No. 25-

In the

Supreme Court of the United States

LORILLARD TOBACCO COMPANY,

Petitioner,

v.

DIRECTOR, DIVISION OF TAXATION,

Respondent.

On Petition for a Writ of Certiorari to the Supreme Court of New Jersey

PETITION FOR A WRIT OF CERTIORARI

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QUESTIONS PRESENTED

This Court has struck down state taxing schemes that amount to economic protectionism, incentivizing in-state activities and burdening out-of-state activities, as violative of the Commerce Clause of the United States Constitution. *See*, *e.g.*, *Oregon Waste Systems, Inc. v. Department of Environmental Quality*, 511 U.S. 93 (1994), *Fulton Corp. v. Faulkner*, 516 U.S. 325 (1996), and *Comptroller of the Treasury of Maryland v. Wynne*, 575 U.S. 542 (2015).

This Court has likewise struck down a state taxing scheme that indirectly taxes out-of-state income or transactions lacking a sufficient connection or nexus with the taxing state as violative of the Due Process Clause of the Fourteenth Amendment. *See*, *e.g.*, *Hunt-Wesson, Inc. v. Franchise Tax Board*, 528 U.S. 458 (2000).

Under New Jersey's corporate business tax, a royalty payor was disallowed otherwise deductible royalty expenses paid to a related party, with the amount of the disallowance determined by the extent of the related party royalty recipient's New Jersey activity. The more New Jersey activity conducted by the related party royalty recipient, the lower the tax burden on the royalty payor; conversely, the less New Jersey activity by the related party royalty recipient, the higher the tax burden on the royalty payor. The New Jersey courts upheld this scheme.

The Questions presented are:

(1) Whether New Jersey's scheme for taxing royalty payments, that conditions the deductibility of related-party royalty payments on the extent of

the royalty recipient's in-state activity, burdens and discriminates against interstate commerce in violation of the Commerce Clause.

(2) Whether New Jersey's scheme for taxing related party royalty payments, that limits the deductibility of the royalty expense to the extent the royalty recipient pays tax in the state on the royalty income, indirectly taxes out-of-state activity with no connection to New Jersey in violation of the Commerce or Due Process Clauses.

PARTIES TO THE PROCEEDINGS

Lorillard Tobacco Company ("Lorillard") is Petitioner here and was Plaintiff-Appellant below.

The Director, Division of Taxation (the "Division") is Respondent here and was Defendant-Respondent below.

RULE 29.6 DISCLOSURE STATEMENT

Pursuant to Supreme Court Rule 29.6, Lorillard states as follows:

Lorillard merged with and into R.J. Reynolds Tobacco Company on June 12, 2015, with R.J. Reynolds Tobacco Company continuing as the surviving entity.

R.J. Reynolds Tobacco Company is an indirect, wholly owned subsidiary of British American Tobacco p.l.c., a publicly held company.

The captioned Petitioner, "Lorillard Tobacco Company," ceased to exist on June 12, 2015 and, therefore, has no current parent corporation and no publicly held corporation that owns 10% or more of its stock.

PROCEEDINGS DIRECTLY RELATED

- *Lorillard Tobacco Company v. Director, Division of Taxation*, Docket No. 090721, Supreme Court of New Jersey (the "Order"). The Order was entered on October 3, 2025, reported at 262 N.J. 25.

- *Lorillard Tobacco Company v. Director, Division of Taxation*, Docket Nos. A-0595-23, A-0596-23, Superior Court of New Jersey, Appellate Division. Decision Dated April 29, 2025, reported at 2025 N.J. Super. Unpub. LEXIS 699.

- *Lorillard Tobacco Company v. Director, Division of Taxation*, Docket Nos. 008305-2007, 014043-2012, Tax Court of New Jersey. Decision Dated and Entered September 13, 2023, reported at 2023 N.J. Tax Unpub. LEXIS 16.

- *Lorillard Tobacco Company v. Director, Division of Taxation*, Docket Nos. A-3444-18, A-0002-19, Superior Court of New Jersey, Appellate Division. Decision Dated September 21, 2021, reported at 33 N.J. Tax 43.

- *Lorillard Tobacco Company v. Director, Division of Taxation*, Docket No. 008305-2007, Tax Court of New Jersey. Decision Dated and Entered February 27, 2019, reported at 31 N.J. Tax 153.

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New Jersey's corporate income tax regime disallowed otherwise deductible royalty payments made by a taxpayer to a related party, with the disallowed amount determined by the extent of the related party's New Jersey activity. The more activity the related party conducted in New Jersey, the smaller the disallowance and the greater the tax benefit (including no disallowance at all, *i.e.*, a 100 percent deduction is permitted, when the related party's activities in New Jersey exceed the taxpayer's own New Jersey activities). Conversely, the less activity the related party conducted in New Jersey, the greater the disallowance and the smaller the tax benefit (including full disallowance, *i.e.*, a 100 percent deduction denial, when the related party conducts all of its activities outside of New Jersey). New Jersey has acknowledged that this scheme incentivizes intrastate activity at the expense of interstate commerce but has not attempted to meet its burden to defend the discrimination. The result is a taxing scheme that not only discriminates against interstate commerce but also unconstitutionally indirectly taxes income earned outside New Jersey that has no connection to New Jersey.

This Court has made clear that the Commerce Clause prohibits states from enacting tax schemes that discriminate against or unduly burden interstate commerce. *See, e.g.*, *Oregon Waste Systems, Inc. v. Department of Environmental Quality*, 511 U.S. 93 (1994); *Fulton Corp. v. Faulkner*, 516 U.S. 325 (1996); *Comptroller of the Treasury of Maryland v. Wynne*, 575 U.S. 542 (2015). This Court has also made clear that the Due Process Clause requires both a minimal connection between a state and the transaction it seeks to tax, and a rational relationship between the tax imposed and the taxpayer's in-state activities. *See, e.g.*, *Hunt-Wesson, Inc. v. Franchise Tax Board*, 528 U.S. 458 (2000).

The decisions below uphold a state taxing scheme that does precisely what this Court's precedents forbid. By its own terms, New Jersey's tax imposes a heavier burden on interstate activity, results in double taxation of the same income stream, and reaches income with no connection to the state. This approach conflicts with this Court's precedents requiring that state taxes neither discriminate against interstate commerce nor extend beyond a state's legitimate taxing jurisdiction.

If left unreviewed, the decisions below will encourage, and provide a roadmap for, other states to adopt similar tax schemes. The issues presented are of great importance to multistate businesses, which face the prospect of disproportionately high and unconstitutional tax burdens as a result of such protectionist regimes, disadvantaging the interstate activities of these multistate businesses and advantaging intrastate commerce.

This case presents a critical, recurring question of federal constitutional law. Review is necessary to reaffirm the limits of state taxing power under the Commerce and Due Process Clauses and to ensure state tax schemes do not discriminate against interstate commerce in violation of this Court's precedents.

Petitioner, Lorillard, respectfully petitions for a writ of certiorari to review the Supreme Court of New Jersey's Order in this matter.

OPINIONS BELOW

The Superior Court of New Jersey, Appellate Division decision, 2025 N.J. Super. Unpub. LEXIS 699, is reproduced at App. 2-19. The Tax Court of New Jersey decision, 2023 N.J. Tax Unpub. LEXIS 16, is reproduced at App. 20-46. An earlier Superior Court of New Jersey, Appellate Division decision, 33 N.J. Tax 43, is reproduced at App. 47-65. An earlier Tax Court of New Jersey decision, 31 N.J. Tax 153, is reproduced at App. 66-91.

JURISDICTION

The Supreme Court of New Jersey entered its Order in this case denying Lorillard's petition for certification to that court and dismissing its notice of appeal on October 3, 2025.

This Court's jurisdiction is invoked pursuant to 28 U.S.C. § 1257(a). The Supreme Court of New Jersey's Order qualifies as a "[f]inal judgment or decree[]" within the meaning of that statute.

CONSTITUTIONAL, STATUTORY, AND REGULATORY PROVISIONS INVOLVED

The Commerce Clause, U.S. Const. art. I, § 8, cl. 3 is reproduced at App. 92.

The Due Process Clause, U.S. Const. Amend. XIV, Sec. 1, is reproduced at App. 93.

The relevant provisions of New Jersey's statutes and regulations, *i.e.*, N.J.S.A. § 54:10A-4.4(b) (2002), N.J.S.A.

§ 54:10A-4.4(c)(1)(b) (2002), N.J.A.C. 18:7-5.18(b)(3) (pre-2020), and N.J.A.C. 18:7-5.18(b)(3) (2020), are reproduced at App. 94-96.

STATEMENT OF THE CASE

A. Legal Background

Under New Jersey's Corporation Business Tax ("CBT"), every non-exempt corporation must pay a yearly franchise tax for the privilege of exercising a franchise or, for deriving receipts, having contacts, doing business, employing or owning capital or property, or maintaining an office in New Jersey. N.J.S.A. 54:10A-2. When a royalty payor and payee are unrelated, the payor fully deducts the payment from income, and the payee includes the amount in income. N.J.S.A. 54:10A-4(k); I.R.C. §§ 61(a), 162(a).

As part of the Business Tax Reform Act of 2002, the New Jersey legislature enacted N.J.S.A. 54:10A-4.4(b) (the "Addback Statute") which requires taxpayers, in calculating CBT liability, to "add back" to taxable income otherwise deductible royalties paid to a related party. The add back increases the tax a corporation would otherwise be required to pay. The Legislature explained that the Addback Statute was intended to address transactions where a multicorporate structure exports income from New Jersey as a form of expense. Assemb. Budget Comm. Statement to A. 2501 at 2 (June 27, 2002).

