tax purposes for the periods at issue. The Alien S&D Affiliates did not file corporation franchise tax returns in New York State for any of the periods at issue.

28. Petitioner timely filed original New York State combined corporation franchise tax returns (form CT-3-A) for all periods at issue.

29. Petitioner timely filed amended New York State combined corporation franchise tax returns for 2007, 2008, 2009 and 2010.

30. On its amended forms CT-3-A for 2007, 2008, 2009 and 2010, petitioner deducted the Alien Payments on line 15, other subtractions, in the following amounts:

2007	$8,179,964,431.00
2008	$8,768,166,400.00
2009	$8,207,649,952.00
2010	$10,435,412,751.00

Petitioner did not deduct any Third-Party Payments on Line 15 of its forms CT-3-A for any of the periods at issue.

31. For 2007, the $8,179,964,431.00 deduction was composed of $6,068,092,311.00 in software payments pursuant to terms akin to the sample agreement described in finding of fact 20; $784,111,279.00 in hardware payments pursuant to terms akin to the sample agreement described in finding of fact 21; $1,772,987,213.00 in service/maintenance payments pursuant to terms akin to the sample agreement described in finding of fact 22; and $94,773,628.00 in buy-in/other payments pursuant to terms akin to the sample agreement described in finding of fact 23.

32. For 2008, the $8,768,166,400.00 deduction was composed of $6,426,579,964.00 in software payments

pursuant to terms akin to the sample agreement described in finding of fact 20; $942,064,461.00 in hardware payments pursuant to terms akin to the sample agreement described in finding of fact 21; $1,341,030,312.00 in service/maintenance payments pursuant to terms akin to the sample agreement described in finding of fact 22; and $58,491,663.00 in buy-in/other payments pursuant to terms akin to the sample agreement described in finding of fact 23.

33. For 2009, the $8,207,649,952.00 deduction was composed of $6,082,061,194.00 in software payments pursuant to terms akin to the sample agreement described in finding of fact 20; $788,515,378.00 in hardware payments pursuant to terms akin to the sample agreement described in finding of fact 21; $1,299,158,626.00 in service/maintenance payments pursuant to terms akin to the sample agreement described in finding of fact 22; and $37,914,754.00 in buy-in/other payments pursuant to terms akin to the sample agreement described in finding of fact 23.

34. For 2010, the $10,435,412,751.00 deduction was composed of $6,045,010,532.00 in software payments pursuant to terms akin to the sample agreement described in finding of fact 20; $2,056,285,953.00 in hardware payments pursuant to terms akin to the sample agreement described in finding of fact 21; $1,361,414,368.00 in service/maintenance payments pursuant to terms akin to the sample agreement described in finding of fact 22; and $972,701,898.00 in buy-in/other payments pursuant to terms akin to the sample agreement described in finding of fact 23.

35. On its amended forms CT-3-A and CT-3M for 2007, 2008, 2009, and 2010, petitioner requested refunds in the following (total) amounts:

2007	$3,640,689.00
2008	$4,764,483.00
2009	$5,822,312.00
2010	$35,382,756.00

36. On its original forms CT-3-A for 2011 and 2012, petitioner deducted the Alien Payments on line 15, other subtractions, in the following amounts:

2011	$8,158,917,978.00
2012	$7,392,258,177.00

Petitioner did not deduct any Third-Party Payments on line 15 of its forms CT-3-A for any of the periods at issue.

37. For 2011, the $8,158,917,978.00 deduction was composed of $5,643,552,996.00 in software payments pursuant to terms akin to the sample agreement described in finding of fact 20; $274,906,946.00 in hardware payments pursuant to terms akin to the sample agreement described in finding of fact 21; $1,498,060,515.00 in service/maintenance payments pursuant to terms akin to the sample agreement described in finding of fact 22; and $742,397,521.00 in

buy-in/other payments pursuant to terms akin to the sample agreement described in finding of fact 23.

38. For 2012, the $7,392,258,177.00 deduction was composed of $5,647,363,014.00 in software payments pursuant to terms akin to the sample agreement described in finding of fact 20; $312,280,649.00 in hardware payments pursuant to terms akin to the sample agreement described in finding of fact 21; $1,328,718,902.00 in service/maintenance payments pursuant to terms akin to the sample agreement described in finding of fact 22; and $103,895,612.00 in buy-in/other payments pursuant to terms akin to the sample agreement described in finding of fact 23.

39. On its original forms CT-3-A and CT-3M for 2011, petitioner requested a refund of $32,760,047.00.

40. On its original forms CT-3-A and CT-3M for 2012, petitioner requested an overpayment of $26,614,724.00 to be credited to the next period.

41. The Division conducted audits of petitioner's corporation franchise tax returns for the periods at issue.

42. The Division determined that petitioner could not deduct the Alien Payments in computing its combined entire net income in any of the periods at issue.

43. By notice of disallowance dated October 7, 2015, the Division denied petitioner's claims for refund for the 2007, 2008 and 2009 tax years. By notice of disallowance dated September 28, 2016, the Division denied petitioner's claim for refund for tax year 2010.

44. The Division also made other adjustments (unrelated to the amounts petitioner deducted on line

15 of its forms CT-3-A) to petitioner's New York State combined corporation franchise tax returns for the 2007 through 2009 tax years that are not at issue here. Petitioner and the Division executed a closing agreement with respect to those adjustments.

45. The Division issued a notice of deficiency, notice number L-045504338, on October 5, 2016, asserting additional corporation franchise tax and MTA surcharge in the amount of $64,615,318.00 for the 2011 and 2012 tax years, plus interest and penalty pursuant to Tax Law § 1085 (k) for substantial under reporting of the amount asserted due. The notice of deficiency reflects the disallowance of the Alien Payments claimed as royalties on line 15 of its form CT-3-A in those years. The Division also made other adjustments not at issue here that are reflected in the notice of deficiency.

46. The only remaining issue is whether petitioner may deduct the Alien Payments on its forms CT-3-A for any of the periods at issue. Any of these amounts determined to be properly deducted from petitioner's combined entire net income would likewise be excluded from the denominator of the receipts factor of petitioner's business allocation percentage (BAP). Any of these amounts determined to be properly included in petitioner's combined entire net income would likewise be included in the denominator of the receipts factor of petitioner's BAP.

47. Whether the Alien S&D Affiliates are "related members" for purposes of Tax Law former § 208 (9) (o) is not at issue in this matter.

THE DETERMINATION OF THE ADMINISTRATIVE LAW JUDGE

The Administrative Law Judge rejected the Division's contention that the software payments and the buy-in/other payments made by the Alien Affiliates were not royalties as defined in Tax Law § 208 (9) (o) (1) (C). He found that both categories of payments fit within that definition.

Next, the Administrative Law Judge addressed the main issue: whether the royalty payments paid to petitioner by the Alien Affiliates were properly excluded from petitioner's ENI pursuant to Tax Law former § 208 (9) (o) (3). The Administrative Law Judge found that the legislature intended for the royalty income exclusion to work in tandem with the royalty payment add back provision under Tax Law former § 208 (9) (o) (2) to eliminate a common tax avoidance strategy by which corporate taxpayers made deductible royalty payments to controlled affiliates. According to the Administrative Law Judge, the legislature's intent was for such royalty payments to be subject to tax once, by either the payer or the payee, and not to go untaxed. The Administrative Law Judge found that petitioner's interpretation effectively added words to Tax Law former § 208 (9) (o) (3) (i.e., the Alien Affiliates "would" have been subject to Tax Law former § 208 (9) (o) (2) *if they were New York taxpayers*). The Administrative Law Judge observed that the add back provision does not apply to petitioner's Alien Affiliates because such entities were not New York taxpayers. He determined, accordingly, that the income exclusion provision should not apply to petitioner. The Administrative Law Judge reasoned that, otherwise, the royalty payments will not be subject to tax at all,

an outcome he deemed contrary to the legislature's intent. The Administrative Law Judge also found support for his statutory interpretation in the legislative history of the 2013 amendments to Tax Law § 208 (9) (o) by which the royalty income exclusion was repealed. The Administrative Law Judge thus concluded that petitioner improperly excluded the payments at issue from its entire net income.

