No. 19-_____

IN THE

Supreme Court of the United States

JOHN M. PAZ,

Petitioner,

v.

DIRECTOR, DIVISION OF TAXATION,

Respondent.

On Petition For Writ of Certiorari to the Superior Court of New Jersey, Appellate Division

PETITION FOR A WRIT OF CERTIORARI

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QUESTIONS PRESENTED

In *Mobil Oil Corp* v. *Commissioner of Taxation of Vermont,* 445 U.S. 425, 444 (1980), this Court stated that, for State income tax purposes, taxation by allocation and taxation by apportionment are "theoretically incommensurate."

The questions presented are:

1. Whether it is constitutionally permissible for the domiciliary State of a corporation engaged in a multistate unitary business to allocate to itself for taxation purposes the entire gain realized by the corporation on the sale of all the assets of the unitary business, given the fact that the corporation apportioned the gain among over 20 States where the business was conducted, in accordance with this Court's decisions in *Mobil Oil Corp., supra*; *Container Corp. of America* v. *Franchise Tax Board*, 463 U.S. 159, 169 (1983); *Allied-Signal, Inc.* v. *Director, Division of Taxation,* 504 U.S. 768 (1992), and *MeadWestvaco Corp.* v. *Illinois Department of Revenue*, 553 U.S. 16 (2008).

2. Whether a nonresident individual taxpayer, as the sole shareholder of an S corporation conducting a multistate unitary business, may be personally taxed by the corporation's domiciliary State on 100% of the gain realized on the sale of all the assets of the business, even though the same gain was taxed on an apportioned basis by the other States where the business was conducted and only 25% of the gain was apportioned to the domiciliary State.

RELATED PROCEEDINGS

Supreme Court of New Jersey:

Paz v. *Director, Division of Taxation,* No. 082574 (Sept. 20, 2019)

Superior Court of New Jersey, Appellate Division:

Paz v. *Director, Division of Taxation,* No. A-4452-16T4 (Jan. 31, 2019)

Tax Court of New Jersey:

Xylem Dewatering Solutions, Inc., John M. Paz, et al. v. *Director, Division of Taxation,* Nos. 011704-2015, 000056-2016 and 000057-2016 (Apr. 10, 2017)

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PETITION FOR WRIT OF CERTIORARI

John M. Paz respectfully petitions for a writ of certiorari to review the judgment of the New Jersey Superior Court, Appellate Division ("Appellate Division"), in this case.

OPINIONS BELOW

The New Jersey Supreme Court order denying petitioner's petition for certification was entered on September 20, 2019 and is reported at 239 N.J. 382, 217 A.3d 737. (App. 1a.) The opinion of the Appellate Division is reported at 31 N.J. Tax 76. (App. 2a.) The opinion of the Tax Court of New Jersey ("Tax Court"), as corrected, is reported at 30 N.J. Tax 41. (App. 7a.)

JURISDICTION

The New Jersey Supreme Court order denying review of the decision of the Appellate Division was entered on September 20, 2019. On December 6, 2019, Justice Alito extended the time within which to petition for certiorari through January 21, 2020. This Court's jurisdiction is invoked under 28 U.S.C. § 1257(a).

STATUTES AND REGULATIONS INVOLVED

U.S. Const., Art. I, § 8, cl. 3, provides:

> The Congress shall have Power. . . [t]o regulate commerce with foreign Nations, and among the several States, and with the Indian Tribes. . . .

U.S. Const., Amdt. 14, § 1, provides:

> No State shall…deprive any person of life, liberty, or property, without due process of law….

Relevant portions of the New Jersey taxing statute are set forth at App. 43a.

STATEMENT OF THE CASE

A. Relevant Facts

Petitioner, a Pennsylvania resident, was the owner and president of Godwin Pumps of America, Inc. ("Godwin Pumps"), a corporation engaged in the business of assembling, selling, renting, and servicing industrial and contractor's pumps throughout the United States. Godwin Pumps had its commercial domicile in New Jersey.

Over a period of 25 years, petitioner built Godwin Pumps into a highly successful multistate business operating in New Jersey and over 20 other States as part of a single unitary business.[1] By 2010, over 60% of the real and tangible personal property of Godwin Pumps and over 68% of its employees were located in States other than New Jersey.

For both federal and state income tax purposes, Godwin Pumps was an S corporation. It filed federal and State income tax returns, but its income passed through to its shareholders, who were directly subject to tax on such income.[2] Petitioner's direct and beneficial ownership of the corporation's stock made

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[1] A "unitary business" is a business operated across state lines that is characterized by functional integration, centralized management, and economies of scale. *Mobil Oil Corp.* v. *Comm'r of Taxation of Vt.,* 445 U.S. 425, 438 (1980).

[2] Under the Internal Revenue Code, a corporation with no more than 100 shareholders may elect to be treated as an S corporation rather than a C corporation if its shareholders consent. 26 U.S.C. § 1361. For further explanation, *see Comptroller of Treasury of Md.* v. *Wynne,* 575 U.S. 542 (2015).

him the sole shareholder of Godwin Pumps for federal and New Jersey income tax purposes.

On August 3, 2010, petitioner sold all the stock of Godwin Pumps to ITT Corporation and one of its affiliates. For federal income tax purposes, petitioner and the purchasers made a joint election under Internal Revenue Code ("I.R.C.") § 338(h)(10)). That election, which was respected for New Jersey income tax purposes, caused the stock sale to be treated as a sale by Godwin Pumps of all the assets of the business to the purchasers, followed by a distribution of the sale proceeds from Godwin Pumps to petitioner in complete liquidation of Godwin Pumps. Such an election is frequently made in conjunction with the sale of an entire business.[3]

Godwin Pumps filed a final short-year New Jersey S corporation return for the period ending August 3, 2010. It reported $357,290,215 of gain realized on the deemed asset sale. It attributed $48,842,984 of the gain to the sale of tangible assets and $308,447,231 to the sale of goodwill. Godwin

[3] Under a joint I.R.C. § 338(h)(10) election, the buyer is treated as having purchased all the assets of the business at the price it paid for the stock. The tax basis of the assets is then increased by allocating the total price paid to the assets acquired. The buyer is then allowed to claim appropriate depreciation and amortization deductions with respect to the acquired assets by reference to their increased tax basis, without having to make an actual asset-by-asset purchase. Consequently, "it is common" to structure the sale of a company as a stock sale with an accompanying I.R.C. § 338(h)(10) election. *See, e.g.*, Potter, Section 338(h)(10) Elections of S Corporations, Incremental Costs, and Considerations Following Tax Reform, 45 Corp. Tax'n 3, 4 (Nov./Dec. 2018).

Pumps also determined that under New Jersey's statutory method of formulary apportionment, 25% of the gain should be apportioned to New Jersey. Godwin Pumps applied the formulary apportionment methods of the other States where it conducted business to determine the amount of gain apportionable to each of those States.

Because the Godwin Pumps S corporation income flowed directly through to petitioner for New Jersey income tax purposes, petitioner reported both an apportioned share of the company's operating income for its final period and 25% of the gain from the asset sale as New Jersey taxable income on his 2010 New Jersey nonresident individual income tax return. Petitioner paid approximately $10 million of New Jersey individual income tax on the gain from the asset sale (calculated using a somewhat higher apportionment factor of 30% that was corrected on an amended return).

Petitioner also filed nonresident individual tax returns in over 20 States where Godwin Pumps operated. In each of those States, petitioner reported and paid tax on an apportioned share of the gain from the asset sale. Petitioner paid a total of more than $9 million in income tax on the gain from the asset sale to States other than New Jersey.[4] As a result,

[4] Petitioner paid over $9 million of nonresident income tax to the following States: Arizona, California, Connecticut, Delaware, Georgia, Illinois, Indiana, Kentucky, Maine, Maryland, Massachusetts, Montana, New Hampshire, New York, North Carolina, Ohio, Oregon, Rhode Island, South Carolina, Tennessee, Texas, Virginia and West Virginia. Approximately

petitioner paid a combined amount of over $19 million in State income tax on the gain from the sale of Godwin Pumps.

As a Pennsylvania resident, petitioner separately reported and paid income tax to that State for the year 2010 on the entire amount of the gain from the sale of Godwin Pumps, receiving a credit against his Pennsylvania tax for the taxes he paid to the other States.

B. Proceedings Below

In December 2015, the New Jersey Division of Taxation ("Division") issued an individual assessment against petitioner for an additional $19,166,036 in tax due for the year 2010. The Division did not challenge petitioner's apportionment of Godwin Pumps operating income to New Jersey for that year. It did assert, however, that New Jersey was entitled to tax 100% of the gain from the asset sale. The Division contended that the income from the asset sale constituted statutory "nonoperational income" under N.J. Stat. Ann. § 54:10A-6.1.a.[5] Because Godwin

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3.5% of petitioner's 2010 taxable income was attributable to the operating income of Godwin Pumps.

[5] N.J. Stat. Ann. § 54:10A-6.1.a (2010), provided in pertinent part as follows:

> "Operational income" subject to allocation to New Jersey means income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations. . . . . Income that a taxpayer demonstrates with clear and convincing evidence is not operational income is classified as nonoperational income, and the nonoperational income of taxpayers is not subject to

Pumps had its principal place of management (i.e., its commercial domicile) in New Jersey, the Division claimed the right under the statute to tax the entire gain.[6]

In January 2016, petitioner contested the assessment in the Tax Court on both statutory and constitutional grounds. Petitioner argued, *inter alia*, that under the Due Process Clause and the Commerce Clause of the Constitution, New Jersey could not properly tax 100% of the gain realized on the asset sale. The case was heard on cross-motions for summary judgment.

The Tax Court ruled against petitioner in April 2017. It considered itself bound by its own prior decision holding that a corporation's gain from an asset sale under I.R.C. § 338(h)(10) was "nonoperational income" within the meaning of the

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> allocation but shall be specifically assigned; provided, that 100% of the nonoperational income of a taxpayer that has its principal place from which the trade or business of the taxpayer is directed or managed in this State shall be specifically assigned to this State to the extent permitted under the Constitution and statutes of the United States.

[6] In issuing the assessment, the Division intended to allocate 100% of the $357 million gain from the asset sale to New Jersey. As noted by the Tax Court, the Division "maintains that the entirety of the deemed gain on sale was allocated to New Jersey." (App. 10a.) However, due to what appears to be an oversight or computational error inconsistent with the Division's position, the Division did not allocate to New Jersey the $48,842,984 in gain from the sale of tangible assets, and only allocated to New Jersey the $308,447,231 in gain attributable to the sale of goodwill.

applicable New Jersey taxing statute.[7] Because the prior decision had not addressed "the constitutional issues implicated in the unitary business principle," however, the Tax Court recognized that it was required to address those issues for the first time.[8] (App. 39a.)

After citing *MeadWestvaco Corp.* v. *Illinois Department of Revenue*, 553 U.S. 16 (2008), for support that the business income of a unitary business must be apportioned among the States where the business is conducted, the Tax Court restated its position that the income from the Godwin Pumps asset sale was "nonoperational income" (also referred to as "nonbusiness income") within the meaning of the New Jersey statute.[9] (App. 40a.) The

[7] *McKesson Water Prods. Co.* v. *Director, Div. of Taxation*, 23 N.J. Tax 449 (2007), *aff'd,* 408 N.J. Super. 213, 974 A.2d 443 (App. Div.), *cert. denied*, 200 N.J. 506, 983 A.2d 1113 (2009). In *McKesson*, New Jersey was a nondomiciliary State seeking to tax an apportioned share of the gain on a sale of all the assets of a corporation in a § 338(h)(10) transaction. The court concluded that the gain was attributable to "an extraordinary event in the company's history" and therefore did not constitute "operational income" that was apportionable under the New Jersey taxing statute. The court did not decide whether the business conducted was a unitary business.

