No. ______

In the
Supreme Court of the United States

THE WALT DISNEY COMPANY AND CONSOLIDATED SUBSIDIARIES,
Petitioner,

v.

THE TAX APPEALS TRIBUNAL OF THE STATE OF NEW YORK and THE COMMISSIONER OF TAXATION AND FINANCE OF THE STATE OF NEW YORK,
Respondents.

On Petition for Writ of Certiorari to the New York Court of Appeals

PETITION FOR WRIT OF CERTIORARI

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September 20, 2024

QUESTION PRESENTED

New York taxed intellectual-property royalties that companies received from their foreign affiliates, but not royalties received from New York affiliates. The New York Court of Appeals held that under the plain terms of the statute, a company's obligation to pay the tax depended on a geographic distinction: If a royalty-paying affiliate subjected itself to New York's jurisdiction, then the royalty-receiving taxpayer could deduct the income; otherwise, the taxman cometh. That textbook discrimination resulted in textbook injury here. Disney licenses its valuable intellectual property to a host of affiliated entities worldwide, in exchange for royalties. Had those affiliates been New York taxpayers, Disney's tax bill would have been millions of dollars lower. The Court of Appeals did not deny that the statute textually discriminated against out-of-state taxpayers. But because there are some circumstances in which the law would have no discriminatory effect on a different taxpayer, the court rejected Disney's as-applied challenge to textually obvious and financially consequential discrimination. That tortured result distorts this Court's clear teachings, conflates the standard for facial discrimination with the standard for facial invalidation, and exacerbates a deep conflict on basic principles of dormant Commerce Clause doctrine.

The question presented is:

Whether a state tax law that on its face treats royalty income derived from corporate affiliates less favorably if the affiliates do not subject themselves to the state's jurisdiction facially discriminates against interstate and foreign commerce.

PARTIES TO THE PROCEEDING

The Walt Disney Company and Consolidated Subsidiaries is petitioner here and was petitioner-appellant below.

The Tax Appeals Tribunal of the State of New York and the Commissioner of Taxation and Finance of the State of New York are respondents here and were respondents-respondents below.

CORPORATE DISCLOSURE STATEMENT

The Walt Disney Company and Consolidated Subsidiaries ("Disney") is a for-profit corporation that has no parent company and maintains various domestic and international subsidiaries. The following subsidiaries were included in Disney's Annual Financial Report for the fiscal year ending October 1, 2022:

Name of Subsidiary	Country of Incorporation
Century (Asia) Ltd.	United States
ABC Cable Networks Group	United States
ABC Enterprises, Inc.	United States
ABC Family Worldwide, Inc.	United States
ABC Holding Company Inc.	United States
ABC Kids Europe Holdings, Inc.	United States
ABC News/Starwave Partners	United States
ABC Signature, LLC	United States
ABC, Inc.	United States
Accelerator Investments LLC	United States
American Broadcasting Companies, Inc.	United States
Asianet Star Communications Private Limited	India
BAMTech, LLC	United States
Banner Productions Limited	United Kingdom
Beijing Hulu Software Technology Development Co., Ltd.	China
Buena Vista International, Inc.	United States
Buena Vista Television, LLC	United States
Buena Vista Video On Demand	United States
Buzzer Investments Ltd	Mauritius

BVI Television Investments, Inc.	United States
Cable LT Holdings, Inc.	United States
DCL Maritime LLC	United States
DCL Port Facilities Corporation	United States
Disney Consumer Products, Inc.	United States
Disney Destinations, LLC	United States
Disney DTC LLC	United States
Disney Enterprises, Inc.	United States
Disney FTC Services (Singapore) Pte. Ltd.	Singapore
Disney Magic Company Limited	United Kingdom
Disney Magic Corporation	United States
Disney Networks Group Asia Pacific Limited	Hong Kong
Disney Networks Group Netherlands Holding B.V.	Netherlands
Disney Networks Group Netherlands Holding II B.V.	Netherlands
Disney Online	United States
Disney Shopping, Inc.	United States
Disney Sports DTC, LLC	United States
Disney Streaming Technology LLC	United States
Disney Studio Production Services Co., LLC	United States
Disney Vacation Club Management, LLC	United States
Disney Vacation Development, Inc.	United States
Disney Worldwide Services, Inc.	United States
Disney/ABC International Television, Inc.	United States

Eredivisie Media & Marketing C.V.	Netherlands
ESPN Enterprises, Inc.	United States
ESPN Productions, Inc.	United States
ESPN, Inc.	United States
Euro Disney Associes SAS	France
FX Networks, LLC	United States
FX Productions, LLC	United States
FXX Network, LLC	United States
Hongkong International Theme Parks Limited	Hong Kong
Hudson Square Realty, LLC	United States
Hulu,LLC	United States
International Family Entertainment, Inc.	United States
KABC Television, LLC	United States
KTRK Television, Inc.	United States
LFL Production, LLC	United States
LFL Productions Limited	United Kingdom
Lucasfilm Entertainment Company Ltd. LLC	United States
Lucasfilm Ltd. LLC	United States
Magical Cruise Company, Limited	United Kingdom
Maker Studios, LLC	United States
Marvel Brands LLC	United States
Marvel Characters, Inc.	United States
Marvel Entertainment, LLC	United States
Marvel Studios LLC	United States
MVL Film Finance LLC	United States
National Geographic Partners, LLC	United States
NGC Europe Limited	United Kingdom

NGC Network International, LLC	United States
NGC Network Latin America, LLC	United States
Novi Digital Entertainment Private Limited	India
Pacific 2.1 Entertainment Group, Inc.	United States
Pixar	United States
Playdom, LLC	United States
Searchlight Pictures, Inc.	United States
Shanghai International Theme Park Associated Facilities Company Limited	China
Shanghai International Theme Park Company Limited	China
Star India Private Limited	India
Star ISP Ltd	Mauritius
STAR US Holdings Subsidiary, LLC	United States
STARTV ATC Holding Limited	British Virgin Islands
Streamboat Willie Productions LLC	United States
TFCF America, Inc.	United States
TFCF Cable Ventures, LLC	United States
TFCF Corporation	United States
TFCF Entertainment Group Holdings, LLC	United States
TFCF Entertainment Group, LLC	United States
TFCF Europe, Inc.	United States

TFCF International Channels (US) Inc.	United States
TFCF Latin American Channel LLC	United States
TFCF Movie Channel, Inc.	United States
TFCF SPV, Inc.	United States
The Walt Disney Company (Canada) Ltd.	Canada
The Walt Disney Company (China) Limited	China
The Walt Disney Company (France) S.A.S.	France
The Walt Disney Company (Germany) GmbH	Germany
The Walt Disney Company (Japan) Ltd.	Japan
The Walt Disney Company (Korea), LLC	South Korea
The Walt Disney Company Limited	United Kingdom
The Walt Disney Company Medya Eglence ve Ticaret Limited Sirketi	Turkey
The Woodlands Enterprises, LLC	United States
TWDC Enterprises 18 Corp.	United States
TWDC Investment Enterprises II, LLC	United States
TWDC Investment Enterprises, LLC	United States
Twentieth Century Fox Film Corporation	United States

Twentieth Century Fox Film International, Inc.	United States
Twentieth Century Fox International Television, Inc.	United States
Twentieth Century-Fox Telecommunications International, Inc.	United States
Twentieth Television, Inc.	United States
UTV Software Communications Private Limited	India
WABC Television (New York), LLC	United States
Walt Disney Holdings (Hong Kong) Limited	Hong Kong
Walt Disney Parks and Resorts U.S., Inc.	United States
Walt Disney Pictures	United States
Walt Disney Travel Co., Inc.	United States
WD Holdings (Shanghai), LLC	United States
WPVI Television (Philadelphia), LLC	United States

STATEMENT OF RELATED PROCEEDINGS

Walt Disney Co. & Consolidated Subsidiaries v. Tax Appeals Tribunal, No. 35, consolidated with *International Business Machines Corp. & Combined Affiliates v. Tax Appeals Tribunal*, No. 34 (N.Y.) (consolidated opinion issued April 23, 2024)

Matter of Walt Disney Co. & Consolidated Subsidiaries v. Tax Appeals Tribunal, No. 532479 (App. Div. 3d Dep't) (opinion issued October 20, 2022).

Matter of Walt Disney Co., DTA No. 828304 (Tax Appeals Tribunal opinion issued August 6, 2020; Division of Tax Appeals opinion issued May 29, 2019).

International Business Machines Corp. & Combined Affiliates v. Tax Appeals Tribunal, No. 34, consolidated with *Walt Disney Co. & Consolidated Subsidiaries v. Tax Appeals Tribunal*, No. 35 (N.Y.) (consolidated opinion issued April 23, 2024).

International Business Machines Corp. & Combined Affiliates v. Tax Appeals Tribunal, No. 533572 (App. Div. 3d Dept 2023) (opinion issued March 16, 2023).

Matter of International Business Machines. Corp., DTA Nos. 827825, 827997, and 827998 (Tax Appeals Tribunal opinion issued March 5, 2021; Division of Tax Appeals opinion issued December 19, 2019).

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PETITION FOR WRIT OF CERTIORARI

This Court's "existing dormant Commerce Clause cases all but dictate the result" that the decision below cannot stand. *Comptroller of Treasury of Md. v. Wynne*, 575 U.S. 542, 550 (2015). The New York Court of Appeals held that, under the "plain terms" of a New York statute, a company that received royalty payments from a corporate affiliate was eligible for a tax deduction if, *but only if*, the company's affiliate was a *New York taxpayer*. App.10. That is textbook facial discrimination, and the remedy for it should have been obvious. "Time and again this Court has held that … state laws violate the Commerce Clause if they mandate 'differential treatment of in-state and out-of-state economic interests that benefits the former and burdens the latter.'" *Granholm v. Heald*, 544 U.S. 460, 472 (2005) (quoting *Or. Waste Sys., Inc. v. Dep't of Envtl. Quality of Or.*, 511 U.S. 93, 99 (1994)); *see also, e.g.*, *Hughes v. Oklahoma*, 441 U.S. 322, 337 (1979) ("Such facial discrimination by itself may be a fatal defect[.]"). Even dormant Commerce Clause skeptics have endorsed and applied this one unshakeable rule. *See, e.g.*, *New Energy Co. of Ind. v. Limbach*, 486 U.S. 269 (1988) (Scalia, J.). That rule should have carried the day here, as both the majority and concurring opinions acknowledged that eligibility for the deduction "depend[ed] on a geographic distinction." *E.g.*, App.39 (Wilson, C.J., concurring). Yet rather than subject the statute to the strict scrutiny this Court's precedents demand, the court brushed aside the undeniable (and undenied) textual discrimination and upheld the statute on the ground that not every application of it would have a discriminatory impact.

That was a basic category mistake. The near-fatal Commerce Clause sin of facially—i.e., textually—discriminating against interstate or foreign commerce has nothing to do with the *Salerno* standard for facial challenges. That should have been beyond obvious in the context of this deficiency and refund dispute, which is as as-applied as it gets. Moreover, once a statute facially (or textually, if that helps avoid any *Salerno* conflation) discriminates against out-of-state commerce, the burden shifts to the state to justify the discrimination as necessary to address a legitimate state interest. *See Tenn. Wine & Spirits Retailers Ass'n v. Thomas*, 588 U.S. 504, 518 (2019); *Or. Waste Sys.*, 511 U.S. at 101. New York cannot possibly carry that burden here, since (after the tax years at issue) it joined 17 other states in addressing the issue via non-discriminatory means.

Remarkably, the decision below is not alone in conflating the demanding standard for plaintiffs seeking to invalidate a statute in toto and the demanding burden on states that facially discriminate against out-of-state taxpayers. Multiple state courts of last resort now hold that, to show that a state law textually discriminates against interstate or foreign commerce, a challenger must also show that there is no set of circumstances under which the law would operate evenhandedly. Even though this Court has already rejected that argument, multiple state courts—who (somewhat ironically) have exclusive jurisdiction over as-applied deficiency and refund disputes like this—have proven unable or unwilling to get the message. Only this Court can set things right.

Finally, the question presented is important. Hundreds of millions of dollars in tax liabilities turn on the decision below in New York alone, and that is just the tip of the iceberg given that numerous state high courts have made the same basic mistake. Much about Commerce Clause jurisprudence is murky, but the one clear loadstar in the constellation is that textual discrimination on a statute's face violates the first principles of our national commercial union. This Court's review to reestablish first principles is imperative.

OPINIONS BELOW

The Court of Appeals' decision, --- N.E.3d ----, 2024 WL 1724639, is reproduced at App.1-41. The decision of the Appellate Division, Third Department, 210 A.D.3d 86, is reproduced at App.42-50. The underlying decisions are reproduced at App.51-95.

JURISDICTION

The Court of Appeals issued its opinion on April 23, 2024. Justice Sotomayor granted an application on July 17, 2024, extending the certiorari deadline to and including September 20, 2024. This Court has jurisdiction under 28 U.S.C. §1257(a).

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

The Commerce Clause, U.S. Const. art. I, §8, cl. 3, is reproduced at App.125. The relevant provisions of New York law are reproduced at App.125-130.

STATEMENT OF THE CASE

A. Legal Background

Corporations doing business in New York must pay an annual franchise tax. N.Y. Tax Law Art. 9-A. In the period at issue here, a corporation's taxable income for purposes of Article 9-A was its "'entire net income' (ENI) allocated to New York." App.3. "ENI generally consisted of the taxpayer's entire federal taxable income (FTI)." App.3. To determine the amount of FTI allocated to New York, taxpayer (and taxing authorities) used "the business allocation percentage (BAP)," which was determined by "comparing a taxpayer's business receipts from New York to its total business receipts from all sources (including related-member royalties)." App.3.

For decades, "receipts from intangibles such as royalties on intellectual property (IP) were allocated to the jurisdiction in which the IP was used," and "royalty receipts were included in all taxpayers' ENI." App.3. But at the end of the last century, New York became concerned that "multinational conglomerates" were "avoid[ing] state taxes on income derived from intellectual property." App.3. The particular scheme it sought to capture went as follows: "[A] parent corporation 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," and then "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." App.3-4.

In 2003, New York enacted Tax Law §208.9(*o*)[1] to try to counteract such schemes. Although the legislature's stated aim was to "eliminate tax loopholes concerning royalty payments," App.4, the statute went well beyond that—as Disney's case painfully illustrates.

Under §208.9(*o*), New York allowed taxpayers to deduct royalties received from corporate affiliates if, but only if, their royalty-paying affiliates were also New York taxpayers. The statute accomplished this discrimination in two steps. First, taxpayers that deducted royalty payments were required to reverse the federal deduction and "add back" to their New York taxable income all royalty payments involving corporate affiliates. N.Y. Tax Law §208.9(*o*)(2) ("[A] taxpayer must add back royalty payments to a related member during the taxable year to the extent deducted in calculating its federal taxable income."). Second, taxpayers that received royalty payments could deduct such payments received from affiliates—but only if "such royalty payments" were already "added back under [§208.9(*o*)(2)] or other similar provision in this chapter." *Id.* §208.9(*o*)(3). Because the deduction was limited to cases in which the royalties had been added back *under the New York tax code*, a company that received royalty payments from an affiliated entity could *not* take the deduction unless the affiliate was also a New York taxpayer. "By its

[1] Unless otherwise noted, references to §208 are to the version in effect from 2003-2013.

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." App.10. As a result, taxpayers with foreign royalty-paying affiliates owed more than those with domestic affiliates only.

New York did not cure that basic differential treatment in amending the statute in 2007 to carve out two scenarios: The add-back requirement did not apply if the royalty payor and the royalty payee filed a single, joint return, N.Y. Tax Law §208.9(*o*)(2)(A) (2007), or 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,'" App.6 (quoting §208.9(*o*)(2)(B)(ii) (2007)).[2]

New York repealed §208.9(*o*) in 2013. App.67. Under the new regime, taxpayers generally may deduct royalties paid by corporate affiliates regardless of where the paying affiliate is domiciled. *See* 2013 N.Y. Sess. Laws, ch. 59, pt. E, §2; N.Y.App.Div.R.79.[3] That non-discriminatory regime eliminates the abuses that New York originally targeted by requiring (with some exceptions) that corporations, in computing their ENI, add back all royalty payments made to related members. *See* N.Y. Dep't of Tax'n & Finance, *Summary of Budget Bill Corporation Tax Changes*

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[2] The amendment also clarified that the add-back requirement did not apply "if the royalty was ultimately paid to a non-related company for a valid business purpose." App.6 (quoting statute).

[3] "N.Y.App.Div.R." refers to the Record on Review at the Supreme Court Appellate Division.

Enacted in 2013—Effective for Tax Years 2013 and After, TSB-M-13(6)C, at 1-3 (Aug. 8, 2013), https://tinyurl.com/3j5kahxr. The new regime also mirrors the laws of each of the 17 other states with similar royalty-tax regimes. *See* Jerome R. Hellerstein et al., *State Taxation* ¶7.20[3] & n.942 (3d ed. 2001 & Supp. 2023); *see also* N.Y.App.Div.R.315-16, 355-57 (New York acknowledging that the non-discriminatory 2013 version was based "upon a Multistate Tax Commission model statute").