The Administrative Law Judge then addressed petitioner's contention that the Division's interpretation of Tax Law former § 208 (9) (o) violates the dormant Commerce Clause of the United States Constitution. The Administrative Law Judge noted petitioner's claim that the statute is unconstitutional on its face and that the Division of Tax Appeals' jurisdiction does not extend to such claims. He further observed that the Division of Tax Appeals has authority to rule on as-applied constitutional claims, but found that petitioner did not establish that the relevant statute was unconstitutional as applied here. The Administrative Law Judge determined that Tax Law former § 208 (9) (o) does not impose a heavier burden on royalty payments based on the location of the payer. Rather, the Administrative Law Judge found that the statute subjects royalty payments to tax once regardless of whether the payer is a New York taxpayer. The Administrative Law Judge also noted that the add back and exclusion provisions are triggered only if the payer and payee are related parties as defined in the statute. The Administrative Law Judge thus concluded that the statute, as applied, does not discriminate against interstate commerce.

Accordingly, the Administrative Law Judge denied the petition and sustained the notices of disallowance and the notice of deficiency.

ARGUMENTS ON EXCEPTION

Petitioner contends that the royalty payments at issue fit within the plain language of the royalty income exclusion statute pursuant to the following argument. First, petitioner notes that the exclusion permits the deduction of royalty payments from a related member and that a related member need not be a taxpayer. Second, petitioner contends that the royalties were deductible in calculating federal taxable income within the meaning of the add back provision. Third, petitioner asserts that the royalties would be required to be added back to the Alien Affiliates' taxable income within the meaning of the exclusion provision.

Petitioner contends that the Administrative Law Judge failed to apply the plain statutory language and improperly considered legislative history to ascertain the legislative intent. Even if considered, petitioner contends that such legislative history is not inconsistent with its interpretation.

Contrary to the Administrative Law Judge's conclusion, petitioner asserts that the subsequent amendments to the royalty income exclusion statute demonstrate that prior law permitted exclusion of royalty income under the circumstances present here.

Petitioner also contends that the royalty income exclusion provision as interpreted and applied by the Administrative Law Judge results in different treatment for royalties received from New York taxpayers and non-New York taxpayers and thereby

discriminates against interstate and foreign commerce contrary to the Commerce Clause of the United States Constitution.

Petitioner also argues that the royalty income exclusion as interpreted in the determination will result in double taxation if a non-New York related member-royalty payer is in a jurisdiction with an add back statute. Petitioner asserts that such an outcome is unconstitutional. Petitioner offers no further explanation or argument in support of this claim.

In response, the Division asserts, first, that the relevant statutes should be interpreted strictly against petitioner in accordance with the statutory construction rule for deductions, exemptions and exclusions as described in ***Matter of Wegman's Food Markets, Inc. v Tax Appeals Trib. of the State of N.Y.*** (33 NY3d 587 [2019]).

The Division agrees with the determination's conclusion that, under the statutory scheme in effect during the period at issue, a royalty recipient cannot deduct royalty payments if those payments are not also required to be added back by the related member-royalty payer. The Division contends that the deductions claimed in the present matter are prohibited because, in the language of Tax Law former § 208 (9) (o) (3), the subject royalty payments "would not be required to be added back" because petitioner's alien affiliates are not New York taxpayers and are thus not subject to the add back provision. Hence, the Alien Affiliates "would [never] be required" to add back the royalty payments. The Division thus contends that only a royalty payer that is a New York taxpayer "would" be required to add back a royalty

payment "under" Tax Law former § 208 (9) (o) (2). The Division echoes the determination's finding that petitioner's proposed interpretation reads words into the statute. The Division notes further that Tax Law former § 208 (9) (o) (2) requires the add back for royalty payments to related members and thus requires the add back whether such royalty payments are made to a New York taxpayer or not. According to the Division, then, the reference in Tax Law former § 208 (9) (o) (3) to "related member," a term that includes nontaxpayers, does not support petitioner's position.

The Division also argues that its interpretation of Tax Law former § 208 (9) (o) (3) is consistent with the legislative history of Tax Law former § 208 (9) (o) (2), as well as the 2013 amendments of those provisions. The Division cites its own memoranda in support of the 2003 enactment of the expense add back and the 2013 amendments to Tax Law former § 208 (9) (o).

The Division also contends that Tax Law former § 208 (9) (o) (3), as applied, does not discriminate against interstate or foreign commerce. The Division denies petitioner's claim that that provision, as interpreted in the determination, favors New York taxpayers. The Division's argument relies on the notion, discussed above, that the royalty payments are subject to tax once whether the related member-royalty payer is a New York taxpayer or not. The Division asserts that the royalty income exclusion and expense add back provisions must be construed as a whole and that petitioner's argument on this issue improperly considers these provisions in isolation. The Division further contends that the complimentary exclusion and add back features of Tax Law former

§ 208 (9) (o) distinguish the present matter from the cases cited by petitioner in support of its position.

The Division disputes petitioner's claim of double taxation by noting, first, that there is neither evidence nor any contention that Tax Law former § 208 (9) (o) (3), as applied, resulted in double taxation. The Division also asserts that inclusion of royalty income in petitioner's entire net income pre-apportionment is not taxation. According to the Division, only the amount of the royalty income that is apportioned to New York in accordance with the Tax Law is taxed by New York.

Subsequent to the filing of its exception, the Division withdrew its claim that the Administrative Law Judge erroneously determined that the payments made by the Alien Affiliates were royalties within the meaning of Tax Law § 208 (9) (o) (1) (C). The Division did not withdraw its exception, but requested clarification with respect to its legal arguments in support of its position on the royalty income exclusion issue.

OPINION

Article 9-A of the Tax Law imposes a franchise tax on all domestic and foreign corporations doing business, employing capital, owning or leasing property, or maintaining an office in New York State (Tax Law § 209 [1] [a]). Corporations located within the Metropolitan Commuter Transportation District are also subject to an additional surcharge tax (Tax Law former § 209-B). During the years at issue, corporations reported their article 9-A tax liability on the greatest of four alternative bases, one of which was entire net income (ENI) (Tax Law former § 210 [1]).

Petitioner reported its liability during the years at issue on the ENI base (Tax Law former § 210 [1] [a]).

ENI is generally a taxpayer's entire federal taxable income modified by specific additions or subtractions (Tax Law former § 208 [9]). During the years at issue, ENI consisted of investment income and business income (Tax Law former § 208 [6], [8]). Investment income was allocated to New York using the investment allocation percentage (Tax Law former § 210 [3] [b]). Business income was allocated to New York using the business allocation percentage (BAP) (Tax Law former § 210 [3] [a]). These allocated amounts were totaled to arrive at the ENI base, which was subject to tax at the applicable rate (Tax Law former § 210 [1] [a]).

Tax Law former § 208 (9) (o) (3), the royalty income exclusion, was a subtraction modification to ENI that provided:

> "Royalty income exclusions. For the purpose of computing entire net income or other taxable basis, *a taxpayer shall be allowed to deduct royalty payments* directly or indirectly *received from a related member* during the taxable year to the extent included in the taxpayer's federal taxable income *unless such royalty payments would not be required to be added back under [Tax Law former § 208 (9) (o) (2)]* or other similar provision in this chapter" (emphasis added).

Tax Law former § 208 (9) (o) (2), referenced above, is the royalty expense add back, an addition modification that requires a taxpayer to add back royalty payments made to a related member in computing ENI, to the extent such payments were

deductible in calculating federal taxable income, unless one of the following exceptions apply: (1) the taxpayer-royalty payer is included in a combined report with the related member-royalty payee; (2) the related member-royalty payee later pays the royalty amounts to an unrelated party during the taxable year; or (3) the royalty payments are made to a non-U.S. related member that is subject to a comprehensive tax treaty with the United States. None of these exceptions apply here.