[8] The unitary business principle has its underpinnings in the Due Process Clause and the Commerce Clause. With respect to State income taxation, it contemplates that income derived from, or attributable to, a unitary business is to be apportioned among the States where the business is conducted. *Mobil Oil Corp., supra; Container Corp. of Am.* v. *Franchise Tax Bd.,* 463 U.S. 159 (1983).

[9] New Jersey statutes use different terms to define several concepts commonly used when considering the apportionment of

Tax Court then reached the surprising conclusion that the State statutory definition controlled its constitutional analysis:

> The Constitution does not require that nonbusiness income be apportioned among the states. See Ala. Dep't of Revenue v. Kimberly-Clark Corp., 95 So.3d. 820, 826 (Ala. Civ. App. 2012).
>
> The income at issue arose from the deemed sale of assets in connection with a complete liquidation of the corporation. That income is clearly nonoperational income under McKesson, by which precedent this court is bound. There is no constitutional requirement that such income be apportioned and it is appropriately allocated to the domiciliary state, New Jersey.

(App. 40a.)

The Tax Court thus upheld the allocation of 100% of the gain to New Jersey even though no decision of this Court has permitted a State to allocate to itself 100% of the gain from a sale of all the assets of a unitary business, and even though that allocation

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income for tax purposes. What is commonly considered "apportionment" is referred to as "allocation" in N.J. Stat. Ann. § 54:10A-6.1.a. What is commonly considered "allocation" is referred to as "assignment." N.J. Stat. Ann. § 54:10A-6.1.a. To avoid confusion, this petition will refer to the more commonly accepted terms "apportionment" and "allocation," except when quoting the New Jersey statute or opinions of the New Jersey courts.

caused substantial multiple taxation of the gain realized.

Petitioner appealed to the Appellate Division, raising, *inter alia,* his constitutional arguments.[10] With one judge concurring, the Appellate Division affirmed the Tax Court *per curiam*, "substantially for the reasons expressed" in the Tax Court's opinion. (App. 3a.) The Appellate Division did not undertake a constitutional analysis of its own. The concurring opinion recognized that petitioner "must endure the consequences of being subjected to double taxation by more than one state for the same asset gains," as a result of not requesting refunds from the States to which he paid individual income tax on an apportioned basis. (App. 6a.)

Petitioner then filed a Petition for Certification with the Supreme Court of New Jersey, again raising his constitutional arguments. That petition was denied on September 20, 2019. (App. 1a.)

REASONS FOR GRANTING THE PETITION

This petition should be granted because this case raises several fundamental issues regarding the proper application of the unitary business principle to state taxation of income earned in interstate commerce.

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[10] The Tax Court decision below also addressed an assessment against Xylem Dewatering Solutions, Inc. (successor to Godwin Pumps) and certain trusts established by petitioner. (App. 10a-11a.) The Tax Court set aside this assessment and New Jersey did not appeal. That issue is no longer part of the case.

At issue are the proper tax treatment of gain realized on a sale of *all* the assets of a corporation's unitary business in a single transaction and the taxing authority of the domiciliary State in such cases. This Court has not previously considered these issues, and the States are divided on the proper tax treatment of the gain in such cases. No State, however, has gone as far as New Jersey has here, concluding that, as the domiciliary State of the selling corporation, it is constitutionally entitled to allocate to itself 100% of the gain from the asset sale because its taxing statute treats the gain as "nonoperational income" that is not apportionable.

The decision below is in conflict with three decisions of this Court. In *Allied-Signal, Inc.* v. *Director, Division of Taxation,* 504 U.S. 768 (1992), and *MeadWestvaco, supra,* this Court established that, under the unitary business principle, gain realized on the sale of an asset that is part of a unitary business is constitutionally apportionable income. That rule applies irrespective of the scope and meaning of State taxing statutes. In *Mobil Oil Corp.* v. *Commissioner of Taxes Vermont,* 445 U.S. 425 (1980), this Court established that it is not constitutionally permissible for income earned by a unitary business to be both apportionable to various States and also allocable entirely to a single State.

Here, the assets in question are by definition part of the unitary business because they *are* the unitary business. The income realized from their sale was apportioned among over 20 States where the business was conducted. Yet, the courts below allowed the same income to be allocated entirely to New Jersey, producing both a direct conflict among the States and substantial double taxation.

If this Court allows this case to stand, it would indicate that a State statutory definition can set the constitutional limitations on State taxation of unitary business income. It would also indicate that income can be allocated in its entirety to a single State notwithstanding the fact that the same income has been properly apportioned to numerous other States, thereby ensuring multiple taxation of that income. This case warrants review because it provides a unique vehicle through which the Court can address both of those fundamental issues.

This case also warrants review because it presents a situation where one State has subjected a nonresident individual taxpayer to tax on 100% of the gain realized on the sale of all the assets of the taxpayer's business, even though that gain is attributable in large part to activities conducted in over 20 other States. Such an overreach results in grossly unfair apportionment that is inconsistent with what the Due Process Clause and the Commerce Clause permit in the case of nonresident individual taxpayers. This Court should review the case to rectify the unconstitutional result upheld by the courts below.

I. THE DECISION BELOW CONFLICTS WITH DECISIONS OF THIS COURT INVOLVING APPLICATION OF THE UNITARY BUSINESS PRINCIPLE

A. The Unitary Business Principle

This Court developed the "unitary business principle" to establish the scope of a state's taxing power under the Constitution with respect to business activity conducted in interstate commerce. Although it originally focused on the taxation of property and capital, the concept was extended to income taxation exactly 100 years ago.[11] The unitary business principle is derived from the Due Process and Commerce Clauses and addresses what would otherwise be a basic constitutional prohibition against States taxing income earned beyond their borders.

As previously noted, a "unitary business" is characterized by functional integration, centralization of management, and economies of scale. *Mobil Oil Corp.*, *supra*, at 438. When a multistate enterprise operates as a unitary business, rather than as a group of separate businesses, the income it generates in each State where it operates is considered attributable in part to its activities in all the States where the business is conducted. As a result, when "a certain set of activities constitute[s] a 'unitary business,' a State must then apply a formula

[11] *Underwood Typewriter Co.* v. *Chamberlain,* 254 U.S. 113 (1920). The full history of the unitary business principle is discussed in *Allied-Signal* at 778-780 and *MeadWestvaco* at 25-27.

apportioning the income of that business within and without the State." *Container Corp.*, 463 U.S. at 169. By contrast, if income is generated by a non-unitary aspect of a taxpayer's business that does not have any connection with the activities carried on in the taxing State, the State cannot tax that income at all. *See, e.g., ASARCO Inc.* v. *Idaho State Tax Comm'n,* 458 U.S. 307, 325-329 (1982).

B. A Sale of All the Assets of a Unitary Business Produces Constitutionally Apportionable Income

This Court has not previously considered the constitutionally proper tax treatment of income realized from a sale of all the assets of a corporation's unitary business in a single transaction. In cases where a State has sought to tax an apportioned part of the gain in such a transaction, State courts have reached conflicting results.

Courts in some States have allowed apportionment of the gain based on interpretations of their own taxing statutes that call for the apportionment of "business income."[12] Courts in other States have concluded that no portion of the gain may be taxed by the State because the gain

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[12] *See, e.g., First Data Corp.* v. *Arizona Dept. of Revenue*, 233 Ariz. 405, 313 P.3d 548 (App. 2013); *CenturyTel, Inc.* v. *Department of Revenue,* 353 Or. 316, 297 P.3d 1264 (2013); *Newell Window Furnishing, Inc.* v. *Johnson,* 311 S.W.3d 441 (Tenn. App. 2008).

represents nonapportionable "nonbusiness income" under their statutes.[13]

This Court has considered two cases involving the sale of specific assets owned by a corporation operating a unitary business. In *Allied-Signal, supra,* this Court held that the sale of a minority block of stock in an unrelated company by a corporation operating a unitary business did not produce income that was constitutionally apportionable to New Jersey because the asset sold was not a part of the taxpayer's unitary business being conducted there. The Court bolstered its conclusion by referencing its prior decisions in *ASARCO, supra,* and *F.W. Woolworth Co.* v. *Taxation and Revenue Department of New Mexico,* 458 U.S. 354 (1982), stating that in those cases "we struck down a state attempt to include in the apportionable tax base income not derived from the unitary business." 504 U.S. at 780.[14]

[13] *See, e.g., American States Ins. Co.* v. *Hamer*, 352 Ill. App. 3d 521, 816 N.E.2d 659 (2004); *ABB C-E Nuclear Power, Inc.* v. *Director of Revenue,* 215 S.W.3d 85 (Mo. 2007); *Canteen Corp.* v. *Commonwealth,* 818 A.2d 594 (Pa. Commw. 2003), *aff'd per curiam,* 578 Pa. 504, 854 A.2d 440 (2004).

[14] In *ASARCO*, this Court acknowledged the conclusion of the Idaho Supreme Court that the income in question was apportionable "business income" within the meaning of the Idaho taxing statute. Nevertheless, this Court held that, because the income was derived from "discrete business enterprises" that had nothing to do with the unitary business activities conducted by the taxpayer in Idaho, the income was not constitutionally apportionable income and Idaho was therefore not entitled to tax any portion of it. A similar result was reached in *Woolworth*.

In *MeadWestvaco, supra,* this Court considered the tax consequences of the sale of an entire line of business by a corporation engaged in a unitary business. Mead conducted its unitary business in Illinois and other States, and Illinois claimed the right to tax an apportioned share of Mead's gain on the sale. In light of the determinative role played by the unitary business principle, this Court remanded the case to the Illinois appellate court for a specific determination as to whether the assets sold were in fact a part of Mead's unitary business. Consistent with *Allied-Signal,* an affirmative answer to that question would have caused Mead's gain on the asset sale to be constitutionally apportionable to Illinois.

Here, the assets in question are by definition part of the Godwin Pumps unitary business because they represent the entirety of that business. Based on *Allied-Signal* and *MeadWestvaco,* the income generated by their sale is clearly attributable to the unitary business. The income is therefore constitutionally apportionable income and was reported as such to over 20 States where Godwin Pumps conducted its business. The fact that Godwin Pumps was liquidated as part of the transaction does not change the analysis. *See Allied-Signal at* 789-790 (subsequent use of proceeds not determinative of whether income from sale was attributable to seller's unitary business).

C. The Decision Below Misapplied the Unitary Business Principle in Choosing Allocation Over Apportionment

The Tax Court below recognized that it was required to address the proper application of the unitary business principle. Unfortunately, its effort to do so was completely misguided.

The Tax Court did not undertake to determine whether the gain from the asset sale was attributable to the Godwin Pumps unitary business, as this Court's decisions in *Allied-Signal* and *MeadWestvaco* clearly require. Instead, the Tax Court relied on its own prior decision that treated the gain from a sale of all the assets of a business in a § 338(h)(10) transaction as constituting "nonoperational income" (i.e., nonbusiness income) under the New Jersey taxing statute. (In that case, New Jersey was a nondomiciliary State seeking apportionment and the court did not determine whether the business in question was a unitary business.)[15]

Considering itself bound by its own precedent in characterizing the gain from the Godwin Pumps asset sale as nonbusiness income, the Tax Court concluded its brief unitary business analysis by stating that "[t]he Constitution does not require that nonbusiness income be apportioned among the states." (App. 40a.) It therefore held that petitioner's entire gain was allocable to New Jersey as the domiciliary State.