B. Factual and Procedural Background

The Walt Disney Company is a multinational mass media and entertainment corporation headquartered in California. It is the owner of some of the best-known intellectual property in the world, from Mickey Mouse to the Pixar, Lucasfilm, and Marvel entertainment franchises. It also, through subsidiaries and licensees, runs a famous, worldwide series of parks, including Disney World, Disneyland, Disneyland Paris, and Tokyo Disney. Approximately 5-6% of Disney's total taxable income was allocable to New York during the relevant years. App.7.

Disney licenses its intellectual property to a wide array of subsidiaries, allowing them to use its valuable property in showing its movies, selling consumer products, on cruise ships, and at foreign theme parks. *See* N.Y.App.Div.R.77-78. As a result of those licenses, Disney receives substantial royalty income from its subsidiaries. A significant amount of that income comes from foreign subsidiaries in countries that are not parties to a tax treaty that satisfies the terms of New York's statute.

For tax years 2009 and 2010, Disney deducted royalty payments received from its foreign subsidiaries. App.7. Disney also filed an amended tax return for 2008, seeking a refund for the foreign royalty income. App.7. After New York's Tax Department audited Disney, denied its refund request for 2008, and issued a notice of deficiency for 2009 and 2010, Disney initiated this suit. Disney challenged both the denial of the tax-refund claim and the notices of deficiency before an Administrative Law Judge of the State Division of Tax Appeals and then before the State Tax Appeals Tribunal. App.8-9.

Disney made two main arguments in support of its claim. First, it argued that, as a matter of text and constitutional avoidance, the deduction should be available under the statute where, if the royalty-paying affiliate *were* a New York taxpayer, it would be allowed to take the deduction. Second, Disney argued that, if the statute were *not* so construed, it would facially discriminate against interstate and foreign commerce and therefore violate the Commerce Clause. *See* App.118-19, App.70-72; *see also* App.9-11. The ALJ and the Tax Appeals Tribunal both rejected these arguments, App.123, App.86-93, as did the intermediate appellate court, App.43-44, App.47-50.

Disney then appealed to the Court of Appeals, which consolidated Disney's challenge with IBM's similar challenge. App.1. The court began by definitively construing §208.9(*o*), holding that the deduction was only available to subsidiaries who did business in New York: "[T]he 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." App.10 (emphasis added). The court embraced, as particularly "astute[]," App.15, the summary put forward in Chief Judge Wilson's concurring opinion: The statute was "most straightforward[ly]" read to "disallow[] a deduction for royalty payments from a corporation that does not do business in New York," but allows it for one that does. App.23, App.31. Put simply, "the tax deduction does depend on a geographic distinction between New York and non-New York taxpayers." App.39 (Wilson, C.J., concurring). Accordingly, the Court of Appeals rejected Disney's constitutional-avoidance argument.

The court then avoided finding that express discrimination unconstitutional by conflating the standard for bringing facial challenges with the test for determining whether a statute facially—i.e., textually—discriminates against interstate or foreign commerce in an as-applied challenge based on the Commerce Clause. Disney and IBM challenged the statute only *as applied to them*, which makes sense, as refund actions and tax-deficiency disputes are paradigmatic as-applied challenges. Nonetheless, the court ruled against them on the ground that they failed to satisfy the demanding standard for a *facial* challenge. App.12 (requiring petitioners to show "that no set of circumstances exists under which the [statute] would be valid"). That conflation was outcome determinative. The court explained that, in some cases, §208.9(*o*) would "result[] in a neutral economic impact on the corporate group as a whole." App.15. It made no difference that that was not true as to Disney or IBM. Because the court could imagine circumstances in which the statute would not be

discriminatory in operation, it held that Disney "failed to meet th[e] high burden" facial challenges demand. App.14.

The court went on to distinguish this Court's cases underscoring the discriminatory nature of §208.9(*o*). In the Court of Appeals' telling, the problem with the New York law struck down in *Westinghouse Electric Corp. v. Tully*, 466 U.S. 388 (1984) (per curiam), was that 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." App.15-16. The court did not explain what, if anything, made the current New York tax law relevantly different. The court then moved on to distinguishing this Court's decision in *Kraft General Foods v. Iowa Department of Revenue and Finance*, 505 U.S. 71 (1992), which involved a materially similar law involving dividends instead of royalties. App.15. The Court of Appeals opined that what really drove the result in *Kraft* was not (as this Court had held) the law's textual discrimination, but that the facial discrimination was unavoidable in practice. App.15. In taking that narrow view of *Kraft*, the Court of Appeals followed *General Electric Co. v Commissioner*, 914 A.2d 246 (N.H. 2006), which likewise held that a tax statute that distinguished on its face was "not facially discriminatory" so long as it "sought to tax each corporate group one time" and thus achieved "'taxing symmetry'" in some cases. App.16.[4]

[4] The court's application of the internal consistency test, *see* App.19 (holding that Disney and IBM "failed to show that"

Chief Judge Wilson separately addressed Disney's argument that §208.9(*o*) improperly incentivized business to be done in New York. Remarkably, he candidly agreed about the incentive, but viewed that as more of a feature than a bug. App.39. In his view, §208.9(*o*)'s "geographic distinction between New York and non-New York taxpayers" was not only perfectly reasonable, but perfectly consistent with the Commerce Clause—even though 17 states (plus D.C.) and now New York itself all address the same problem through non-discriminatory means. App.39-40.

REASONS FOR GRANTING THE PETITION

When a party brings a pre-enforcement challenge seeking to invalidate a statute on its face, rendering it unconstitutional in all its applications, she understandably faces a very high hurdle. In such circumstances, the plaintiff must "establish that no set of circumstances exists under which the [law] would be valid." *United States v. Salerno*, 481 U.S. 739, 745 (1987). But when a party brings a post-enforcement as-applied challenge to a statute on the ground that it impermissibly discriminates against interstate or foreign commerce on its face—without any need to consider purposes or effects—the *Salerno* standard is wholly irrelevant. "Despite the overlapping 'facial' labels, whether a statute discriminates on its face for dormant Commerce Clause purposes is a different concept from the general notion of a facial challenge to a statute." *NextEra Energy Cap. Holdings, Inc. v. Lake*, 48 F.4th

208.9(*o*) "necessarily discriminates" "in … application"), only made things worse, as IBM explains in its separate petition arising out of the same decision.

306, 321 n.6 (5th Cir. 2022). "The facial inquiry for dormant Commerce Clause challenges is just one [way of] asking whether the statutory language is discriminatory (as opposed to whether the statute has a discriminatory purpose or effect)." *Id.*

The New York Court of Appeals lost sight of these well-established principles, hopelessly conflating the *Salerno* standard—which imposes extraordinary demands on plaintiffs seeking extraordinary relief (facial invalidation)—and the test for facially discriminatory laws—which imposes extraordinary burdens on government defendants to justify laws that textually discriminate against interstate or foreign commerce. This led the court to make egregious procedural and substantive errors, applying the *Salerno* standard to a quintessential as-applied challenge, while approving a textually discriminatory statute based on the kind of permissive balancing test applicable to facially neutral statutes.

The errors the decision below made are fundamental. Yet, remarkably, the Court of Appeals is not the only state high court to make them. The decision below replicates errors reached by other state high courts and deepens a split with other courts that correctly perceive the difference between difficult-to-bring facial challenges and difficult-to-defend facial discrimination against interstate or foreign commerce.

The issue is important, and this case is a clean vehicle. Indeed, it is difficult to imagine a more prototypical as-applied challenge than a tax-deficiency proceeding or a refund action. And it is difficult to imagine a cleaner shot at the facial-discrimination issue. In many Commerce Clause challenges to state

tax laws, questions of statutory construction complicate things on the front end and the "compensatory tax" doctrine muddies things on the back end. But not here. The New York Court of Appeals definitively interpreted §208.9(*o*) to make geography dispositive. And the New York legislature itself has made clear that a better-tailored and facially neutral option is available. Finally, the split in authority among state high courts takes on added importance because jurisdictional doctrines born of federalism channel as-applied challenges to state taxes into state court. If Disney had brought a pre-enforcement facial challenge to §208.9(*o*) in federal court, it would have faced not only the demanding test of *Salerno*, but the anti-tax-injunction prohibition of 28 U.S.C. §1341. Disney availed itself of the state court proceedings that provide the proper and generally exclusive forum for as-applied challenges to state taxes, only to face the wholly inapposite *Salerno* standard. The proper respect for federalism and the rights of taxpayers demand that this error not go unremedied. The Court should grant certiorari.

I. The Decision Below Conflicts With This Court's Clear And Longstanding Precedent.

1. This Court has long held that "State laws discriminating against interstate commerce on their face are 'virtually *per se* invalid.'" *Fulton Corp. v. Faulkner*, 516 U.S. 325, 331 (1996) (quoting *Or. Waste Sys.*, 511 U.S. at 99); *see also Tenn. Wine*, 588 U.S. at 514-18 (summarizing the rule's historical bona fides). "This rule is essential to the foundations of the Union." *Granholm*, 544 U.S. at 472. While other, ancillary aspects of dormant Commerce Clause doctrine may be

less "[a]ssured[]" of their place in the firmament of constitutional law, *Nat'l Pork Producers Council v. Ross*, 598 U.S. 356, 364 (2023), the antidiscrimination rule is fundamental—particularly for state laws that discriminate by their plain terms, thus obviating any need to ascertain effects or to wade through legislative history to try to divine legislative purpose. *See generally Amerada Hess Corp. v. Dir., Div. of Tax'n, N.J. Dep't of Treas.*, 490 U.S. 66, 75 (1989) ("[A] tax may violate the Commerce Clause if it is facially discriminatory, has a discriminatory intent, or has the effect of unduly burdening interstate commerce."). When a state law by its plain terms gives "differential treatment [to] in-state and out-of-state economic interests" in a way "that benefits the former and burdens the latter," it can be upheld only in the rare circumstance in which a state can carry the "extremely difficult burden" of demonstrating that the law "advances a legitimate local purpose that cannot be adequately served by reasonable nondiscriminatory alternatives." *Or. Waste Sys.*, 511 U.S. at 99; *Camps Newfound/Owatonna, Inc. v. Town of Harrison*, 520 U.S. 564, 581-82 (1997); *see also Sporhase v. Nebraska ex rel. Douglas*, 458 U.S. 941, 958 (1982) ("the 'strictest scrutiny' [is] reserved for facially discriminatory legislation" (quoting *Hughes*, 441 U.S. at 337)).

The rule for state laws that discriminate against *foreign* commerce is much the same. Indeed, the only difference is that "the constitutional prohibition against state taxation of foreign commerce is broader than the protection afforded to interstate commerce, in part because matters of concern to the entire Nation are implicated." *Kraft*, 505 U.S. at 79 (citation omitted); *see also Japan Line, Ltd. v. Los Angeles*

Cnty., 441 U.S. 434, 446-51 (1979); *cf.* Michael S. Knoll & Ruth Mason, *The Dormant Foreign Commerce Clause After* Wynne, 39 Va. Tax Rev. 357, 371 (2020) (noting that "all of the cases in which the dormant foreign Commerce Clause has played an important role are tax cases").

This bedrock antidiscrimination rule applies with full force to state tax laws. A state law that "explicitly deprives" private parties of "beneficial tax treatment because" of their foreign status "violate[s] the cardinal requirement of nondiscrimination" no less than a state law that explicitly imposes more onerous regulatory obligations on out-of-state actors. *New Energy Co.*, 486 U.S. at 274; *see W. Lynn Creamery, Inc. v. Healy*, 512 U.S. 186, 193 (1994) (describing such "tariff[s]" as the "paradigmatic example of a law discriminating against interstate commerce"). That makes sense. "Taxation is regulation just as prohibition is." *Compania Gen. de Tabacos de Filipinas v. Collector of Internal Revenue*, 275 U.S. 87, 96 (1927). And concerns about tax wars among the states drove the Framers to convene in Annapolis and Philadelphia and jettison the Articles of Confederation in favor of a federal Constitution. *See The Federalist* No. 42, at 267-68 (James Madison) (Clinton Rossiter ed., 1961). Against that backdrop, it should come as no surprise that a centuries-old wall of precedent holds up the rule that no state may "impose a tax which discriminates against interstate [or foreign] commerce." *Wynne*, 575 U.S. at 549-50 (quoting *Nw. States Portland Cement Co. v. Minnesota*, 358 U.S. 450, 458 (1959)).

2. All of that should have made this case simple. This is "the rare instance where a state artlessly

disclose[d] an avowed purpose to discriminate" on the face of the statute, *Dean Milk Co. v. City of Madison*, 340 U.S. 349, 354 (1951), and did so in a context where many states, and now even New York, address the same perceived problem through neutral legislation. New York Tax Law §208.9(*o*) allowed corporate taxpayers to take a deduction for royalty payments received from affiliated entities doing business in the state. "By its plain terms," however, §208.9(*o*) "disallow[ed] [the] deduction for royalty payments from a corporation that does not do business in New York." App.10 (maj. op.); App.31 (Wilson, C.J., concurring). A corporate taxpayer's ability to take the royalty-income deduction thus "depend[ed] on a geographic distinction": If a taxpayer's royalty-paying affiliate did not do business in the state, then the royalty-receiving taxpayer would owe more in taxes. App.39 (Wilson, C.J., concurring).

Although the combination of add-backs and deductions is convoluted, the facial discrimination against foreign commerce is clear. Disney would owe New York less money—i.e., it would get a tax break—if its royalty-paying subsidiaries did business in New York (and thus subjected themselves to New York's regulatory jurisdiction). The company took a sizable tax hit, by contrast, because many of its royalty-paying subsidiaries did business exclusively outside of New York. The result is straightforward discrimination that violates even the narrowest conception of the dormant Commerce Clause.

The Court of Appeals evaded that clear-cut conclusion only by mangling the appropriate legal standard, hopelessly conflating the demanding

standard for a *plaintiff* seeking to invalidate a statute on its face and the demanding burden on a *state defendant* seeking to defend a statute that facially discriminates against out-of-state taxpayers. To be clear, Disney's challenge here is as as-applied as challenges come. Even respondents admitted as much below. *See, e.g.*, Br. for Resp. N.Y.S. Comm'r of Tax'n & Finance 32, No. 532479 (N.Y. App. Div. Apr. 29, 2022). That should not be surprising. Far from involving a pre-enforcement challenge to §208.9(*o*) as to all taxpayers, this case involves an enforcement action against Disney for deficiencies in the 2009 and 2010 tax years and a refund action based on §208.9(*o*)'s application to Disney in the 2008 tax year.

These as-applied challenges have worked their way up from administrative proceedings all the way to the New York Court of Appeals, as New York law requires. And the relief in these as-applied actions would be limited to Disney—a point Disney repeatedly stressed below. *See, e.g.*, N.Y.App.Div.R.3769. Yet despite all that, the Court of Appeals treated this prototypical as-applied challenge to an expressly discriminatory statute as a *Salerno*-style facial challenge, and held that Disney could not obtain the deduction unless it could demonstrate "that no set of circumstances exists under which [§208.9(*o*)] would be valid." App.12 (maj. op.); App.25 (Wilson, C.J., concurring) (quoting *Salerno*, 481 U.S. at 745).

That is a fundamental category mistake. To be sure, Disney argued that Tax Law §208.9(*o*) discriminates against interstate commerce by its plain terms—i.e., that the statute textually discriminates against out-of-state taxpayers, such that no inquiry

into discriminatory purpose or effect was necessary. But that argument properly placed the statute in the most dubious category of discriminatory legislation for purposes of this as-applied challenge; it has nothing to do with—and certainly did not trigger—the demanding *Salerno* standard for facial challenges. As the Fifth Circuit has explained, "whether a statute discriminates on its face for dormant Commerce Clause purposes is a different concept from the general notion of a facial challenge." *NextEra*, 48 F.4th at 321 n.6. Indeed, if the rule were otherwise, then the most obviously discriminatory laws—those that discriminate by their plain terms irrespective of purpose and effects—would become the most difficult to challenge. That "sounds absurd, because it is." *Sekhar v. United States*, 570 U.S. 729, 738 (2013).

The Court of Appeals' "facial" conflation here distorted its analysis at every turn. The majority and concurrence just identified circumstances where §208.9(*o*) could be constitutionally applied and called it a day. *See* App.18-20 (maj. op.); App.34-36 (Wilson, J., concurring). But that is not remotely sufficient to reject an as-applied challenge to a textually discriminatory law. Indeed, it is hard to overstate the difference between the *Salerno* standard the Court of Appeals applied and the proper standard for textually discriminatory laws. The *Salerno* standard purposefully puts an extraordinary burden on the plaintiff who seeks the extraordinary remedy of invalidating a statute on its face, typically before it has ever been enforced. *See Moody v. NetChoice, LLC*, 144 S.Ct. 2383, 2397 (2024) (*Salerno* erects a "very high bar"). The proper test for textually discriminatory laws, by contrast, shifts the burden to

the state-government defendant and imposes on it an extraordinary burden to justify a law that openly discriminates against out-of-state businesses or taxpayers. *See Fulton*, 516 U.S. at 344. In particular, the burden shifts to the government to show that it could not accomplish its legitimate objectives through non-discriminatory or less-burdensome means. *See Or. Waste Sys.*, 511 U.S. at 101-02. And if the Court of Appeals had reached that point in the proper analysis, then this case would have been over. Not only do 17 other states (and D.C.) employ non-discriminatory means to address the same problem §208.9(*o*) targets, Hellerstein, *supra*, ¶7.20[3] & n.942, but since 2013 New York itself has joined them. Thus, under the proper standard for this as-applied challenge to a facially discriminatory statute, this is an open and shut case.