As relevant here, New Jersey law contains an exception to the Addback Statute when the taxpayer establishes that the adjustments are "unreasonable." N.J.S.A. 54:10A-4.4(c)(1)(b) (the "Unreasonable Exception"). The purpose of the

Unreasonable Exception is to avoid a corporation and its affiliate having to both pay tax on the same income stream. "Unreasonable" is undefined in the statute.

The Division promulgated the regulation at issue in this case, N.J.A.C. 18:7-5.18, which limited the Unreasonable Exception to apply only to "the extent that the payee pays tax to New Jersey on the income stream." N.J.A.C. 18:7-5.18(b)(3) (pre-2020) (the "Regulation"). The Division narrowed the Unreasonable Exception with its CBT form Schedule G-2, the use of which the Division identifies in the form's instructions as the sole method for claiming any exception to the Addback Statute on a CBT return, by mandating a wooden mathematical formula that provides only a partial exception if the royalty payee's New Jersey allocation factor is less than the royalty payor's factor.[1] Nonetheless, the purpose of the Unreasonable Exception was to "allow[] the deduction of costs if disallowance would be unreasonable since the payee paid tax to New Jersey on the same income stream." 35 N.J. Reg. 1573(a).

On April 8, 2020, the Division adopted an amendment (the "Amendment") to the Regulation that deleted the geographic limit, *i.e.*, it removed the language requiring a taxpayer to show "the extent that the payee pays tax to New Jersey on the income stream." N.J.A.C. 18:7-5.18(b)

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1. The multistate tax concept that the CBT law refers to as "allocation" (*i.e.*, how a corporation divides its income for tax purposes among the states in which it conducts business), this Court calls "apportionment." Inasmuch as this Petition focuses on Lorillard's U.S. constitutional arguments and the primary legal authorities are this Court's decisions, we refer to this concept as "apportionment," except when specifically referring to New Jersey's CBT allocation factor.

(3) (post-2020). The Amendment also added language, contrary to the Unreasonable Exception's text, requiring a taxpayer to establish *both* that an adjustment is "unreasonable" *and* that one of five other circumstances applies, including "[u]nfair duplicate taxation" or "[a]n unconstitutional result[.]" *Id*. The Amendment had an effective date of April 8, 2020 and, by its own terms, was to expire on October 5, 2020. 52 N.J.R. 1025(a). It contained no retroactivity provision, and the Division represented that it was intended to apply prospectively. Critically, Schedule G-2, the sole method for calculating the Unreasonable Exception, remained unchanged post 2020. The Amendment was later replaced by more permanent regulations that mirrored the Amendment and became effective in April 2021. 53 N.J.R 544(a) (Apr. 5, 2021).

B. Factual and Procedural Background

This case involves undisputed facts and Lorillard's challenge to the Division's assessment of CBT for tax years 2002–2005 and 2007–2010 ("Years at Issue"). The facts and the companies' names are discussed as they were during the Years at Issue.

Lorillard is a corporation organized under the laws of the State of Delaware and is based in Greensboro, North Carolina. Lorillard manufactures, markets, distributes, and sells cigarettes at wholesale throughout the United States, Puerto Rico, and various United States territories. R.79.[2]

2. Citation references to "R" followed by a number are to Lorillard's Appendix originally filed with the New Jersey Superior

Under a license agreement, Lorillard pays its subsidiary, Lorillard Licensing Company LLC ("Licensing"), royalties with respect to trademarks and other intellectual property that are owned by Licensing. Lorillard filed federal income tax returns and filed CBT returns in New Jersey for the Years at Issue. R.79, 662, 684.

Licensing is a North Carolina limited liability company that is based in Greensboro, North Carolina. Licensing elected to be taxed as a corporation for federal income tax purposes and, as such, paid income tax in North Carolina and other states during the Years at Issue. Licensing is the owner of various trademarks and intellectual property, which it manages, protects, and licenses to Lorillard and to a third party. R.81, 778.

Licensing had no physical presence in New Jersey, and the trademarks it licensed to Lorillard were applied by Lorillard at Lorillard's factory in North Carolina. Licensing did not initially file CBT returns for the tax years 2002-2005 as it had no physical presence in New Jersey, Lorillard had no stores in New Jersey, and those years preceded the Supreme Court of New Jersey's decision in *Lanco, Inc. v. Dir., Div. of Tax'n*, 188 N.J. 380 (2006), *cert.* denied, 551 U.S. 1131 (2007), which held that a taxable presence in New Jersey did not require physical presence when a licensee placed licensed trademarks on licensee's stores in New Jersey. After the Division asserted nexus and assessed tax on the royalties Licensing received from Lorillard, Licensing filed CBT returns and

Court, Appellate Division on March 14, 2024 and later filed with the Supreme Court of New Jersey on June 10, 2025.

paid CBT for the tax years 2002-2005 and 2007 under New Jersey's 2009 Tax Amnesty Program, though its nexus facts were distinguishable from *Lanco*. Licensing timely filed CBT returns and paid CBT for the tax years 2008-2010. R.81; *Lorillard Tobacco Co. v. Dir., Div. of Tax'n*, 31 N.J. Tax 153, 162 (Tax 2019).

For its part, Lorillard filed CBT returns for the Years at Issue, initially adding back all royalty deductions with respect to royalty payments to Licensing, which increased its CBT liability. *Id*. After Licensing filed the aforementioned CBT returns, Lorillard filed claims for refund of CBT paid for the Years at Issue, claiming the Unreasonable Exception applied in full because Licensing paid CBT on the same royalties. R.35-36, 83, 277, 364, 445, 559, 662, 684-685. The Division, however, limited the exception using Schedule G-2, which applied the exception only to the extent of Licensing's New Jersey allocation factor. *Lorillard Tobacco Co., supra.*, 31 N.J. Tax at 163. Lorillard's refund claims were denied, and it timely filed complaints in the Tax Court of New Jersey (the "Tax Court") for the Years at Issue. R.39, 83, 660-682, 685.

In a February 27, 2019 decision, the Tax Court found in favor of Lorillard on statutory grounds. *Lorillard Tobacco Co., supra.*, 31 N.J. Tax at 174. The Tax Court concluded that the Division's use of Schedule G-2 to limit the Unreasonable Exception was not a fair or reasonable exercise of discretion under the Addback Statute and held that Lorillard was entitled to the full amount of its refund claims. In light of the relief granted to Lorillard, the Tax Court found it unnecessary to address Lorillard's arguments that the Regulation and Schedule G-2 violated the U.S. Constitution. *Id*.

The Division appealed to the Superior Court of New Jersey, Appellate Division (the "Appellate Division"), and Lorillard cross-appealed with respect to its constitutional arguments that the Tax Court did not address. While the appeal was pending, the Division promulgated the Amendment but did not change Schedule G-2, which implemented the Unreasonable Exception the same way before and after the Amendment. R.695-98, 780-83.

On September 21, 2021, the Appellate Division issued its opinion, reversing the Tax Court's decision in favor of Lorillard on statutory and regulatory grounds. *Lorillard Tobacco Co. v. Dir., Div. of Tax'n*, 33 N.J. Tax 43, 48 2021 N.J. Super. Unpub. LEXIS 2212, *2 (App. Div. Sept. 21, 2021). However, inasmuch as the Appellate Division determined that the constitutional issues raised by Lorillard "require consideration" and that "[t]he Tax Court should decide them in the first instance," the Appellate Division "return[ed] the cases to the Tax Court for consideration of these issues." *Id.* at **59, *20. The Appellate Division also stated that it was unable to determine whether the Amendment rendered the constitutional issues moot. *Id.*

On September 13, 2023, the Tax Court issued its opinion on remand (the "Remand Decision") (1) finding that the Regulation's geographic limitation was unconstitutional but (2) determining that the Amendment applied retroactively to the Years at Issue and "cure[d] the constitutional concern." R.18. The Remand Decision ignored this Court's binding precedents in *Oregon Waste*, *Fulton*, and *Wynne*, and while it found that the Regulation was unconstitutional because it imposed a geographic limitation, the court declared the defect "cured" by the Amendment, despite the fact that the Division's methodology in calculating the Unreasonable Exception through Schedule G-2, based on the royalty recipient's allocation factor, remained unchanged.

The Remand Decision failed to analyze this Court's jurisprudence holding that state tax schemes that favor in-state activity over out-of-state activity are "virtually per se invalid," that the burden shifts to the taxing authority to justify the discrimination, and that states must then satisfy the "strictest scrutiny." The Remand Decision never held the Division to its burden.

Lorillard appealed from the Tax Court's Remand Decision to the Appellate Division, challenging both the retroactive application of the Amendment and the continued denial of a full refund, raising its constitutional arguments. R.1-14.