As to the correct standard of construction of Tax Law former § 208 (9) (o) (3), where, as in the present matter, "the question is whether taxation is negated by a statutory exclusion or exemption, . . . 'the presumption is in favor of the taxing power'" (***Matter of Wegman's Food Markets, Inc. v Tax Appeals Trib. of the State of N.Y.*** (33 NY3d at 592 quoting ***Matter of Mobil Oil Corp. v Finance Adm'r of City of N.Y.***, 58 NY2d 95, 99 [1983]). This means that any ambiguity or uncertainty in the meaning of the statute must be resolved against the taxpayer and that the taxpayer's interpretation of the statute must be not only plausible, but must be the only reasonable construction (***Matter of Charter Dev. Co., L.L.C. v City of Buffalo***, 6 NY3d 578, 582 [2006]).

The language of the statute "is the clearest indicator of legislative intent and courts should construe unambiguous language to give effect to its plain meaning" (***Matter of DaimlerChrysler Corp. v Spitzer***, 7 NY3d 653, 660 [2006]). The statutory language "must be read in [its] context, and words, phrases, and sentences of a statutory section should be interpreted with reference to the scheme of the entire section" (McKinney's Cons Laws of NY, Book 1,

Statutes § 97). Ultimately, proper statutory construction focuses on "the precise language of the enactment in an effort to give a correct, fair and practical construction that properly accords with the discernable intention and expression of the Legislature [citation omitted]" (***Matter of 1605 Book Ctr. v Tax Appeals Trib. of State of N.Y.***, 83 NY2d 240, 244, 245 [1994], ***cert denied*** 513 US 811 [1994]).

Turning to our analysis of the statutory language, we note first that petitioner and its Alien Affiliates were related members for purposes of Tax Law former § 208 (9) (o) (3) (***see*** finding of fact 47). As defined in Tax Law former § 208 (9) (o) (1) (A), that term means an entity or entities that have a controlling interest in another entity or entities. The definition expressly provides that a related member may be a nontaxpayer.

As noted, petitioner argues that, as none of the statutory exceptions to the add back are applicable, then the royalty payments at issue are the type that "would be required" to be added back under Tax Law former § 208 (9) (o) (2). According to petitioner, the payments thus meet the requirement for the income exclusion under Tax Law former § 208 (9) (o) (3) (royalty payments from related member excluded from ENI unless they would *not* be required to be added back under the add back provision).

While the present matter was pending, this Tribunal issued our decision in ***Matter of Walt Disney Co.*** (Tax Appeals Tribunal, August 6, 2020), where we held that the royalty income exclusion under Tax Law former § 208 (9) (o) (3) was not available to a taxpayer where, as here, the related member-alien affiliates were not New York taxpayers. We also

determined that this interpretation of Tax Law former § 208 (9) (o) (3) as applied to the facts in ***Disney*** did not discriminate against foreign commerce as asserted by petitioner in that case and thus did not violate the dormant Commerce Clause. The royalty transactions between petitioner and its Alien Affiliates are not materially different than the royalty transactions at issue in ***Disney***. Accordingly, pursuant to the following discussion, we reject petitioner's arguments and we sustain the Administrative Law Judge's conclusions on the issues presented herein.

In ***Disney***, we analyzed the statutory language and determined that royalty payments "would not be required to be added back" under Tax Law former § 208 (9) (o) (2) if the royalty payer was not a New York taxpayer. Specifically, we found that the plain meaning of "would" as used in Tax Law former § 208 (9) (o) (3) required that we consider all circumstances under which add back of royalties was not required, one of which occurred when the related member was not a taxpayer.

We also found that our interpretation of the statutory language, i.e., that the income exclusion was conditioned on a corresponding expense add back, comported with the overall statutory scheme. We noted that both the add back and exclusion provisions were enacted together and that the add back was expressly intended to eliminate a loophole by which a corporation reduced its ENI base by transferring intangible assets to a related corporation and paid a royalty for the use of such assets (***see*** L 2003, chs 62, 63, 686; New York Bill Jacket, 2003 SB 5725, Ch 686 Part M). By denying a deduction, the add back subjects a taxpayer-royalty payer to franchise tax on

royalties paid to a related member (with certain exceptions not relevant here). Where both the royalty payer and payee are New York taxpayers, the add back and income exclusion together simply shift the incidence of tax on the royalties from payee to payer and thereby avoid subjecting the same revenue to franchise tax twice. Considering the language of Tax Law former § 208 (9) (o) as a whole, and the express intent of the add back provision, we concluded in ***Disney*** that the legislature did not intend for a taxpayer to gain the benefit of the income exclusion under subparagraph (3) without the accompanying cost to a related member of the add back under subparagraph (2).

Contrary to petitioner's contention, we do not find that the 2013 amendments to Tax Law former § 208 (9) (o) support its interpretation here. As we stated in ***Disney***, our interpretation of Tax Law former § 208 (9) (o) (3) "draws no inference from the 2013 repeal of that provision (***see*** L 2013 ch 59)." In ***Disney***, we found that the legislative history of the repeal statute offered "no insight as to the legislative intent underlying the 2003 enactment of that provision."

As noted, we also determined in ***Disney*** that our interpretation of Tax Law former § 208 (9) (o) (3) as applied therein did not discriminate against foreign commerce and thus did not violate the dormant Commerce Clause. In reaching this conclusion, we followed the principle of taking the "whole scheme of taxation into account" (***Halliburton Oil Well Cementing Co. v Reily***, 373 US 64, 69 [1963]). We further noted that case law defines dormant Commerce Clause discrimination in terms of economic interests, as opposed to the interests of taxable

entities (***e.g. Oregon Waste Sys., Inc. v Dept. of Envtl. Quality of Oregon***, 511 US 93, 99 [1994] ["'discrimination' simply means differential treatment of in-state and out-of-state economic interests that benefits the former and burdens the latter"]; ***New Energy Co. of Indiana v Limbach***, 486 US 269, 273 [1988] [discrimination defined generally as "regulatory measures designed to benefit in-state economic interests by burdening out-of-state competitors"]). We also observed that the income exclusion and the expense add back provision apply only in the context of related member transactions and that related members, by definition, share the same economic interest. Accordingly, we considered the impact of both the income exclusion and the expense add back components of Tax Law former § 208 (9) (o) on the shared economic interest of the petitioner in ***Disney*** and its related member alien affiliates. We thus concluded that Tax Law former § 208 (9) (o) (3) as applied did not violate the dormant Commerce Clause.

In the present matter, petitioner cites ***Kraft Gen. Foods, Inc. v Iowa Dept. of Revenue and Fin.*** (505 US 71 [1992]) in support of its dormant Commerce Clause claim. In ***Kraft***, an Iowa law that allowed a deduction for dividends received from domestic subsidiaries, but not for dividends received from foreign subsidiaries, was determined to discriminate against foreign commerce and thereby violate the Commerce Clause. We think that ***Kraft*** is distinguishable. Specifically, in contrast to the unequal treatment of the two groups of taxpayers in ***Kraft***, the overall impact of Tax Law former § 208 (9) (o) is to impose a similar ENI burden on the shared economic interests of related members, whether or not

the royalty payer is also a taxpayer. As we explained in ***Disney***:

> "As discussed, petitioner did not qualify for the income exclusion because its related member alien affiliates were not subject to the expense add back. Petitioner was thus required to include the royalties in its ENI. In the hypothetical comparison of related members similarly situated in all respects except that the royalty payer is also a taxpayer, the payee may exclude the royalties, but the payer is subject to the add back and thus includes the royalties in its ENI. In both instances, a related member pays tax on the royalties. Petitioner pays the tax directly, while its similarly situated counterpart pays the tax indirectly through its controlling interest in its related member."

As to petitioner's contention that the Administrative Law Judge's interpretation will result in unconstitutional double taxation if a non-New York related member-royalty payer is in a jurisdiction with an add back statute, we note our limited jurisdiction on questions of constitutionality. We may consider the constitutionality of a statute as applied to a specific set of facts (***Matter of Eisenstein***, Tax Appeals Tribunal, March 27, 2003), but we may not consider the constitutionality of a statute on its face, as facial validity is presumed at the administrative level (***Matter of A & A Serv. Sta., Inc.***, Tax Appeals Tribunal, October 15, 2009). As there is no evidence in the record that petitioner's Alien Affiliates were taxed on the royalty payments, there is no issue of double taxation here.