3. In fact, this Court has *already held* that the distinction §208.9(*o*) explicitly drew constitutes verboten discrimination. "The principal dispute" in *Kraft* was "whether, on its face, [an Iowa law] discriminates against foreign commerce." 505 U.S. at 75. The Iowa statute there "treat[ed] dividends received from foreign subsidiaries less favorably than dividends received from domestic subsidiaries." *Id.* Specifically, in-state parent firms were allowed to deduct dividends received from domestic subsidiaries, even if they did not conduct business in Iowa, but they could not deduct dividends received from foreign subsidiaries doing business abroad. *Id.* at 74. The law in *Kraft* was thus materially indistinguishable from the law here, save that it involved "dividends" instead of "royalties." A majority of this Court had no trouble recognizing the discrimination on the face of the

statute. "[T]he applicability of the Iowa tax necessarily depend[ed] not only on the domicile of the subsidiary, but also on the location of the subsidiary's business activities." *Id.* at 77. And that, the Court held, is what "discriminatory treatment" means. *Id.*

At the same time, *Kraft* well illustrates how confusion over the proper standard of review and proper role of *Salerno* can distort the substantive analysis. The taxpayer in *Kraft* argued that the Iowa tax law "discriminate[d] against foreign commerce" "on its face." *Id.* at 75. The dissent inferred from that nomenclature that the petitioner had "brought a *facial* challenge to the Iowa taxing scheme" and thus needed to carry the "heavy" burden to "show that 'no set of circumstances exists under which the Act would be valid.'" 505 U.S. at 82-83 (Rehnquist, C.J., dissenting) (quoting *Salerno*, 481 U.S. at 745). But the majority correctly declined to embrace that category mistake. *Id.* at 77-82 (maj. op.). And that made all the difference. After all, the majority in *Kraft* did not deny that there would be circumstances in which the Iowa law would *not* impose unequal tax burdens on domestic and foreign dividends, or even that those circumstances would be all that uncommon. *See id.* at 80 n.23; *see also Appeal of Morton Thiokol, Inc.*, 864 P.2d 1175, 1185 (Kan. 1993) ("The first paragraph [of *Kraft*'s footnote 23] sketches circumstances in which there would be no inequality; the second paragraph explains why the discriminatory circumstances are the ones on which the Court based its ruling."). "If the no-set-of-circumstances test had applied" in *Kraft*, then, the state's argument "that corporations could avoid the differential treatment of domestic and foreign commerce if they were organized differently"

would have carried the day, "since it would have shown that under some circumstances the tax could operate constitutionally." *Conoco, Inc. v. Tax'n & Revenue Dep't of N.M.*, 931 P.2d 730, 737 (N.M. 1996).

Kraft controls this case, yet the Court of Appeals brushed it aside in two sentences. In the Court of Appeals' (re)telling, the Iowa law in *Kraft* was discriminatory *not* because (as this Court held) it imposed greater state-tax obligations if a company's "subsidiary's business activities" took place abroad rather than domestically, but because "the Iowa scheme contained no add-back requirement." App.15. That is certainly *a* distinction between the two laws, but it is not one with any constitutional significance. The add-back layer is necessitated by New York's decision to override federal law's non-discriminatory tax treatment of royalties—hardly a promising basis for defending the New York regime. To be sure, one add-back option allowed a taxpayer to get a deduction under §208.9(*o*) if its subsidiary filed a return in New York, even if it did no actual business there, and there was no such "tax filing" option in *Kraft*. *See* App.14-15. But the opportunity to voluntarily submit to the state's taxing authority in lieu of actually doing business in-state hardly makes the law less discriminatory. And to the extent it thought this option made the law non-discriminatory as to some other taxpayers, that only highlights the problems created by the Court of Appeals' misapplication of the *Salerno* standard.[5]

[5] At the very least, the requirement that affiliates submit to New York's taxing authority constitutes an unconstitutional

In fact, the Court of Appeals need not have even looked beyond this Court's cases invalidating *New York* tax schemes to find §208.9(*o*) facially discriminatory and unconstitutional. In *Westinghouse Electric Corp. v. Tully*, 466 U.S. 388 (1984) (per curiam), New York "predicat[ed] the tax credit on the extent of a subsidiary's in-state … activities," "creat[ing] a direct incentive to move business into New York" and therefore "violat[ing] the dormant Commerce Clause." App.16 (discussing *Westinghouse*). That is precisely the incentive §208.9(*o*) creates for companies to submit themselves to New York tax authorities, as the Chief Judge candidly acknowledged and applauded in his concurring opinion. App.39-40. But this Court has long recognized that the Constitution forbids a state from "using its power to tax an in-state operation as a means of 'requiring (other) business operations to be performed in the home State.'" *Boston Stock Exch. v. State Tax Comm'n*, 429 U.S. 318, 336 (1977).

All that precedent cannot be put aside on the ground that §208.9(*o*) discriminates on the basis of filing taxes in New York, rather than doing business in New York. *Cf. Lewis v. BT Inv. Managers, Inc.*, 447 U.S. 27, 42 n.9 (1980) ("[D]iscrimination based on the

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condition on the right to do business in the state. *See W. Union Tel. Co. v. Kansas ex rel. Coleman*, 216 U.S. 1, 33-37 (1910) (plurality op.); *W. & S. Life Ins. Co. v. State Bd. of Equalization of Cal.*, 451 U.S. 648, 662 & n.14 (1981). A state may not violate the Constitution "under the guise of a surrender of a right in exchange for a valuable privilege which the state threatens otherwise to withhold." *Frost v. R.R. Comm'n of Cal.*, 271 U.S. 583, 593 (1926); *see also Koontz v. St. Johns River Water Mgmt. Dist.*, 570 U.S. 595, 601-02, 604-09 (2013).

extent of local operations is itself enough to establish the kind of local protectionism" that triggers strict scrutiny.). Not only is filing taxes a particular form of doing business in New York, it is a particularly problematic connection with the state to use as a basis for discriminatory treatment, since it subjects the foreign subsidiary to the full regulatory ambit of in-state tax officials. *Cf. Mallory v. Norfolk S. Ry. Co.*, 600 U.S. 122, 161 & n.7 (2023) (Alito, J., concurring in part and concurring in the judgment) (arguing that "Pennsylvania's registration-based jurisdiction law discriminates against out-of-state companies" "by forcing them to increase their exposure to suits on all claims in order to access Pennsylvania's market while Pennsylvania companies generally face no reciprocal burden for expanding operations into another State").

At most, discriminating on the basis of in-state filing status, rather than in-state business activities, might make a difference for the state's justification once the taxpayer has carried its burden of showing facial discrimination against out-of-state or foreign taxpayers. But once the burden shifts, this case is effectively over, as countless states, including New York today, manage to address the underlying concerns that motivated §208.9(*o*) without facially discriminating against out-of-state taxpayers.

II. The Decision Below Exacerbates Deep And Enduring Divisions Among State Courts.

The highest court of one of the Nation's largest states got fundamental principles of constitutional law fundamentally wrong. That itself is remarkable. More remarkable still, the Court of Appeals is far from alone. Indeed, New York's is not the only state high

court to conflate the defendant-friendly *Salerno* standard and the defendant-demanding standard for laws that make their disfavored treatment of out-of-state taxpayers manifest on their face. And state courts are sharply divided on how to apply *Kraft*. Many states have laws that by their plain terms treat income derived from out-of-state subsidiaries and affiliates less favorably than income from in-state ones. On one side of the split, courts hold that *Kraft* means what it says and that these statutes are facially discriminatory and invalid as a result. On the other side, courts (including the court below) evade *Kraft* by conflating the *Salerno* and substantive standards or otherwise ignoring this Court's clear teaching.

1. On one side of the split are courts that properly apply this Court's teachings. The Ohio Supreme Court's decision in *Emerson Electric Co. v. Tracy*, 735 N.E.2d 445 (Ohio 2000), is a prime example. At issue there was an Ohio law that "treat[ed] dividends from foreign subsidiaries less favorably than those from domestic subsidiaries" in calculating taxable income. *Id.* at 447. The question in *Emerson* was whether that provision "unconstitutionally discriminate[d] against foreign commerce." *Id.* The Ohio Supreme Court held that it did. The court acknowledged that—unlike "the Iowa statute" in *Kraft*—Ohio's statute did not "entirely prohibit the deduction of dividends derived from foreign subsidiaries." *Id.* at 448. In other words, there might be some circumstances in which the statute did *not* have a discriminatory effect. But that "difference in the degree of discrimination has no constitutional significance" when it comes to a state law that discriminates against interstate or foreign commerce "on its face." *Id.* When facing a facially

discriminatory state law, *Emerson* held, courts need not "consider the extent of the discrimination before finding it unconstitutional under the Commerce Clause." *Id.* Three justices dissented, insisting that the taxpayers' burden was to show "that there are *no circumstances in which* [*the*] *statute could be constitutionally applied*." *Id.* at 450 (Cook, J., dissenting) (emphasis in original) (quoting *Kraft*, 505 U.S. at 84-85 (Rehnquist, C.J., dissenting)).

The Supreme Court of New Mexico sided with the *Emerson* majority in *Conoco*. *See* pp.20-21, *supra*. That case likewise involved a challenge to a "tax scheme for dividends received by a parent corporation from its foreign subsidiaries." 931 P.2d at 731. The state argued that the taxpayers' challenge failed because they could not "meet their burden of proof under *United States v. Salerno* … to show that 'no set of circumstances exists under which the Act would be valid.'" *Id.* at 736 (quoting *Salerno*, 481 U.S. at 745). The court rejected that argument in no uncertain terms: "[W]e do not think the Taxpayers' claims fail merely because the [statute] may have the effect of treating dividends from domestic and foreign subsidiaries equally for certain corporations." *Id.* at 737. That conclusion followed not only from *Kraft*, *see id.*; *see also* pp.20-21, *supra.*, but also from bedrock principles. New Mexico's law "treat[ed] dividends from foreign subsidiaries less favorably than dividends from domestic subsidiaries." 931 P.3d at 737. Even if it might not "discriminate against every conceivable taxpayer," the law imposed differential treatment by its plain terms in a way that "discriminated against [the challengers]." *Id.* at 738. And that, the court held, is what it means for a law to

"facially discriminate[] against foreign commerce in violation of the Foreign Commerce Clause." *Id.* at 737.

The Rhode Island high court reached a similar conclusion. Under Rhode Island's law, "net income for [state] tax purposes [did] not include dividends paid by domestic corporations," but "foreign dividends [we]re usually taxable as net income." *Dart Indus., Inc. v. Clark*, 657 A.2d 1062, 1064 (R.I. 1995). After rejecting the claim that *Kraft* did not have retroactive effect, *id.* at 1065-66, the court had no trouble finding the statute facially discriminatory. By its terms, the law "treat[ed] dividends paid by a foreign corporation less favorably than those paid by domestic corporations." *Id.* at 1066. And that—just the plain text—was all the court needed "to hold that [it] 'facially discriminates against foreign commerce and therefore violates the Foreign Commerce Clause.'" *Id.* (quoting *Kraft*, 505 U.S. at 82). Two California appeals courts reached the same conclusion in invalidating materially similar laws. *See Farmer Bros. Co. v. Franchise Tax Bd.*, 134 Cal.Rptr.2d 390, 398 (Cal. Ct. App. 2003); *Ceridian Corp. v. Franchise Tax Bd.*, 102 Cal.Rptr.2d 611, 620 (Cal. Ct. App. 2000).

In all of these cases, it was certainly possible that there would be circumstances or applications in which the challenged laws would have no discriminatory effect. Yet, in all of these cases, the majority understood that there is a fundamental difference between the plaintiff's burden when seeking the facial invalidation of a statute and the proper test for when a statute "discriminates against interstate commerce" on its face, such that "[i]t is not necessary to look beyond the text of th[e] statute" to shift the burden to

the state to try to justify that textually-evident discrimination. *Camps Newfound*, 520 U.S. at 575-76.

2. Unfortunately, not every court has gotten the message. *General Electric Co. v. Commissioner*, 914 A.2d 246 (N.H. 2006), is Exhibit A and provided a model for the decision below. As in *Kraft* and many of the cases just discussed, the "central issue" in *General Electric* was whether a law allowing taxpayers to take "a deduction for dividends received from foreign corporations doing business in New Hampshire, while denying a deduction for dividends received from foreign corporations not doing business in New Hampshire," "facially discriminate[d] against foreign commerce." *Id.* at 254. The Supreme Court of New Hampshire acknowledged that there was little (if any) daylight between its law and the tax laws of Rhode Island and California. But rather than follow "*Dart*" (Rhode Island) or "the decisions of the California appellate courts," the court rejected them. *Id.* at 259 ("[W]e do not agree with their analysis.").

The court instead found the state law non-discriminatory and valid by invoking *Salerno*. The court did not deny that the statute textually distinguished between foreign interests and domestic interests and singled out the former for worse treatment than the latter on its face. Instead, and despite what this Court made clear in *Kraft*, *Camps Newfound*, and a bevy of other decisions, the New Hampshire court deemed that textual discrimination insufficient to answer the question of whether the statute was facially discriminatory. Because there could be cases in which the statute would not result in any discrimination in effect (e.g., if "both the unitary

business with the foreign subsidiary operating in New Hampshire and the unitary business with the foreign subsidiary not operating in New Hampshire are each only taxed once"), the court held that the statute was not discriminatory at all. *Id.*

The New York Court of Appeals here relied on *General Electric* and took its (faulty) reasoning to its logical end. App.16, 19-20. The Court of Appeals asserted that "there is no differential treatment on the corporate group level" here—i.e., a corporate group with foreign subsidiaries that file New York returns is treated the same as a corporate group with domestic subsidiaries that file New York returns—and took from that that "the challenged taxing scheme is thus not facially discriminatory." App.16. But that utterly ignores the relevant discrimination—i.e., the undeniable discrimination against out-of-state subsidiaries that decline to submit themselves to the New York tax authorities. A corporate group with only New York subsidiaries will never face that unfavorable treatment, and the discrimination is evident on the face of the statute. Needless to say, a taxpayer with only New York subsidiaries or out-of-state subsidiaries that opt to file New York returns has no constitutional complaint, which is part and parcel of why Disney has not brought anything more than an as-applied challenge and never sought to invalidate §208.9(*o*) in toto. But that hardly defeats an as-applied challenge to a law that discriminates against foreign taxpayers on its face. Under the facts of *this as-applied* challenge, Disney lost out on millions of dollars in tax deductions simply because its subsidiaries were non-New York taxpayers. That is discrimination, plain and simple. And Disney was

under no obligation to show that *other* taxpayers' circumstances would entitle them to similar relief just to get its own money back. This Court should grant certiorari to make that clear.

III. This Case Is An Ideal Vehicle To Address These Important And Recurring Issues.

As the preceding section makes clear, the issues this case presents are frequently recurring. And this case well illustrates the dangers of leaving this split of authority in place. While one might have dismissed *General Electric* as an outlying decision making an obvious error, the Court of Appeals embraced that decision and replicated the error in the context of New York's tax scheme, where the stakes are substantially higher. Disney and IBM are hardly the only oxen gored by New York's discriminatory tax scheme. Numerous other taxpayers have as-applied challenges working through the system; the issue here implicates hundreds of millions of dollars in state tax liability.

Moreover, the split of authority among state high courts takes on added importance here given principles of federalism and jurisdictional limits on challenging state tax laws in federal courts. Federal courts may have little difficulty in distinguishing between a plaintiff seeking facial invalidation of a statute in toto and a plaintiff bringing an as-applied challenge to a statute that discriminates on its face. *See, e.g.*, *NextEra*, 48 F.4th at 321 n.6. But when it comes to challenges to state tax laws, federal court is rarely an option. Instead, the federal anti-tax-injunction act precludes jurisdiction over most challenges to state tax laws, and directs litigants instead to state court or state administrative

proceedings. 28 U.S.C. §1341. Thus, Disney had little choice here but to pursue an as-applied challenge through the New York administrative and judicial systems. But having pursued that as-applied challenge from the halls of the state administrative system up to and through New York's high court, it was poured out based on a misapplication of the standard for facial challenges. That is not only cruelly ironic, but manifestly important. Federal law makes state courts the exclusive forum for federal constitutional disputes of this nature, and yet the state courts cannot agree on the proper standard for evaluating them. Only this Court can clear up that confusion.