In its argument before the Tax Court, New Jersey quoted the following from this Court's opinion in *Allied-Signal*:

> State legislatures have relied upon our precedents by enacting tax codes which allocate intangible nonbusiness income to the domiciliary State. . . . . Were we to adopt New

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[15] *See* note 7, *supra.*

> Jersey's theory, we would be required either to invalidate those statutes or authorize what would be certain double taxation.

504 U.S. at 785. New Jersey concluded its argument by claiming that "there is no Constitutional violation in assigning nonoperational income to a specific state." Division Tax Court Brief at 27.

The clear implication of New Jersey's argument was that this Court had put its imprimatur on state statutes "which allocate intangible nonbusiness income to the domiciliary State." But unless this Court actually intended to back away from its own precedents, which seems unlikely, the only income earned by a corporation operating a unitary business that could be potentially allocable to a specific State would be what might be termed "nonunitary income," i.e., income not attributable to the unitary business being conducted in the taxing State. (Examples would include the gain realized on the asset sale in *Allied-Signal* and the dividends received in *ASARCO*.) "Nonunitary income" may or may not fall within a State's statutory definition of "nonbusiness income" in any particular case, but only the "nonunitary income" of a unitary business is potentially allocable income.[16]

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[16] Currently, more than half the States have statutes that prescribe the allocation of certain types of income to the State of domicile. *See, e.g.,* Cal. Rev. & Tax. § 25125(c) (capital gains and losses from sales of intangible personal property allocable to California if commercial domicile); Pa. Stat. Ann., Tit. 72, § 7401(3)2.(a)(6)(C) (nonbusiness gains and losses from sales or other disposition of intangible personal property allocable to Pennsylvania if commercial domicile); Tenn. Code Ann. § 67-4-

Had the courts below properly applied the unitary business principle here, they would have had no choice but to conclude that the gain on the asset sale was constitutionally apportionable income, not income allocable entirely to New Jersey. By reaching the conclusion they did, they placed New Jersey as the domiciliary State in direct conflict with the various nondomiciliary States where the business was conducted and to which the gain was reported on an apportioned basis.

It is fundamentally incorrect for a State court to rely on State statutory definitions to characterize income the State seeks to tax when a unitary business is involved. Constitutional principles trump state definitions in fixing the boundaries for unitary business taxation.

That point was made absolutely clear by *MeadWestvaco*'s reference to a specific portion of this Court's opinion in *Allied-Signal.* At the time *Allied-Signal* was decided, many States had modeled their taxing statutes by reference to language contained in UDITPA (the Uniform Division of Income for Tax Purposes Act) defining "business income" and "nonbusiness income." This Court rejected New Jersey's broad-based argument in *Allied-Signal* that all income (business or nonbusiness) earned by a corporation present in the taxing State should be apportionable. The Court also rejected less sweeping proposals presented by certain *amici curiae* and

2011(d) (nonbusiness interest and dividends allocable to Tennessee if commercial domicile).

instead reaffirmed its adherence to the unitary business principle.

MeadWestvaco pointedly noted that, in reaching its conclusions, *Allied-Signal* had "declin[ed] to adopt UDITPA's 'business income' test as the constitutional standard for apportionment." 553 U.S. at 20, n.2. That statement clearly establishes that there is in fact a "constitutional standard" for apportionment when a unitary business is involved, and that State statutory definitions do not serve as that standard. The determination of when income is constitutionally apportionable in such cases is made through proper application of the unitary business principle.

As also noted in *MeadWestvaco*, States have begun to move away from the UDITPA model to enact taxing statutes such as the one enacted by Illinois in 2004. It provides that the term "business income" means "all income that may be treated as apportionable business income under the Constitution of the United States." Ill. Comp. Stat., ch. 35, § 5/1501(a)(1);*MeadWestvaco* at 20-21, n.2.[17]

Here, petitioner reported the asset sale to Illinois and other States, apportioned the gain among those States, and paid the appropriate taxes due. New Jersey then asserted that it intended to allocate 100% of the gain to itself. Such an allocation is allowed under the New Jersey taxing statute only "to the extent permitted under the Constitution and statutes

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[17] Other similar statutes include Ind. Code § 6-3-1-20; Iowa Code § 422.32(1)(b)(1); Kan. Stat. Ann. § 79-3271(a); N.C. Gen. Stat. Ann. § 105-130.4(a)(1); Pa. Stat. Ann., Tit. 72, § 7401(3)(2)(a)(1); W. Va. Code Ann. § 11-24-3a(a)(2).

of the United States." Both the New Jersey statute and the Illinois statute thus implicate the Constitution.

The fact that the courts below concluded that allocation was permissible here reflects a mistaken belief, perhaps supported by this Court's comments in *Allied-Signal,* that all income statutorily treated as "nonbusiness income" may be allocated to the taxpayer's domiciliary State. That misunderstanding shows that genuine confusion exists in the State courts regarding the use of State statutory definitions in determining the proper tax treatment of unitary business income.[18] This case provides the perfect opportunity for this Court to clarify the role and scope of the unitary business principle and thereby prevent future conflicts of the type that has arisen here.

[18] For examples where both allocation and apportionment of the same income suggest uncertainty regarding the role of the unitary business principle, *see, e.g., Glatfelter Pulpwood Co.* v. *Commonwealth,* 619 Pa. 243, 61 A.3d 993 (2013) (gain on sale of Delaware timberland allocated entirely to Delaware under Delaware statute and also apportioned to Pennsylvania as timberland was part of taxpayer's unitary business) and *Ex. parte Kimberly-Clark Corp.,* 95 So.3d 820 (Ala. Civ. App. 2012), *cert. denied*, 568 U.S. 1138 (2013) (gain on sale of facility treated as "nonbusiness income" under Alabama statute was allocated entirely to Alabama even though facility was part of taxpayer's unitary business and same income was apportioned to States where the business was conducted).

II. CONSTITUTIONALLY APPORTIONABLE INCOME CANNOT ALSO BE ALLOCATED TO A SINGLE STATE

A. The Significance of *Mobil Oil Corp.* v. *Commissioner of Taxation of Vermont*

In *Mobil Oil Corp.* v. *Commissioner of Taxation of Vermont*, 445 U.S. 425 (1980), this Court was faced with the question whether foreign source dividend income received by a U.S. parent company from its foreign subsidiaries and affiliates was apportionable to Vermont. The parent company sought to establish a constitutional preference for the allocation of 100% of its dividend income to New York as its commercial domicile to preclude that income from being apportioned to Vermont or any other state.

In considering the parent company's arguments, this Court first undertook to establish the relationship between apportionment and the unitary business principle, stating: "[T]he linchpin of apportionability in the field of state income taxation is the unitary-business principle." 445 U.S. at 439. In other words, when income is attributable to a unitary business, it is apportionable.

To avoid the apportionment of its dividend income to Vermont, therefore, the parent company had to show that the dividends were generated through activities unrelated to the unitary business it was conducting in Vermont and elsewhere. This Court determined that the dividends were in fact attributable to the unitary business.

This Court then considered whether allocation of the dividend income to the domiciliary State should nevertheless be permitted. Because New York did not actually tax foreign source dividends at the time, the question was hypothetical but the Court was willing to address it.

The Court was mindful of the multiple taxation that would result from both allocation and apportionment of the same income. But the fact that the parent was conducting a unitary business in a number of States and that the dividend income was attributable to that business meant that the domiciliary State should not have the "exclusive" right to tax such income. *Id.* at 445-46. The Court then set forth a basic tenet of unitary business taxation:

> Taxation by apportionment and taxation by allocation to a single situs are theoretically incommensurate, and if the latter method is constitutionally preferred, a tax based on the former cannot be sustained.

445 U.S. at 444-45.

The Court concluded that it saw "no adequate justification" for preferring allocation of the dividend income to the domiciliary State over apportionment. Because the unitary business was conducted in various States that conferred benefits and privileges on the business, those States should be allowed to tax an apportioned share of the income derived from the business. In such cases, apportionment, not allocation, is "ordinarily the accepted method." 445 U.S. at 446.

Under *Mobil Oil Corp.,* therefore, apportionment is the constitutionally preferred method of taxing income attributable to a unitary business. The possibility of also allocating the same income to a particular State is precluded because of the resulting multiple taxation. That is a cardinal principle established by *Mobil Oil Corp.*

B. Petitioner's Exposure to Double Taxation

Petitioner's case presents the precise issue that was considered hypothetically in *Mobil Oil Corp.* The gain realized on the sale of all the assets of Godwin Pumps has been both apportioned to over 20 States and allocated entirely to New Jersey.

New Jersey's position is that the Constitution permits the domiciliary State to allocate all of the income from the asset sale to itself, even though petitioner would owe $19 million in new tax to New Jersey. According to the court below, the onus is on the taxpayer to convince the nondomiciliary States to give up their claim to tax an apportioned share of the same income.

The nondomiciliary States, on the other hand, can point to *Allied-Signal, MeadWestvaco, Container Corp.* and *Mobil Oil Corp.,* and insist that apportionment of the gain on a sale of all the assets of a unitary business such as Godwin Pumps is the constitutionally correct result. It was on that basis that petitioner initially paid a total of approximately $19 million in tax to the States where the business was conducted, including approximately $10 million to New Jersey.

Either New Jersey is correct or the nondomiciliary States are correct, but not both. Yet, unless this Court resolves the conflict that has developed here, petitioner will owe $38 million in tax instead of $19 million. The suggestion made below that petitioner should have sought tax refunds from the nondomiciliary States actually underscores the need for this Court's intervention. Unless this Court states otherwise, the nondomiciliary States are under no obligation to defer to the domiciliary State in situations like this. The reverse is also true. Absent a proper resolution of the issue, the result will inevitably be double taxation.

The New Jersey decisions below will also very likely lead to conflicts between States in other situations if State statutory definitions are allowed to determine the proper tax treatment of income earned by a unitary business.[19] Statutes such as the one adopted by Illinois and a number of other States (*see* note 17, *supra,* and accompanying text), which are as broad (or as narrow) as the Constitution permits, are certain to put additional pressure on this Court to provide guidance regarding the proper role and scope of the unitary business principle in taxing income earned in interstate commerce.

To prevent future conflicts of this type, the Court should use this opportunity to reinforce the basic proposition that apportionment and allocation are "incommensurate." If the *Mobil Oil Corp.* analysis is allowed to be disregarded, the end result will be numerous instances of certain double taxation when assets of a unitary business are sold, something the Commerce Clause guards against and this Court should reject.

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[19] *See* cases described in footnote 18, *supra.*

III. TAXING A NONRESIDENT INDIVIDUAL ON INCOME THAT IS NOT ATTRIBUTABLE TO THE TAXING STATE VIOLATES THE DUE PROCESS CLAUSE AND THE COMMERCE CLAUSE

A. States May Only Tax Income Earned by Nonresident Individuals Within the State

This Court recently affirmed that individual taxpayers are entitled to the same constitutional protections as corporate taxpayers. *Comptroller of the Treasury of Md.* v. *Wynne,* 575 U.S. 542 (2015). In addition to the protections of the Due Process Clause and the Commerce Clause that generally apply to all businesses and individuals, this Court has recognized a further layer of protection for nonresident individuals. Although it is well understood that the state of residence may tax an individual's entire worldwide income if it so chooses, with appropriate credits allowed for taxes paid to other jurisdictions, a nonresident State may only tax income earned by that individual within that State. It may not tax income of that individual that was earned elsewhere.[20]

In the case of nonresident individuals, this Court has recognized the narrow scope of a State's power to impose a personal income tax based solely on the source of the income in the State. *See Shaffer* v. *Carter,* 252 U.S. 37 (1920) (upholding Oklahoma tax

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[20] J. Hellerstein, W. Hellerstein & J. Swain, *State Taxation,* ¶ 20.05[1] (3d ed. 2001 & Supp. 2019-3) ("It is well settled that the states possess the constitutional power to tax nonresidents on personal income derived from sources within the state.")

on nonresidents that applied only to income derived from nonresident's property owned within Oklahoma and business, trade, or profession carried on in Oklahoma). *See also Oklahoma Tax Comm'n* v. *Chickasaw Nation,* 515 U.S. 450, 463, n.11 (1995) ("For nonresidents, in contrast, jurisdictions generally may tax only income earned within the jurisdiction.").