On April 29, 2025, the Appellate Division issued its decision, affirming the Tax Court's Remand Decision for substantially the same reasons set forth by the Tax Court ("Appellate Division's Decision on Constitutional Issues"). App. 2-19. Just like the Remand Decision, the Appellate Division's Decision on Constitutional Issues failed to analyze this Court's core cases regarding discrimination and did not hold the Division to its strict scrutiny burden. Indeed, the Appellate Division's Decision on Constitutional Issues failed to "comment on" Lorillard's argument that the Regulation and Schedule G-2 were facially discriminatory and adopted the Remand Decision's constitutional "analysis" wholesale. *Id*. Instead, the Appellate Division's Decision on Constitutional Issues focused only on the retroactivity question, affirming that the Amendment applied retroactively and "cured" the unconstitutionality of the Regulation, despite the Division's express intent that the Amendment applied prospectively and that there could not be a cure because the Division did not change its methodology in calculating the Unreasonable Exception. *Id*. The fact that the Division never changed its approach and simply kept discriminating against interstate commerce in the exact same manner that the Tax Court agreed was unconstitutional, even after amending its regulation, did not factor into either court's analysis.

Lorillard filed an appeal as of right pursuant to Article VI, Section V, paragraph 1(a) of the New Jersey Constitution (allowing appeals to the Supreme Court of New Jersey "[i]n causes determined by the appellate division of the Superior Court involving a question arising under the Constitution of the United States. . . .") and N.J. Ct. Rule 2:2-1(a)(1) (allowing appeals as of right to the Supreme Court of New Jersey "in cases determined by the Appellate Division involving a substantial question arising under the Constitution of the United States. . . .") from the Appellate Division's Decision on Constitutional Issues.

Though the case qualified for an appeal as of right, Lorillard also filed a Petition for Certification with the Supreme Court of New Jersey, arguing that the Division's actions in taxing Lorillard violated both New Jersey law (the Addback Statute and the Unreasonable Exception) and the U.S. Constitution.

On October 3, 2025, the Supreme Court of New Jersey issued the Order (1) denying Lorillard's Petition for Certification and (2) dismissing Lorillard's Notice of Appeal without any discussion. Lorillard now seeks this Court's review of the New Jersey courts' decisions in this matter. App. 1.

REASONS FOR GRANTING THE PETITION

The decisions of the New Jersey courts present a direct conflict with this Court's long-standing Commerce and Due Process Clause precedents. The courts below upheld a tax scheme that discriminates against interstate commerce and permits the taxation of out-of-state activities that have no connection to New Jersey. By permitting an addback only to the extent of the New Jersey activity of the royalty recipient and taxing the royalty income received by the royalty recipient using the royalty payor's apportionment factor, New Jersey's methodology incentivizes intrastate activity at the expense of interstate commerce and unconstitutionally taxes income beyond its borders, contradicting this Court's established jurisprudence.

This case presents the important and recurring question of the constitutional limits on state taxation of multistate businesses. The New Jersey scheme at issue, and the courts' approval of it, threaten to undermine the uniformity and predictability that are essential to the operation of interstate commerce. The decisions below, if left undisturbed, will encourage states to ignore this Court's precedents, engage in economic protectionism, discriminate against interstate and commerce, and adopt similar discriminatory tax schemes, increasing the risk of multiple taxation of the same income and inconsistent treatment for businesses operating across state lines.

The questions presented implicate not only the proper application of this Court's precedents, but also the broader constitutional framework that governs the relationship between state taxing authority and the national economy.

Moreover, this case is an ideal vehicle for resolving these critical issues. The relevant facts are undisputed, and the constitutional questions are cleanly presented. The stakes for multistate businesses, state tax administration, and the integrity of the Commerce and Due Process Clauses are significant. Only this Court can provide the definitive guidance necessary to ensure that state tax regimes do not impermissibly burden or discriminate against interstate commerce in violation of the Constitution.

For these reasons, and as set forth in detail below, the petition should be granted.

I. The Decision Below Directly Conflicts with This Court's Precedents Interpreting the Commerce and Due Process Clauses and is Incorrect

The New Jersey courts' decisions upholding the Division's methodology for calculating the Unreasonable Exception stand in direct conflict with this Court's established Commerce and Due Process Clause jurisprudence. This Court has repeatedly held that state tax regimes must not discriminate against interstate commerce or reach beyond a state's legitimate taxing authority. The decisions below disregard these fundamental limits, endorsing a regime that, both facially and in effect, burdens out-of-state activities and taxes out-of-state income in a manner this Court has consistently struck down in precedents like *Oregon Waste*, *Fulton*, *Wynne*, and *Hunt-Wesson*.

A. The Regulation and Schedule G-2 Unconstitutionally Discriminate Against Interstate Commerce

The Commerce Clause prohibits states from enacting tax schemes that discriminate against interstate commerce, either on their face or in practical effect. This principle is not only articulated in *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977) but is also the central holding of several of this Court's more recent decisions that discrimination will not be tolerated.

The Division's methodology, through its use of the Regulation that limits the Unreasonable Exception to the extent that the recipient pays tax in New Jersey and Schedule G-2 that further limits the Unreasonable Exception to the relative allocation factor of the recipient in New Jersey, unconstitutionally discriminates against interstate commerce.

While Lorillard sought to deduct its royalty payments to Licensing via its refund claims, the Division insisted on using the geographic restriction contained in Schedule G-2 in calculating the Unreasonable Exception. This Court has explained that "the first step in analyzing any law subject to judicial scrutiny under the negative Commerce Clause is to determine whether it regulates evenhandedly with only incidental effects on interstate commerce or discriminates against interstate commerce." *Or. Waste Sys., Inc. v. Dep't of Env't. Quality*, 511 U.S. 93, 99 (1994) (internal quotation marks omitted) (*quoting Hughes v. Oklahoma*, 441 U.S. 322, 336 (1979)). Moreover, "'discrimination' simply means differential treatment of in-state and out-of-state economic interests that benefits the former and burdens the latter." *Id*. Further, when discriminatory, the State has the burden of proving that the challenged regulation advances a legitimate local purpose and there is no non-discriminatory alternative. *Id*. at 100-01.

A law "facially discriminates" against interstate commerce if it "tax[es] a transaction or incident more heavily when it crosses state lines than when it occurs entirely within the State." *Chem. Waste Mgmt., Inc. v. Hunt*, 504 U.S. 334, 342 (1992) (*quoting Armco Inc. v. Hardesty*, 467 U.S. 638, 642 (1984)).

Here, the Regulation limits the Unreasonable Exception to the Addback Statute solely to "the extent that the payee pays tax *to New Jersey* on the income stream." N.J.A.C. 18:7-5.18(b)(3) (emphasis added). The Division's Schedule G-2 calculates the Unreasonable Exception to the extent of payee's allocation factor in New Jersey—its relative level of business activity in New Jersey. Therefore, the Regulation and Schedule G-2 discriminate against interstate commerce on their faces because they contain a geographic limit: the exception applies (*i.e.*, a deduction is allowed) if, and only to the extent, the royalty is paid to a New Jersey taxpayer, and then only to the extent that taxpayer allocates income to New Jersey.

Indeed, *the Division has conceded that the Regulation and Schedule G-2 are facially discriminatory* by acknowledging that "[w]hen subsidiary's New Jersey presence increases, parent benefits, thus incentivizing New Jersey activity to the detriment of interstate commerce." App. 98. This critical admission is fatal to the Division's case, yet the New Jersey courts ignored it.

Moreover, the Division's methodology in calculating the Unreasonable Exception results in "differential treatment of in-state and out-of-state economic interests that benefits the former and burdens the latter." *Or. Waste*, 511 U.S. at 99. For example, compare the tax results in the following two scenarios.

In the first scenario, the related member royalty payee operates only in New Jersey and has a 100% CBT allocation factor. In the second scenario, the royalty payee operates in both New Jersey and Pennsylvania and allocates 50% of its income to each state. The payor in the first scenario is entitled to a full Unreasonable Exception under the Regulation and Schedule G-2, while the payor in the second scenario is entitled only to a partial Unreasonable Exception. The only factual difference, resulting in the higher tax burden in the second scenario, is that the payee is operating in interstate commerce and pays tax to Pennsylvania and New Jersey, not just to New Jersey. The payor in the first scenario benefits from the payee operating only in New Jersey, and the payor in the second scenario is burdened by the payee operating in interstate commerce (Pennsylvania as well as New Jersey).

In this case, Licensing's allocation factor for the tax years at issue was less than Lorillard's (*i.e.*, Lorillard conducted more activities in New Jersey than Licensing did). Because Licensing's allocation factor was less than Lorillard's allocation factor, the Division denied a portion of Lorillard's otherwise deductible royalty expense deductions. If Licensing engaged in more New Jersey activity (at least as much as Lorillard), the Division would not have denied any portion of Lorillard's royalty expense deductions (*i.e.*, Lorillard would have been permitted to deduct 100 percent of its royalty payments to Licensing). Lorillard was unconstitutionally burdened because Licensing engaged in more interstate commerce than New Jersey would have preferred.

The unconstitutional provision at issue in *Fulton* is functionally identical to the Regulation and Schedule G-2 inasmuch as the amount of the tax benefit provided to a shareholder (there, a deduction from North Carolina's intangibles tax) was determined by reference to the apportionment percentage in North Carolina of the corporation in which it owned stock. *Fulton Corp. v. Faulkner*, 516 U.S. 325, 327-28 (1996). Specifically, North Carolina imposed an intangibles tax on resident shareholders' stock but granted a deduction tied directly to the issuer's North Carolina apportionment percentage. The less business the corporation conducted in North Carolina, the smaller the deduction and the higher the shareholder's tax; if the issuer had no North Carolina activity, the shareholder received no deduction and paid the full tax. Conversely, as the corporation's North Carolina activity increased, the shareholder's deduction increased and the intangibles tax decreased—reaching a 100 percent deduction when the corporation conducted all of its business in the State. This structure made the shareholder's tax liability inversely proportional to the issuer's in-State activity and, as this Court held, the scheme facially discriminated against interstate commerce.