With respect to the remaining basis for the Division's exception, we note that, following the Division's withdrawal of its contention that the Administrative Law Judge improperly determined that the payments made by the Alien Affiliates were royalties, the Division's exception expresses no disagreement with any of the determination's findings of fact or conclusions of law (***see*** p 18). Hence, there is no basis for the Division's exception (***see*** 20 NYCRR 3000.17 [b]). We thus deem the Division's exception to be withdrawn.

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

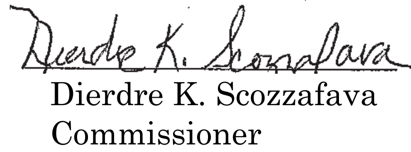
1. The exception of International Business Machines Corporation and Combined Affiliates is denied;

2. The determination of the Administrative Law Judge is affirmed;

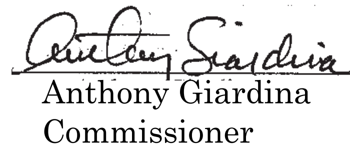
3. The petitions of International Business Machines Corporation and Combined Affiliates are denied;

4. The notices of disallowance, dated October 7, 2015 and September 28, 2016, and notice of deficiency dated October 5, 2016 are sustained.

DATED: Albany, New York
March 05, 2021



Dierdre K. Scozzafava
Commissioner



Anthony Giardina
Commissioner

APPENDIX D

Determination of the Administrative Law Judge, dated December 19, 2019

[pp. 763 - 784]

STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petitions of INTERNATIONAL BUSINESS MACHINES CORPORATION AND COMBINED AFFILIATES for Redetermination Deficiencies or for Refunds of Corporation Franchise Taxes under Article 9-A of the Tax Law for the Tax Periods January 1, 2007 through December 31, 2012.	: : : : : : :	DETERMINATION DTA NOS. 827825, 827997 AND 827998

Petitioner, International Business Machines Corporation and Combined Affiliates, filed petitions for redetermination of deficiencies or for refunds of corporation franchise taxes under article 9-A of the Tax Law for the tax periods January 1, 2007 through December 31, 2012.

On, December 17, 2018 and December 21, 2018, respectively, petitioner, appearing by Baker &

McKenzie LLP (Scott Brandman, Esq., and David Pope, Esq., of counsel), and the Division of Taxation appearing by Amanda Hiller, Esq. (Jennifer L. Baldwin, Esq., of counsel), waived a hearing and agreed to submit the matter for determination based on documents and briefs to be submitted by June 21, 2019, which date commenced the six-month period for the issuance of this determination. After review of the evidence and arguments presented, Kevin R. Law, Administrative Law Judge, renders the following determination.

ISSUES

I. Whether petitioner may exclude royalties received from foreign affiliates in the computation of its entire net income.

II. Whether denying petitioner an exclusion under Tax Law former § 208 (9) (o) for royalties received from its alien affiliates because the alien affiliates are not New York taxpayers violates the dormant Commerce Clause of the United States Constitution.

FINDINGS OF FACT

The parties executed a stipulation of facts in connection with this matter. Such stipulated facts have been substantially incorporated into the findings of fact set forth herein except for stipulated facts which set forth undisputed procedural matters whose recitation is unnecessary for the resolution of this matter.

1. International Business Machines Corporation (IBM) is a New York corporation and the publicly-traded parent of a worldwide group of companies.

2. IBM World Trade Corporation (WTC) is a Delaware corporation headquartered in New York.

3. IBM owns 100 percent of the outstanding stock of WTC.

4. IBM and WTC filed as part of a federal consolidated return, along with numerous other domestic affiliates, for federal corporate income tax purposes during the periods at issue.

5. IBM and WTC filed as part of petitioner's New York State combined report, along with numerous other domestic affiliates, for New York State corporation franchise tax purposes for the tax years 2007 through 2012 (periods at issue).

6. IBM operates in over 170 countries, primarily through locally incorporated subsidiary companies (Alien Affiliates).

7. IBM is responsible for selling IBM products and services in the United States directly to third parties.

8. WTC serves several functions as IBM's principal entity to conduct offshore activities, including: (1) operates a network of branches in countries where IBM does not have full fledged subsidiaries; (2) contracts directly with third party customers to sell IBM products in certain countries; (3) sublicenses the right to distribute IBM products to IBM Alien Affiliates; and (4) serves as the holding company for IBM's Alien Affiliates.

9. WTC does not have any United States sales.

10. IBM and WTC indirectly own 100 percent of the outstanding stock of IBM's Alien Affiliates. The subset of affiliates which engage in sales to third party customers are commonly referred to within IBM as sales and distribution affiliates (Alien S&D Affiliates).

11. Since its incorporation in 1911, IBM's mode of operations has changed over time as the company has adapted to changes to the global economy.

12. IBM serves as the legal owner to all IBM intangible property, including the IBM brand.

13. IBM directs, controls, and funds all research and development activity (R&D) performed by IBM and its Alien Affiliates.

14. IBM incurs globally-benefitting selling, general and administrative (SG&A) expenses, including worldwide marketing expenses related to the IBM brand.

15. IBM historically granted the economic right to exploit intangible property to WTC and the Alien Affiliates through a series of intercompany agreements.

16. IBM and WTC grant the Alien Affiliates the right to exploit IBM's intangible property relating to software, hardware, and services in a designated region in exchange for specified payments by the Alien S&D Affiliate.

17. During the periods at issue, IBM, WTC, and certain Alien S&D Affiliates were parties to a cost

sharing arrangement whereby certain IBM costs, such as R&D, were borne by WTC and the Alien S&D Affiliates collectively with IBM.

18. The payments received by IBM from WTC and the Alien Affiliates as part of these cost sharing arrangements were not included as royalty payments and were not deducted on line 15, other subtractions, of petitioner's original or amended forms CT-3-A for the periods at issue.

19. The Alien S&D Affiliates earn revenue by selling IBM hardware, sublicensing IBM software, and providing services to third party customers.

20. During the periods at issue, the Alien S&D Affiliates paid IBM or WTC 60 percent of their revenue for the rights under IBM's patents, trademarks, copyrights, mask works, knowledge and technical know-how related thereto to use, distribute, and market IBM computer software programs. As part of the stipulation of facts, the parties submitted a copy of a sample software agreement (software agreement) in effect during the periods at issue between IBM and an Alien S&D Affiliate. The software agreement provided, in pertinent part as follows:

> "IBM . . . grants to [Alien S&D Affiliate] under IBM's Copyrights, Mask Work Rights and Patents the non-exclusive rights (i) to license and distribute copies of IBM programs for their ultimate use by customers, (ii) to use such IBM Programs in revenue producing activities, (iii) to use such IBM programs internally, (iv) to make or have made copies for the purposes described above, for distribution to affiliated companies, and for

> translation or modification of such IBM programs, and (v) to allow [Alien S&D Affiliate's] customers to use, make copies of and modify IBM Programs pursuant to the terms of [Alien S&D Affiliate's] agreements with its customers. . .
>
> IBM . . . grants [Alien Affiliate] . . . the right to use all of IBM's Trademarks on or in association with IBM Programs . . .
>
> IBM agrees ... to allow [Alien S&D Affiliate] ... access to and use of all knowledge and technical know-how, both confidential and other, that it may have available at any given time relating to the reproduction, use, modification, marketability, education of users, service and maintenance of IBM Programs and to make such knowledge and technical know-how available to [Alien S&D Affiliate] in the United States of America without separate charge. . ."

Under the software agreement, "Programs" are defined as "instructions written, contained, or recorded on materials, documents or machine readable media capable of being executed on, or used in the operation of, a machine; and information, technology, or data related thereto." "IBM Programs" are defined as "Programs protected by IBM's Patents, Mask Work Rights or Copyrights."

In addition to the agreed upon monetary payments, the software agreement granted IBM the "non-exclusive, unrestricted license with respect to Programs now or hereafter existing under [the Alien S&D Affiliate's] Patents, Mask Work Rights and Copyrights, including the right to sublicense to others."