This case presents a uniquely clean vehicle for doing so. Some challenges to state tax laws are bedeviled by unresolved questions of statutory construction. But, here, the decision below rejected efforts to avoid or minimize constitutional difficulties and definitively construed §208.9(*o*) to discriminate against non-New York taxpayers. As the concurring judge emphasized, geography is dispositive. App.39 (Wilson, C.J., concurring). That definitive state-court construction is now binding on all taxpayers and this Court. *See 324 Liquor Corp. v. Duffy*, 479 U.S. 335, 345 n.6 (1987) ("We may not 'construe a state statute contrary to the construction given it by the highest court of a State.'" (quoting *O'Brien v. Skinner*, 414 U.S. 524, 531 (1974))). No antecedent interpretive questions could complicate this Court's resolution of the constitutional issue here.

What is more, the facial-discrimination question is dispositive here. When it comes to state laws that

facially discriminate against out-of-state taxpayers and commerce, strict scrutiny is not always fatal in fact. When the burden shifts, government defendants sometimes can justify the differential treatment as the only way to accomplish the state's legitimate objectives. That is especially true in tax cases, where the "compensatory tax" doctrine supplies a "specific way of justifying a facially discriminatory tax as achieving a legitimate local purpose that cannot be achieved through nondiscriminatory means." *Or. Waste Sys.*, 511 U.S. at 102; *see, e.g.*, *CompUSA Stores, L.P. v. Dep't of Tax'n*, 418 P.3d 645 (Haw. 2018) (holding that a state law is facially discriminatory, but upholding the law under the compensatory tax doctrine); *Frey v. Comptroller of Treasury*, 29 A.3d 475 (Md. 2011) (similar). But, here, there is no need to apply that doctrine and no possibility that §208.9(*o*) could be saved under strict scrutiny. As explained above, New York is in no position to deny that a non-discriminatory fix is possible, as it has been employing one for years. The New York legislature repealed §208.9(*o*) in 2013 and replaced it with a non-discriminatory alternative that mirrors the laws of all other states with similar royalty-income-tax regimes. *See* pp.6-7, *supra*.[6] In doing so, New York made clear

[6] Because the law has been repealed and replaced, there is also no risk that further developments might moot the case. But Disney (and IBM) are not the only ones fighting to get their money back under §208.9(*o*). *See, e.g.*, *In re Kimberly-Clark Co. & Combined Affiliates*, DTA No. 828259 (N.Y. Div. Tax App., Apr. 15, 2021); *In re Genzyme Co.*, DTA No. 828091 (N.Y. Div. Tax App., Apr. 7, 2022). Hundreds of millions of dollars in taxes on billions of dollars in transactions still remain contested in this and other cases.

that there is available a more tailored, non-discriminatory approach that still solves the basic problem New York and other states were targeting, *see* p.7, *supra*. The Court of Appeals' refusal to faithfully follow this Court's teachings and subject §208.9(*o*) to strict scrutiny was thus dispositive.

Finally, the question presented is particularly important given recent developments in the doctrine. Across decades, nearly "every Member of [this] Court" (and a host of lower-court judges) lamented that many aspects of dormant Commerce Clause doctrine—including inquiries into purpose and effects—were fraught with problems and "virtually unworkable in application." *Camps Newfound*, 520 U.S. at 610-11 (Thomas, J., dissenting) (citing cases). The one shining exception was the antidiscrimination rule, which looks only to the duly enacted text. Justice Scalia, while famously comparing other Commerce Clause tests to akin to asking "whether a particular line is longer than a particular rock is heavy," *Bendix Autolite Corp. v. Midwesco Enters., Inc.*, 486 U.S. 888, 897 (1988) (Scalia, J., concurring in the judgment), identified the textual discrimination prohibition as a paradigm of clarity. *See* Antonin Scalia, *The Rule of Law As A Law of Rules*, 56 U. Chi. L. Rev. 1175, 1185 (1989) (noting that "the principle … that a state cannot overtly discriminate against interstate commerce" is "clear in itself, and there can be little variation in applying it to the facts," even if "challeng[ing] state laws that do not overtly discriminate against interstate commerce, but affect it to an excessive degree" is more questionable).

The decision below paradoxically makes the most egregious and clearest Commerce Clause violations the most difficult to bring. Inquiries into purpose and effects, or balancing under *Pike v. Bruce Church, Inc.*, 397 U.S. 137, 142 (1970), are not readily conflated with the *Salerno* standard for facial challenges. But as the decision below and the New Hampshire Supreme Court decision it follows illustrate, courts have confused as-applied claims of facially evident discrimination (which should elevate the state's burden) and facial challenges to a statute in all its applications (which properly elevates the plaintiff's burden). That error is too fundamental and consequential to let stand, especially when taxpayer's as-applied challenges are jurisdictionally relegated to state courts. *See* 28 U.S.C. §1341. Simply put, this Court is the only federal court that can correct this mistake. This Court should grant review to set things right.[7]

[7] At the very least, the Court should hold this petition pending *Zilka v. City of Philadelphia*, No. 23-914, which raises similar dormant Commerce Clause issues and in which the Court has called for the views of the Solicitor General.

CONCLUSION

For the foregoing reasons, this Court should grant the petition for certiorari.

Respectfully submitted,

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September 20, 2024

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Appendix A

NEW YORK COURT OF APPEALS

No. 34

WALT DISNEY CO. AND CONSOLIDATED SUBSIDIARIES,
Appellant,
v.
TAX APPEALS TRIBUNAL OF N.Y., et al.,
Respondents.

No. 35

INTERNATIONAL BUSINESS MACHINES CORP. & COMBINED AFFILIATES,
Appellant,
v.
TAX APPEALS TRIBUNAL OF N.Y., et al.,
Respondents.

Decided: Apr. 23, 2024

OPINION

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 current scheme for taxing royalty payments between related entities.

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]

[2] The terms "parent" and "subsidiary" are used throughout to describe related corporate entities for clarity and ease of description, however, for purposes of the Tax Law it is sufficient that the payor and payee entities are related through common

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 directly or indirectly received from a related

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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.

> 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 there was no risk of evasion (former Tax Law § 208

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[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]).

[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

[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.

WTC and granted it a non-exclusive license to use certain IP. 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]

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

[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.

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

[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

arguments or 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

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tax" would not be a "New York taxpayer" able to claim the royalty addback under former Tax Law § 208 (9) (o) (3).

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]

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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

But a "New York taxpayer" for purposes of this 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

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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 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*.

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 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

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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

jurisdiction would follow the related member add-back provision in former section 208 (9) (o) (2). Thus the royalty-paying 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

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.

[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.

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.

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

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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]).

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.

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

[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

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 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

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corporation's net income at $500 and tax $450. The total taxable income in both jurisdictions is $450 + $40, or $490.

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 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.

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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%.

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

NEW YORK SUPREME COURT
APPELLATE DIVISION

No. 532479

WALT DISNEY CO. AND CONSOLIDATED SUBSIDIARIES,
Petitioner,
v.
TAX APPEALS TRIBUNAL OF N.Y., et al.,
Respondents.

Argued: Sept. 13, 2022
Decided and Entered: Oct. 20, 2022

Before: Garry, P.J., Egan Jr., Clark, Fisher
and McShan, JJ.

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 sustaining a notice of deficiency of corporate franchise tax imposed under Tax Law article 9-A.

Petitioner is a corporation organized under the laws of Delaware and is the parent company to an affiliated group of entities, which are part of petitioner's combined group in its tax filings, that are in the business of producing and licensing to others

content and other media, entertainment and consumer products. During the tax years ending in 2008 through 2010 (hereinafter the audit period), petitioner, through its subsidiaries, licensed intellectual property to affiliates organized under the law of foreign countries through various licensing agreements in exchange for royalty payments. Petitioner deducted royalty payments received from its foreign affiliates for the audit period under Tax Law § 208 (former [9] [o]).

In May 2017, after an audit, the Division of Taxation disallowed the royalty deductions and issued petitioner a notice of deficiency stating that petitioner owed additional corporate franchise tax plus interest for the audit period. Petitioner sought review with the Division of Tax Appeals and, following a hearing, an Administrative Law Judge (hereinafter ALJ) sustained the notice of deficiency, concluding that the Division of Taxation properly determined that petitioner was required to add the royalty payments back into its income. Petitioner filed an exception with respondent Tax Appeals Tribunal, which affirmed the ALJ's determination. Petitioner commenced this proceeding in this Court to challenge the Tribunal's determination.

Petitioner argues that it has the right to deduct royalty payments under the plain meaning of the statute. According to petitioner, Tax Law § 208 (former [9] [o]) unambiguously allowed a taxpayer to exclude royalty payments received from a related member unless one of three conditions were met—none of which apply here. Petitioner asserts that, because the definition of "related member" does not

require such entity to be a taxpayer, petitioner was entitled to deduct royalty payments as income from its foreign affiliates. Petitioner further contends that respondents created a new exception not provided for in the statute by holding that petitioner would only be entitled to the exclusion if the foreign affiliates were New York taxpayers, thereby discriminating against out-of-state commerce and violating the dormant Commerce Clause of the US Constitution.

"Judicial review of a determination of the Tribunal is limited. If the determination is rationally based upon and supported by substantial evidence, it must be confirmed, even if a different conclusion is reasonable" (*Matter of BTG Pactual NY Corp. v New York State Tax Appeals Trib.*, 203 AD3d 1347, 1348-1349 [3d Dept 2022] [internal quotation marks, brackets and citations omitted]; *see Matter of Black v New York State Tax Appeals Trib.*, 206 AD3d 1482, 1484 [3d Dept 2022]). "Interpretation given a statute by the agency charged with its enforcement is, as a general matter, given great weight and judicial deference, so long as the interpretation is neither irrational, unreasonable nor inconsistent with the governing statute" (*Matter of Obus v New York State Tax Appeals Trib.*, 206 AD3d 1511, 1512 [3d Dept 2022] [internal quotation marks and citations omitted]).

> "Ultimately, however, legal interpretation is the court's responsibility; where the question is one of pure statutory reading and analysis, dependent only on accurate apprehension of legislative intent, there is little basis to rely on any special competence or expertise of the

> administrative agency and its interpretation is therefore to be accorded much less weight" (*Matter of Carmel Academy v New York State Educ. Dept.*, 169 AD3d 1287, 1288 [3d Dept 2019] [internal quotation marks, brackets and citations omitted], *lv denied* 35 NY3d 901 [2020]; *accord Matter of Obus v New York State Tax Appeals Trib.*, 206 AD3d at 1512).

The taxpayer bears the burden "to overcome a tax assessment and establish its unambiguous entitlement to an exclusion," exemption or deduction (*Matter of XO Communications Servs., LLC v Tax Appeals Trib. of the State of N.Y.*, 182 AD3d 717, 718 [3d Dept 2020], lv denied 36 NY3d 903 [2020]). Such statutory exclusions, exemptions or deductions are to be construed "in favor of the taxing power" (*Matter of Wegmans Food Mkts., Inc. v Tax Appeals Trib. of the State of N.Y.*, 33 NY3d 587, 592 [2019] [internal quotation marks and citation omitted]).

The statutory provision at issue contains two operative sections, one of which governs payments made *from* a "related member" and one of which governs payments to a "related member" (*see* Tax Law § 208 [former (9) (o) (2), (3)]). A related member is defined as "a person, corporation or entity, . . . 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" (Tax Law § 208 [former (9) (o) (1) (A)]). A taxpayer is defined as "any corporation subject to tax under [Tax Law article 9-A]" (Tax Law § 208 [2]). Petitioner, as

the entity receiving royalty payments from a "related member," is governed by Tax Law § 208 (former [9] [o] [3]), which states that,

> "[f]or 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 § 208 (former [9] [o] [2])] or other similar provision in [Tax Law chapter 60]."

Therefore, in order to determine whether an entity that receives royalty payments is entitled to deduct them from its income, an examination must be made of whether the entity that made the royalty payments is entitled to add them back under Tax Law § 208 (former [9] [o] [2]) (*see* Tax Law § 208 [former (9) (o) (3)]). Such provision provides that, "[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" unless one of three conditions are met (Tax Law § 208 [former (9) (o) (2) (A), (B)]).

In enacting this statute, the Legislature indicated that it was passed to "[c]larif[y] the provisions of law which eliminate tax loopholes concerning royalty payments . . . to exclude royalty payments made to certain foreign corporation related members" (Sponsor's Mem, Bill Jacket, L 2003, ch 686). When this statute was amended in 2013 (*see* L 2013, ch 59,

sec 1, pt E, § 2), a memorandum in support of the 2013-2014 executive budget was written, which stated that the then-current statute had been "interpreted by some taxpayers in ways that are inconsistent with the intent of the statute and the Department's interpretation" and, therefore, the amendment "would eliminate those inconsistent readings with clear language on the applicability of the required add-back . . . in order to prevent tax avoidance while allowing for fair and equitable administration."

At the hearing, the Division of Taxation's employees testified that petitioner was denied the royalty deduction because the foreign affiliates it had received payments from were not New York taxpayers. The ALJ found that "[t]he addback and exclusion provisions contained in Tax Law [§ 208 former] (9) (o) work in tandem to ensure that royalty transactions between related members are taxed only once" and do "not escape taxation altogether." In determining that petitioner's interpretation of the statute effectively allowed it to avoid taxation on that income, which went against the Legislature's intent in enacting the statute, the ALJ concluded that the Division of Taxation's interpretation of the statute was rational and therefore petitioner was not permitted to deduct royalty payments from its income. When the Tribunal affirmed the findings of the ALJ, it added that "the [L]egislature did not intend for a taxpayer to gain the benefit of the income exclusion . . . without the corresponding cost to a related member of the add back."

Although the question presented here "is one of pure statutory reading and analysis" and the

Tribunal's interpretation of the statute is therefore given "less weight" (*Matter of Obus v New York State Tax Appeals Trib.*, 206 AD3d at 1512 [internal quotation marks and citations omitted]), we nonetheless find that the plain meaning of the statute supports the Tribunal's interpretation. Under the statute, petitioner would be entitled to deduct royalty payments received from its foreign affiliates unless the foreign affiliates would not be required to add back the royalty payments on their own tax returns (*see* Tax Law § 208 [former (9) (o) (3)]). Since only taxpayers are required to add back royalty payments to their tax returns, the foreign affiliates, as nontaxpayers, would not be required to add back the payments (*see* Tax Law § 208 [former (9) (o) (2)]). Although petitioner argues that the definition of a related member includes nontaxpayers (*see* Tax Law § 208 [former (9) (o)]), this is immaterial because the operative paragraph only applies to taxpayers, who are defined as "any corporation subject to tax under this article" (Tax Law § 208 [2]). Therefore, since the foreign affiliates, as nontaxpayers, would not be required to—and simply could not—add back royalty payments on their nonexistent tax returns, petitioner is statutorily precluded from deducting the royalty payments from its income (*see* Tax Law § 208 [former (9) (o) (3)]). Such construction of the statutory text provides the clearest indication of the legislative intent, and is construed in a manner "to give effect to its plain meaning" (*Matter of BTG Pactual NY Corp. v New York State Tax Appeals Trib.*, 203 AD3d at 1351 [internal quotation marks and citations omitted]; *see Matter of Obus v New York State Tax Appeals Trib.*, 206 AD3d at 1512;

Matter of Carmel Academy v New York State Educ. Dept., 169 AD3d at 1288).

Lastly, we reject petitioner's argument that Tax Law § 208 (former [9] [o]) violates the dormant Commerce Clause of the US Constitution (US Const, art I, § 8) because it favors in-state commerce and discriminates against out-of-state commerce. This provision of the US Constitution prohibits a state from "impos[ing] a tax which discriminates against interstate commerce by providing a direct commercial advantage to local business" (*Westinghouse Elec. Corp. v Tully*, 466 US 388, 403 [1984] [internal quotation marks, ellipsis and citations 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]; *Hunter v Warren County Bd. of Supervisors*, 21 AD3d 622, 626 [3d Dept 2005]). 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" (*American Tel. & Tel. Co. v New York State Dept. of Taxation & Fin.*, 84 NY2d 31, 34-35 [1994] [internal quotation marks and citation omitted]). "[L]egislative 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 Frontier Ins. Co. v Town Bd. of Town of Thompson*, 285 AD2d 953, 955 [3d Dept 2001] [internal quotation marks and citation omitted]; *see Chavis v New York Temporary State Commn. on Lobbying*, 16 AD3d 886, 887 [3d Dept 2005]).

Petitioner argues that the statute discriminates against out-of-state commerce because petitioner is not permitted to deduct royalty payments received from its foreign affiliates that do not file taxes in New York, while it would be able to deduct royalty payments for any affiliates that do file New York tax returns. However, this argument neglects to realize that the reason why petitioner would be permitted to deduct such royalty payments from its income, if its affiliates were New York taxpayers, is because the affiliate would be paying taxes on that income (*see* Tax Law § 208 [former (9) (o) (2), (3)]). Thus, such royalty income tax would be paid by either the taxpayer or its affiliate—not both. Since similarly situated entities would also be paying taxes on the royalty income once in either scenario, whether or not such commerce is from an out-of-state source, petitioner has failed to show differential treatment between in-state and out-of-state economic interests that rises to the level of unconstitutional discrimination (*see American Tel. & Tel. Co. v New York State Dept. of Taxation & Fin.*, 84 NY2d at 34-35; *see also Matter of Frontier Ins. Co. v Town Bd. of Town of Thompson*, 285 AD2d at 955). The parties' remaining contentions have been examined and found to be lacking merit or are academic.