Here, the Regulation and Schedule G-2 provide a deduction for the royalty payor tied directly to the royalty payee's New Jersey apportionment percentage. The less business the royalty payee conducts in North Jersey, the smaller the deduction for the royalty payor and the higher the royalty payor's tax; if the royalty payee has no New Jersey activity, the royalty payor receives no deduction and pays tax on 100 percent of the royalties. Conversely, as the royalty payee's New Jersey activity increases, the royalty payor's deduction increases and the tax on the royalties decreases—reaching a 100 percent deduction when the royalty payee conducts all of its business in New Jersey. The tax scheme in the Regulation and Schedule G-2 is functionally identical to the tax scheme that this Court struck down in *Fulton*. Like the unconstitutional geographic limit that was struck down by this Court in *Fulton*, the unconstitutional geographic limit in the Regulation and Schedule G-2 should likewise be struck down here.

The Regulation and Schedule G-2 are also similar to the unconstitutional provision in *Oregon Waste Systems*. There, a higher tax burden was imposed on waste produced outside of Oregon than waste produced inside of Oregon. *Or. Waste Sys.*, 511 U.S. at 96. Here, application of the Regulation and Schedule G-2 results in a higher tax burden on companies paying royalties to related members producing income outside of New Jersey than related members producing income inside of New Jersey.

Despite Lorillard raising *Fulton* and *Oregon Waste* in briefing and at oral argument at both levels, neither the Tax Court nor the Appellate Division ever even addressed this Court's binding precedents in their respective decisions. Had they done an analysis under those cases, they would have come to the inescapable conclusion that the Division's methodology using the geographically limited Regulation and Schedule G-2 was discriminatory.

The Tax Court and the Appellate Division erred in finding neither facial discrimination nor discriminatory impact. The Tax Court contradicted itself by finding no facial discrimination yet describing the Regulation as containing an unconstitutional geographic limit. App. 34, 39-41. And the Appellate Division adopted this flawed analysis wholesale. An unconstitutional geographic limit in a regulation's text is the essence of facial discrimination. Moreover, both courts ignored that New Jersey's taxing scheme engages in economic protectionism favoring intrastate activity over interstate activity. As this Court held in *Comptroller of the Treasury of Md. v. Wynne*, 575 U.S. 542, 545 (2015), a tax scheme that "creates an incentive for taxpayers to opt for intrastate rather than interstate economic activity" is discriminatory and has the same economic effect as a tariff—"the quintessential evil targeted by the dormant Commerce Clause." *Id.*

The fact that the Regulation and Schedule G-2 treat New Jersey domiciled payors and non-New Jersey domiciled payors the same in determining their Unreasonable Exception is irrelevant because the extent of the Unreasonable Exception permitted to either payor is not determined by reference to their own activities. Instead, it is determined solely by reference to the level of activities in New Jersey by the payees. Therefore, the relevant comparison is between two payors (wherever domiciled), one that pays royalties to a payee with a substantial amount of activities in New Jersey and one that pays royalties to a payee with less activity in New Jersey. It is clear that the Regulation and Schedule G-2 impermissibly favor the payor that pays royalties to a payee with a substantial amount of activities in New Jersey over the payor who pays royalties to the payee with less activity in New Jersey.

In addition to disregarding this Court's binding precedents, both the Tax Court and the Appellate Division failed to address the examples presented above which illustrate how the Division's methodology acts to impermissibly incentivize intrastate activity. The Division's methodology, via the Regulation and Schedule G-2, results in unconstitutional discrimination against Lorillard inasmuch as it results in a higher tax burden on Lorillard based solely on the fact that Licensing operates in interstate commerce. Further, the fact that the Schedule G-2 remained unchanged after the effective date of the Amendment means that the unconstitutional discrimination described above persisted, and the constitutional infirmity found to exist by the Tax Court and the Appellate Division was not cured, even if the Amendment applies retroactively to the Years at Issue.

Given that Lorillard has established discrimination (the Regulation and Schedule G-2 do not permit an Unreasonable Exception for those taxpayers that pay affiliates that pay tax in any other jurisdiction), the Division had the heavy burden of proving that: (1) the Regulation and Schedule G-2 advance a legitimate local purpose; and (2) there is no non-discriminatory alternative. The Division has *never* attempted to do so, and the New Jersey Courts have not required the Division to satisfy its burden. The Regulation and Schedule G-2 "must be invalidated unless [the Division] can show that [they] advance[] a legitimate local purpose that cannot be adequately served by reasonable nondiscriminatory alternatives. . . . [The] burden of justification is so heavy that facial discrimination by itself may be a fatal defect." *Or. Waste Sys.*, 511 U.S. at 100-101 (internal citations and quotations omitted); *confirmed by Camps Newfound/*

Owatonna v. Town of Harrison, Me., 520 U.S. 564, 582 (1997) ("Perhaps realizing the weight of its burden, the Town has made no effort to defend the statute under the *per se* rule, and so we do not address this question."). Even if the Division had attempted to defend its methodology under the strict scrutiny standard required for facially discriminatory tax schemes, it would not withstand such scrutiny. There is no evidence that less discriminatory alternatives—such as a methodology that does not condition the Unreasonable Exception on geographic location—would be inadequate to serve a legitimate state interest. *Or. Waste*, 511 U.S. at 100-101; *Hughes*, 441 U.S. at 336-337.

Here, Licensing pays tax to New Jersey and to other states on its royalty income stream, yet the Regulation considers only the taxes paid to New Jersey, and Schedule G-2 further limits the Unreasonable Exception to the extent of the payee's allocation factor in New Jersey. Such geographic limitations violate the principles of antidiscrimination. *See Fulton*, 516 U.S. at 327 (1996) (finding tax forcing shareholders in out-of-state corporations to pay tax on a higher share of value than shareholders of corporations operating solely in North Carolina to be unconstitutionally discriminatory).

The Appellate Division discounted Lorillard's argument that even if the Amendment applied retroactively, Schedule G-2's geographic restriction remained and the Division's method never changes and was at all times to the present unconstitutional. The Appellate Division agreed with the Tax Court that the Division's methodology in calculating the Unreasonable Exception was constitutional because "the Division offered taxpayers an opportunity to seek additional deductions, albeit as a separate refund claim on a separate form." App. 45. However, this reasoning ignores that Schedule G-2 *is the only way* a taxpayer may seek to claim the Unreasonable Exception. App. 29. That other refund claims may be made claiming an addback exception for other reasons is irrelevant to this matter. The Division's unconstitutional methodology for calculating the Unreasonable Exception is not cured because the Division may, in theory, also consider some other reasons for permitting an exception to the Addback Statute. The Division's unconstitutional approach in practice, which was generally applicable to all taxpayers, including Lorillard, and which never changed, cannot be cured because the Division later says it may also be willing to consider other approaches that are constitutional if pressed by a specific taxpayer in a particular case to do so.

Finally, the Appellate Division found that the Tax Court "engaged in a form of 'judicial surgery' to preserve the regulatory scheme" by removing the geographic limitation from the Regulation, even if the Amendment did not achieve that result. App. 17-18. Leaving aside that the Tax Court did not purport to engage in judicial surgery, such surgery would not have been successful because the discriminatory geographic limit in Schedule G-2 and the Division's discriminatory method in calculating the Unreasonable Exception remained *unchanged*.

This Court has made clear that state tax regimes cannot impose greater burdens on interstate commerce than on intrastate commerce. The Supreme Court of New Jersey's Order upholding the Division's methodology in calculating the Addback Exception is irreconcilable with this Court's precedents, as it sanctions a system that facially and functionally discriminates against interstate business activity and encourages states to engage in economic protectionism.[3]

B. The Division's Methodology Indirectly Taxes the Out-of-State Activities of Licensing that New Jersey Cannot Tax Directly

The Division's methodology in implementing the Unreasonable Exception also operates as an impermissible indirect tax on out-of-state activity with no connection to New Jersey that New Jersey cannot tax directly and which is prohibited by this Court. *See, e.g.*, *Hunt-Wesson, Inc. v. Franchise Tax Bd. of Cal.*, 528 U.S. 458 (2000).

In *Hunt-Wesson*, this Court held that a state cannot indirectly tax activity that it cannot tax directly. *Id.* at 460, 463-64. The *Hunt-Wesson* Court rejected California's interest expense deduction limit. *Id.* at 460. Under the California law at issue in *Hunt-Wesson*, a multistate

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3. Earlier this year, this Court denied certiorari in two cases stemming from the same New York State Court of Appeals decision involving New York's addback statute, which differs from New Jersey's. *See International Business Machines Corporation & Combined Affiliates v. New York Tax Appeals Tribunal, et al.*, Docket No. 24-332 and *The Walt Disney Company v. New York Tax Appeals Tribunal, et al.*, Docket No. 24-333. Unlike New York's addback statute, which ensured the royalty stream was taxed on only one side of the related-party transaction but not both, New Jersey's scheme simultaneously taxes the same royalty income at the payor level (via addback) *and* at the payee level (by imposing CBT on the receipts). New Jersey's scheme produces the double taxation of a single income stream that New York's framework avoided. New York wanted to have its cake. New Jersey wants to have its cake and eat it too.

corporation could deduct its interest expense, but the amount of interest expense that could be deducted from California unitary income was limited to the amount by which the interest expense exceeded interest and dividend income that the corporation received from a nonunitary business or investment (*i.e.*, income that California could not tax). *Id*. at 461. So, if a corporation had $150,000 in interest expense and it received $100,000 in dividend income from a nonunitary subsidiary (which dividend California could not directly tax), the corporation could deduct only $50,000, notwithstanding that it had $150,000 in total interest expense. *Id*. at 461-62.