B. New Jersey's Taxation of Petitioner Oversteps New Jersey's Taxing Authority and Results in Extraterritorial Taxation

Petitioner, as the sole shareholder of an S corporation, is the actual taxpayer with respect to the sale of all the assets of Godwin Pumps. New Jersey, as the corporation's domiciliary State, has claimed the right to tax 100% of petitioner's income from the asset sale. As a result, New Jersey has subjected petitioner to individual income taxation on 100% of the gain realized on that sale, even though petitioner is a nonresident of New Jersey and is properly subject to tax by New Jersey only on his New Jersey source income.

Under petitioner's application of New Jersey's apportionment formula for business income, only 25% of the income from the asset sale was apportioned to New Jersey. That is the proper amount to be considered income earned by petitioner within New Jersey. As can be seen, however, the income taxed by New Jersey is about four times the amount that is properly attributable to New Jersey.

In upholding the allocation to New Jersey of 100% of the gain from the asset sale, the decisions below ultimately denied petitioner the right of fair apportionment guaranteed under the Due Process Clause and the Commerce Clause. Fair apportionment requires that the income attributed to a State is not "out of all appropriate proportion to the business transacted by the appellant in that State." *Exxon Corp.* v. *Wisconsin Dept. of Revenue,* 447 U.S. 207, 220 (1980) (quoting *Hans Rees' Sons* v. *North Carolina,* 283 U.S. 123, 135 (1931)).

Allocating 100% of the gain on the asset sale to New Jersey is no apportionment at all and by definition cannot be "fair." In addition, it subjects petitioner to multiple taxation, as the other States where the business was conducted also claim their fair share of the income generated by the asset sale. New Jersey failed to recognize petitioner's constitutional right to fair apportionment. This Court should review the case to protect all nonresident individual taxpayers from such extraterritorial taxation.

CONCLUSION

For the reasons stated above, the petition for a writ of certiorari should be granted.

Respectfully submitted,

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January 2020

APPENDIX

APPENDIX A

SUPREME COURT OF NEW JERSEY
C-1050 September Term 2018
082574

John M. Paz,

Plaintiff-Petitioner

v.

Director, Division
of Taxation,

Defendant-Respondent.

FILED
SEP 20 2019
Heather J. Baker
CLERK

ORDER

A petition for certification of the judgment in A-004452-16 having been submitted to this Court, and the Court having considered the same;

It is ORDERED that the petition for certification is denied, with costs; and it is further

ORDERED that the notice of appeal is dismissed.

WITNESS, the Honorable Stuart Rabner, Chief Justice, at Trenton, this 17th day of September, 2019.

Heather J Baker

CLERK OF THE SUPREME COURT

APPENDIX B

SUPERIOR COURT OF NEW JERSEY
APPELLATE DIVISION
DOCKET NO. A-4452-16T4

JOHN M. PAZ,

Plaintiff-Petitioner

v.

DIRECTOR, DIVISION
OF TAXATION,

Defendant-Respondent.

Argued January 14, 2019 – Decided January 31, 2019

Before Judges Sabatino, Haas and Mitterhoff. (Judge Sabatino concurring).

On appeal from the Tax Court of New Jersey, Docket No. 0057-2016, whose opinion is reported at 30 N.J. Tax 41 (Tax 2017).

David J. Shipley argued the cause for appellant (McCarter & English, LLP, attorneys; David J. Shipley, of counsel and on the briefs; Aliza Sherman and Michael A. Guariglia, on the briefs).

Michael J. Duffy, Deputy Attorney General, argued the cause for respondent (Gurbir S. Grewal, Attorney General, attorney; Melissa H. Raksa, Assistant Attorney General, of counsel; Michael J. Duffy, on the brief).

PER CURIAM

The May 23, 2017 judgment is affirmed substantially for the reasons expressed in the Tax Court judge's April 7, 2017 opinion reported at 30 N.J. Tax 41 (Tax Ct. 2017).[1]

We add the following brief comments concerning the argument raised by plaintiff in Point I.D. of his appellate brief, where he asserts that the Tax Court judge "improperly deferred" to the Division of Taxation's (the Division's) legal arguments regarding the construction of the Gross Income Tax statute. This argument lacks merit.

In the "Standard of Review" section of the opinion, the judge stated that "[t]he review of this matter begins with the presumption that determinations made by the Director [of the Division] are valid[,]" and later wrote that "[d]eterminations of the Director are afforded a presumption of correctness[.]" Xylem, 30 N.J. Tax at 50. We agree with appellant that by using

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[1] Xylem Dewatering Sols., Inc. v. Director, Div. of Taxation, 30 N.J. Tax 41 (Tax Ct. 2017).

the terms "presumption of correctness" and "presumption of validity," the judge seems to have overstated the deference the Tax Court should apply to the Division's interpretation and application of tax statutes following its review of the facts and the law governing a particular issue. Having canvassed the judge's entire decision, however, we detect no instance where the judge failed to fully and fairly review the record developed by the parties before properly making her own independent determinations on the questions of law involved in this matter.

In addition, we have applied our own de novo standard of review in considering all of plaintiff's contentions on appeal. Waksal v. Director, Div. of Taxation, 215 N.J. 224, 232 (2013). Therefore, we reject plaintiff's argument on this point.

Affirmed.

I hereby certify that the foregoing is a true copy of the original on file in my office.

CLERK OF THE APPELLATE DIVISION

SABATINO, P.J.A.D., concurring.

I join with my colleagues in affirming the Tax Court's intricate and impressive decision. In doing so, I nonetheless must acknowledge that appellant has raised substantial issues.

The Division of Taxation "sourced" to New Jersey all of the gains appellant, a Pennsylvania resident, made from selling his company's assets that were spread around the country in more than twenty other states. The statutory path the Division followed in reaching that result is not as straight or as clear as, say, the path of Route One from Elizabeth to Trenton as marked on a Road Atlas or Google Maps.

It is still not obvious to me why principles under the Corporate Business Tax ("CBT"), rather than the Gross Income Tax ("GIT"), dictate the state tax allocation or assignment of these gains realized by a Subchapter S corporation in liquidating its business and its out-of-state assets. It would have been far better if the statutes had cross-referenced one another and provided explicit direction on this pivotal issue. Alas, they did not. So we are left with the parties' somewhat meandering explanations of how to solve the question.

The Division's tax forms and regulations (one of which is now repealed) lent colorable support to appellant's position that these gains would be allocated among the various other states, rather than totally assigned to New Jersey as the business's state of incorporation.

As appellant apparently did not file protective refund claims in those other states after being notified of the Division's assessment, he must endure the consequences of being subjected to double taxation by more than one state for the same asset gains.

The Tax Court recognized the legitimacy of appellant's confusion by declining to impose penalties upon him, a determination the Division notably has not cross-appealed.

That said, I am ultimately persuaded that it is best here to defer to the expertise of the Division and the Tax Court on these close and rather arcane issues. Moreover, counsel have advised us the pertinent statutes have been amended since the tax years in question in this case, and those laws now make clear the proper method of allocation or assignment. So I join in affirming, having expressed these concerns.

I hereby certify that the foregoing
is a true copy of the original on
file in my office.

CLERK OF THE APPELLATE DIVISION

APPENDIX C

NOT FOR PUBLICATION WITHOUT THE APPROVAL OF THE TAX COURT COMMITTEE ON OPINIONS

CORRECTED 4/10/2017 - add appearance for plaintiff

XYLEM DEWATERING SOLUTIONS, INC., JOHN M. PAZ, AND XYLEM DEWATERING SOLUTIONS, INC., JOHN M. PAZ, JOHN M. PAZ 2010 GRANTOR RETAINED ANNUITY TRUST FBO JEFFREY PAX, JOHN M. PAZ 2010 GRANTOR RETAINED ANNUITY TRUST FBO JUDITH PAZ AND JOHN M. PAZ 2010 GRANTOR RETAINED ANNUITY TRUST FBO SHARON TREECE Plaintiff, v. DIRECTOR, DIVISION OF TAXATION, Defendant.	:	TAX COURT OF NEW JERSEY DOCKET NO. 011704-2015 DOCKET NO. 000056-2016 DOCKET NO. 000057-2016 Approved for Publication In the New Jersey Tax Court Reports

Decided: April 7, 2017

David J. Shipley and Aliza Sherman for plaintiff (McCarter & English, LLP, attorneys).

Michael J. Duffy for defendant (Christopher S. Porrino, Attorney General of New Jersey, attorney).

FIAMINGO, J.T.C.

This is the court's opinion with respect to the parties' cross-motions for summary judgment. The primary issue presented is whether the gain from the deemed sale of assets of a New Jersey S corporation under Internal Revenue Code §338(h)(10) is sourced to New Jersey on the non-resident shareholders' New Jersey Non-Resident Gross Income Tax returns.

Plaintiffs' motion for summary judgment as to the sourcing of the income on the deemed sale of assets is denied and defendant's cross-motion on that issue is granted. The court finds that the correct method of sourcing the income on the deemed sale of assets is with reference to the Corporation Business Tax statutes. In this regard, the holding of McKesson Water Prods. Co. v Director, Div. of Taxation, 408 N.J. Super. 213 (App. Div.), certif. denied, 200 N.J. 506 (2009), controls to allocate the income to New Jersey as the corporate plaintiff's domiciliary state. Defendant's assessment of gross income tax on the non-resident shareholders is affirmed.

The court grants plaintiffs' motion to void the assessment for additional tax on the corporate plaintiff based on the income attributable to the Trust shareholders and denies defendant's cross-motion on this issue. The court finds that the retroactive election filed by the Trust shareholders cured the prior failure to elect to be consenting shareholders.

Finally, the court grants plaintiffs' motion to abate underpayment penalties, finding their position reasonable in light of the lack of certainty in the regulations and lack of judicial guidance. In light of the court's rulings, the court denies plaintiffs' demand for litigation costs.

I. Facts

Xylem Dewatering Solutions, Inc. (formerly known as Godwin Pumps of America, Inc.) (the "Corporation"), is a New Jersey corporation that, in 1997 elected to be taxed as an S corporation for both Federal and New Jersey tax purposes. Until February 2010, John Paz, a nonresident of New Jersey, was its sole shareholder ("Paz"). On or about February 1, 2010, Paz transferred 49 of the 350 issued and outstanding shares of the Corporation to three Grantor Retained Annuity Trusts (the "GRATs") established by him as grantor. Paz and the GRATs will be collectively referred to herein as the "Shareholders."[1]

On or about August 3, 2010, the Shareholders sold all of the shares of the Corporation. The parties elected to apply Internal Revenue Code ("I.R.C.") §338(h)(10) to the transaction. Because of the election, for federal income tax purposes the sale of stock by the Shareholders of the Corporation was disregarded and the transaction was treated as a sale of all of the assets of the Corporation followed immediately by the liquidation of the Corporation. See I.R.C. §338.