Garry, P.J., Egan Jr., Clark and McShan, JJ., concur.

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

ENTER:

[handwritten: signature]
Robert D. Mayberger
Clerk of the Court

Appendix C

NEW YORK TAX APPEALS TRIBUNAL

DTA No. 828304

IN RE WALT DISNEY CO. AND
CONSOLIDATED SUBSIDIARIES,

Petitioner.

Decided: Aug. 6, 2020

DECISION

Petitioner, The Walt Disney Company and Consolidated Subsidiaries, and the Division of Taxation each filed an exception to the determination of the Administrative Law Judge issued on May 30, 2019. Petitioner appeared by Pillsbury Winthrop Shaw Pittman, LLP (Marc A. Simonetti, Esq., Andrew D. Appleby, Esq. and Dmitrii Gabrielov, 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 filed a brief in reply to petitioner's brief in

opposition. Oral argument was heard on February 6, 2020 in Albany, New York, 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 has established the amount claimed as royalty payments from its alien affiliates during the years at issue.

II. Whether some of those payments were royalties as defined in Tax Law § 208 (9) (o) (1) (C).

III. Whether petitioner may exclude royalties received from its alien affiliates in the computation of its entire net income pursuant to Tax Law former § 208 (9) (o) (3).

IV. 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 facts as determined by the Administrative Law Judge.[1] Those facts appear below.

1. Petitioner, The Walt Disney Company and Consolidated Subsidiaries, is a diversified worldwide entertainment company comprised of a group of corporations incorporated within the United States. Petitioner's operations are comprised of five business segments: Media Networks, Parks and Resorts, Studio

[1] We have considered and we reject requests for findings of fact made by both parties.

Entertainment, Consumer Products and Interactive Media.

2. The Media Networks segment includes a domestic broadcast television network (ABC Television Network), television production and distribution operations, domestic television stations, international and domestic cable networks (e.g., ESPN and Disney Channel), domestic broadcast radio networks and stations, and publishing and digital operations.

3. In the Parks and Resorts segment, petitioner owns and operates the Walt Disney World Resort in Florida, the Disneyland Resort in California, the Disney Vacation Club, the Disney Cruise Line and Adventures by Disney. Petitioner also manages and has ownership interests in Disneyland Paris and Hong Kong Disneyland Resort, and licenses the operations of the Tokyo Disney Resort in Japan.

4. The Studio Entertainment segment produces and acquires live-action and animated motion pictures, direct-to-video content, musical recordings and live stage plays. Petitioner distributes produced and acquired films in the theatrical, home entertainment and television markets under such banners as Walt Disney Pictures, Touchstone Pictures, Pixar Miramax and Dimension.

5. The Consumer Products segment engages with licensees, manufacturers, publishers and retailers throughout the world to design, develop, publish, promote and sell a wide variety of products based on existing and new characters and other intellectual property through its merchandise licensing, publishing and retail businesses. Petitioner's

worldwide merchandise licensing operations include products such as toys, home decor and furnishings, stationery, accessories, health and beauty, food, footwear and consumer electronics. Petitioner licenses characters from its film, television and other properties and earns royalties, which are usually based on a fixed percentage of the selling price of the products.

6. The Interactive Media Segment creates and delivers Disney-branded entertainment and lifestyle content through interactive media, such as multi-platform games and internet websites.

7. Petitioner's businesses are affected by its ability to exploit and protect against infringement of its intellectual property, including its trademarks, trade names, copyrights, patents and trade secrets. Petitioner's intellectual property includes rights in the content of motion pictures, television programs, electronic games, sound recordings, character likenesses, theme park attractions, books and magazines.

8. Petitioner's New York State corporation franchise tax reports filed for the audit period included all affiliates in petitioner's consolidated federal forms 1120 filed for the tax periods ended September 27, 2008 (FYE 2008) and October 3, 2009 (FYE 2009) and most of petitioner's affiliates included in its consolidated federal forms 1120 for the tax period ended October 2, 2010 (FYE 20 10) (collectively the audit period). Both petitioner's state combined reports and federal tax returns include Buena Vista International, Inc., Disney Enterprises, Inc., Disney Interactive Studios, Inc. (f/k/a Buena Vista Games,

Inc.), ABC, Inc., Buena Vista Theatrical Group Ltd. and Walt Disney World Company, Inc.

9. Petitioner's combined group members owned 100% of the voting power and value of Buena Vista International, Inc., Disney Enterprises, Inc., Disney Interactive Studios, Inc. (f/k/a Buena Vista Games, Inc.), ABC, Inc., Buena Vista Theatrical Group Ltd., and Walt Disney World Company, Inc., during the entire audit period.

10. On petitioner's original and first five amended New York State forms CT-3-A for FYE 2008, petitioner deducted $355,477.00 on line 15 (other subtractions). On its sixth amended FYE 2008 form CT-3-A, petitioner deducted $1,728,785,592.00 on line 15. Of the $1,728,785,592.00 claimed on line 15, $355,477.00 is not at issue in this matter. The remaining amount was included in the amounts reported on line 1a (gross receipts or sales), and line 7 (gross royalties), on petitioner's federal form 1120 for FYE 2008. Petitioner agrees that $44,096,153.00 of the $1,728,785,592.00 reported on line 15 of its sixth amended form CT-3-A for FYE 2008 should not have been deducted.

11. On petitioner's original form CT-3-A for FYE 2009, petitioner deducted $1,583,177,067.00 on line 15. Of the $1,583,177,067.00 reported on line 15, $138,000.00 is not at issue in this matter. The remaining amount was included in the amounts reported on line 1a and on line 7 of petitioner's federal form 1120 for FYE 2009.

12. On petitioner's original form CT-3-A for FYE 2010, petitioner deducted $2,179,325,577.00 on line 15. Of the $2,179,325,577.00 reported on line 15, $575,000.00 is not at issue in this matter. The

remaining amount was included on line 1a and line 7 of petitioner's federal form 1120 for FYE 2010. Petitioner agrees that $5,336,418.00 of the $2,179,325,577.00 reported on line 15 of its FYE 2010 form CT-3-A should not have been deducted.

13. The Division of Taxation (Division) audited petitioner's combined reports for the audit period. The Division identified the large amounts petitioner reported on line 15 of petitioner's combined reports during the audit period. On a statement attached to its form CT-3-A for FYE 2009, petitioner described the line 15 amount as "Parent Company Share Adjustment." No explanation of the line 15 amount was provided for FYE 2010. On its sixth amended form CT-3-A for FYE 2008, petitioner explained that it was amending the return to "[i]nclude a deduction from the combined entire net income base for foreign royalty income under N.Y. Tax Law 208(9)(0)(3)."

14. During the course of the audit, the Division submitted four information document requests (IDRs) to petitioner seeking various information and/or documentation. As is relevant here, in its first IDR to petitioner, IDR#1, dated April 29, 2014, the Division made the following request:

> "Support and explanation of CT-3A line (15) deduction for the 09/2009, 09/2010 and 09/2011 periods. In the 09/2009 CT-3A the deduction of $1,583,039,067 is described as 'Parent Company Share Adjustment.'
>
> a. For the 09/2009 period, on what line of the federal consolidated return was the $1,583,039,067 item(s) reported?

b. For the 09/2010 period, a deduction of $2,178,750,577 was deducted on the CT-3A line (15). On what line of the federal consolidated return was the $2,178,750,577 items(s) reported?

c. For the 09/2011 period, a deduction of $2,667,633,394 was deducted on the 3A line (15). On what line of the federal consolidated return was the $2,667,633,394 item(s) reported?

d. What New York State Tax Law section supports the deductions taken on the CT-3A line (15) for the periods ending 09/2009, 09/2010 and 09/2011."

15. Along with its response to the other requests made in IDR#1, petitioner responded to the foregoing inquiry as follows:

"a. For the 09/2009 period, the $1,583,039,067 was reported on line(s) 1A and of the federal consolidated return.

b. For the 09/2010 period, the $2,178,750,577 was reported on line(s) 1A and 7 of the federal consolidated return.

c. The 09/2011 period is not included in the scope of this audit.

d. New York Tax Law § 208.9(o)(3) which allows royalty income received from a related corporation to be excluded from the recipient's taxable income provided the deduction for such royalty income is required to be added back to the payer's

> taxable income under § 208.9(o)(3) supports the deductions taken on the CT-3A line (15) for the periods ending 09/2009 and 09/2010."

16. On January 9, 2015, the Division sent IDR#2 to petitioner. This IDR posed no questions nor requested documentation on the royalty income exclusion previously identified.

17. Subsequently, on November 16, 2016, the Division sent IDR#3 to petitioner, which requested support for the line 15 amounts, including the statutory authority for such deduction and a breakdown by payer and amount paid.

18. For FYE 2009, petitioner responded as follows:

Legal Entity	Description	Amount
Disney Enterprises, Inc.	DEI-CP Parent Company Share	$498,598,200
Disney Enterprises, Inc.	DEI-Corp Royalty from Magical Cruise Co. Ltd.	$28,877,289
Disney Enterprises, Inc.	DEI-Corp Royalty from Euro Disneyland	$30,369,733
Buena Vista International, Inc.	BVI Parent co Share	$1,025,193,844
	Total Foreign Royalty Revenue From Related Entities Not in Federal Consolidated Return	$1,583,039,067

19. For FYI 2010, petitioner responded as follows:

Legal Entity	Description	Amount
Disney Enterprises, Inc.	DEI-CP Parent Company Share	$529,660,116
Disney Enterprises, Inc.	DEI-Corp Royalty from Magical Cruise Co. Ltd.	$22,678,808
Disney Enterprises, Inc.	DEI-Corp Royalty from Euro Disneyland	$60,370,000
Buena Vista International, Inc.	BVI Parent co Share	$1,566,041,653
	Total Foreign Royalty Revenue From Related Entities Not in Federal Consolidated Return	$2,178,750,577

20. Petitioner did not provide detail for FYE 2008 because, at the time, it had yet to amend its FYE 2008 form CT-3-A to include such subtraction.

21. The auditor's handwritten notes contained in the audit file indicate that she believed that petitioner's response to IDR#3 Item 5 did not provide much detail. On the auditor's copy of IDR#3 her handwritten notes that indicate this item was "Done" and that petitioner had responded on January 26, 2016. The audit file makes no mention of petitioner

failing to adequately substantiate the royalty income exclusion claimed or that the amounts claimed were royalties. The auditor's notes state:

> "Taxpayer deducted foreign royalty income rec'd from a related corporation for the 2009 & 2010 periods. Tp cited NY tax law §208.9(o)(3) in support of the royalties exclusion from income. Audit's position is that royalty income rec'd from related corporations who are NY filers can be excluded from income. Foreign royalty exclusion for the FY 2009 & 2010 periods as filed is disallowed."

22. During the audit period, petitioner licensed intellectual property to its alien affiliates pursuant to licensing agreements. Petitioner's alien affiliates are identified in petitioner's exhibits 1 and 2. There is no dispute that the alien affiliates are related members as defined in Tax Law former § 208 (9) (o).

23. Petitioner's alien affiliates are entities all organized under the laws of foreign countries, and were not members of petitioner's New York State corporation franchise tax group because entities organized under the laws of foreign countries were not includable in a franchise tax combined return under the tax law in effect during the periods in issue.

24. Petitioner's alien affiliates were regarded as non-U.S. entities or owned by related non-U.S. entities for federal income tax purposes during the entire audit period.

25. Petitioner owned at least 30%, directly or indirectly, of the capital, profits or beneficial interest

in each of its alien affiliates during the entire audit period.

26. In general, petitioner's licensing agreements granted the alien affiliates the right, in return for royalty payments, to exploit in specified non-U.S. territories for specified periods of time: Disney characters; copyrights; trade names; literary works; dramatic works; pictorial, graphic works; motion pictures; sound recordings; cruise ship designs; and/or other intellectual property rights.

27. At the hearing in this matter, petitioner presented the testimony of its tax principal, Aaron Solomon. Mr. Solomon oversees the teams that prepare petitioner's federal and state tax returns and manage federal and state tax audits. Mr. Solomon explained the general nature of the licensing agreements and how the payments received by petitioner from its alien affiliates pursuant to these agreements were accounted for on petitioner's books and records and for tax purposes.

28. Petitioner's licensing agreements generally fell into three categories: (i) motion picture or television programming; (ii) consumer products or merchandising; and (iii) other agreements operating a theme park.

29. In the consumer products or merchandise licensing agreements, the foreign affiliate pays petitioner for access to the Disney characters and

other Disney materials. Payment is based on undisclosed percentages of gross sales.[2]

30. In the "other" category, the foreign affiliate pays petitioner for the right to operate a [Disney theme park] or a Disney-themed cruise line, including the use of the Disney name and design. Payment is based on undisclosed percentages of gross revenues.

31. Agreements in the motion picture or television programming category include those relating to film distribution. The foreign affiliate pays petitioner for the right to advertise, promote, produce and license the product incorporating licensed property for distribution in a territory. Payment is based on an undisclosed percentage of gross revenues less distribution expenses. If distribution expenses exceed the payment, petitioner would be required to reimburse the alien affiliate for the shortfall. Mr. Solomon did not believe that the merchandise licensing or theme park and cruise ship license agreements allowed the payment owed to petitioner to be reduced by the alien affiliate's distribution expenses. Pursuant to these types of agreements, petitioner was required to deliver to the alien affiliate: "[a] new or used, complete, final, full timed 35mm or 16mm positive print and/or non-theatrical video cassettes of the Picture, fully cut, main and end titled, edited, scored and assembled with soundtrack printed thereon in synchronization with the photographic

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[2] During the course of these proceedings, petitioner redacted portions of the license agreements containing trade secrets and other confidential information.

action and fit and ready for exhibition and distribution."

32. Petitioner's combined group entities that licensed this intellectual property to its alien affiliates during the audit period were Buena Vista International, Inc., Disney Enterprises, Inc., Disney Interactive Studios, Inc. (f/k/a Buena Vista Games, Inc.), ABC, Inc., Buena Vista Theatrical Group Ltd., and Walt Disney World Company, Inc.

33. Introduced as exhibit 1 was a schedule prepared by petitioner under the direction and supervision of Mr. Solomon listing intercompany agreements between petitioner and its alien affiliates detailing the payments received by petitioner's combined entities and its alien affiliates during the audit period. The schedule lists the payer, the payee, the specific agreement giving rise to the payments, the term of the agreement, the product line licensed, the territory covered, and the amount paid by tax year. For FYEs 2008, 2009 and 2010, the payments paid by the alien affiliates to petitioner amounted to $1,487,104,221.00, $1,491,821,746.00, and $1,901,121,890.00, respectively.[3] Mr. Solomon credibly testified that the subject license agreements were collected and the amounts claimed as royalties came directly from petitioner's accounting system. All of the subject license agreements listed were in effect during the entire audit period.

[3] Reacted copies of the agreements listed in exhibit 1 are set forth as exhibit S to the joint stipulation of facts entered into the record by the parties.

34. Petitioner introduced a second schedule as exhibit 2, which was similar to exhibit 1, except that the agreement, term, product line and territory fields of the spreadsheet were left blank. Mr. Solomon testified that these fields were not filled in because the amounts only constituted approximately 10% of the total foreign affiliate royalties claimed. In all other respects, the exhibits were prepared in the same manner. For FYEs 2008, 2009 and 2010, the payments made by the alien affiliates to petitioner as reflected on exhibit 2 amounted to $197,229,741.00, $91,217,321.00, and $272,292,269.00, respectively.

35. The cumulative total payments received by petitioner from its alien affiliates for licensing its intellectual property rights amounted to $1,684,335,970.00, $1,583,041,076.00, and $2,173,416,179.00 for FYEs 2008, 2009 and 2010, respectively.

36. Petitioner treated the payments from the alien affiliate as royalties for financial reporting purposes.

37. In petitioner's general ledger accounting system, the payments from its alien affiliates were generally booked to the "Parent Company Share-Intercompany" account, with a few booked to a broader "Royalty" account. Mr. Solomon explained that "Parent Company Share-Intercompany" is petitioner's terminology for a royalty coming from a foreign related parry to a United States parry and it is also the name of an account in petitioner's general ledger for such payments.

38. The payments petitioner received from its alien affiliates were included in its federal taxable

income as reported on its federal consolidated income tax returns during the audit period.

39. The alien affiliates' federal informational returns (IRS forms 5471, 8858 and 8865) during the audit period included the alien affiliate royalty payments as expenses in the "Rents, royalties, and license fees paid" and/or "Parent Company Share-Intercompany" line-items.

40. Petitioner did not license from unrelated third parties the intellectual property that it licensed to the alien affiliates, except for a few films that petitioner licensed from third parties and then licensed to its alien affiliates.

41. Petitioner excluded the subject payments from its entire net income during the audit period because it concluded that Tax Law former § 208 (9) (o) permitted the royalty income exclusion as long as the royalty payments were received from a related member, whether or not the related member was a New York taxpayer.