This Court concluded that California's interest expense deduction limit was an impermissible indirect tax on activity that California otherwise was prohibited from taxing under the U.S. Constitution. *Id*. at 460, 463-64, 468. This Court explained that "[u]nder our precedent, this 'nonunitary' income may not constitutionally be taxed by a State other than the corporation's domicile," and although "California's statute does not directly impose a tax on nonunitary income[,] . . . it simply denies the taxpayer use of a portion of a deduction from unitary income . . . , income which does bear a 'rational relationship' or 'nexus' to California." *Id*. at 464. In so doing, California imposed a tax upon constitutionally protected nonunitary income. *Id*. at 466. Here, while New Jersey is permitted to tax the royalty income received by Licensing, it may do so only to the extent of Licensing's allocation factor. New Jersey's method impermissibly taxes the royalty income received by Licensing using *Lorillard's* allocation factor.

By denying the deduction to Lorillard for amounts for which Licensing did not pay New Jersey tax, New Jersey is attempting to tax Licensing's income earned outside New Jersey's borders because the deduction limit corresponds to amounts that New Jersey could not tax. If a payee such as Licensing has 100% of its activity in New Jersey, then a payor such as Lorillard would receive a 100% royalty deduction. However, if payee Licensing moves 50% of its business to Pennsylvania, then New Jersey can tax 50% of its activity and the 50% that it cannot tax will be indirectly taxed by New Jersey as a denied deduction for payor Lorillard. Here, Licensing's New Jersey allocation factors for the tax years at issue were less than Lorillard's allocation factors. As Licensing's allocation factors were lower than Lorillard's, the Division's methodology indirectly taxes a portion of Licensing's income that exceeds the amount of Licensing's New Jersey income as determined using its own allocation factor (*i.e.*, the percentage of Licensing's income that the Division seeks to tax is the sum of Licensing's own allocation percentage plus the percentage difference between Licensing's and Lorillard's allocation factors). Based on its methodology in calculating the Unreasonable Exception, the Division is taxing income of Licensing it could not have otherwise taxed. This is the functional equivalent of the limit struck down in *Hunt-Wesson*.

This Court explained in *Hunt-Wesson* that "a 'tax on sleeping measured by the number of pairs of shoes you have in your closet is a tax on shoes.'" *Hunt-Wesson*, 528 U.S. at 464 (*quoting Trinova Corp. v. Mich. Dep't of Treasury*, 498 U.S. 358, 374 (1991)). Here, a tax increase on Lorillard measured by the portion of Licensing's income that New Jersey cannot constitutionally tax or a tax benefit for Lorillard limited by the portion of Licensing's income that New Jersey can tax is an unconstitutional indirect tax on Licensing.

Given that the Division does not dispute the accuracy or reasonableness of Licensing's CBT allocation factor, New Jersey may not constitutionally impose any additional CBT on Licensing. Therefore, the Division cannot assert that Lorillard must pay CBT on those amounts upon which New Jersey cannot tax Licensing. As in *Hunt-Wesson*, this results in an impermissible and unconstitutional indirect tax because the Division's methodology taxes income outside of New Jersey's jurisdictional reach directly in conflict with this Court's precedents.

II. The Questions Presented Implicate the Constitutional Limits on State Taxation of Multistate Businesses and the Proper Application of This Court's Precedent and are of Great Public Importance

The questions presented in this case go to the heart of the constitutional framework and anti-protectionism that govern state taxation of multistate businesses. The Commerce Clause and the Due Process Clause together establish critical boundaries on the power of individual states to tax entities engaged in interstate commerce.

Multistate businesses depend on a stable and predictable legal environment in which to operate—and one that is free of economic protectionism via discrimination. The Constitution's restrictions on state taxation are designed to ensure that no state can erect barriers to interstate commerce or impose tax burdens that reach beyond its borders. When a state, such as New Jersey, adopts a tax regime that singles out interstate transactions for unfavorable treatment or attributes out-of-state income to itself, it undermines the uniformity and fairness that the Commerce Clause and Due Process Clause are intended to protect.

This Court's precedents—including *Complete Auto*, *Oregon Waste Systems*, *Fulton*, *Wynne*, and *Hunt-Wesson*—provide a well-defined framework for evaluating the constitutionality of state tax schemes. The questions presented here directly implicate whether courts will be required to apply that framework, or whether states will be permitted to circumvent constitutional limits through tax mechanisms that discriminate against or overreach into interstate commerce.

The issues raised by this case are not confined to New Jersey. Many states seek to expand their taxing authority beyond constitutional bounds.[4] If the decisions below are allowed to stand, they will serve as a blueprint for other states to enact comparable protectionist measures, leading to a patchwork of inconsistent and burdensome tax rules that threaten the free flow of commerce across state lines and encouraging a race to the bottom for states seeking to engage in economic protectionism.

Given the significant and recurring nature of these constitutional questions, it is imperative that this Court provide clear guidance. Only this Court can ensure that the constitutional limits on state taxation are uniformly

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4. *See*, *e.g.*, *Dep't of Tax'n v. FJ Mgmt., Inc.*, 82 Va. App. 498 (Ct. App. Va. 2024) (Virginia's attempt to unconstitutionally tax non-unitary income); *In the Matter of the Application of Edward and Doris Zelinsky*, Case No. 25-CV-1156, currently pending before the New York Supreme Court, Appellate Division (New York's attempt to tax income earned exclusively while taxpayer was working out-of-state).

and properly enforced, and that states do not erode the protections that the Commerce Clause and Due Process Clause afford to interstate commerce.

The questions presented have far-reaching implications for the structure of state taxation, the rights of multistate businesses, and the health of the national economy and are of great public importance.

III. This Case is an Ideal Vehicle to Resolve the Issues

This case presents an ideal vehicle for the Court to address the constitutional limits on state taxation of multistate businesses and the proper application of this Court's precedent. The relevant facts are undisputed and have been fully developed in the record, allowing the Court to focus squarely on the legal questions presented. The case directly raises the core constitutional issues regarding the reach of state taxing authority and the risk of discriminatory or extraterritorial taxation, as well as the proper interpretation and application of this Court's Commerce Clause and Due Process jurisprudence.

Moreover, the state tax regime at issue is representative of a broader trend among states to expand their taxing power over interstate businesses.[5] The legal questions are cleanly presented, and there are no procedural obstacles that would prevent the Court from reaching the merits. As a result, this case provides an ideal vehicle for the Court to clarify the constitutional boundaries that govern state taxation of multistate businesses and to provide much-needed guidance to states, taxpayers, and courts nationwide.

5. *See*, *e.g.*, Footnote 4, *supra*.

CONCLUSION

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

Respectfully submitted,

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December 24, 2025

APPENDIX

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APPENDIX A — ORDER OF THE SUPREME COURT OF NEW JERSEY, FILED OCTOBER 3, 2025

SUPREME COURT OF NEW JERSEY

C-96 September Term 2025
090721

LORILLARD TOBACCO COMPANY,

Plaintiff-Petitioner,

v.

DIRECTOR, DIVISION OF TAXATION,

Defendant-Respondent.

ORDER

A petition for certification of the judgment in A-0595/0596-23 having been submitted to this Court, and the Court having considered the same;

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

ORDERED that the notice of appeal is dismissed.

WITNESS, the Honorable Stuart Rabner, Chief Justice, at Trenton, this 30th day of September, 2025.

/s/
CLERK OF THE SUPREME COURT

APPENDIX B — OPINION OF THE SUPERIOR COURT OF NEW JERSEY, APPELLATE DIVISION, FILED APRIL 29, 2025

SUPERIOR COURT OF NEW JERSEY,
APPELLATE DIVISION

DOCKET NOS. A-0595-23, A-0596-23

LORILLARD TOBACCO COMPANY,

Plaintiff-Appellant,

v.

DIRECTOR, DIVISION OF TAXATION,

Defendant-Respondent.

Argued March 5, 2025—Decided April 29, 2025

OPINION

On appeal from the Tax Court of New Jersey, Docket Nos. 8305-2007 and 14043-2012.

Before Judges Sabatino, Gummer, and Jablonski.

PER CURIAM

In these consolidated cases, plaintiff Lorillard Tobacco Company ("Lorillard") appeals the Tax Court's September 13, 2023 decision adjudicating its long-standing dispute with the New Jersey Division of Taxation concerning Lorillard's request for a refund for the years 1999 through 2004.

Lorillard contends the Tax Court erred with respect to its challenges to a regulation, N.J.A.C. 18:7-5.18(b)(3), which implements the Corporation Business Tax ("CBT") Act, N.J.S.A. 54:10A-1 to -41. The regulation was amended in 2020, apparently as the result of the present litigation. The Tax Court concluded that, although the pre-2020 version of the regulation violated the Dormant Commerce Clause of the United States Constitution, the 2020 amendment is a curative enactment that retroactively resolved the constitutional defect and applies to the tax years at issue.

We affirm, substantially for the sound reasons set forth in the written opinion of Presiding Tax Court Judge Mala Sundar. We amplify the judge's decision in our discussion that follows.

I.