21. During the periods at issue, the Alien S&D Affiliates paid WTC a percentage (typically 5 to 10 percent) of their gross charges, less returns and allowances, for the rights under IBM's patents and trademarks to manufacture and sell IBM computer hardware. The rate applied to the gross charges less returns and allowances varied by product family. As part of the stipulation of facts, the parties submitted a copy of a sample hardware agreement (hardware agreement) in effect during the periods at issue between WTC and an Alien S&D Affiliate. The representative hardware agreement provided, in pertinent part as follows:

> "WTC . . . grants to [Alien S&D Affiliate] a non-exclusive, nontransferable license under IBM Technology to manufacture or have made (when [Alien S&D Affiliate] acts in its capacity as a manufacturer and not in its capacity as a distributor), for subsequent sale, lease, internal use, or other disposition, Products within Product Families specified [therein], and to practice any method or process used in such manufacture or internal use by [Alien S&D Affiliate].
>
> WTC .. . grants to [Alien S&D Affiliate] ... a non-exclusive, nontransferable license to utilize the now and hereafter existing IBM Trademarks on or in association with Products produced under the grant [above] for the purpose of marketing, selling and leasing such Products and to use in its trade names the IBM Trademark 'IBM' ..."

The hardware agreement defines "Technology" as:

> "any and all technologies, procedures, processes, designs, inventions, discoveries, know-how and works of authorship, including without limitation, documentation and all (i) issued patents, utility models, and the like and applications therefor, (ii) copyrights, whether or not registered, and other rights in works of authorship, (iii) mask work rights, (iv) trade secrets, (v) confidential information, (vi) the right to extract data from databases under current and future laws and (vii) other intellectual property rights constituting, embodied in, or pertaining thereto. Technology shall not include trademarks or service marks."

In turn, "IBM Technology" is defined as "all Technology now or hereafter owned by or licensed to IBM, including Technology covered under an IBM Cost Sharing Agreement, for which IBM has the right to grant the licenses granted in [the Hardware Agreement]."

22. During the periods at issue, the Alien S&D Affiliates paid WTC for the right to provide services, including maintenance services, systems integration, outsourcing network services, consulting, and education services relating to IBM products. As part of the stipulation of facts, the parties submitted a copy of a sample service agreement in effect during the periods at issue between WTC and an Alien S&D Affiliate. This representative service agreement provided, in pertinent part as follows:

> "[WTC] . . . grants to [Alien S&D Affiliate] a non-exclusive, nontransferable license under IBM Intellectual Property, which is necessary to enable

[Alien S&D Affiliate] to provide Services related to ITS products and Programs to Unaffiliated Customers. [WTC] . . . grants to [Alien S&D Affiliate] a non-exclusive, nontransferable license under IBM Intellectual Property necessary to enable [Alien S&D Affiliate] to manufacture and have made maintenance parts (other than hard disk drive maintenance parts) for ITS Products and to acquire hard disk maintenance parts for ITS Products from Subsidiaries in order to: (i) sell or lease such maintenance parts to Unaffiliated Customers; and, (ii) to use or otherwise dispose of such maintenance parts.

[WTC] . . . grants to [Alien S&D Affiliate] a non-exclusive license and rights under IBM's Services Copyrights: (i) to license and distribute copies for their ultimate use by Unaffiliated Customers, (ii) to use in revenue producing activities, (iii) to use internally, (iv) to make or have made copies for the purposes described above, for distribution to Subsidiaries, and for translation or modification, and (v) to allow [Alien S&D Affiliate's] Unaffiliated Customers, for the customers internal use only, to use, copy, and modify such licensed IBM Service Copyrights pursuant to the terms of [Alien S&D Affiliate's] agreements with customers.

[WTC] . . . sublicenses [Alien S&D Affiliate] to have the right to use all IBM Trademarks on or in association with (i) Services; (ii) maintenance parts, and (iii) Vendor Developed Products, and to use in its trade names the IBM Trademark 'IBM.'

> In addition to the grant of the foregoing licenses and rights, [WTC] agrees . . . to allow [Alien S&D Affiliate] . . . access to all knowledge and technical know-how, both confidential and other, related to the grants [above] that [WTC] may have available at any given time, and to make such knowledge and technical know-how available to [Alien S&D Affiliate] in the form in which it exists and where it exists without separate charge . . . under Services Agreements."

23. During the periods at issue, the Alien S&D Affiliates paid IBM or WTC for the economic rights to already existing intangible property for the purpose of creating cost-shared intangibles with IBM and distributing IBM products within their respective region. As part of the stipulation of facts, the parties submitted a copy of a sample platform contribution agreement between IBM and an Alien S&D Affiliate in effect during the periods at issue. A typical Platform Contribution Agreement provided for the following:

> "[IBM] . . . grants to [Alien Affiliate] . . . a terminable, sublicensable, non exclusive license to [IBM's] interests to and under the PCT Assets to use such PCT Assets for purposes of creating Cost Shared Intangibles in accordance with the [Cost Sharing Agreement]; and . . . a terminable, sublicensable, non-exclusive license to [IBM's] interests to and under the IBM Products to exploit such IBM Products commercially within the [Alien S&D Affiliate's] Territory solely for purposes of engaging in transactions consisting of licensing, sublicensing and sales of IBM Products . . ."

"PCT Assets" is defined as:

> "(a) the Intangible Property owned, acquired by, licensed to, or developed by [IBM] on or prior to the Effective Date that is embodied or used in, or otherwise relates to, IBM Products *and* (ii) used in conducting intangible development under the [Cost Sharing Agreement]; and
>
> (b) any other Platform Contribution acquired by, licensed to, or developed by, [IBM] on or prior to the Effective Date and used in conducting intangible development under the [Cost Sharing Agreement] relating to IBM products ..."

Payments under the Platform Contribution Agreement (buy-in/other payments) are based on varying percentages of revenue from sales of IBM hardware products and IBM software products.

24. IBM and WTC did not file with any of its Alien S&D Affiliates as part of petitioner's federal consolidated return for federal income tax purposes during the periods at issue.

25. For federal income tax purposes, petitioner included the payments IBM and WTC received from the Alien S&D Affiliates pursuant to the hardware, software and services agreements (Alien Payments) on line 7, gross royalties, of its respective federal forms 1120 for all periods at issue. The remaining amounts petitioner reported on line 7 of its federal forms 1120 reflect amounts received directly from third parties in the United States (Third Party Payments).

26. The Alien Payments were neither directly nor indirectly paid to, nor incurred by, any unrelated parties during the periods at issue.

27. IBM and WTC did not file with the Alien S&D Affiliates as part of petitioner's combined report for New York State corporation franchise tax purposes for the periods at issue. The Alien S&D Affiliates did not file corporation franchise tax returns in New York State for any of the periods at issue.

28. Petitioner timely filed original New York State combined corporation franchise tax returns (form CT-3-A) for all periods at issue.

29. Petitioner timely filed amended New York State combined corporation franchise tax returns for 2007, 2008, 2009 and 2010.

30. On its amended forms CT-3-A for 2007, 2008, 2009 and 2010, petitioner deducted the Alien Payments on line 15, other subtractions, in the following amounts:

2007	$8,179,964,431.00
2008	$8,878,166,400.00
2009	$8,207,649,952.00
2010	$10,435,412,751.00

Petitioner did not deduct any Third Party Payments on Line 15 of its forms CT-3-A for any of the periods at issue.

31. For 2007, the $8,179,964,431.00 deduction was composed of $6,068,092,311.00 in software payments pursuant to terms akin to the sample agreement described in finding of fact 20, $784,111,279.00 in hardware payments pursuant to terms akin to the sample agreement described in finding of fact 21, $1,772,987,213.00 in service/maintenance payments pursuant to terms akin to the sample agreement described in finding of fact 22, and $94,773,628.00 in buy-in/other payments pursuant to terms akin to the sample agreement described in finding of fact 23.