42. The Division asserted that petitioner could not exclude the alien affiliate payments from its entire net income because the alien affiliates were not New York taxpayers, citing Tax Law former § 208 (9) (o) as authority for its position that the royalty exclusion should be disallowed.[4]

43. Neither the audit supervisor, Mr. Daniel Zagorscak, nor the auditor, Ms..Angelika Moutidis, consulted with the Division's legal counsel prior to

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[4] The Division also made other adjustments to petitioner's forms CT-3-A as reflected in the schedules introduced as exhibit K with the stipulation of facts that are not at issue in this matter.

disallowing the royalty exclusion claimed by petitioner.

44. On May 8, 2017, the Division issued notice of deficiency L-046397543, which asserted tax of $3,995,511.00, plus interest, for the audit period, and denied petitioner's overpayment claim for FYE 2008.

45. Petitioner timely filed a petition protesting the notice of deficiency.

46. The Division filed its answer to the petition, which generally denied the allegations in the petition, including the allegations that the payments petitioner received from its alien affiliates were royalties.

47. The hearing in this matter was held on June 28 and 29, 2018. In her opening statement, the Division's representative clearly stated that the majority of payments petitioner was seeking to exclude from its entire net income did not constitute royalties.

48. In 2003, the statute in question, Tax Law § 208 (9) (o) was enacted effective for tax years beginning on or after January 1, 2003. Subsequently, in 2013, Tax Law § 208 (9) (o) was amended to eliminate the royalty income exclusion provision effective for tax years beginning on or after January 1, 2013.

49. Petitioner subpoenaed Ms. Deborah Liebman to appear and give testimony at the hearing in this matter. Ms. Liebman was the Division's attorney who oversaw its income tax legislation and guidance function in its Office of Counsel during the audit period.

50. Ms. Liebman testified that the Division regularly drafts proposed bills for the New York State Division of the Budget, which the Division of the Budget may incorporate into the New York Governor's proposed revenue bills.

51. Ms. Liebman had no specific familiarity with Tax Law former § 208 (9) (o) (3) or recollection of the subsequent amendment of the statute that occurred in 2013.

52. Ms. Liebman testified that Tax Law former § 208 (9) (o) (3) "does not say anything about" the royalty payer having to be a New York taxpayer. Likewise, Mr. Zagorscak testified that Tax Law former § 208 (9) (o) (1) (A) stated that the royalty payer did not have to be a New York taxpayer.

53. Petitioner also subpoenaed Mr. Robert Plattner to appear and give testimony at the hearing in this matter. Mr. Plattner served as the Division's Deputy Commissioner of Tax Policy from May 2007 through February 2018.

54. Mr. Plattner testified that the Division advises the Governor's Division of the Budget if the Division believes there are constitutional infirmities with a tax statute.

55. Mr. Plattner testified that he was aware that a tax that discriminates against out-of-state taxpayers violates the Commerce Clause of the United States Constitution and that a state may not impose a tax that discriminates against interstate commerce by providing a commercial advantage to local business.

56. Mr. Plattner further testified that a tax formula that penalizes out-of-state economic activity

in favor of in-state economic activity is discriminatory and violates the Commerce Clause.

THE DETERMINATION OF THE ADMINISTRATIVE LAW JUDGE

The Administrative Law Judge first determined that the payments from the alien affiliates to petitioner were royalties as defined in Tax Law § 208 (9) (o) (1) (C). The Administrative Law Judge found that such payments were made in connection with the licensing of intangible assets, consistent with the terms of the agreements between petitioner and its alien affiliates. The Administrative Law Judge also noted that the Division's auditors appear to have been satisfied that the payments were royalties.

Next, the Administrative Law Judge addressed whether the royalty payments paid to petitioner by its 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 ("escape taxation"). The Administrative Law Judge noted 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 contrary to the legislature's intent. The Administrative Law Judge found that petitioner's interpretation improperly 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 found further support for the Division's interpretation of the statute in 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.

Finally, the Administrative Law Judge rejected petitioner's contention that the interpretation of Tax Law former § 208 (9) (o) as applied herein violates the dormant Commerce Clause of the United States Constitution. 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. Accordingly, the Administrative Law Judge concluded that the statute, as applied, does not discriminate against interstate (or foreign) commerce.

The Administrative Law Judge thus denied the petition and sustained the notice of deficiency.

ARGUMENTS ON EXCEPTION

As it did below, petitioner contends that Tax Law former § 208 (9) (o) (3), properly construed, permits the exclusion of the payments at issue. The focus of petitioner's statutory construction argument is the statute's use of the word "would." That is, the statute permits taxpayers to deduct related member royalties unless such royalties "would not be required" to be added back under the royalty add back provision. According to petitioner, considering that the statutory definition of related member expressly includes nontaxpayers, this phrasing means that the royalty income exclusion applies if the royalty is the type that would be required to be added back, regardless of whether it is added back. In other words, petitioner contends that, if none of the statutory exceptions to the add back apply, then the income may be excluded. Petitioner asserts that other provisions of the Tax Law and the Divisions regulations use "would" in a similar manner. Petitioner also notes that the legislature could have drafted the statute to expressly require that royalty payments be added back on a New York return for the royalty income exclusion to apply but did not. Petitioner thus contends that the statutory language compels a result in its favor.

Petitioner takes issue with the determination's conclusion that its interpretation effectively adds words to the statute. To the contrary, petitioner asserts that its interpretation comports with the meaning of "would" as used therein and that it is the Administrative Law Judge's construction that

effectively rewrites the statute to require that the royalty payer be a New York taxpayer for the income exclusion to apply.

Petitioner contends that the determination failed to apply the statute's unambiguous language and thus impermissibly looked to legislative history and legislative intent for guidance. Petitioner notes that the determination did not expressly find that the statute was ambiguous, but even if it did, petitioner contends that the determination relied on the wrong legislative history. Specifically, petitioner asserts that the determination erroneously relied on the legislative history of the expense add back provision, not the income exclusion provision. Petitioner contends that the determination simply speculates that the legislature's intent in enacting the expense add back extends to the income exclusion. Petitioner also contends that the determination erroneously found that the 2013 repeal of the exclusion supports its interpretation. Petitioner contends that the legislature's intent in 2013 has no bearing on its intent in 2003 when the law at issue was enacted. Petitioner further asserts that the determination's reliance on the Division's 2013 memorandum in support of the repeal legislation was erroneous. Petitioner contends that this document reflects the Division's concerns regarding the income exclusion that arose after the law was passed in 2003. Petitioner argues that the Division's 2013 memorandum actually supports its position in the present matter because, according to petitioner, it shows the Division's concern that the exclusion statute did not require the related member payer to be a New York taxpayer.

Petitioner also contends that the determination erroneously relied on the Division's policy concerns in interpreting the royalty income exclusion statute. Petitioner asserts that the "escape from taxation" outcome decried in the determination can also effectively occur under the Division's interpretation, such as when the related member royalty payer is a New York taxpayer with a negligible business allocation percentage (BAP). Under that scenario, according to the Division's interpretation, the payee gets the income exclusion because the taxpayer-payer adds back the royalty payment. However, given the payer's very low BAP, very little tax will ultimately be paid to New York on the added-back royalty. Hence, according to petitioner, the concern that royalty payments between related members might go untaxed is not a reason to favor the Division's interpretation. Petitioner further contends that, even if these policy considerations were justified, the determination's interpretation is impermissible because such policy considerations cannot override the plain statutory language.

As it did below, petitioner also asserts that the determination's application of the royalty income exclusion in the present matter discriminates against interstate and foreign commerce in violation of the dormant Commerce Clause of the United States Constitution. According to petitioner, the application of this provision is discriminatory because it conditions the benefit of the exclusion on whether the alien affiliates are New York taxpayers with U.S. taxable income. In other words, according to petitioner, the determination's interpretation results in disparate treatment based solely on the extent of

the related member's New York activities. Petitioner thus argues that the statute as applied forecloses tax-neutral decisions by discriminating against out-of-state intellectual property licensing activity and thereby puts pressure on taxpayers to conduct such licensing activity with affiliates that do business in New York.

Petitioner also contends that the determination's interpretation of the royalty income exclusion violates the fundamental statutory construction principle that statutes must be interpreted to avoid constitutional infirmities. Petitioner asserts that its interpretation passes constitutional muster and therefore must be preferred to the determination's, even if the royalty income exclusion is reasonably open to two interpretations.

Petitioner also argues that the determination's constitutional analysis is fundamentally flawed because it does not analyze similarly situated taxpayers. According to petitioner, the proper analysis here is a comparison between a taxpayer parent-taxpayer subsidiary and a taxpayer parent-nontaxpayer subsidiary, similarly situated in all other respects. Petitioner contends that the determination improperly compared petitioner's related entity transactions to similar transactions between non-related entities.

Petitioner contends that the "subject to tax once" outcome of the royalty add back and income exclusion provisions does not render the income exclusion constitutional as applied in the present matter because such an outcome relates only to the tax base of the related members, not their tax burden.

Petitioner notes that, as discussed, the difference in tax burden between a taxpayer like petitioner who loses out on the exclusion under the Division's interpretation and the parent of a subsidiary with a minimal New York presence under the same interpretation is significant. According to petitioner, the impact of a tax is discriminatory even if the income is always included in one entity's tax base because it imposes a heavier tax burden on a New York parent that engages in intellectual property licensing activity with non-New York subsidiaries.

In response, the Division asserts, first, that the relevant statutes should be interpreted strictly against petitioner in accordance with the statutory construction rule for exemptions and exclusions as described in *Matter of Wegman's Food Mkis., 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 party royalty payer. The Division contends that the deduction is prohibited because, in the language of Tax Law former § 208 (9) (o) (3), the royalty payments at issue "would not be required to be added back" because petitioner's alien affiliates are not New York taxpayers and are thus not subject to Tax Law former § 208 (9) (o) (2). Hence, the alien affiliates "would [never] be required" to add back the royalty payments. The Division echoes the determination's finding that petitioner's proposed interpretation reads words into

the statute (i.e., the alien affiliates "would" have been subject to Tax Law former § 208 (9) (o) (2) if they were New York taxpayers). In addition to the requirement that the royalty payer be a New York taxpayer, the Division asserts that the term "would" conditions the availability of the deduction on whether one of the three statutory exceptions applies. The Division 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). 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 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 or not such royalty payments are made to a New York taxpayer.

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 enactment of the expense add back in 2003 and the repeal of the income exclusion provision and modification to the expense add back in 2013.

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 deduction 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.

In support of its own exception, the Division asserts that the determination improperly found that payments by the alien affiliates pursuant to agreements to distribute motion pictures and television programs were royalties under the statutory definition. The Division contends that, while there may be intellectual property rights in a motion picture or television program, payments for the distribution of these "complete and final" products are not directly connected to such intangible assets. The Division further contends that the fact that petitioner receives no payment and is required to reimburse its alien affiliates for their distribution costs if distribution revenues are insufficient confirms that the distribution agreements do not license intangible assets, contrary to the determination. The Division notes also that petitioner reported payments from its distribution agreements on its tax returns as gross receipts and not gross royalties.

Additionally, the Division contends that petitioner failed to prove the amount of the payments it seeks to deduct as royalty payments.

In response to the Division's exception, petitioner asserts that it proved that the arrangements between the alien affiliates and Buena Vista International, Inc. were intellectual properties (IP) licensing transactions and that the payments to Buena Vista from the alien affiliates were royalties. Petitioner asserts that royalty payments are broadly defined in Tax Law § 208 (9) (o) (1) (C). Petitioner notes that the auditors were satisfied that the payment to Buena Vista were royalties; that the agreements between Buena Vista and the alien affiliates are structured as and use the language of IP licensing agreements; that the agreements would be considered IP licensing agreements under federal law; that its tax principal credibly testified regarding the agreements; and that its redaction of portions of the agreements in the record should not undermine the credibility of those documents for purposes of this matter.

Petitioner also opposes the Division's claim that petitioner failed to prove the royalty amounts paid by the alien affiliates. Petitioner notes that this was not an issue on audit and that it was raised at the hearing for the first time. Petitioner notes that its tax principal testified credibly regarding the amount of the royalty payments at issue. Petitioner notes that the Division offered no evidence to rebut the documentation or the testimony presented to show the amount of the subject payments.

On the question of statutory construction, petitioner takes the position that language of Tax Law former § 208 (9) (o) (3) is unambiguous and thus leaves no room for interpretation. Even allowing for ambiguity, petitioner contends that, as an exclusion,

this provision must be construed in its favor. Petitioner contends that the rule to the contrary as expressed in *Matter of Wegman's Food Mkts., Inc. v Tax Appeals Trib. of the State of N.Y* is dicta and that the concurring opinion in that case more accurately states the law (33 NY3d at 596-602).

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 the taxpayer's entire federal taxable income with modifications that either add to or subtract from federal taxable income (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]).

We first address the Division's contention that petitioner failed to prove the amount of the payments claimed as royalties during the years at issue. Petitioner bears the burden to overcome the asserted deficiency (*Matter of Grace v New York State Tax Commn.*, 37 NY2d 193, 195 [1975] *rearg denied* 37 NY2d 816 [1975], *lv denied* 338 NE2d 330 [1975]; Tax Law § 1089 [e]). As the Division correctly notes, this includes establishing the accuracy of the amount it seeks to exclude from its ENI as royalty payments. It is unclear from the record when the Division first raised this issue. The notice of deficiency was premised solely on the Division's position that petitioner's deduction of claimed royalty payments from its federal taxable income in computing its ENI was contrary to Tax Law former § 208 (9) (o) (3) (*see* finding of fact 42) and the Division's answer does not raise this issue. The Division did, however, raise this issue in its opening statement at the hearing. The Division may raise an alternate ground for an assessment so long as the petitioner is afforded sufficient notice and an opportunity to be heard (*see Matter of Clark*, Tax Appeals Tribunal, September 14, 1992).

While petitioner denies the Division's contention, it makes no procedural objection. That is, it does not contend that the timing in raising this issue was fundamentally unfair or contrary to the principles of due process (*see Matter of Sholly*, Tax Appeals Tribunal, January 11, 1990 [procedural improprieties that raise fairness or due process concerns may require a shift in the burden of proof]). Hence, we do not address that question.

With respect to the merits of the Division's contention, we defer to the Administrative Law Judge's finding that Mr. Solomon, petitioner's tax principal, credibly testified that the amounts claimed as royalties came directly from petitioner's accounting system (*see* finding of fact 33). Although we are not bound by an administrative law judge's credibility assessment, we find nothing in this record to alter it (*Matter of Strachan*, Tax Appeals Tribunal, June 28, 2018). We also find it significant in this case that, despite an extensive audit of the records of petitioner's business operations,[5] and despite the number and amount of payments claimed as royalties, neither the audit report nor the auditor's testimony contend that the amount of such payments was inaccurate (*see* finding of fact 21). Accordingly, we conclude that petitioner's records were accurate with respect to the claimed royalty payments and that petitioner's returns, as modified (*see* findings of fact 10 and 12),'accurately reflect petitioner's records.

We next address whether petitioner's deduction of the royalty payments from its federal taxable income in computing its ENI for the years at issue pursuant to the royalty income exclusion provision under Tax Law former § 208 (9) (o) (3) was proper.

During the period at issue, Tax Law former § 208 (9) (o) (3) stated:

> "Royalty income exclusions, For the purpose of computing entire net income or other

[5] The tax field audit record, which is in evidence as part of the audit report, shows that 262.50 hours were charged to the audit over three-plus years.

> 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. That provision requires a taxpayer to add back royalty payments made to a related member in computing ENT, 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 Mkts., 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]). We disagree with petitioner's contention that the court's opinion in Wegman's on this point is dicta (*see* 33 NY3d at 592 ["We reiterate our settled rule of construction to ensure consistent application of taxing statutes"]). We thus also disagree with petitioner that we should be guided by the rule expressed in the concurring opinion (*see id.* at 596-602).[6]

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 Or. v Tax Appeals Trib. of State of N.Y.*, 83 NY2d 240, 244, 245 [1994], *cert denied* 513 US 811 [1994]).

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[6] Indeed, *Matter of Weginan's* appears to render meaningless any argument over a statute's classification as an exclusion or exemption.

Turning to our analysis of the statutory language, we note first that there is no dispute that petitioner and its alien affiliates were "related members" as used in Tax Law former § 208 (9) (o) (3). 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 to whether the alien affiliate payments were royalties, Tax Law § 208 (9) (o) (1) (C) defines royalty payments for purposes of the income exclusion and expense add back 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 includes 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 §2 08 [9] [o] [1] [C]).

The Division challenges payments made pursuant to agreements between Buena Vista International, Inc. and certain alien affiliates to distribute motion pictures and television programs (*see* finding of fact 31). These agreements are in the form of licensing

agreements pursuant to which the licensor (Buena Vista International) grants to the licensee (the alien affiliate) the right to advertise, promote, produce and license the product for distribution in a specific geographical area (*id.*). Copyright protection extends to "motion pictures and other audiovisual works" (17 USC § 102 [6]). Copyright includes the right to distribute copies of the work in physical form and to exhibit the work publicly (17 USC § 106 [1], [4]). The agreements thus show that the challenged payments were for the use, or license to use, Buena Vista International's copyright interests in certain motion pictures and television programming. Payments for the use of copyrights are expressly included in the definition of royalty payments in Tax Law § 208 (9) (o) (1) (C).