The facts and lengthy procedural history are well known to the parties and detailed at length in previous opinions.[1] We incorporate by reference that background.

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1. *See Lorillard Tobacco Co. v. Dir., Div. of Tax'n* (*Lorillard III*), 33 N.J. Tax 43 (App. Div. 2021); *Lorillard Tobacco Co. v. Dir., Div. of Tax'n* (*Lorillard II*), 31 N.J. Tax 153 (Tax 2019); *Lorillard Licensing Co., LLC v. Dir., Div. of Tax'n* (*Lorillard I*), 28 N.J. Tax 590 (Tax 2014), *aff'd*, 29 N.J. Tax 275, 277-78 (App. Div. 2015). These case-numbering designations differ somewhat from those used by the trial court and in the parties' briefs.

Succinctly stated, this dispute concerns royalties that Lorillard paid to an affiliated company, Lorillard Licensing Co. ("Licensing"), during the tax years at issue and whether those royalty payments were properly deducted in calculating Lorillard's liability to New Jersey for CBT taxes or instead should have been "added back" to Lorillard's taxable income.

Lorillard is incorporated in Delaware and based in North Carolina. During the years at issue, Lorillard manufactured, marketed, and distributed cigarettes wholesale throughout the United States, including in New Jersey. Lorillard had no offices, employees, nor bank accounts in this state. *Lorillard Licensing Co. v. Dir., Div. of Tax'n* (*Licensing*), 29 N.J. Tax 275, 277 (App. Div. 2015). In December 1999, Lorillard entered into an agreement with Licensing, a North Carolina company with no physical presence in New Jersey. Lorillard paid Licensing royalties for trademarks and other intellectual property. *Lorillard III*, 33 N.J. Tax at 48.

The Business Tax Reform Act and Its Treatment of Royalties

On July 2, 2002, the Legislature enacted the Business Tax Reform Act ("BTRA"), *L.* 2002, *c.* 40, which amended the CBT Act. *A.H. Robins Co. v. Dir., Div. of Tax'n*, 365 N.J. Super. 472, 480-81 (App. Div. 2004). One of its provisions at the time, the "add-back" statute, *L.* 2002, *c.* 40, § 5 (codified at N.J.S.A. 54:10-4.4 but repealed effective July 3, 2023, by *L.* 2023, *c.* 96, § 14), required Lorillard to add back to its income any royalty payments it had made to a related member such as Licensing. *Lorillard III*, 33 N.J. Tax at 49. In particular, the add-back statute provided:

> For purposes of computing its entire net income [ENI] under section 4 of P.L. 1945, c. 162 (C.54:10A-4), a taxpayer *shall add back otherwise deductible interest expenses and costs* and intangible expenses and costs directly or indirectly paid, accrued or incurred to, or in connection directly or indirectly with one or more direct or indirect transactions with, one or more related members.

[N.J.S.A. 54:10A-4.4(b) (emphasis added).]

According to N.J.S.A. 54:10A-4.4(a)(3), royalties were deemed "intangible expenses." However, a taxpayer was not required to add back royalty payments if the taxpayer could establish that the add-back amount was "unreasonable" or if the taxpayer and the Division agreed to an alternative method of apportionment. N.J.S.A. 54:10A-4.4(c).

Because New Jersey is a "separate entity" state, an affiliate that received royalties was also required to pay tax on that income. To avoid double taxation in which the corporation and the affiliate would each pay tax on the same royalties, the Legislature provided that a taxpayer could claim an exception to the add-back statute on the ground that it was unreasonable (the "unreasonableness exception"). However, the Legislature did not define what was considered unreasonable. *Lorillard III*, 33 N.J. Tax at 56; N.J.S.A. 54:10A-4.4(c).

The Key Regulation in this Case: N.J.A.C. 18:7-5.18

The Division promulgated the regulation at the heart of this case, N.J.A.C. 18:7-5.18, to provide guidance to taxpayers as to what would qualify for the unreasonableness exception for both the payment of interest and the payment of royalties to a related entity. A basis for claiming the unreasonableness exception specifically with respect to royalties was codified in N.J.A.C. 18:7-5.18(b)(3). That provision instructed, before the regulation's 2020 amendment, that the Division should permit a taxpayer to take a deduction "[i]f the taxpayer establishes that the adjustments are unreasonable *by showing the extent that the payee [the company that received the royalties] pays tax to New Jersey on the income stream.*" (Emphasis added).

CBT Schedule G-2

When the Division adopted N.J.A.C. 18:7-5.18(b)(3), it also created CBT Schedule G-2. 35 N.J.R. 1573(a) (Apr. 7, 2003). Schedule G-2 provided a formula to calculate the amount a taxpayer's royalty payment qualified for deductibility under the unreasonableness exception. An "allocation factor" was calculated for both the payor of royalties and the payee, based on each corporation's in-state sales, payroll, and property. *Morgan Stanley & Co. v. Dir., Div. of Tax'n*, 28 N.J. Tax 197, 211 (Tax 2014). A formula applied to the allocation factors of the payor and the payee determined the amount to be deducted under the unreasonableness exception.

Schedule G-2 also noted the following separate avenue for relief regarding other exceptions that could not be claimed on that Schedule:

> *A separate Refund Claim* (Form A-3730) stipulating all the facts and providing all applicable evidence to support the taxpayer's claim, *must be submitted in order to request any other exception.*

[(Emphasis added).]

The Division's Interactions with Lorillard and Licensing

In September 2006, the Division assessed Licensing and determined that it owed $24,251,739 in unpaid CBT for the years 1999 through 2004. To arrive at this determination, the Division had included in the liability of Licensing the royalties that it received from Lorillard.

Licensing responded that it had no nexus with New Jersey and did not owe CBT. *Licensing*, 29 N.J. Tax at 276. Licensing also filed a complaint in the Tax Court in November 2006. In that case, we subsequently affirmed the Tax Court's decision that the Division had no right to royalties that Licensing had received for sales in other states. *Id.* at 280.

Meanwhile, in light of the Division's assessment of Licensing, in February 2007, Lorillard filed an amended CBT return seeking a refund in the amount of $4,297,701 for CBT attributable to royalties it had paid to Licensing from 2002 to 2005. Lorillard claimed refunds pursuant to the unreasonableness exception as follows: for 2002, $1.25 million; for 2003, $1.09 million; for 2004, $976,352; and for 2005, $982,664. The Division denied Lorillard's refund request.

Thereafter, in 2007 the complaint was filed in *Lorillard I. Lorillard III*, 33 N.J. Tax at 49. Among other things, Lorillard asserted it would be unfair to tax Licensing and Lorillard for the same royalties. According to Lorillard, in 2002, it had paid taxes in North Carolina and Iowa; in 2003, it paid income taxes in those states as well as Oklahoma and South Carolina; in 2004, Lorillard also paid income taxes in those four states, as well as Florida and Massachusetts. *Licensing*, 29 N.J. Tax at 278.

In 2009, Licensing filed CBT returns and paid CBT under the 2009 Amnesty Program for years 1999 through 2004. *Lorillard III*, 33 N.J. Tax at 49. Thereafter, in 2010, the Division issued a partial refund to Lorillard in the amount of $1,495,424, based on the amount of CBT paid by Licensing. *Ibid.* The Division paid a partial refund because Licensing's allocation factor was lower than Lorillard's for those years, resulting in a lesser CBT payment for Licensing than what Lorillard owed in CBT taxes.

The Morgan Stanley Decision

Meanwhile, in a separate case involving another taxpayer, the Tax Court in 2014 decided *Morgan Stanley*, 28 N.J. Tax at 216-21, and analyzed the meaning of the unreasonableness exception with respect to the interest add-back provision in N.J.S.A. 54:10A-4, as well as the legislative history of the BTRA. The court in *Morgan Stanley* found that the Director of the Division had abused his discretion in applying the unreasonableness exception with respect to adding back interest payments to a taxpayer's income. *Id.* at 225-26.

Subsequent Developments

Turning back to the present matter involving Lorillard, in February 2019, the Tax Court held that Lorillard was entitled to the full amount of its refund claim for the years 2002-2005. However, the court did not reach Lorillard's argument that N.J.A.C. 18:7-5.18(b)(3) violated the Commerce Clause. *Lorillard II*, 31 N.J. Tax at 174. The Division appealed, and Lorillard cross-appealed.

In July 2019, the Tax Court ordered that Lorillard was entitled to its full refund request for the years 2007 through 2010. Again, the court did not address the question as to whether N.J.A.C. 18:7-5.18(b)(3) was unconstitutional. The Division appealed. Lorillard cross-appealed, again seeking a resolution of its constitutional arguments. The appeals were consolidated.

The 2020 Amendment of N.J.A.C. 18:7-5.18

While the appeals from the 2017 and 2019 Tax Court decisions were pending – and most significantly for the present appeal – the Division amended N.J.A.C. 18:7-5.18 in 2020. The amendment adopted nearly the exact language the Tax Court had used in *Morgan Stanley*. 52

N.J.R. 1025(a) (May 4, 2020).

The Division declared that the 2020 amendment pertained to both interest *and* royalty deductions and was enacted, in part, to comply with case law cited in *Morgan Stanley*. 52 N.J.R. 1991(a) (Nov. 2, 2020). To that end, the 2020 amendment omitted the previous language in the regulation that had pertained to an "income stream" in New Jersey. Instead, the revised regulation stated that an unreasonableness exception would be permitted:

> If the taxpayer establishes, to the satisfaction of the Director, that the adjustments are unreasonable by clear and convincing evidence, and any one of the following circumstances applies:
>
> i. Unfair duplicate taxation;
>
> ii. A technical failure to qualify the transactions under the statutory exceptions;
>
> iii. An inability or impediment to meet the requirements due to legal or financial constraints;
>
> iv. An unconstitutional result; or
>
> v. The transaction is equivalent to an unrelated loan transaction. . . .