32. For 2008, the $8,768,166,400.00 deduction was composed of $6,426,579,964.00 in software payments pursuant to terms akin to the sample agreement described in finding of fact 20, $942,064,461.00 in hardware payments pursuant to terms akin to the sample agreement described in finding of fact 21, $1,341,030,312.00 in service/maintenance payments pursuant to terms akin to the sample agreement described in finding of fact 22, and $58,491,663.00 in buy-in/other payments pursuant to terms akin to the sample agreement described in finding of fact 23.

33. For 2009, the $8,207,649,952.00 deduction was composed of $6,082,061,194.00 in software payments pursuant to terms akin to the sample agreement described in finding of fact 20, $788,515,378.00 in hardware payments pursuant to terms akin to the sample agreement described in finding of fact 21, $1,299,158,626.00 in service/maintenance payments pursuant to terms akin to the sample agreement described in finding of fact 22, and $37,914,754.00 in buy-in/other payments pursuant to terms akin to the sample agreement described in finding of fact 23.

34. For 2010, the $10,435,412,751.00 deduction was composed of $6,045,010,532.00 in software payments pursuant to terms akin to the sample agreement described in finding of fact 20, $2,056,285,953.00 in hardware payments pursuant to terms akin to the sample agreement described in finding of fact 21, $1,361,414,368.00 in service/maintenance payments pursuant to terms akin to the sample agreement described in finding of fact 22, and $972,701,898.00 in buy-in/other payments pursuant to terms akin to the sample agreement in described in finding of fact 23.

35. On its amended forms CT-3-A and CT-3M for 2007, 2008, 2009, and 2010, petitioner requested refunds in the following (total) amounts:

2007	$3,640,689.00
2008	$4,764,483.00
2009	$5,822,312.00
2010	$35,382,756.00

36. On its original forms CT-3-A for 2011 and 2012, petitioner deducted the Alien Payments on line 15, other subtractions, in the following amounts:

2011	$8,158,917,978.00
2012	$7,392,158,177.00

Petitioner did not deduct any Third Party Payments on line 15 of its forms CT-3-A for any of the periods at issue.

37. For 2011, the $8,158,917,978.00 deduction was composed of $5,643,552,996.00 in software payments pursuant to terms akin to the sample agreement described in finding of fact 20, $274,906,946.00 in hardware payments pursuant to terms akin to the sample agreement described in finding of fact 21, $1,498,060,515.00 in service/maintenance payments pursuant to terms akin to the sample agreement described in finding of fact 22, and $742,397,521.00 in buy-in/other payments pursuant to terms akin to the sample agreement described in finding of fact 23.

38. For 2012, the $7,392,258,177.00 deduction was composed of $5,647,363,014.00 in software payments pursuant to terms akin to the sample agreement in described in finding of fact 20, $312,280,649.00 in hardware payments pursuant to terms akin to the sample agreement described in finding of fact 21, $1,328,718,902.00 in service/maintenance payments pursuant to terms akin to the sample agreement described in finding of fact 22, and $103,895,612.00 in buy-in/other payments pursuant to terms akin to the sample agreement described in finding of fact 23.

39. On its original forms CT-3-A and CT-3M for 2011, petitioner requested a refund of $32,760,047.00.

40. On its original forms CT-3-A and CT-3M for 2012, petitioner requested an overpayment of $26,614,724.00 to be credited to the next period.

41. The Division conducted audits of petitioner's corporation franchise tax returns for the periods at issue.

42. The Division determined the petitioner could not deduct the Alien Payments in computing its combined entire net income in any of the periods at issue.

43. By notice of disallowance dated October 7, 2015, the Division denied petitioner s claims for refund for the 2007, 2008 and 2009 tax years. By notice of disallowance dated September 28, 2016, the Division denied petitioner's claim for refund for tax year 2010.

44. The Division also made other adjustments (unrelated to the amounts petitioner deducted on line 15 of its forms CT-3-A) to petitioner's New York State combined corporation franchise tax returns for the 2007 through 2009 tax years that are not at issue here. Petitioner and the Division executed a closing agreement with respect to those adjustments.

45. The Division issued a notice of deficiency, notice number L-045504338, on October 5, 2016, asserting additional corporation franchise tax and MTA surcharge in the amount of $64,615,318.00 for the 2011 and 2012 tax years, plus interest and penalty pursuant to Tax Law § 1085 (k) for substantial under reporting of the amount asserted due. The notice of deficiency reflects the disallowance of the Alien Payments claimed as royalties on line 15 of its form CT-3-A in those years. The Division also made other adjustments not at issue here that are reflected in the notice of deficiency.

46. The only remaining issue is whether petitioner may deduct the Alien Payments on its forms CT-3-A for any of the periods at issue. Any of these amounts determined to be properly deducted from petitioner's

combined entire net income would likewise be excluded from the denominator of the receipts factor of petitioner's business allocation percentage (BAP). Any of these amounts determined to be properly included in petitioner's combined entire net income would likewise be included in the denominator of the receipts factor of petitioner's BAP.

47. Whether the Alien S&D Affiliates are "related members" for purposes of Tax Law former 208 (9) (o) is not at issue in this matter.

CONCLUSIONS OF LAW

A. Article 9-A of the Tax Law imposes a franchise tax on all domestic and foreign corporations doing business, employing capital, owning or leasing property, or maintaining an office in New York State (Tax Law former § 209 [I]).[1]

B. In New York, corporate taxpayers report their tax liability based on their computation of the highest of four income bases, one of which is their entire net income (ENI) base (Tax Law former § 210 [1] [a-d]). A corporation's ENI is computed by calculating its entire net income, generally consisting of its investment income (Tax Law former § 208 [6]) and its business income (*see* Tax Law former §§ 210 [1] [a]; [3]; 208 [8], [9]; 209 [1]). In turn, the corporation's investment income and business income are allocated to New York pursuant to the corporation's investment allocation percentage (IAC) (Tax Law former § 210 [3] [b]) and its

[1] An additional surcharge tax is imposed, per Tax Law former § 209-B, upon corporations located or doing business within the Metropolitan Commuter Transportation District (MCTD).

BAP (Tax Law former § 210 [3] [a]), with the resulting amounts totaled to arrive at the corporation's ENI base.

C. In determining a corporation's ENI, Tax Law § 208 (9) provides that ENI means "total net income from all sources, which shall be presumably the same as the entire taxable income" subject to certain modifications. The modifications at issue in this proceeding are contained in Tax Law former § 208 (9) (o), which provided that a taxpayer was allowed to deduct royalty payments received from a related member during the taxable year, to the extent such was included in the taxpayer's federal taxable income, unless the royalty payments were not required to be added back under the expense disallowance provisions or other similar provisions of the Tax Law. Royalty payments to related members were not required to be added back if: (i) the related members were part of a combined report (combined reporting exception); or (ii) the related member paid the royalty during the same tax year to a non-related member for a valid business purpose in an arm's-length deal (the conduit exception); or (iii) the royalty payments were paid to a related member organized under the laws of a foreign country subject to a comprehensive tax treaty with the United States and the payments were taxed in that country at a rate equal to or greater than the rate in New York (treaty exception) (Tax Law former § 208 [9] [o] [2] [B]). A related member was defined as a controlling interest in a corporation or other entity (Tax Law former § 208 [9] [o] [1] [A]). A controlling interest meant either 30 percent or more of the total combined voting power of all classes of stock in a corporation or 30 percent or more of the capital, profits,

or beneficial interest in that voting stock (Tax Law former § 208 [9] [o] [1] [B]).

D. First, addressing whether the amounts petitioner deducted from ENI were royalties, the Division has taken the position that not all of the payments in question were royalty payments. As noted in the findings of fact, the payments in question fall into four categories; to wit: (i) hardware payments; (ii) software payments; (iii) service payments: and (iv) buy in/other payments. In its brief, the Division appears to accept that the hardware payments and service payments are royalties but contends that the software payments and buy/in other payments do not qualify as royalties. Specifically the Division contends that "[t]he difference in rates IBM and WTC charged the Alien S&D Affiliates pursuant to the Software Agreements (60 percent) as opposed to the Hardware and Services Agreements (2 to 15 percent) shows that the software payments are comprised of more than just payments for the use of trademarks, copyrights, mask works, et cetera, and are more akin to a revenue sharing arrangement for the sale of IBM software abroad. As such, the software payments go beyond the definition of 'royalty payments' in Tax Law 208(9)(o)(l)(C)." As to the buy-in other payments, the Division asserts that petitioner has not proven that these payments qualify as royalties. The Division's arguments are rejected.