In reaching this conclusion, we necessarily reject the Division's contention that payments to distribute complete and final films (*see* finding of fact 31) are not directly connected to intangible assets. As noted, copyright, which is an intangible asset, includes the right to distribute a work in physical form; here, a complete and final film. We also reject the Division's contention that the structure of compensation under the agreements, whereby the licensee is guaranteed to be reimbursed for its distribution costs (*id.*), indicates that they were not licensing agreements. We agree with petitioner that this feature does not change the nature of the agreements or the character of the payments. Similarly, petitioner's reporting of these payments on its tax returns as gross receipts, rather than gross royalties, does not change their character.

We next address whether the royalty payments from the alien affiliates to petitioner "would not be required" to be added back under Tax Law former § 208 (9) (o) (2). 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).

We agree with petitioner that statute's use of "would" is important to a proper understanding of the conditional clause in Tax Law former § 208 (9) (o) (3). We disagree with petitioner, however, as to the implications of the use of that word here. The Merriam-Webster online dictionary provides that "would" is used in "the conclusion of a conditional sentence to express a contingency or possibility" (merriam-webster.com/dictionary/would [last accessed July 7, 2020]). Petitioner offers that "would" indicates "the consequence of an imagined event or situation" (lexico.com/en/definition/would [last accessed July 7, 2020]). The phrase "would not be required to be added back" in Tax Law former § 208 (9) (o) (3) thus requires that we consider or imagine the possible circumstances or situations under which related member royalty payments would not be required to be added back under Tax Law former § 208 (9) (o) (2). As petitioner correctly observes, such payments would not be required to be added back if any of the three statutory exceptions in Tax Law

former § 208 (9) (o) (2) applied. Contrary to petitioner's contention, however, related member royalty payments also plainly would not be required to be added back if the related member-royalty payer is not a New York taxpayer. Nontaxpayers, of course, are not subject to Tax Law former § 208 (9) (o) (2).

Petitioner correctly notes that this straightforward interpretation of "unless such royalty payments would not be required to be added back under [Tax Law former § 208 (9) (o) (2)]" in Tax Law former § 208 (9) (o) (3) means that the related member-royalty payer must be a New York taxpayer for the related member-royalty payee to claim the income exclusion. Petitioner asserts that this is an incorrect interpretation of the statute. We disagree.

Contrary to our interpretation here, petitioner argues that the word "would" in the income exclusion statute, as opposed to "were," means that the royalty payments do not *actually* have to be added back, so long as they *would* have to be added back *if* the related member royalty payer was a New York taxpayer. Citing Tax Law § 210-C (2) (c) and 20 NYCRR 6-2.5 (b), petitioner contends that the Tax Law and the Division's regulations have used "would" in this manner. These provisions, however, are clearly distinguishable from Tax Law former § 208 (9) (o) (3). As relevant here, each such provision refers to "a corporation . . . that/which would be taxable . . . if subject to tax" (*see* Tax Law §2 10-C [2] [c], 20 NYCRR 6-2.5 [b]). The statute and regulation cited by petitioner thus expressly define the circumstances under which the entity "would be taxable," i.e., "if subject to tax." In contrast, Tax Law former § 208 (9)

(o) (3) contains no language limiting the circumstances under which related member royalty payments "would not be required" to be added back. It is reasonable, therefore, to consider all such circumstances, including where the royalty payer is not a New York taxpayer.

Petitioner also contends that, considering that the add back provision applies only to taxpayers and the income exclusion applies to royalty payments received from a related member, a term that includes nontaxpayers, the legislature intended for the income exclusion to apply to royalty payments made by a related member that is not a taxpayer. We disagree. As discussed above, the possible circumstances under which royalty payments "would not be required" to be added back includes payments by a nontaxpayer-related member. The use of the term "related member" in the income exclusion statute is consistent with this interpretation. Indeed, related member status is the entire basis for the expense add back and income exclusion statute.

Our explication of the language of Tax Law former § 208 (9) (o) (3) comports with the overall statutory scheme of Tax Law former § 208 (9) (o) (*see* McKinney's Cons Laws of NY, Book 1, Statutes § 97). Both the add back provision in subparagraph (2) and the income exclusion provision in subparagraph (3) were enacted together (*see* L 2003, chs 62, 63, 686). The add back was 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* New York Bill Jacket, 2003 S.B. S5725, 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). As discussed, the income exclusion provision is conditioned on the application of the add back. 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 also 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 find that the legislature did not intend for a taxpayer to gain the benefit of the income exclusion under subparagraph (3) without the corresponding cost to a related member of the add back under subparagraph (2).

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). We agree with petitioner that the Statement in Support of Chapter 59 of Part E of the Laws of 2013 (i.e., the repeal legislation) provides no insight as to the legislative intent underlying the 2003 enactment of that provision. We also agree with the Administrative Law Judge that the same statement does not support petitioner's interpretation of the statute.

We thus conclude that the determination's construction of Tax Law former § 208 (9) (o) (3) was reasonable. Accordingly, petitioner's proposed construction, while not unreasonable, may not prevail (*see Matter of Wegmans*, 33 NY3d at 592). We further conclude, therefore, that petitioner has failed to

establish entitlement to the claimed royalty income exclusion.

We now address petitioner's contention that the determination's interpretation of Tax Law former § 208 (9) (o), affirmed herein, violates the Commerce Clause of the United States Constitution (US Const, art I, § 8, cl 3). Although we lack jurisdiction to consider the constitutionality of a statute on its face (*Matter of A & A Serv. Sta., Inc.*, Tax Appeals Tribunal, October 15, 2009), 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). Accordingly, to the extent that petitioner's constitutional claim is an as-applied challenge, we consider it now. Petitioner bears the burden to prove its as-applied constitutional challenge (*Matter of Brussel*, Tax Appeals Tribunal, June 25, 1992).

The Commerce Clause gives Congress affirmative authority to regulate commerce between the states and with foreign nations. The clause also has an imputed component that limits. State authority to "regulate in a manner which affects interstate commerce" (*Matter of Tamagni v Tax Appeals Trib. of State of N.Y.*, 91 NY2d 530, 539 [1998], *cert denied* 525 US 931 [1998]).

In *Complete Auto Transit, Inc. v Brady* (430 US 274 [1977], *rehearing denied* 430 US 976 [1977]), the Supreme Court outlined a four-pronged test to determine whether a state tax violates the dormant Commerce Clause. To be valid, a state tax must: (1) have a substantial nexus with the taxing state; (2) be fairly apportioned; (3) not discriminate against

interstate commerce; and (4) be fairly related to the services provided by the state (*id.* at 279). If foreign commerce is implicated, additional scrutiny is required (*Japan Line, Ltd. v County of Los Angeles*, 441 US 434, 451 [1979]).

Petitioner contends that Tax Law former § 208 (9) (o) as interpreted herein discriminates against interstate and foreign commerce under the third prong of the *Complete Auto Transit* test. Specifically, petitioner contends that the royalty income exclusion is discriminatory because a New York related member-royalty payee's income exclusion is conditioned on the New York State activity of its related member royalty payer. As discussed, under Tax Law former § 208 (9) (o), petitioner, a taxpayer-related member that receives royalty payments from a nontaxpayer-related member, may not deduct such payments in calculating its ENI, while an otherwise similarly situated taxpayer-related member that receives royalty payments from a related member that is a taxpayer may deduct such payments. Petitioner thus contends that it has been subject to unlawful discrimination.

We disagree with petitioner's contention. In considering a dormant Commerce Clause violation, "a proper analysis must take the 'whole scheme of taxation into account'" (*Halliburton Oil Well Cementing Co. v Reily*, 373 US 64, 69 [1963] [quotation and citation omitted]). Here, this means considering both the income exclusion and the expense add back components of Tax Law former § 208 (9) (o). Furthermore, 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 Envd. 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"]). Accordingly, different treatment of similarly situated taxable entities does not necessarily indicate unlawful. discrimination. The expense add back and income exclusion provisions at issue apply only to transactions between related members. As noted previously, in a related member relationship, one or more members owns or controls a controlling interest in the other member or members (Tax Law former § 208 [9] [o] [1] [A]). Related members thus share the same economic interest. Accordingly, we must consider the overall economic interest of the related members in considering whether Tax Law former § 208 (9) (o) (3) as applied unlawfully discriminated against petitioner.

Considered in light of these principles, it is clear that Tax Law former § 208 (9) (o) (3) as applied did not discriminate against petitioner in violation of the dormant Commerce Clause. 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. Given the reality of this shared economic interest, we see no advantage for New York taxpayers and no burden on interstate or foreign commerce with respect to such related member transactions (*see Fulton Corp. v Faulkner*, 516 US 325, 331 [1996] [state tax law is discriminatory if it "taxes a transaction or incident more heavily when it crosses state lines than when it occurs entirely within the State"]).

We note that the cases cited by petitioner in support of its dormant Commerce Clause claim are distinguishable (e.g. *Kraft General Foods, Inc. v Iowa Dept. of Revenue and Fin.*, 505 US 71 [1992]; *Westinghouse Elec. Corp. v Tully*, 466 US 388 [1984]; *Boston Stock Exch. v State Tax Commm.*, 429 US 318 [1977]). None of the cases so cited involve a statute applicable only to entities with a shared economic interest wherein the benefit of a deduction for one such related entity is always offset by the cost of an expense add back to another related entity.

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

1. The exception of The Walt Disney Company and Consolidated Subsidiaries is denied;
2. The exception of the Division of Taxation is denied;
3. The determination of the Administrative Law Judge is affirmed;

4. The petition of The Walt Disney Company and Consolidated Subsidiaries is denied; and
5. The notice of deficiency dated May 8, 2017 is sustained.

DATED: Albany, New York
August [handwritten: 06], 2020

[handwritten: signature]
Roberta Moseley Nero
President

[handwritten: signature]
Dierdre K. Scozzafava
Commissioner

[handwritten: signature]
Anthony Giardina
Commissioner

Appendix D

NEW YORK DIVISION OF TAX APPEALS

DTA No. 828304

IN RE WALT DISNEY CO. AND CONSOLIDATED SUBSIDIARIES,

Petitioner.

Decided: May 30, 2019

DETERMINATION

Petitioner, The Walt Disney Company and Consolidated Subsidiaries, filed a petition for redetermination of a deficiency or for refund of corporation franchise tax under article 9-A of the Tax Law for the tax periods ended September 27, 2008, October 3, 2009 and October 2, 2010. A hearing was held before Kevin R. Law, Administrative Law Judge, in Albany, New York, on June 28 and 29, 2018, with all briefs to be submitted by November 30, 2018, which date began the six-month period for the issuance of this determination. Petitioner appeared by Pillsbury Winthrop Shaw Pittman, LLP (Marc A. Simonetti, Esq., Andrew D. Appleby, Esq., and Dmitrii Gabrielov, Esq., of counsel). The Division of Taxation appeared by Amanda Hiller, Esq. (Jennifer L. Baldwin, Esq., of counsel).

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. In addition, petitioner submitted 59 proposed findings of fact. Petitioner's proposed findings of fact 1 through 13, 15 through 19, 21, 22, 25 through 27, 29 through 43, 45, 46, 50 and 53 through 59 are accepted and have been substantially incorporated into the findings of fact. Proposed finding of fact 14, 24 and 28 are not supported by the record. Proposed finding of fact 20 is rejected as it is redundant. Proposed finding of fact 23 is rejected as conclusory. Petitioner's proposed findings of fact 44, 47 through 49, 51 and 52 are rejected as they take testimony out of context from the rest of the testimony, are conclusory and relate to matters of law.

1. Petitioner, The Walt Disney Company and Consolidated Subsidiaries, is a diversified worldwide entertainment company comprised of a group of corporations incorporated within the United States. Petitioner's operations are comprised of five business segments: Media Networks, Parks and Resorts, Studio

Entertainment, Consumer Products and Interactive Media.

2. The Media Networks segment includes a domestic broadcast television network (ABC Television Network), television production and distribution operations, domestic television stations, international and domestic cable networks (e.g., ESPN and Disney Channel), domestic broadcast radio networks and stations, and publishing and digital operations.

3. In the Parks and Resorts segment, petitioner owns and operates the Walt Disney World Resort in Florida, the Disneyland Resort in California, the Disney Vacation Club, the Disney Cruise Line and Adventures by Disney. Petitioner also manages and has ownership interests in Disneyland Paris and Hong Kong Disneyland Resort, and licenses the operations of the Tokyo Disney Resort in Japan.

4. The Studio Entertainment segment produces and acquires live-action and animated motion pictures, direct-to-video content, musical recordings and live stage plays. Petitioner distributes produced and acquired films in the theatrical, home entertainment and television markets under such banners as Walt Disney Pictures, Touchstone Pictures, Pixar Miramax and Dimension.

5. The Consumer Products segment engages with licensees, manufacturers, publishers and retailers throughout the world to design, develop, publish, promote and sell a wide variety of products based on existing and new characters and other intellectual property through its merchandise licensing, publishing and retail businesses. Petitioner's

worldwide merchandise licensing operations include products such as toys, home d6cor and furnishings, stationary, accessories, health and beauty, food, footwear and consumer electronics. Petitioner licenses characters from its film, television and other properties and earns royalties, which are usually based on a fixed percentage of the selling price of the products.

6. The Interactive Media Segment creates and delivers Disney-branded entertainment and lifestyle content through interactive media, such as multi-platform games and internet websites.

7. Petitioner's businesses are affected by its ability to exploit and protect against infringement of its intellectual property, including its trademarks, trade names, copyrights, patents and trade secrets. Petitioner's intellectual property includes rights in the content of motion pictures, television programs, electronic games, sound recordings, character likenesses, theme park attractions, books and magazines.

8. Petitioner's New York State corporation franchise tax reports filed for the audit period included all affiliates in petitioner's consolidated federal forms 1120 filed for the tax periods ended September 27, 2008 (FYE 2008) and October 3, 2009 (FYE 2009) and most of petitioner's affiliates included in its consolidated federal forms 1120 for the tax period ended October 2, 2010 (FYE 2010) (collectively the audit period). Both petitioner's state combined reports and federal tax returns include Buena Vista International, Inc., Disney Enterprises, Inc., Disney Interactive Studios, Inc. (f/k/a Buena Vista Games,

Inc.), ABC, Inc., Buena Vista Theatrical Group Ltd., and Walt Disney World Company, Inc.

9. Petitioner's combined group members owned 100% of the voting power and value of Buena Vista International, Inc., Disney Enterprises, Inc., Disney Interactive Studios, Inc. (f/k/a Buena Vista Games, Inc.), ABC, Inc., Buena Vista Theatrical Group Ltd., and Walt Disney World Company, Inc., during the entire audit period.

10. On petitioner's original and first five amended New York State forms CT-3-A for FYE 2008, petitioner deducted $355,477.00 on line 15 (other subtractions). On its sixth amended FYE 2008 form CT-3-A, petitioner deducted $1,728,785,592.00 on line 15. Of the $1,728,785,592.00 claimed on line 15, $355,477.00 is not at issue in this matter. The remaining amount was included in the amounts reported on line 1a (gross receipts or sales), and line 7 (gross royalties), on petitioner's federal form 1120 for FYE 2008. Petitioner agrees that $44,096,153.00 of the $1,728,785,592.00 reported on line 15 of its sixth amended form CT-3-A for FYE 2008 should not have been deducted.

11. On petitioner's original form CT-3-A for FYE 2009, petitioner deducted $1,583,177,067.00 on line 15. Of the $1,583,177,067.00 reported on line 15, $138,000.00 is not at issue in this matter. The remaining amount was included in the amounts reported on line 1a and on line 7 of petitioner's federal form 1120 for FYE 2009.

12. On petitioner's original form CT-3-A for FYE 2010, petitioner deducted $2,179,325,577.00 on line 15. Of the $2,179,325,577.00 reported on line 15, $575,000.00 is not at issue in this matter. The

remaining amount was included on line 1a and line 7 of petitioner's federal form 1120 for FYE 2010. Petitioner agrees that $5,336,418.00 of the $2,179,325,577.00 reported on line 15 of its FYE 2010 form CT-3-A should not have been deducted.

13. The Division of Taxation (Division) audited petitioner's combined reports for the audit period. The Division identified the large amounts petitioner reported on line 15 of petitioner's combined reports during the audit period. On a statement attached to its form CT-3-A for FYE 2009, petitioner described the line 15 amount as "Parent Company Share Adjustment." No explanation of the line 15 amount was provided for FYE 2010. On its sixth amended form CT-3-A for FYE 2008, petitioner explained it was amending the return to "[i]nclude a deduction from the combined entire net income base for foreign royalty income under N.Y. Tax Law 208(9)(0)(3)."