[N.J.A.C. 18:7-5.18(b)(3).]

The 2020 amendment also contained illustrative examples of how the unreasonableness exception should be applied. N.J.A.C. 18:7-5.18(d).

The amended regulation was thereafter replaced by more permanent regulations that mirrored the 2020 amendment and became effective in April 2021. 53 N.J.R. 544(a) (Apr. 5, 2021). However, notwithstanding the 2020 amendment, Part II, Exception 2 of Schedule G-2 was not amended and continued to limit the payor's deduction to the amount of CBT paid by the affiliated payee.

Our 2021 Remand to the Tax Court

On September 21, 2021, we reversed the Tax Court's decisions in part and remanded for that court to consider the constitutional question, in light of the 2020 amendment. *Lorillard III*, 33 N.J. Tax at 59.

After further briefing, the Tax Court issued on September 13, 2023 its remand determination. It ruled that N.J.A.C. 18:7-5.18(b)(3), as it existed prior to the 2020 amendment, violated the Dormant Commerce Clause in transgressing principles of "fair apportionment" and "external consistency." The court found the old regulation was flawed because it "did not permit a payor the option to show that there was out-of-state(s) multiple taxation of the royalties received by Licensing from [Lorillard] from New Jersey-based sales." The court held the old regulation violated the constitution by "denying [Lorillard] a deduction of the amount of royalties paid to Licensing without consideration of [whether] those same amounts were reported/taxed elsewhere."

The Tax Court found, however, that the 2020 amendment cured the constitutional problem. Therefore, the Tax Court held that the 2020 amendment should be applied retroactively to Lorillard's refund requests, and it dismissed both of Lorillard's complaints. *Ibid.*

II.

The present appeal by Lorillard ensued.[2] The taxpayer essentially makes two arguments: (1) the Tax Court erred in failing to declare the pre-2020 regulation and Schedule G-2 "facially discriminatory"; and (2) the Tax Court erred in applying the 2020 amendment to N.J.A.C. 18:7-5.18 retroactively to the tax years in dispute. We need not comment on the first argument, as we adopt the Tax Court's constitutional analysis. We instead focus on the second argument contesting the Tax Court's retroactive application of the 2020 amendment.

We acknowledge that the retroactivity issue before us arises in a distinctive context. Lorillard stresses that the adoption of the 2020 amendment recited an effective date of April 8, 2020, many years after the tax years at issue. Lorillard also stresses that when litigating the constitutional issues on remand in the Tax Court, the parties agreed that the 2020 amendments did not apply retroactively. But, as the Tax Court explained, those points are not dispositive.

Because the retroactivity issue involves a question of law, we review the Tax Court's ruling on that issue

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2. The Division has not cross-appealed.

de novo. *Waksal v. Dir., Div. of Tax'n*, 215 N.J. 224, 231 (2013). Having undertaken such review, we adopt the Tax Court's ruling.

Generally speaking, new statutes and regulations are ordinarily applied prospectively for reasons of fairness. *Metromedia, Inc. v. Dir., Div. of Tax'n*, 97 N.J. 313, 329-34 (1984). However, there are three recognized exceptions to that general principle: (1) when the Legislature or administrative agency intended retroactivity of the new provision; (2) when the parties' expectations warrant retroactive application; (3) or when the new provision is "ameliorative or curative." *State v. J.V.*, 242 N.J. 432, 444 (2020) (citing *Gibbons v. Gibbons*, 86 N.J 515, 522-23 (1981)). The Tax Court appropriately invoked that third exception.

Applying the curative exception in the context of a statutory amendment, the Supreme Court explained in *James v. New Jersey Manufacturers Insurance Co.*, 216 N.J. 552, 564 (2014), as follows:

> A . . . provision also may be afforded retroactive application if it is "curative," that is, designed to "remedy a perceived imperfection in or misapplication of a statute." *Schiavo v. John F. Kennedy Hosp.*, 258 N.J. Super. 380, 386 (App. Div. 1992), *aff'd*, 131 N.J. 400 (1993); *see Cruz v. Cent. Jersey Landscaping, Inc.*, 195 N.J. 33, 46 (2008). "Generally, curative acts are made necessary by inadvertence or error in the original enactment of a statute or in

> its administration." 2 Sutherland, *Statutory Construction*, § 41.11, at 417 (5th ed. 1991). We have explained that an amendment is curative if it does "not alter the act in any substantial way, but merely clarifie[s] the legislative intent behind the [previous] act." *2nd Roc-Jersey Assocs. v. Town of Morristown*, 158 N.J. 581, 605 (1999); *accord Schiavo*, 258 N.J. Super. at 386 (stating similarly that "the new statute [must be] intended simply to explain and to clarify the existing law rather than to change the meaning of the original law" (internal citations and quotation marks omitted)).

[*James*, 216 N.J. at 564 (citations reformatted).]

Lorillard asserts that the 2020 amendment to N.J.A.C. 18:7-5.18(b)(3) was not curative because, in its view, the amendment changed the law instead of clarifying it. The Division presently[3] argues the amendment was curative, inasmuch as it adopted the language of *Morgan Stanley* as to the correct method of determining an unreasonableness exception. Thus, the Division argues the amendment brought the regulation – as it pertained to royalties – into harmony with the legislative intent as to interest payments, as determined in *Morgan Stanley*.

The Tax Court reasoned that the 2020 amendment was

3. The Division is not estopped by the position it took in the Tax Court that the 2020 amendment applies prospectively. As the Tax Court correctly noted, the parties' positions are not dispositive on a question of law such as retroactivity.

aimed at clarifying how the unreasonableness exception should be applied, after *Morgan Stanley* had faulted the Division's previous application of the regulation as applied to interest payments. The Tax Court found, and we agree, that the 2020 amendment was curative because it eliminated the geographic limitation in the unreasonableness exception, thereby curing the double-taxation problem as to royalty payments.

The revised regulation clarified how the unreasonableness exception should be applied by the Division. The amendment sought to carry out the unreasonableness exception while avoiding an unconstitutional result, such as double taxation. Instead of retaining language tied to "income stream" in New Jersey, the amended regulation accomplished the same legislative objectives as the earlier version of the regulation, without violating the Commerce Clause. Simply stated, the 2020 amendment was curative because it cured a constitutional problem.

In *Seashore Ambulatory Surgery Center, Inc. v. New Jersey Department of Health*, 288 N.J. Super. 87, 97-99 (App. Div. 1996), we similarly recognized and applied the principle that retroactivity is acceptable when a regulation is ameliorative or curative. In *Seashore*, we held that a regulation requiring that a certificate of need from the Department of Health must be obtained before a physician could maintain two operating rooms in his private practice was applicable, even though the current regulation applied to "new" facilities. *Ibid.* We rejected the notion that the phrase "new surgical facility" indicated that the Legislature intended the regulation to be applied purely prospectively, because the regulation manifestly was meant to be curative. *Ibid.*

The Tax Court appropriately relied upon *In re Appeal by Progressive Casualty Insurance Co.*, 307 N.J. Super. 93, 101 (App. Div. 1997), in which we held that the history of a regulation supported its retroactive application as a "curative enactment." Here, as the Tax Court explained, the history stemming back to the *Morgan Stanley* case provided the curative rationale for the 2020 amendment. The revision aligned the treatment of royalty payments with interest payments to an affiliated company. The 2020 amendment was thereby intended "to remedy a perceived imperfection in or misapplication of a [regulation]." *Johnson v. Roselle EZ Quick LLC*, 226 N.J. 370, 388 (2016).

Lorillard argues the 2020 amendment cannot cure the regulation's unconstitutionality because the Division continues to use Schedule G-2, as it did before the amendment. Lorillard contends that, by utilizing Schedule G-2, the Division continues to permit only a deduction for Lorillard in the amount of Licensing's allocation factor. Consequently, the Division allegedly is still applying the geographic limitation.

The Tax Court recognized that Schedule G-2 remained unchanged after the 2020 amendment. However, the Division offered taxpayers an opportunity to seek additional deductions, albeit as a separate refund claim on a separate form. The Tax Court recognized that, although using a separate form was administratively tedious, Lorillard nonetheless could seek more deductions beyond the Schedule G-2 calculations. In this regard, the court astutely observed:

> Of course, this also means that Part II of Schedule G-2 cannot be the be-all and end-all of the partially deductible amount. Rather, it is, and should be *a starting point with [Lorillard] having the opportunity to show more in terms of tax actually paid by Licensing in other jurisdictions* on the royalties received from [Lorillard] on [Lorillard's] sales of tobacco products in New Jersey.

[(Emphasis added).]

We agree. Schedule G-2 invites the taxpayer to submit a different form (Form A-3730) to request other deductions. The fact that the Division still uses Schedule G-2 does not undermine the curative nature of the 2020 amendment. Also, the Division points out that while Lorillard has been invited to show the amount of taxes that Licensing paid in other United States jurisdictions, it has not yet done so.