The Corporation filed a short year U.S. Income Tax Return for an S Corporation, Form 1120S, for the period ending August 3, 2010, reporting income from

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[1] The Corporation, Paz and the GRATS will collectively be referred to as plaintiffs.

operations for that period, as well as the gain from the deemed sale of its assets. The gain from the sale of assets aggregated $357,290,215. Of this amount, $48,842,984 was attributed to the sale of tangible assets and $308,447,231 was attributed to the sale of goodwill.

The Corporation also filed a New Jersey S Corporation Business Tax ("CBT") return for the period ending August 3, 2010. On that return, the Corporation reported a total of $113,385,758 to its shareholders as "S income/loss allocated to New Jersey" on the Schedule K-1 (Shareholder's Share of Income/Loss) to the return while reporting total income of $370,356,782. Paz's New Jersey non-resident GIT return for calendar year 2010 reflected S corporation income in the amount of $113,417,512 from New Jersey sources.[2]

The New Jersey Division of Taxation ("Division") audited the Corporation's CBT returns for the years 2009 through 2011. As a result of that audit, proposed adjustment workpapers were issued to Paz on September 8, 2014, and to the Corporation on November 6, 2014. With respect to the Corporation, the workpapers proposed: 1) that net long term gain in the amount of $308,447,231 was assignable to New Jersey, thus increasing the amount of income from the Corporation sourced to New Jersey;[3] and 2) an

[2] John Paz's individual share was $99,549,991 and the GRATs' shares was an aggregate of $13,835,767.

[3] Plaintiff maintains that only the deemed gain on goodwill was allocated to New Jersey. Defendant ("Director") maintains that the entirety of the deemed gain on sale was allocated to New Jersey. The Workpapers clearly allocate $308,447,231 to New

assessment against the Corporation of $3,580,461 in GIT on the income allocable to the GRATs as non-consenting S corporation shareholders.[4]

The adjustment to the amount of income from the Corporation sourced to New Jersey increased the New Jersey sourced income on Paz's non-resident GIT return. The proposed workpapers issued to Paz proposed additional GIT of $19,162,818, plus interest and penalties of more than $5,800,000.

On January 8, 2015 the Corporation filed a "Retroactive S Election Application" Form CBT-2553-R, on which the GRATs evidenced their consent to New Jersey's jurisdiction to tax and collect tax. That form was returned to the Corporation by the Division on or about March 30, 2015, with a hand written note which provided, "This corporation has been an S-corp since 1997.? Please call 609 [XXX XXXX] S Corp Unit." Thereafter, on May 7, 2015, the Division issued a notice rejecting the Retroactive S Election Application, stating that "[t]he [Corporation] submitted a timely CBT-2553 (New Jersey S Corporation election) starting in 1997 and has maintained such status" and "[t]here is no provision in the law or regulations allowing a shareholder to retroactively consent to taxation in this State."

In or about April 2015, the Corporation filed an amended CBT return on which it 1) "sourced" the gain on the deemed sale of fixed assets based on the

Jersey as "Nonoperational gains - Section 338(h)(10)" and do not appear to differentiate between fixed assets and goodwill.

[4] Additional adjustments were made which are not pertinent to this motion.

location of the assets; and 2) "sourced" the gain on the deemed sale of goodwill using the three-year average of its allocation factors for the 2007, 2008, and 2009 tax years. Although the return was filed by the Corporation, the amended return states "[t]he gain from the [Corporation's] deemed asset sale is sourced to New Jersey under the gross income tax rules applicable to 'net gains or income from the disposition of property.'" (emphasis added.) The Corporation issued amended Schedule K-1's to its shareholders allocating $90,018,927 of the entire deemed gain on sale of $357,290,215 to New Jersey.

The change in the sourcing of the corporate income on the deemed sale of assets affected the GIT calculated to be due from Paz on the original New Jersey GIT non-resident return filed by him, and in April 2015, he filed an amended return requesting a refund of $1,741,684.[5]

On December 16, 2015, the Division issued a Notice of Assessment against the Corporation demanding $5,116,396.39, representing the tax due from the GRATs as "non-consenting" S corporation shareholders in the amount of $3,580,810, plus penalties and interest of $1,535,586. On December 24, 2015, the Division issued a Notice of Tax Due to Paz of $26,792,003.92, consisting of GIT of $19,166,036.18, penalties of $958,301.81, and interest of $6,667,665.84. The additional tax was assessed primarily as a result of the characterization of the

[5] All income allocated to the GRATs was included on both of the GIT returns filed by Paz since the GRATs constituted grantor trusts of which he was grantor.

$308,447,231 gain on the I.R.C. §338(h)(1) deemed asset sale as non-operational income of the Corporation allocable to New Jersey under the CBT Act, and includable in the Shareholders' non-resident GIT calculations as New Jersey source income. The Corporation and the GRATs filed a complaint in the Tax Court on August 5, 2015, contesting the Director's denial of the Corporation's Retroactive S Election Application. On January 6, 2016, Paz filed a complaint in Tax Court appealing the Director's December 24, 2015 Notice of Tax Due and the Corporation filed a complaint contesting the Director's December 16, 2015 Notice of Assessment against it.[6]

The Corporation, Paz, and the GRATs jointly filed a motion for summary judgment in these matters. The Director filed a cross-motion for summary judgment. Both motions were argued before this court on December 16, 2016.

II. Legal Issues and Analysis

A. Summary Judgment

Summary judgment should be granted where "the pleadings, depositions, answers to interrogatories and admissions on file, together with the affidavits, if any, show there is no genuine issue as to any material fact challenged and the moving party is entitled to a judgment or order as a matter of law." R. 4:46-2(c). In Brill v. Guardian Life Ins. Co., 142 N.J. 520, 523

[6] A fourth complaint was filed by the Corporation in March, 2016 contesting a Notice of Assessment issued to the Corporation, but that complaint is not the subject of the current motion for summary judgment.

(1995), our Supreme Court established the standard for summary judgment as follows:

> [W]hen deciding a motion for summary judgment under Rule 4:46- 2, the determination whether there exists a genuine issue with respect to a material fact challenged requires the motion judge to consider whether the competent evidential materials presented, when viewed in the light most favorable to the non-moving party in consideration of the applicable evidentiary standard, are sufficient to permit a rational factfinder to resolve the alleged disputed issue in favor of the non-moving party.

"The express import of the Brill decision was to 'encourage trial courts not to refrain from granting summary judgment when the proper circumstances present themselves.'" Township of Howell v. Monmouth Cty Bd. of Taxation, 18 N.J. Tax 149, 153 (Tax 1999) (quoting Brill, supra, 142 N.J. at 541).

The parties contend and the court concludes that there is no genuine dispute with respect to any of the material facts in this matter. Resolution of these matters by summary judgment is appropriate.

B. Standard of Review

The review of this matter begins with the presumption that determinations made by the Director are valid. See Campo Jersey, Inc. v. Director, Div. of Taxation, 390 N.J. Super. 366, 383 (App. Div.), certif. denied, 190 N.J. 395 (2007); L&L Oil Service, Inc. v. Director, Div. of Taxation, 340 N.J. Super. 173, 183 (App. Div. 2001); Atlantic City Transp. Co. v.

Director, Div. of Taxation, 12 N.J. 130, 146 (1953). "New Jersey Courts generally defer to the interpretation that an agency gives to a statute [when] that agency is charged with enforc[ement.]" Koch v. Director, Div. of Taxation, 157 N.J. 1, 8 (1999) (citing Smith v. Director, Div. of Taxation 108 N.J. 19, 25 (1987)). Determinations by the Director are afforded a presumption of correctness because "[c]ourts have recognized the Director's expertise in the highly specialized and technical area of taxation." Aetna Burglar & Fire Alarm Co. v. Director, Div. of Taxation, 16 N.J. Tax 584, 589 (Tax 1997) (citing Metromedia, Inc. v. Director, Div. of Taxation, 97 N.J. 313, 327 (1984)). The Supreme Court has directed courts to accord "great respect" to the Director's application of tax statutes, "so long as it is not plainly unreasonable." Metromedia, supra, 97 N.J. at 327. However, where the interpretation of an administrative agency is plainly at odds with a statute, that interpretation will not be upheld. See Oberhand v. Director, Div. of Taxation, 193 N.J. 558, 568 (2008) (citing GE Solid State v. Director, Div. of Taxation, 132 N.J. 298, 306 (1993)).

C. Discussion

1. General Principles of the CBT Act

The CBT Act requires that all non-exempt domestic and foreign corporations pay an annual franchise tax for the privilege of having or exercising its corporate franchise in New Jersey, or for the privilege of deriving receipts from sources within the State, or for the privilege of engaging in contacts within the state, or for the privilege of doing business, employing capital or owning capital or property, or maintaining an office in New Jersey. N.J.S.A. 54:10A-2. In general, corporations which are subject to tax in New Jersey are taxed on that proportion of their "entire net income" allocable to New Jersey. N.J.S.A. 54:10A-5(c)(1).

Corporations electing S corporation status are subjected to a different tax scheme under both federal and New Jersey tax laws. Under federal tax law, an S corporation's income, losses, deductions, and credits pass through to its shareholders, based on their individual percentage ownership in the corporation. See I.R.C. §1366. The shareholders, in turn, report their pro rata share of the income and losses on their personal income tax returns in accordance with federal tax laws, and are assessed taxes at their individual tax rates. Id. Technically, under New Jersey tax law, the entire net income of an electing S corporation is subject to CBT. N.J.S.A. 54:10A-5(c)(2). For tax years ending on or after July 1, 2007, however, "no rate of tax" is imposed on an S corporation's entire net income.[7] N.J.S.A. 54:10A-5(c)(2)(ii). Further, an electing S corporation is not subject to the GIT. N.J.S.A. 54A:5-9. The income, dividends, and gains of an S corporation, however, are allocated to its shareholders and subjected to GIT on the shareholders' personal income tax return whether or not actually distributed. Id. Thus, although an S corporation's entire net income is not subject to the CBT

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[7] All S Corporations are however subject to the CBT minimum tax obligation, N.J.S.A. 54:10A-5(e), and New Jersey S corporations are also subject to the regular CBT on its New Jersey entire net income that is subject to federal income taxation. N.J.S.A. 54:10A-5(c)(3).

or the GIT directly, all of its income is taxed at the shareholder level.

2. S Corporation Election

The CBT Act defines an "S corporation" as "a corporation included in the definition of an 'S corporation' pursuant to [I.R.C. §1361]." N.J.S.A. 54:10A-4(o). A "New Jersey S corporation" is a "corporation that is an S corporation; which has made a valid election pursuant to [N.J.S.A. 54:10A-5.22]; and which has been an S corporation continuously since the effective date of the valid election made pursuant to [N.J.S.A. 54:10A-5.22]." N.J.S.A. 54:10A-4(p).

In order for a corporation to elect to be a New Jersey S corporation, the corporation and its shareholders on the date of the election (the "initial shareholders") must consent to the election and the jurisdictional requirements of becoming a New Jersey S corporation. N.J.S.A. 54:10A-5.22. Specifically, the initial shareholders must consent to: the State's right to tax and collect the tax on the shareholder's income; the right of the State to tax and collect the tax, regardless of a change of the initial shareholder's residency; and the State's right to collect the tax directly from the corporation should a shareholder other than an initial shareholders fail to consent to the State's jurisdiction to tax and collect the tax. N.J.S.A. 54:10A-5.22(b).