E. Tax Law § 208 (9) (o) (1) (C) defines royalties as:

> "[P]ayments directly connected to the acquisition, use, maintenance or management, ownership,

> sale, exchange, or any other disposition of licenses, trademarks, copyrights, trade names, trade dress, service marks, mask works, trade secrets, patents and any other similar types of intangible assets as determined by the commissioner, and include amounts allowable as interest deductions. . . to the extent such amounts are directly or indirectly for, related to or in connection with the acquisition, use, maintenance or management, ownership, sale, exchange or disposition of such intangible assets" (Tax Law § 208 [9] [o] [1] [C]).

With respect to the software payments, the stipulated facts provide that they were for the rights under IBM's patents, trademarks, copyrights, mask works, knowledge and technical know-how related thereto to use, distribute, and market IBM computer software programs. These payments fall directly within the definition of a royalty. The Division's argument that the consideration paid by the Alien S&D Affiliates is inflated and is really a revenue sharing arrangement is purely speculative and there is nothing in the record to suggest otherwise. Likewise, with respect to the buy-in/other payments, these payments were for the economic rights to already existing intangible property for the purpose of creating cost-shared intangibles with IBM and distributing IBM products within their respective region, and were based on varying percentages of revenue from sales of IBM hardware products and IBM software products. Again, these payments fall squarely within the definition of a royalty contained in Tax Law § 208 [9] [o] [1] [C]. It is noted that under the Treasury's transfer pricing regulations, a buy-in payment may take the form of a royalty (*see* Treas Reg § 1.482-7A

[g]). It is therefore concluded that the Alien Payments were royalties for purposes of Tax Law § 208 [9] [o] [1] [C].

F. Having found that the Alien Payments were royalties, the next issue to be addressed is whether such amounts may be properly excluded from ENI. Specifically, the statute provides that:

> "For the purpose of computing entire net income or other taxable basis, a taxpayer shall be allowed to deduct royalty payments directly or indirectly received from a related member during the taxable year to the extent included in the taxpayer's federal taxable income unless such royalty payments would not be required to be added back under subparagraph two of this paragraph or other similar provision in this chapter" (Tax Law former § 208 [9] [o] [3]).

Petitioner contends that its alien affiliates would not be required to add back the royalty payments under subparagraph two of former section 208 (9) (o) of the Tax Law, which provides as follows:

> "(A) [F]or the purpose of computing entire net income or other applicable taxable basis, a taxpayer must add back royalty payments to a related member during the taxable year to the extent deductible in calculating federal taxable income.
>
> (B) The add back of royalty payments shall not be required if and to the extent that such payments meet either of the following conditions:

> (i) the related member during the same taxable year directly or indirectly paid or incurred the amount to a person or entity that is not a related member, and such transaction was done for a valid business purpose and the payments are made at arm's length
>
> (ii) the royalty payments are paid or incurred to a related member organized under the laws of a country other than the United States, are subject to a comprehensive income tax treaty between such country and the United States, and are taxed in such country at a tax rate at least equal to that imposed by this state."

G. Petitioner contends that under the plain wording of the statute, the Alien Payments would not have to be added back to ENI if the Alien S&D Affiliates were New York taxpayers because they did not meet the combined reporting exception, the conduit exception, or the tax treaty exception of Tax Law § 208 (9) (o) (2). Petitioner argues that the definition of "related member," which includes corporations with a controlling interest whether such entity is a taxpayer or not, indicates that the Legislature intended that the royalty income exclusion apply regardless of whether the payer was a taxpayer or not. In contrast, the Division argues that since the Alien S&D Affiliates were not New York taxpayers nor were they federal taxpayers, the Alien Payments would never have to be added back to taxable income and therefore the exceptions do not apply.

As noted by the Division, the purpose of the statute was to address a common tax avoidance strategy

whereby a corporation transferred its intangible assets, such as trademarks, to a related corporation and paid a royalty for the use of those intangible assets thereby reducing its taxable earnings in New York (***see*** New York Bill Jacket, 2003 S.B. 5725, Ch. 686 Part M [Clarifies the provisions of law which eliminate tax loopholes concerning royalty payments and certain interest payments to exclude royalty payments made to certain foreign corporation related members]). Bearing in mind that the statute should be administered to effectuate the intent of the Legislature (***see Matter of 1605 Book Center v Tax Appeals Tribunal***, 83 NY2d 240 [1994]), excluding royalty income from petitioner's ENI in this instance does not advance this legislative purpose. The addback and exclusion provisions contained in Tax Law former § 208 (9) (o) work in tandem to ensure that royalty transactions between related members are taxed only once, and do not escape taxation altogether. Petitioner's interpretation of the statute effectively adds words that are not present (i.e., *if the payer were a New York taxpayer*). Here, petitioner may not exclude royalty payments received from its Alien Affiliates in computing ENI. Petitioner's arguments overlook that the foreign affiliates payments would not be required to be added back to federal taxable income because the foreign affiliates were not New York taxpayers, much less United States taxpayers. Likewise, there is no indication that the Alien S & D Affiliates paid tax in their home country such that they would qualify for the treaty exemption.

Although petitioner argues that resort to legislative history is inappropriate as the statute is clear, courts have recognized that the absence of facial ambiguity is

rarely, if ever, conclusive and, where the plain meaning is at variance with legislative purpose, sound principles may require examination of a statute's legislative history and context (***see generally New York State Bankers Assn, v Albright***, 38 NY2d 430 [1975] ***mod. on other grounds***, 38 NY2d 953 [1976], [where the court found that while the statute was "literally unambiguous," the legislative history in context established that the Legislature never intended to authorize savings banks to provide checking account services through NOW accounts]); ***Matter of Meyer***, 209 NY 386 [1913] [where Court found literal reading of tax statute must give way to judicial construction in order to prevent unintended results]). In this case, under petitioner's interpretation, the royalty income would escape taxation altogether, a result that the Legislature surely did not intend.

H. Petitioner also argues the 2013 amendments to Tax Law § 208 (9) (o), which removed the royalty income exclusion provision and made other changes to the statute, supports its interpretation. Specifically, petitioner points to the Statement in Support of Chapter 59, Part E of the Laws of 2013, which explained that the pre-2013 version of the statute had been interpreted by some taxpayers in ways that were "inconsistent" with "the Department's interpretation," including the interpretation of "eligibility for the income exclusion provision" and "the scope of the 'related members' definition." Petitioner's argument is misplaced as it takes statements out of context from the other portions of the statement in support which provides as follows:

"The current add-back and exclusion system under the Tax Law and in the NYC Administrative Code has been subject to exploitation by taxpayers. Under the current system, the recipient of royalty payments can exclude these payments as long as the payor is also a New York taxpayer. This creates an incentive for taxpayers to take advantage of the income exclusion provision by allowing the income exclusion for a payment received from a related member with a small New York presence (i.e. a very low business allocation percentage [BAP]), even if the recipient has a large BAP and large royalty income, resulting in significant tax savings.

The provisions of the current statute also have been interpreted by some taxpayers in ways that are inconsistent with the intent of the statute and the Department's interpretation. For example, issues have been raised regarding eligibility for the income exclusion provision, as well as the scope of the 'related members' definition.

This bill would eliminate those inconsistent readings with clear language on the applicability of the required add-back, and the exceptions thereto, in order to prevent tax avoidance while allowing for fair and equitable administration. The bill, which is based upon a Multistate Tax Commission model statute, would modify the royalty income add-back and exclusion provisions of the Tax Law, and in corresponding sections of the NYC Administrative Code, by eliminating the exclusion of royalty income received if the related

member who made the royalty payment was required to add back the payment to its income. Instead, the bill would create several new exceptions to the add-back requirement."

Thus, contrary to petitioner's assertions, the amendment to Tax Law § 208 (9) (o) does not support its interpretation, it actually bolsters the Division's position that Tax Law former § 208 (9) (o) (3) required the related member royalty payer to be a New York taxpayer in order for the payee to be qualified for the royalty income exclusion.