14. During the course of the audit, the Division submitted four information document requests (IDRs) to petitioner seeking various information and/or documentation. As is relevant here, in its first IDR to petitioner, IDR#1, dated April 29, 2014, the Division made the following request:

> "Support and explanation of CT-3A line (15) deduction for the 09/2009, 09/2010 and 09/2011 periods. In the 09/2009 CT-3A the deduction of $1,583,039,067 is described as 'Parent Company Share Adjustment.'
>
> a. For the 09/2009 period, on what line of the federal consolidated return was the $1,583,039,067 item(s) reported?

b. For the 09/2010 period, a deduction of $2,178,750,577 was deducted on the CT-3A line (15). On what line of the federal consolidated return was the $2,178,750,577 items(s) reported?

c. For the 09/2011 period, a deduction of $2,667,633,394 was deducted on the 3A line (15). On what line of the federal consolidated return was the $2,667,633,394 item(s) reported?

d. What New York State Tax Law section supports the deductions taken on the CT-3A line (15) for the periods ending 09/2009, 09/2010 and 09/2011."

15. Along with its response to the other requests made in IDR#1, petitioner responded to the foregoing inquiry as follows:

"a. For the 09/2009 period, the $1,583,039,067 was reported on line(s) 1A and 7 of the federal consolidated return.

b. For the 09/2010 period, the $2,178,750,577 was reported on line(s) 1A and 7 of the federal consolidated return.

c. The 09/2011 period is not included in the scope of this audit.

d. New York Tax Law § 208.9(0)(3) which allows royalty income received from a related corporation to be excluded from the recipient's taxable income provided the deduction for such royalty income is

> required to be added back to the payer's taxable income under § 208.9(0)(3) supports the deductions taken on the CT-3A line (15) for the periods ending 09/2009 and 09/2010."

16. On January 9, 2015, the Division sent IDR#2 to petitioner. This IDR posed no questions nor requested documentation on the royalty income exclusion previously identified.

17. Subsequently, on November 16, 2016, the Division sent IDR#3 to petitioner, which requested support for the line 15 amounts, including the statutory authority for such deduction and a breakdown by payer and amount paid.

18. For FYE 2009, petitioner responded as follows:

Legal Entity	Description	Amount
Disney Enterprises, Inc.	DEI-CP Parent Company Share	$498,598,200
Disney Enterprises, Inc.	DEI-Corp Royalty from Magical Cruise Co. Ltd.	$28,877,289
Disney Enterprises, Inc.	DEI-Corp Royalty from Euro Disneyland	$30,369,733
Buena Vista International, Inc.	BVI Parent co Share	$1,025,193,844
	Total Foreign Royalty Revenue From Related Entities Not in Federal Consolidated Return	$1,583,039,067

19. For FYI 2010, petitioner responded as follows:

Legal Entity	Description	Amount
Disney Enterprises, Inc.	DEI-CP Parent Company Share	$529,660,116
Disney Enterprises, Inc.	DEI-Corp Royalty from Magical Cruise Co. Ltd.	$22,678,808
Disney Enterprises, Inc.	DEI-Corp Royalty from Euro Disneyland	$60,370,000
Buena Vista International, Inc.	BVI Parent co Share	$1,566,041,653
	Total Foreign Royalty Revenue From Related Entities Not in Federal Consolidated Return	$2,178,750,577

20. Petitioner did not provide detail for FYE 2008 because, at the time, it had yet to amend its FYE 2008 form CT-3-A to include such subtraction.

21. The auditor's handwritten notes contained in the audit file indicate that she believed that petitioner's response to IDR#3 Item 5 did not provide much detail. On the auditor's copy of IDR#3 her handwritten notes that indicate this item was "Done" and that petitioner had responded on January 26, 2016. The audit file makes no mention of petitioner

failing to adequately substantiate the royalty income exclusion claimed or that the amounts claimed were royalties. The auditor's notes state:

> "Taxpayer deducted foreign royalty income rec'd from a related corporation for the 2009 & 2010 periods. Tp cited NY tax law §208.9(o)(3) in support of the royalties exclusion from income. Audit's position is that royalty income rec'd from related corporations who are NY filers can be excluded from income. Foreign royalty exclusion for the FY 2009 & 2010 periods as filed is disallowed."

22. During the audit period, petitioner licensed intellectual property to its alien affiliates pursuant to licensing agreements. Petitioner's alien affiliates are identified in petitioner's exhibits 1 and 2. There is no dispute that the alien affiliates are related members as defined in Tax Law former § 208 (9) (o).

23. Petitioner's alien affiliates are entities all organized under the laws of foreign countries, and were not members of petitioner's New York State corporation franchise tax group because entities organized under the laws of foreign countries were not includable in a franchise tax combined return under the tax law in effect during the periods in issue.

24. Petitioner's alien affiliates were regarded as non-U.S. entities or owned by related non-U.S. entities for federal income tax purposes during the entire audit period.

25. Petitioner owned at least 30%, directly or indirectly, of the capital, profits, or beneficial interest

in each of its alien affiliates during the entire audit period.

26. In general, petitioner's licensing agreements granted the alien affiliates the right, in return for royalty payments, to exploit in specified non-U.S. territories for specified periods of time: Disney characters; copyrights; trade names; literary works; dramatic works; pictorial, graphic works; motion pictures; sound recordings; cruise ship designs; and/or other intellectual property rights.

27. At the hearing in this matter, petitioner presented the testimony of its tax principal, Aaron Solomon. Mr. Solomon oversees the teams that prepare petitioner's federal and state tax returns and manage federal and state tax audits. Mr. Solomon explained the general nature of the licensing agreements and how the payments received by petitioner from its alien affiliates pursuant to these agreements were accounted for on petitioner's books and records and for tax purposes.

28. Petitioner's licensing agreements generally fell into three categories: (i) motion picture or television programming; (ii) consumer products or merchandising; and (iii) operating a theme park.

29. In the consumer products or merchandise licensing agreements, the foreign affiliate pays petitioner for access to the Disney characters and other Disney materials. Payment is based on undisclosed percentages of gross sales.[1]

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[1] During the course of these proceedings, petitioner redacted portions of the license agreements containing trade secrets and other confidential information.

30. In the "other" category, the foreign affiliate pays petitioner for the right to operate a Disney-themed cruise line, including the use of the Disney name and design. Payment is based on undisclosed percentages of gross revenues.

31. Agreements in the motion picture or television programming category include those relating to film distribution. The foreign affiliate pays petitioner for the right to advertise, promote, produce and license the product incorporating licensed property for distribution in a territory. Payment is based on an undisclosed percentage of gross revenues less distribution expenses. If distribution expenses exceed the payment, petitioner would be required to reimburse the alien affiliate for the shortfall. Mr. Solomon did not believe that the merchandise licensing or theme park and cruise ship license agreements allowed the payment owed to petitioner to be reduced by the alien affiliate's distribution expenses. Pursuant to these types of agreements, petitioner was required to deliver to the alien affiliate: "[a] new or used, complete, final, full timed 35mm or 16mm positive print and/or non-theatrical video cassettes of the Picture, fully cut, main and end titled, edited, scored and assembled with soundtrack printed thereon in synchronization with the photographic action and fit and ready for exhibition and distribution."

32. Petitioner's combined group entities that licensed this intellectual property to its alien affiliates during the audit period were Buena Vista International, Inc., Disney Enterprises, Inc., Disney Interactive Studios, Inc. (f/k/a Buena Vista Games,

Inc.), ABC, Inc., Buena Vista Theatrical Group Ltd., and Walt Disney World Company, Inc.

33. Introduced as exhibit 1 was a schedule prepared by petitioner under the direction and supervision of Mr. Solomon listing intercompany agreements between petitioner and its alien affiliates detailing the payments received by petitioner's combined entities and its alien affiliates during the audit period. The schedule lists the payer, the payee, the specific agreement giving rise to the payments, the term of the agreement, the product line licensed, the territory covered and the amount paid by tax year. For FYEs 2008, 2009 and 2010, the payments paid by the alien affiliates to petitioner amounted to $1,487,104,221.00, $1,491,821,746.00, and $1,901,121,890.00, respectively.[2] Mr. Solomon credibly testified that the subject license agreements were collected and the amounts claimed as royalties came directly from petitioner's accounting system. All of the subject license agreements listed were in effect during the entire audit period.

34. Petitioner introduced a second schedule as exhibit 2 which was similar to exhibit 1, except that the agreement, term, product line and territory fields of the spreadsheet were left blank. Mr. Solomon testified that these fields were not filled in because the amounts only constituted approximately 10% of the total foreign affiliate royalties claimed. In all other respects, the exhibits were prepared in the same manner. For FYEs 2008, 2009 and 2010, the payments

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[2] Redacted copies of the agreements listed in exhibit 1 are set forth as exhibit S to the joint stipulation of facts entered into the record by the parties.

made by the alien affiliates to petitioner as reflected on exhibit 2 amounted to $197,229,741.00, $91,217,321.00, and $272,292,269.00, respectively.

35. The cumulative total payments received by petitioner from its alien affiliates for licensing its intellectual property rights amounted to $1,684,335,970.00, $1,583,041,076.00, and $2,173,416,179.00 for FYEs 2008, 2009 and 2010, respectively.

36. Petitioner treated the payments from the alien affiliate as royalties for financial reporting purposes.

37. In petitioner's general ledger accounting system, the payments from its alien affiliates were generally booked to the "Parent Company Share-Intercompany" account, with a few booked to a broader "Royalty" account. Mr. Solomon explained that "Parent Company Share-Intercompany" is petitioner's terminology for a royalty coming from a foreign related party to a United States party and it is also the name of an account in petitioner's general ledger for such payments.

38. The payments petitioner received from its alien affiliates were included in its federal taxable income as reported on its federal consolidated income tax returns during the audit period.

39. The alien affiliates' federal informational returns (IRS forms 5471, 8858 and 8865) during the audit period included the alien affiliate royalty payments as expenses in the "Rents, royalties, and license fees paid" and/or "Parent Company Share-Intercompany" line-items.

40. Petitioner did not license from unrelated third parties the intellectual property that it licensed to the alien affiliates, except for a few films that petitioner licensed from third parties and then licensed to its alien affiliates.

41. Petitioner excluded the subject payments from its entire net income during the audit period because it concluded that Tax Law former § 208 (9) (o) permitted the royalty income exclusion as long as the royalty payments were received from a related member, whether or not the related member was a New York taxpayer.

42. The Division asserted that petitioner could not exclude the alien affiliate payments from its entire net income because the alien affiliates were not New York taxpayers, citing Tax Law former § 208 (9) (o) as authority for its position that the royalty exclusion should be disallowed.[3]

43. Neither the audit supervisor, Mr. Daniel Zagorscak, nor the auditor, Ms. Angelika Moutidis, consulted with the Division's legal counsel prior to disallowing the royalty exclusion claimed by petitioner.

44. On May 8, 2017, the Division issued notice of deficiency L-046397543, which asserted tax of $3,995,511.00, plus interest, for the audit period, and denied petitioner's overpayment claim for FYE 2008.

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[3] The Division also made other adjustments to petitioner's forms CT-3-A as reflected in the schedules introduced as exhibit K with the stipulation of facts that are not at issue in this matter.

45. Petitioner timely filed a petition protesting the notice of deficiency.

46. The Division filed its answer to the petition, which generally denied the allegations in the petition, including the allegations that the payments petitioner received from its alien affiliates were royalties.

47. The hearing in this matter was held on June 28 and 29, 2018. In her opening statement, the Division's representative clearly stated that the majority of payments petitioner was seeking to exclude from its entire net income did not constitute royalties.

48. In 2003, the statute in question, Tax Law § 208 (9) (o) was enacted effective for tax years beginning on or after January 1, 2003. Subsequently, in 2013, Tax Law § 208 (9) (o) was amended to eliminate the royalty income exclusion provision effective for tax years beginning on or after January 1, 2013.

49. Petitioner subpoenaed Ms. Deborah Liebman to appear and give testimony at the hearing in this matter. Ms. Liebman was the Division's attorney that oversaw its income tax legislation and guidance function in its Office of Counsel during the audit period.

50. Ms. Liebman testified that the Division regularly drafts proposed bills for the New York State Division of the Budget, which the Division of the Budget may incorporate into the New York Governor's proposed revenue bills.

51. Ms. Liebman had no specific familiarity with Tax Law former § 208 (9) (o) (3) or recollection of the

subsequent amendment of the statute that occurred in 2013.

52. Ms. Liebman testified that Tax Law former § 208 (9) (o) (3) “does not say anything about” the royalty payer having to be a New York taxpayer. Likewise, Mr. Zagorscak testified that Tax Law former § 208 (9) (o) (1) (A) stated that the royalty payer did not have to be a New York taxpayer.

53. Petitioner also subpoenaed Mr. Robert Plattner to appear and give testimony at the hearing in this matter. Mr. Plattner served as the Division’s Deputy Commissioner of Tax Policy from May 2007 through February 2018.

54. Mr. Plattner testified that the Division advises the Governor’s Division of the Budget if the Division believes there are constitutional infirmities with a tax statute.

55. Mr. Plattner testified that he was aware that a tax that discriminates against out-of-state taxpayers violates the Commerce Clause of the United States Constitution and that a state may not impose a tax that discriminates against interstate commerce by providing a commercial advantage to local business.

56. Mr. Plattner further testified that a tax formula that penalizes out-of-state economic activity in favor of in-state economic activity is discriminatory and violates the Commerce Clause.

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 [1]).[4]

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 (Tax Law former § 208 [8]; *see* Tax Law former §§ 210 [1] [a]; [3]; 208 [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 business allocation percentage (BAP) (Tax Law former § 210 [3] [a]), with the resulting amounts totaled to arrive at the corporation's entire net income 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

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[4] 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).

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. In defending the deficiency, the Division has taken the position that petitioner has not met its burden of proving that the payments it received from its alien affiliates were royalties as defined in Tax Law § 208 (9) (o) (1) (C). In response, petitioner argues that this issue was never examined at audit nor was this a basis for the notice of deficiency. According to petitioner, the Division bears the burden of establishing that the payments did not constitute royalties. Contrary to petitioner's assertion, the Division is entitled to assert an alternative basis for the deficiency provided that petitioner is afforded notice of such basis and the opportunity to be heard

(*see Matter of Clark*, Tax Appeals Tribunal, September 14, 1992 [where the Tax Appeals Tribunal held that an amended answer would have put the taxpayers on notice of the alternative grounds for assessment]. The Division's answer clearly raised this as a basis and this claim was also brought up as an issue by the Division's representative in her opening statement at the hearing in this matter. Notwithstanding, it is determined the payments petitioner received from its alien affiliates and claimed as an exclusion in computing its ENI were royalties. Tax Law § 208 (9) (o) (1) (C) define 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 includes 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]).

The payments at issue constituted royalties because such payments were made in connection with the licensing of intangible assets. As noted in the findings of fact, petitioner's licensing agreements generally fall into three categories: (i) motion picture or television

programming; (ii) consumer products or merchandising; and (iii) operating a theme park. These agreements granted the alien affiliates the right, in return for royalty payments, to exploit in specified non-U.S. territories for specified periods of time: Disney characters; copyrights; trade names; literary works; dramatic works; pictorial, graphic works; motion pictures; sound recordings; cruise ship designs; and/or other intellectual property rights. As petitioner notes, the auditors were satisfied that the amounts claimed by petitioner as an exclusion were royalties, as the only reason or authority cited was Tax Law § former 208 (9) (o) and this was the only reason why the notice of deficiency was issued. No mention was made in the audit file that the amounts claimed were not royalties. Mr. Solomon credibly testified as to the license agreements and how the payments were booked and accounted for in petitioner's accounting system. The Division seeks to put petitioner at a disadvantage to prove something during the formal hearing process that should have been explored at the audit level.

E. Having found that the payments received by petitioner from its related members constitute 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."

F. Petitioner contends that under the plain wording of the statute, the alien affiliates royalty payments would not have to be added back to entire net income if the alien affiliates were New York taxpayers because the alien affiliates 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. 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*, 3N Y2d 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, 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 entire net income. 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.

G. 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.

H. 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's 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's 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]).

I. 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, Diu of Taxation*, *NJ Dept of the Treasury*, 490 US 66, 75 [1989]). According to petitioner, providing the royalty income exclusion to the taxpayer only if the payer is a New York taxpayer is facially discriminatory and is per se invalid.

J. 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). Thus, addressing petitioner's constitutional challenge as applied, it is determined that petitioner has not sustained its burden of the proving a constitutional violation. 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]). 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. What petitioner conveniently overlooks is that 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. In this case, petitioner has failed to make a showing that in-state economic interests are benefitted to the detriment of out-of-state interests.

K. Accordingly, the petition of The Walt Disney Company and Consolidated Subsidiaries is denied and notice of deficiency L-046397543 is sustained.

DATED: Albany, New York
May 30, 2019

/s/Kevin R. Law
ADMINISTRATIVE
LAW JUDGE

Appendix E

RELEVANT CONSTITUTIONAL AND STATUTORY PROVISIONS

U.S. Const. art. I, §8, cl. 3

The Congress shall have power …

To regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes[.]

N.Y. Tax Law § 208(9)(o) (2003)

(o) 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) 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.

N.Y. Tax Law § 208(9)(o) (2007)

(o) 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.