With respect to a shareholder who is not an initial shareholder, an S corporation must either deliver the consent of such shareholder to the State's jurisdictional requirements, or make payments to the

Director of the amount of tax on the subsequent shareholder's pro rata share of the S corporation's income calculated at the highest rate of tax under the GIT. N.J.S.A. 54:10A-5.23(a)-(c). The Director may require that the tax estimated to be due be withheld from any distribution made to a nonconsenting shareholder. N.J.S.A. 54:10A-5.23(c). Where a shareholder who is not an initial shareholder fails to deliver a consent and objects to the jurisdiction of the State to withhold payments of the tax due, the State has the right to collect the tax from the corporation. N.J.S.A. 54:10A-5.23(d).

Procedurally, "[a] Federal S corporation must file a New Jersey Subchapter S Election form (CBT-2553) to elect treatment as a New Jersey Subchapter S corporation . . . or to report a change in shareholders." N.J.A.C. 18:7-20.1(c). Here, the Corporation filed its election for 1997 and has been treated as a New Jersey S corporation since. The Director does not contest the status of the Corporation as a New Jersey S corporation. The Director maintains that the GRATs are not initial shareholders and their consent to be taxed was required to be filed once they became shareholders. See N.J.A.C. 18:7-20.1(c)(1)(vii)(1) (if an initial shareholder transfers stock to a "grantor trust of which the shareholder is the grantor, a new CBT-2553 shall be signed and filed by the Trustee in that capacity."). Because the consents were not timely filed, the Director maintains that the State has "the right and jurisdiction to collect a tax . . . directly from the corporation equal to the pro rata share of the S corporation income allocated to this State, . . . of the nonconsenting shareholder times the maximum tax bracket rate provided under [the GIT].” N.J.S.A. 54:10A-5.23(d).

Plaintiffs argue that the GRATs are “grantor trusts” and all of the income otherwise allocable to such trusts is includable on Paz’s personal return and was so included for the year in question. See I.R.C. §671. Thus, according to plaintiffs, it was unnecessary for the GRATs to consent to be taxed because Paz remained the sole shareholder of the Corporation even after the transfer of shares. Plaintiffs maintain that N.J.A.C. 18:7-20.1(c)(1)(vii)(1), requiring that a new CBT-2553 be signed and filed by the Trustee of a grantor trust that becomes a shareholder, is invalid because it is contrary to the technical “income tax definition” of the word “shareholder” and because it is inconsistent with the GIT treatment of a grantor trust as a disregarded entity.

Plaintiffs rely heavily on the treatment of S corporations under the Internal Revenue Code in making their argument. The court finds no contradiction between the definition of an S corporation in I.R.C. §1361(a)(1) and the requirement in the regulations that the trustee of a grantor trust file a Form 2553 upon becoming a shareholder. In fact I.R.C. §1361 supports the Director’s position that a grantor trust is an eligible “shareholder” under the federal statutes. See I.R.C. §1361(c)(2)(A)(1) (allowing as an eligible shareholder “[a] trust all of which is treated [under I.R.C. §671] as owned by an individual who is a citizen or resident of the United States.”)

“That the Legislature may delegate to an administrative agency the authority to promulgate rules and regulations interpreting and implementing a statute is beyond peradventure." T.H. v. Div. of Developmental Disabilities, 189 N.J. 478, 490 (2007). "Agency regulations are promulgated to aid in the practical application of a statute to achieve the legislative purpose." Regent Corp. of Union, Inc. v. Director, Div. of Taxation, 27 N.J. Tax 577, 598 (Tax 2014).

> New Jersey courts generally defer to the interpretation that an agency gives to a statute that agency is charged with enforcing. Smith v. Director, Div. of Taxation, 108 N.J. 19, 25, 527 A. 2d 843 (1987). We have recognized the Director's expertise, particularly in specialized and complex areas of the Act. Metromedia, Inc. v. Director, Div. of Taxation, 97 N.J. 313, 327, 478 A. 2d 742 (1984) (stating that Director's interpretation will prevail "as long as it is not plainly unreasonable"). However, this deference is "not total, as the courts remain the 'final authorities' on issues of statutory construction and are not obliged to 'stamp' their approval of the administrative interpretation." New Jersey Guild of Hearing Aid Dispensers v. Long, 75 N.J. 544, 575, 384 A.2d 795 (1978).
>
> [Koch, supra 157 N.J. at 8.]

The Director's construction of the operative law, "which is not plainly unreasonable and with which the Legislature has not interfered, is entitled to prevail". Aetna Burglar & Fire Alarm, supra, 16 N.J. Tax at 589 (citing Metromedia, supra, 87 N.J. at 327). The party challenging the regulation has the burden of proving the regulation is invalid. New Jersey State

League of Municipalities v. Department of Cmty. Affairs, 158 N.J. 211, 222 (1999). Here, the Director's regulation providing that a grantor trust be treated as a shareholder which is not an initial shareholder, and requiring that a form 2553 signed by the Trustee be filed, is consistent with the plain language and probable intent of N.J.S.A. 54:10A-5.22(b). The regulation is upheld.

The regulations, however, allow for the filing of a Retroactive S Election form where an S corporation authorized to do business in New Jersey, which is registered with the Division, and which has filed CBT returns, has failed to file a timely New Jersey S corporation election. See N.J.A.C. 18:7-20.3(a). The Statement accompanying the proposal to N.J.A.C. 18:7-20.3 provides, in part:

> Since there are occasions when taxpayers may fail to make [a New Jersey S election] due to inadvertence, the procedure is designed to assist honest taxpayers with a procedure that is less draconian in its consequences than requiring the corporate taxpayer to pay tax, penalty and interest on the difference between the S corporation rates and the C corporation rates, requiring the difference between the S corporation rates and the C corporation rates, requiring the shareholders to file amended NJ-1040 returns to get refunds, and deal with the potential disparity in the statute of limitations between corporation business tax and gross income tax.
>
> [39 N.J.R. 3730(a) (Sept. 4, 2007).]

The Director argues that the purpose of the retroactive election is to benefit only corporations which have filed S corporation returns (NJ-CBT-100S) but have failed to timely file New Jersey S corporation election. A strictly literal reading of N.J.A.C. 18:7-20.3 might support the Director's position. There is nothing in the regulation which specifically permits the retroactive filing of consents for non-initial shareholders. The instructions to the Retroactive S Election Application, Form CBT-2553-R, belie a literal interpretation. Those instructions anticipate the filing of a retroactive election by a corporation which has already applied for S corporation status and received approval. Specifically, Instruction 1 to Form CBT-2553-R states:

> This form is to be used by a currently authorized corporation electing New Jersey S corporation status effective retroactively to a prior return period. Submit a copy of the original CBT-2553 if previously approved. If the taxpayer does not currently have New Jersey C Corporation status, an original CBT-2553 must also be submitted.
>
> [Id. (emphasis added).]

Furthermore, Part IV of Form CBT 2553-R indicates that the consenting shareholders consent to New Jersey's "retroactive right and jurisdiction to tax and collect the tax on each shareholder's S corporation income . . . ." Thus, it appears to be clearly anticipated that corporations which have received prior approval of the New Jersey S Election be permitted to file retroactive elections and to permit shareholders to retroactively consent to be taxed.

The Director further argues that, if the court finds that the retroactive election applies to permit an untimely consent by the GRATs, relief should not be granted, because

> [a]ll shareholders have not filed appropriate tax returns and paid tax in full when due as if the New Jersey S corporation election request had been previously approved, and the taxpayers have not reported the appropriate S corporation income on those returns.
>
> [N.J.A.C. 18:7-20.3(c)(4).]

The Director maintains that since the shareholders did not source the income in the manner determined by the Division and thus "have not reported the appropriate S corporation income" on their returns, relief cannot be granted. This argument cannot be sustained. The Corporation allocated all of what it reported as its income to its various shareholders, including the GRATs. The income allocated to the GRATs by the Corporation was included in the return of Paz, as the grantor of the GRATs. The Division reviewed the Corporation's return and made a determination that the Corporation and its shareholders have protested. To adopt the Director's interpretation would mean that any time a taxpayer contests the action of the Director without first paying the tax alleged to be due, that taxpayer cannot be afforded the remedy of a retroactive election. The court finds such an interpretation to have a chilling effect on the ability of a corporation and its shareholders to legitimately contest an assessment. See United Parcel Service General Servs Co. v. Director, Div. of Taxation, 220 N.J. 90, 94 (2014)(taxpayer which timely files tax returns, pays all reported tax liabilities and is found to be liable for additional tax following an audit, has not failed to pay tax).

Finally, the Director argues that the assessment against the Corporation for the taxes due on the GRATs' share of the income was proper, because as of the 2010 tax year the GRATs had not filed a consent. Therefore, the Corporation was required to

> [m]ake payments to the Director of the Division of Taxation on behalf of each nonconsenting shareholder in an amount equal to the shareholder's pro rata share of S corporation income allocated to this State, as defined pursuant to . . . [N.J.S.A.].54A:5-10 [], reflected on the corporation's return for the accounting or privilege period, multiplied by the maximum tax bracket rate provided under N.J.S.[A.] 54A:2-1 in effect at the end of the accounting or privilege period. The payments shall be made no later than the time for filing of the return for the accounting or privilege period.
>
> [N.J.S.A. 54:10A-5.23(c).]

Thus, the Director argues, since the Corporation neither had the executed consents from the GRATs at the appropriate time nor did it pay over the tax as required, it cannot be granted relief.

Once again, the Director argues against the retroactivity permitted by his own regulations. What is the sense of permitting retroactive relief if the taxpayer must first be required to act and be assessed as if the retroactive election were not permitted, only to have the retroactivity thereafter apply? Furthermore by filing the Form CBT-2553-R, the GRATs have consented to the retroactive taxation of the income allocable to them, and the tax due on the amounts allocable to them as reported on the corporate return was in fact paid, albeit by Paz.

The court finds that the failure of the GRATs to file the necessary consents was cured by the filing of the retroactive S Election. Any potential harm to the State has been obviated. While the amount of the income required to be included in the Shareholders' returns has yet to be finally determined, at the time of the filing of the return, the tax due from all of the Shareholders was paid by Paz.

3. General Principles of the GIT Act

Under the GIT, the net income earned by an S corporation from the operation of its business is passed through to its shareholders and taxed in a single category as the "[n]et pro rata share of S corporation income." N.J.S.A. 54A:5-1(p); Miller v. Director, Div. of Taxation, 352 N.J. Super. 98, 104-105 (App. Div. 2002), rev'g and remanding 19 N.J. Tax 522 (Tax 2001). However, where a corporation sells virtually all of its assets and distributes the proceeds to its shareholders in complete liquidation of the corporation, the gain on the actual sale of corporate assets is not taxed as S corporation income. Instead, the two transactions are treated "as if they were one transaction involving a sale of stock to a third party, with the tax being calculated precisely in accordance with the provisions of N.J.S.A. 54A:5-1(c) specifically governing Subchapter S corporations." Id. at 108. This treatment is required in order to avoid a tax on return of capital. Ibid.

In a corporate liquidation subject to the I.R.C. §338(h)(10) election, there is no actual sale of corporate assets. Instead, the shareholders sell their shares in the corporation to a third party and elect to treat the transaction as if the corporation sold all of its assets and liquidated. For federal tax purposes, the shareholders "take their pro rata share of the deemed sale tax consequences into account under section 1366 and increase or decrease their basis in the selling corporation's stock under section 1367." Treas. Reg. §1.338(h)(1)-1(d)(5)(i).

In Mandelbaum v. Director, Div. of Taxation, 20 N.J. Tax 141 (Tax 2002), the court considered the tax consequences under the GIT of a sale of stock subject to an I.R.C. §338(h)(10) election and held that "the income passing through to [the shareholder] as a result of the deemed sale of [the corporation's] assets is taxable under N.J.S.A. 54A:5-1(c)." Id. at 153. The distinction between the characterization of the income on the deemed sale of assets as being from "disposition of property" and not "S corporation income" for GIT purposes forms the basis for the plaintiffs' challenge to the Director's sourcing of income in this matter.