I. Petitioner next argues that the Division's interpretation of Tax Law § 208 (9) (o) violates the dormant Commerce Clause of the United States Constitution. Article I, Section 8, clause 3 of the United States Constitution gives Congress the power "to regulate commerce with foreign Nations, and among the several States...." In addition to Congress' express power to regulate commerce, the dormant or negative Commerce Clause is a legal principle developed by the Supreme Court that gives the adjudicative body the power to protect the free flow of commerce, and thereby safeguard Congress' latent power from encroachment by the several States" when Congress has not affirmatively exercised its Commerce Clause power (***Merrion v Jicarilla Apache Indian Tribe***, 455 US 130, 154 [1982]). Simply stated, the dormant Commerce Clause prohibits states from imposing taxes that "benefit in-state economic interests by burdening out-of-state competitors" (***Fulton Corp. v Faulkner***, 516 US 325, 330 [1996]). In ***Complete Auto Transit, Inc. v Brady***, 430 US 274, 279 (1977), the Supreme Court set forth a

four-pronged test to determine whether a state tax violates the Commerce Clause. Pursuant to this test, a state tax will withstand a Commerce Clause challenge if the tax: (1) is applied to an activity having a substantial nexus with the taxing state; (2) is fairly apportioned; (3) does not discriminate against interstate commerce; and (4) is fairly related to the services provided by the state. Heightened scrutiny is required if foreign commerce is implicated (***see Japan Line, Ltd. v County of Los Angeles***, 441 US 434, 451 [1979]).

J. In this matter, petitioner argues that the dormant Commerce Clause is violated under the third prong of the Complete Auto test, the anti-discrimination requirement. A tax violates the Commerce Clause anti-discrimination requirement if it is "facially discriminatory, has a discriminatory intent, or has the effect of unduly burdening interstate commerce" (***Amerada Hess Corp, v Director, Div. of Taxation, NJ Dept of the Treasury***, 490 US 66, 75 [1989]). Citing ***Kraft General Foods, Inc. v Iowa Department of Revenue*** (505 US 71 [1992]), petitioner argues that allowing the royalty income exclusion to the taxpayer only if the payer is a New York taxpayer is facially discriminatory and is per se invalid.

K. First, it is noted that at the administrative level, statutes are presumed constitutional. The Division of Tax Appeals' jurisdiction as prescribed by its enabling legislation, does not include a challenge that a statute is unconstitutional on its face (***Matter of Fourth Day Enterprises***, Tax Appeals Tribunal, October 27, 1988; ***Matter of Unger***, Tax Appeals Tribunal March 24,

1994). Nonetheless, the Division of Tax Appeals can determine the constitutionality of a statute as applied to the specific facts of the case (***Matter of Waste Conversion***, Tax Appeals Tribunal, August 25, 1994). Here, petitioner has not set forth a constitutional violation as applied. As explained in the preceding conclusions of law, the addback and exclusion provisions work in tandem to ensure that the royalty transaction is only taxed once. "'[D]iscrimination' simply means differential treatment of in-state and out-of-state economic interests that benefits the former and burdens the latter" (***Oregon Waste Sys., Inc. v Department of Envtl. Quality of Oregon***, 511 US 93, 99 [1994]). Thus, petitioner's reliance on ***Kraft General Foods*** is misplaced. In ***Kraft General Foods***, the Supreme Court held that an Iowa statute that taxed only the dividends paid by foreign corporations out of their foreign earnings facially discriminated against interstate commerce in violation of the Commerce Clause. Unlike the statute at issue in ***Kraft General Foods***, Tax Law former § 208 (9) (o) does not impose a heavier burden on the royalty transaction based upon where the payer is located. The transaction is subject to tax once and only once regardless of whether the payer is a New York taxpayer. The addback and exclusion provisions are only triggered if the payer and payee are related parties as defined in the statute. If the payer is not a related party, the royalty payments are included in the payee's ENI based on federal conformity regardless of whether the payer is a New York taxpayer. Similarly, if the royalty payer is not a related party, the payer is not denied a deduction for this expense. Under petitioner's interpretation, the royalty payments

escape taxation altogether. Thus, it cannot be said that Tax Law former § 208 (9) (o) has a discriminatory intent nor has petitioner established that its application herein unduly burdens interstate commerce.

L. Accordingly, the petitions of International Business Machines Corporation and Combined Affiliates are denied; the October 7, 2015, and September 28, 2016, notices of disallowance are sustained; and notice of deficiency L-045504338 is sustained.

DATED: Albany, New York

Dec 19, 2019

ADMINISTRATIVE LAW JUDGE

APPENDIX E

NEW YORK STATUTES ANNOTATED – 2013

McKinney's Consolidated Laws of New York Annotated
Tax Law (Refs & Annos)
Chapter Sixty. Of the Consolidated Laws
Article 9-a. Franchise Tax on Business Corporations (Refs & Annos)

McKinney's Tax Law § 208(9)(o)

(o) [Added by L.2003, c. 62, pt. U3, § 1. See, also, par. (o), above.] Related members expense add back and income exclusion. (1) Definitions. (A) Related member or members. For purposes of this paragraph, the term related member or members means a person, corporation, or other entity, including an entity that is treated as a partnership or other pass-through vehicle for purposes of federal taxation, whether such person, corporation or entity is a taxpayer or not, where one such person, corporation, or entity, or set of related persons, corporations or entities, directly or indirectly owns or controls a controlling interest in another entity. Such entity or entities may include all taxpayers under articles nine, nine-A, thirteen, twenty-two, thirty-two, thirty-three or thirty-three-A of this chapter.

(B) Controlling interest. A controlling interest shall mean (i) in the case of a corporation, either thirty percent or more of the total combined voting power of all classes of stock of such corporation, or thirty percent or more of the capital, profits or beneficial interest in such voting stock of such corporation, and (ii) in the case of a partnership, association, trust or other entity, thirty percent or more of the capital, profits or beneficial interest in such partnership, association, trust or other entity.

(C) Royalty payments. Royalty payments are payments directly connected to the acquisition, use, maintenance or management, ownership, sale, exchange, or any other disposition of licenses, trademarks, copyrights, trade names, trade dress, service marks, mask works, trade secrets, patents and any other similar types of intangible assets as determined by the commissioner, and includes amounts allowable as interest deductions under section one hundred sixty-three of the internal revenue code to the extent such amounts are directly or indirectly for, related to or in connection with the acquisition, use, maintenance or management, ownership, sale, exchange or disposition of such intangible assets.

(D) Valid Business Purpose. A valid business purpose is one or more business purposes, other than the avoidance or reduction of taxation, which alone or in combination constitute the primary motivation for some business activity or transaction, which activity or transaction changes in a meaningful way, apart from tax effects, the economic position of the taxpayer. The economic position of the taxpayer includes an

increase in the market share of the taxpayer, or the entry by the taxpayer into new business markets.

(2) Royalty expense add backs. (A) Except where a taxpayer is included in a combined report with a related member pursuant to subdivision four of section two hundred eleven of this article, for the purpose of computing entire net income or other applicable taxable basis, a taxpayer must add back royalty payments to a related member during the taxable year to the extent deductible in calculating federal taxable income.

(B) The add back of royalty payments shall not be required if and to the extent that such payments meet either of the following conditions:

(i) the related member during the same taxable year directly or indirectly paid or incurred the amount to a person or entity that is not a related member, and such transaction was done for a valid business purpose and the payments are made at arm's length;

(ii) the royalty payments are paid or incurred to a related member organized under the laws of a country other than the United States, are subject to a comprehensive income tax treaty between such country and the United States, and are taxed in such country at a tax rate at least equal to that imposed by this state.

(3) Royalty income exclusions. For the purpose of computing entire net income or other taxable basis, a taxpayer shall be allowed to deduct royalty payments directly or indirectly received from a related member during the taxable year to the extent included in the taxpayer's federal taxable income unless such royalty payments would not be required to be added back

under subparagraph two of this paragraph or other similar provision in this chapter.