GIT is imposed on all New Jersey Gross Income earned by any taxpayer. N.J.S.A. 54A:2- 1. "New Jersey Gross income" consists of sixteen specified categories of income, including "net gains or income from the disposition of property" and "net pro rata share of S corporation income." <u>N.J.S.A.</u> 54A:5-1(c), 5-1(p). GIT is imposed on non-residents based on a percentage of the GIT imposed on a resident, the numerator of which is the non-resident taxpayer's income from sources within New Jersey and the denominator of which is the non-resident taxpayer's gross income calculated as if the taxpayer was a resident of the state. <u>N.J.S.A.</u> 54A:2-1.1. Thus, the source of a non-resident's income is an integral factor in the determination of the amount of GIT imposed.

Both parties concur that gain from the deemed asset sale under <u>I.R.C.</u> §338(h)(10) is taxable as "net gains or income from disposition of property" and not as "S Corporation income" under the GIT. <u>See</u> <u>N.J.A.C.</u> 18:35-1.5(k)(2)(ii). <u>Mandelbaum</u>, <u>supra</u>, 20 <u>N.J. Tax</u> 141. The crux of the disagreement between the parties is the manner in which the income arising from the deemed sale of the corporation's assets is sourced for the purposes of the GIT imposed on the non-resident shareholders.

4. <u>Sourcing of Income</u>

a. **Application of CBT concepts**

"S corporation income" allocated to New Jersey constitutes income from sources within the state for a non-resident taxpayer. N.J.S.A. 54A:5-8(a)(6). S corporation income allocated to New Jersey means "that portion of the S corporation income that is allocated to this State by the allocation factor of the corporation for the [taxable year in question] pursuant to [N.J.S.A. 54:10A-6 through 54:10A-10]." N.J.S.A. 54A:5-10. Thus, in computing the amount of "S corporation income" allocable to a non-resident for

GIT purposes, the statute specifically references the CBT allocation factors of the S corporation.

"Net gains or income from the disposition of property," however, are sourced to New Jersey "to the extent it is earned, received or acquired from sources within this State" based on rules specifically related to the type of property. N.J.S.A. 54A:5-8(a)(1)-(4). Thus, plaintiffs argue, the allocation factor applicable to S corporation income under the CBT is irrelevant in determining the sourcing of gains arising from an I.R.C. §338(h)(10) deemed sale of assets notwithstanding the fact that those deemed gains were earned at the corporate level.

This dispute has its roots in the decisions of Miller, supra 352 N.J. Super. 98 and Mandelbaum, supra, 20 N.J. Tax 141. In Miller, there was an actual sale of assets by an electing S corporation followed by a complete liquidation of the corporation. The Director treated the transactions as they occurred – a sale of assets by the corporation, resulting in S corporation income to the shareholders, and the complete liquidation of the corporation, resulting in income from the disposition of property.

The court held that while the Director's position was a literal application of the GIT, the characterization of the gain on the sale of the corporate assets as S corporation income unavoidably resulted in an unacceptable tax on the return of capital, a result inconsistent with legislative intent. Miller, supra, 352 N.J. Super. at 105. See also Koch, supra, 157 N.J. at 8-14. "[S]ince the literal statutory words are incompatible with the overall legislative purpose not to tax a return on capital, the only solution that appears to us to make sense, without doing violence to the [GIT] Act, is to treat these transactions as a sale of corporate stock." Miller, supra 352 N.J. Super. at 107.

In Mandelbaum, Judge Kuskin was confronted with the sale of S corporation stock in a transaction involving an election under I.R.C. §338(h)(10) similar to that before this court. At the time, neither the GIT Act nor the regulations issued thereunder provided for the GIT treatment of the I.R.C. §338(h)(10) deemed sale of assets. Despite that, the Director argued that the deemed sale of assets should be recognized as a taxable event resulting in S corporation income to the shareholder under N.J.S.A. 54A:5-1(p), followed by a complete liquidation of the corporation, resulting in a capital gain or loss to the selling shareholder under N.J.S.A. 54A:5-1(c). Judge Kuskin held that "in the absence of valid regulations under the GIT Act, the Director may not import and apply federal tax principles from I.R.C. §338(h)(10) and assess gross income tax in accordance with those principles." Mandelbaum, supra, 20 N.J. Tax at 152. Agreeing with Judge Small's analysis in Miller, supra, he found that income not generated in the regular course of business of the corporation should be taxed under N.J.S.A. 54A:5-1(c) and not as regular business income under subsection (p). Ibid.

On September 5, 2006, the Director proposed amendments to GIT regulations applicable to the gain on sale on the disposition of property in connection with the complete liquidation of sole proprietorships and partnerships. See N.J.A.C. 18:35-1.1, 1.3; 38 N.J.R. 3502(a) (Sept. 5, 2006). Simultaneously, new regulations addressing the sale of assets in connection with a liquidation of an S Corporation were proposed. See N.J.A.C. 18:35-1.5; 38 N.J.R. 3502(a), supra.

Specifically, the Director noted:

> The New Jersey Tax Court opinions in Miller v. Director, Division of Taxation, 19 N.J. Tax 522 (2001), reversed 352 N.J.Super. 98, 799 A.2d 660 (App. Div. 2002) and Mandelbaum v. Director, Division of Taxation, 20 N.J. Tax 141 (2002) held that income of a shareholder resulting from the sale of corporate assets is taxable as the net gain from the disposition of property. More specifically, the Courts explained that to the extent that a partnership or subchapter S corporation has income outside of its ordinary trade or business, that income retains its character as gains from the disposition of property when it is passed through to the partners or subchapter S shareholders, and the taxpayer can deduct his or her basis in the stock from the passed-through proceeds from the sale in calculating his or her income tax liability.
>
> [38 N.J.R. 3502(a), supra.]

Thus, N.J.A.C. 18:35-1.1(c)(5), relating to sole proprietorships, provides that "[g]ain or loss from the sale or disposition of assets employed in a trade or business as a result of a complete liquidation of the business must be reported as described in N.J.S.A. 54A:5-1.c, net gains or income from the disposition of property." Similarly, N.J.A.C. 18:35-1.3(2)(i), relating to partnerships, provides "[t]he partnership's gain or loss from the sale or disposition of its assets as a result of a complete liquidation are to be separately reported as net gains or income from disposition of property in accordance with N.J.S.A. 54A:5-1.c." Both regulations contain sourcing rules for business activities carried on both inside and outside of New Jersey, providing that (a) the gain or loss from the sale of real and tangible assets located in New Jersey is sourced to New Jersey; (b) the gain or loss from the sale of real and tangible assets located outside New Jersey is sourced to the other jurisdiction; (c) the gain or loss from the sale of motor vehicle equipment is sourced to the state where the vehicle is registered, unless the vehicle was used predominantly in another state; and (d) the gain or loss from the sale of intangibles is allocated using the average of the business allocations for the last three years. N.J.A.C. 18:35-1.1(e)(5), 1.3(d)(5). Notably, the sourcing of the income under the regulations relates to the use of the property by the unincorporated business entity in its business.

Consistent with the amendments applicable to sole proprietorships and partnerships, the new S corporation regulations governing the "Complete Liquidation of an S Corporation" provide, in part, "if the adopted Federal plan of liquidation requires the S corporation, and ultimately the shareholders(s), to recognize a gain or loss from the deemed sale of its assets, the gain or loss from the deemed sale is reported by the shareholder(s) for gross income tax purposes." N.J.A.C. 18:35-1.5(k)(1).

Additionally, the new regulations provide,

> The income or loss from an S corporation's sale or deemed sale, exchange, distribution or other disposition of all of its assets when in conjunction with the sale, exchange or disposition of all of the S corporation's stock must be reported by the shareholder in the category "net gains or income for the disposition of property."
>
> [N.J.A.C. 18:35-1.5(k)(2)(ii).]

Unlike the regulations applicable to unincorporated business entities the regulations addressing the complete liquidation of S corporations did not precisely address sourcing rules. The examples under the new regulations demonstrate only the application of the regulations to a New Jersey S corporation electing I.R.C. §338(h)(10) treatment "which allocates 100 percent to New Jersey." N.J.A.C. 18:35-1.5(o), Example 4. While not specifically referencing any other sourcing rules, the regulation provides that in the case of a non-resident, that portion of the liquidating distribution representing the gain on sale of the corporation's assets is New Jersey Income. Id.

In April 2007, however, the Director proposed an amendment to CBT regulation N.J.A.C. 18:7-8.12, adding subsection (g), as follows:

> Unless the taxpayer can show by clear and convincing evidence that such a methodology does not properly reflect the activity or business of the taxpayer reasonably attributable to the State, receipts from the sale of tangible and intangible assets in a

> transaction pursuant to I.R.C. 338(h)(10) are allocated and sourced to New Jersey by multiplying the gain by a three-year average of the allocation factors used by target corporation for its three tax return periods immediately prior to the sale.
>
> [39 N.J.R. 1243(a) (April 2, 2007).]

The proposal was intended to provide a "more accurate methodology than sourcing such receipts to New Jersey by reference to the sales fraction only that would reflect customer locations." Id. It is thus clear that the Director intended that the sourcing rules set forth in N.J.A.C. 18:7-8.12 be utilized in deemed asset sales under I.R.C. §338(h)(10). The regulation does not distinguish between the treatment of S corporations and C corporations.

Just prior to the proposal this court decided McKesson Water Prods. Co. v Director, Div. of Taxation, 23 N.J. Tax 449 (Tax 2007), aff'd, 408 N.J. Super 213 (App. Div.), certif. denied, 200 N.J. 506 (2009), in which Judge Kuskin held that "the income resulting from [the corporate taxpayer's] deemed sale of assets was nonoperational income under N.J.S.A. 54:10A-6.1(a).[8] As a result, the income . . . must be assigned to . . . the location of [the target's] principal place of business" 23 N.J. Tax at 465. Applying that holding to the facts of this case, the gain on sale of the corporation's deemed asset sale would be assigned to

[8] Judge Kuskin's decision in McKesson was initially issued as a bench decision March 9, 2007 and was amplified by a Formal Opinion issued August 13, 2007 and published at 23 N.J. Tax 449.

New Jersey and would constitute New Jersey income to Paz and the GRATs. The Director argues, persuasively, that McKesson conclusively established that gains from an I.R.C. §338(h)(10) deemed sale are nonoperational income assignable to the domiciliary state of the corporation and effectively invalidated subsection (g) of N.J.A.C. 18:7-8.12.

Plaintiffs contend, however, there is no statutory cross reference to the CBT for determining the portion of net gains or income from the disposition of property under N.J.S.A. 54A:5-1(c) that should be sourced to New Jersey and that the CBT principles apply only to source S corporation income under N.J.S.A. 54A:5-1(p). Thus, according to plaintiff, the principles of McKesson are inapplicable and the methodology of the regulations for sourcing the gain on the sale of assets disposed of in the complete liquidation of the businesses of sole proprietorships and partnerships should instead control.

The income at issue arose from the sale of assets utilized by the Corporation in its business. But for the fact that these assets were sold (or deemed to be sold) in anticipation of the complete liquidation of the Corporation, it is clear that the sourcing rules of the CBT would apply. The Miller court did not reach its decision by way of comparing the transaction with what would occur if the corporation had been an unincorporated business entity. Miller, supra, 352 N.J. Super. 98. The court reached its decision by finding that the legislative intent behind the GIT Act was not to tax capital. Id. In sourcing the gain from the deemed sale of assets to New Jersey the Director's determination does not run afoul of the court's reasoning in Miller not to tax a return of capital. The sourcing of gain was not a factor in Miller.

Furthermore, the court, albeit in dicta, referenced the rules applicable to S corporations in suggesting an alternative interpretation of the GIT and proposed resolution thereunder. Id. at 101. It would seem, therefore, that the Miller court implicitly recognized the efficacy of applying S corporation concepts under the CBT to the transactions under review in that matter.

Although Judge Kuskin in Mandelbaum, supra, considered the similarity of the principles of taxation applicable to partnerships and S corporations, that comparison related to the characterization of income as being generated in the regular course of business.

> [T]he taxation principals applicable to partnerships and S corporations are not identical, but, for the purposes of determining what constitutes taxable partnership income under category k of N.J.S.A. 54A:5-1 and what constitutes subchapter S corporation income under category p of the same statute, the same principles apply. Under those principles, only income generated in the regular course of business is includable. Other income retains its character and is subject to tax if it fits within one of the other categories of taxable income set forth in N.J.S.A. 54A:5-1.
>
> [20 N.J. Tax at 154.]

This court does not find that the seemingly disparate sourcing treatment of sole proprietors and partners is inapposite to the result achieved here.

While the pass-through tax treatment of S corporation shareholders is similar to that of sole proprietors and partners in partnerships, that treatment is not identical. See e.g. Sidman v. Director, Div. of Taxation, 18 N.J. Tax 636 (Tax 2000)("Nowhere in the legislation (or any regulation) does it state the subchapter S corporations are to be treated as sole proprietors, unlike the regulations about partnerships and sole proprietorships."), aff'd, 19 N.J. Tax 484 (App. Div.), certif. denied 170 N.J. 387 (2001).

To support their position that the sourcing rules set forth in N.J.A.C. 18:35-1.1 and 1.3 should apply to S corporations, plaintiffs point to the language in 38 N.J.R. 3502(a), supra, that, "[t]he adoption of the new rules and amendments is expected to have a beneficial social impact by clarifying the proper procedures for reporting income received from the sale of business stock in a complete liquidation. This treatment is consistent for sole proprietors, partners, and S corporation shareholders". It is clear that the referenced language refers solely to the application of the rulings in Miller and Mandelbaum, that the net income from the disposition of assets in a complete liquidation of a business entity representing a return of capital not be subject to tax. Nothing within Miller or Mandelbaum, supports plaintiffs' position that the CBT sourcing rules should not be applied.

The court concludes that applying the CBT sourcing rules to the deemed gain on sale of assets under I.R.C. §338(h)(10) is wholly consistent with the taxation of such income as net gains from the disposition of property under the GIT.

b. Operational vs. Non-Operational Income

The court in McKesson, supra, reviewed a transaction substantially similar to that before this court and concluded that the gain on the deemed sale was non-operational income under N.J.S.A. 54:10A-6.1, and was therefore assignable to the taxpayer's principal place of business. In McKesson, the result of the transaction was a cessation of the business operations by the target corporation with a complete liquidation and distribution to the shareholders of the proceeds of sale. 23 N.J. Tax at 465.

McKesson is binding on this court. See Badische (BASF) Corp. v. Township of Kearny, 17 N.J. Tax 594, 599 (App. Div. 1998) ("[a] trial judge has the responsibility to comply with the pronouncements of the Appellate Division."). Therefore, unless this matter is either factually distinguishable or there is subsequent binding new law, this court must follow McKesson. There is no discernible difference between the transaction in McKesson and that before this court, and thus the court concludes that factually McKesson is not distinguishable. As noted above, the court does not find that the decisions in Miller, supra, or Mandelbaum, supra, addressed the issue of the sourcing of gain presented here.

The court concludes that McKesson controls so that the income from the deemed sale of assets by the corporation constitutes non-operational income. The court further concludes that such income, having been deemed to be earned by the corporation, must be sourced with reference to the CBT and is assignable to New Jersey as the principal place of business of the corporation under N.J.S.A. 54:10A-6.1.

Plaintiffs next argue that under the plain language of N.J.S.A. 54:10A-6.1, only the taxpayer can classify income as non-operational.[9] The court rejects this argument. Clearly, the initial sentence of N.J.S.A. 54:10A-6.1 by defining "operational income" excludes from that definition such income that is not within the definition. The second sentence provides an opportunity for the taxpayer to demonstrate that income is nonoperational and sets forth the standard of "clear and convincing evidence." Plaintiffs have not made any demonstration which would require this court to conclude that the income could be classified as anything but nonoperational income.

Finally, plaintiffs argue that sourcing the entire gain from the deemed asset sale is violative of the fair apportionment requirement of the Due Process Clause and the Commerce Clause of the United States Constitution because sourcing the entire gain to New Jersey is out of all proportion to the business

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[9] N.J.S.A. 54:10A-6.1 provides:

"Operational income" subject to allocation to New Jersey means income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations and includes investment income serving an operational function. Income that a taxpayer demonstrates with clear and convincing evidence is not operational income is classified as nonoperational income, and the nonoperational income of taxpayers is not subject to allocation but shall be specifically assigned; provided, that 100% of the nonoperational income of a taxpayer that has its principal place from which the trade or business of the taxpayer is directed or managed in this State shall be specifically assigned to this State to the extent permitted under the Constitution and statutes of the United States.

activities conducted in the state by the corporation. Because the McKesson court resolved the issue before them on purely statutory grounds, they did not reach the constitutional issues implicated in the unitary business principle. 408 N.J. Super. at 221.

Plaintiffs' argument is misplaced. As noted by Judge Kuskin, the definitions of operational and nonoperational income in N.J.S.A. 54:10A-6.1(a) have their origin in the UDITPA definitions of business and nonbusiness income. McKesson, supra, 23 N.J. Tax at 456. "Under [the Uniform Division of Income for Tax Purposes Act] and similar statutes, all business income [of a unitary business] is apportioned and all nonbusiness income is allocated." Jerome R. Hellerstein and Walter Hellerstein, State Taxation, §9.05 (3rd ed. 1998).

"The Constitution places limits on a State's power to tax value earned outside of its borders." Allied-Signal, Inc. v. Director, Div. of Taxation, 504 U.S. 768, 784, 112 S. Ct. 2251, 2261, 119 L.Ed. 2d 535, 550 (1992). "Under both the Due Process and the Commerce Clauses the Constitution, a State may not, when imposing an income-based tax, 'tax value earned outside its borders.'" Container Corp. of Am. v. Franchise Tax Bd., 463 U.S. 159, 103 S. Ct. 2993, 77 L.Ed. 2d 545 (1983). Thus, the business income of a unitary business must be apportioned among all the jurisdictions in which it conducts business. See Mead/Westvaco Corp. v. Illinois Dep't of Revenue, 553 U.S. 16, 24-25, 128 S.Ct. 1498, 1505, 170 L.Ed. 2d 404, 412 (2008). "The Commerce Clause forbids the States to levy taxes that discriminate against interstate commerce or that burden it by subjecting activities to multiple or unfairly apportioned taxation." Id. at 24. The gain on the sale of the corporation's assets, however, constituted nonoperational/nonbusiness income and was not "earned" as business income beyond the borders of New Jersey. The Constitution does not require that nonbusiness income be apportioned among the states. See Ala. Dep't of Revenue v. Kimberly-Clark Corp., 95 So. 3d. 820, 826 (Ala. Civ. App. 2012).

The income at issue arose from the deemed sale of assets in connection with a complete liquidation of the corporation. That income is clearly nonoperational income under McKesson, by which precedent this court is bound. There is no constitutional requirement that such income be apportioned and it is appropriately allocated to the domiciliary state, New Jersey.

5. Abatement of Penalties

The Director imposed underpayment penalties to the tax due from both Paz and the corporation on the GRATs' share of the income from the Corporation pursuant to N.J.S.A. 54:49-4. That section provides, in pertinent part, that "[u]nless any part of any underpayment of tax required to be shown on a return or report is shown to be due to reasonable cause, there shall be added to the tax an amount equal to 5% of the underpayment." The Director is authorized to waive the penalty, in whole or in part, "if the failure to pay any tax when due . . . is explained to the satisfaction of the Director." N.J.A.C. 18:2-2.7(a).

As noted above, the tax due from the Corporation for the income tax payable by the GRATs was abated by the retroactive consents filed by the GRATs. Thus, to that extent the underpayment is eliminated and no penalty should be imposed.

The court has found that Paz incorrectly sourced the income taxable to the shareholders on the liquidation of the corporation. Under the facts of this case, the court finds that the failure to pay tax as a result of the incorrect sourcing of income was reasonable. The court reaches this decision in light lack of direct guidance as to the sourcing of income in the N.J.A.C. 18:35-1.5, the Director's regulation at N.J.A.C. 18:7-8.12(g) apportioning the gain on an I.R.C. §338(h)(10) deemed sale, and the seemingly disparate treatment of sole proprietorships and partnerships as set forth in N.J.A.C. 18:35-1.1 and 1.3. The lack of clear direction from the Division and the lack of judicial guidance on the issue lead to the result that the plaintiffs' position regarding the sourcing of gain was reasonable, although ultimately incorrect. Thus, the penalty should be abated. See United Parcel Service, supra 220 N.J. at 93.

6. Litigation Costs

In light of the court's decision, plaintiffs' demand for litigation costs is rejected.

II. Conclusion

For the foregoing reasons, the court affirms the assessment of tax against Paz for the tax on the gain from the deemed sale of assets of the Corporation; rejects the assessment against the Corporation for the GIT imposed on the GRATs; abates the penalty imposed on Paz for the incorrect sourcing of income; and denies plaintiffs' request for litigation costs. In accordance with R. 8:9-3 the parties shall submit computations pursuant to the court's decision hereunder showing the correct amount of the underpayment within 45 days of the date of this opinion.

APPENDIX D

N.J.S.A. 54:10A-6.1

54:10A-6.1. Operational and nonoperational income

Effective: July 2, 2002 to June 29, 2014

a. "Operational income" subject to allocation to New Jersey means income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations and includes investment income serving an operational function. Income that a taxpayer demonstrates with clear and convincing evidence is not operational income is classified as nonoperational income, and the nonoperational income of taxpayers is not subject to allocation but shall be specifically assigned; provided, that 100% of the nonoperational income of a taxpayer that has its principal place from which the trade or business of the taxpayer is directed or managed in this State shall be specifically assigned to this State to the extent permitted under the Constitution and statutes of the United States.

b. Corporate expenses related to nonoperational income are not deductible in determining entire net income. Notwithstanding the provisions of R.S.54:49-6 or any other law to the contrary:

(1) if in prior privilege periods property had been classified as operational property, and later is demonstrated to have been nonoperational property and is subsequently disposed of, all expenses, without limitation, deducted for prior privilege periods related to such nonoperational property shall be added back

and recaptured as income in the period of disposition of such property;

(2) if in prior privilege periods income had been classified as serving an operational function, and later is demonstrated not to have been serving an operational function, all expenses, without limitation, deducted in prior privilege periods related to such income not serving an operational function shall be added back and recaptured as income; and

(3) the denominators of the fractions used to determine the allocation factor pursuant to section 6 of P.L.1945, c. 162 (C.54:10A-6), for privilege periods for which redeterminations are required pursuant to paragraphs (1) and (2) of this subsection shall be redetermined to exclude the amounts, if any, relating to the nonoperational property or the nonoperational

c. The Director of the Division of Taxation shall prescribe such forms for administration and adopt such administrative rules as the director deems necessary for the implementation of this section.