Lastly, Lorillard argues that it is entitled to a full refund of CBT taxes for the years in question because the Tax Court found the pre-2020 version of the regulation unconstitutional. The Tax Court reasonably rejected that all-or-nothing claim for relief. Instead, supported by the 2020 curative amendment, the court engaged in a form of "judicial surgery" to preserve the regulatory scheme while, at the same time, acknowledging Lorillard's ability to receive a partial offset of its tax liabilities based on the amounts that were paid to other jurisdictions. As we have previously noted:

> Pursuant to N.J.S.A. 1:1-10, a court has the power to declare a portion of a statute unconstitutional, while leaving the remainder of the law intact. "In appropriate cases, a court has the power to engage in 'judicial surgery,' or the narrow construction of a statute, to free it from constitutional doubt or defect." *N.J. State Chamber of Com. v. N.J. Election L. Enf't Comm'n*, 82 N.J. 57, 75 (1980).

[*L. Feriozzo Concrete Co. v. Casino Reinvestment Dev. Auth.*, 342 N.J. Super. 237, 251 (App. Div. 2001) (citations reformatted).]

These principles apply to regulations as well as statutes. *Ibid.*

Thus, even if N.J.A.C. 18:7-5.18 had not been amended by the Division in 2020, our courts would have been authorized to delete the unconstitutional language within the regulation and narrow the construction of the regulation so as "to free it from constitutional doubt or defect." *Ibid.* In this way, the Tax Court could have applied the regulation to Lorillard even without the 2020 amendment. The regulation should have been upheld to the fullest extent possible. The 2020 amendment provided a cure to the constitutional problem, granting

Lorillard a measure of partial relief – without entitling it indiscriminately to an excessive refund beyond proven instances of double taxation by other taxing jurisdictions.

In sum, the Tax Court issued a fair and well-reasoned decision that comports with the law and overarching principles of appellate review. To the extent that we have not addressed them explicitly, the remaining points and sub-points made by Lorillard lack sufficient merit to warrant discussion. *R.* 2:11-3(e)(1)(E).

Affirmed.

APPENDIX C — OPINION OF THE TAX COURT OF NEW JERSEY, FILED SEPTEMBER 13, 2023

TAX COURT OF NEW JERSEY

Docket Nos. 008305-2007; 014043-2012

LORILLARD TOBACCO COMPANY

v.

DIRECTOR, DIVISION OF TAXATION

Filed September 13, 2023

OPINION

Not for publication without approval of the Tax Court Committee on Opinions, Tax Court of New Jersey

Mala Sundar, *Presiding Judge*

This opinion decides the issue remanded by the Superior Court, Appellate Division, in the above captioned matters, which is whether N.J.A.C. 18:7-5.18(b)(3) effectuated in Schedule G-2 of the corporation business tax (CBT) return, violates the federal dormant Commerce Clause (DCC). The regulation, pre-2020 amendment, provided that a payor is entitled to a deduction for royalties paid to its related entity (i.e., an exception to the addback of deducted royalties) if the payor proves "the extent that the payee pays tax to New Jersey on the income stream." Schedule G-2 computes the deduction by comparing the payor and payee's New Jersey allocation factor and payment of CBT by the payee: if the payee's allocation factor is lower than the payor's factor, thus, pays lesser CBT on the royalties received, then the payor is allowed a partial deduction. Plaintiff argues that the regulation and Schedule G-2 operate to provide an unconstitutional geographic limitation.

In 2020, the regulation was amended to, among others, delete the phrase "showing the extent that the payee pays tax to New Jersey on the income stream." Plaintiff argues that (1) the amendment does not apply to the tax years at issue; and (2) regardless, the amended regulation is unconstitutional since Schedule G-2 remains unchanged. Defendant agrees with plaintiff that the amendments do not apply to the tax years at issue, but counters that the pre-2020 regulation and Schedule G-2 are constitutional.

For the reasons explained below, the court finds that the pre-2020 regulation is not discriminatory. However, it violates the external consistency part of the fair apportionment prong of the DCC due to its geographic limitation which prevents consideration of whether tax was paid or payable on the same income in other jurisdictions, when computing the allowable deduction in New Jersey to the payor. The deletion of the geographic limitation in 2020 and inclusion of illustrative instances operate as the most sensible interpretation of the addback statute and cures the constitutional concern. Therefore, the 2020 version of the regulation can apply to the tax years at issue here. Consequently, the court dismisses the complaints.

BACKGROUND

The detailed facts are set forth in the prior reported decisions. *See Lorillard Tobacco Co. v. Dir., Div. of Taxation*, 31 N.J. Tax 153 (Tax 2019), *rev'd and remanded*, 33 N.J. Tax 43 (App. Div. 2021). Briefly, plaintiff, Lorillard Tobacco Company (LTC), claimed a 100% exception to the addback of (i.e., 100% deduction for) New Jersey allocated royalties it paid to its wholly owned subsidiary, Lorillard Licensing Co., LLC (Licensing), for tax years 2002-2005; and 2007-2010. Defendant, Director, Division of Taxation (Taxation), granted LTC a partial exception since Licensing's New Jersey allocation factor was lower than LTC's New Jersey allocation factor, thus, Licensing's CBT payment on the royalties received from LTC was lesser than LTC's CBT due as a result of the royalty addback.

This court agreed with LTC that not permitting a full deduction when Licensing had filed returns and paid CBT on its allocable portion of New Jersey income, was an unreasonable exercise of Taxation's discretion. Due to this ruling on the merits, the court did not address LTC's constitutional arguments. Both parties appealed this court's decision. The Appellate Division reversed and held:

> There is nothing unreasonable about allowing an exception to the add back to the extent the related party paid taxes in New Jersey to avoid possible double taxation. [Taxation's] regulation defines one means by which the add back is unreasonable, e.g., to the extent the related entity paid New Jersey taxes.

[Taxation] granted [LTC's] refund request, corresponding to [Licensing's] CBT payments, by using a comparison of the allocation factors between the [two]. . . . The tax on [LTC's] add back that was not excepted as unreasonable was related to its activity in New Jersey based on its allocation factor.

The purpose of the [Business Tax Reform Act] BTRA . . . was to close a loophole on tax avoidance. There was nothing unreasonable about [Taxation's] decision to grant the exception "only to the extent of the New Jersey taxes paid by" [Licensing]. This was a balanced approach. It considered the need to achieve the intent of the BTRA to close loopholes and the need by the filer to avoid an unreasonable add back. [LTC] is not precluded from showing that it is unreasonable in some manner not to refund the balance of the remaining add back based on facts special to its situation.

The Tax Court appeared to shift the burden from [LTC] to [Taxation]. The statutes give the taxpayer the burden of establishing an exception to the disallowance of deductions: "adjustments . . . shall not apply if . . . the taxpayer establishes by clear and convincing evidence, as determined by the director, that the adjustments are unreasonable. . . ." N.J.S.A. 54:10A-4.4(c)(1)(b). If further adjustment

> was needed, [LTC] was not precluded from requesting this.

[33 N.J. Tax at 58.]

Although LTC cross-appealed that the regulation and Schedule G-2 are unconstitutional because they (1) are discriminatory; (2) indirectly tax Licensing's out-of-state activities; and (3) result in gross distortion of LTC's New Jersey allocable income, the Appellate Division held that the constitutional "issues require consideration" by the Tax Court "in the first instance" as "its familiarity with the tax issues in this context will be helpful." *Id.* at 59. The court noted that due to "the amendment of N.J.A.C. 18:7-5.18 in the interim, we also are unable to determine on this record if the constitutional issues are now moot." *Ibid.*

Parties submitted briefs on the remanded issue, after which the court heard oral arguments. At the court's direction, parties provided supplemental briefs on the application of an out-of-state case, *Surtees v. VJF, Inc.*, 8 So.3d 959 (Ala. Ct. of Civ. App. 2008), since the plaintiff therein had attacked Alabama's royalty addback statute as unconstitutional on similar grounds as plaintiff 's attack herein of New Jersey's addback regulation, N.J.A.C. 18:7-5.18(b)(3).[1]

1. The only factual difference in *Surtees* is that the payor did not addback the royalties paid. *Surtees*, 8 So.3d at 960. The legal difference is that the payor attacked the constitutionality of Alabama's addback statute, which included a subject-to-tax-elsewhere exception, in addition to the unreasonableness exception to the addback. *See* Ala. Code § 40-18-35(b)(1); (b)(2). Whereas here, LTC attacks the constitutionality of Taxation's methodology of construing the unreasonableness exception.

Thereafter, the court requested the parties to attempt a resolution based on the 2020 amendments to N.J.A.C. 18:7-5.18(b)(3) since the Appellate Division observed that the same could moot LTC's constitutional arguments. The parties advised that the attempted resolution was unsuccessful, therefore, the court could issue its decision.

Thereafter, the parties also briefed the court's question whether the 2020 amendments to N.J.A.C. 18:7-5.18(b)(3) were retroactive. Both parties agreed that they were not.

THE CHALLENGED REGULATION

N.J.S.A. 54:10A-4.4(b) requires an entity doing business in New Jersey, to addback "otherwise deductible" royalties paid to a related member in computing its allocable entire net income (ENI).[2] If the payor "establishes by clear and convincing evidence, as determined by" Taxation that the addback is "unreasonable," then the addback "shall not apply." N.J.S.A. 54:10A-4.4(c)(1)(b). Taxation

2. An entity's ENI is the amount federally reported (often called "Line 28" income), with New Jersey "additions and subtractions." *Int'l Bus. Machines Corp. v. Dir., Div. of Taxation*, 26 N.J. Tax 102, 108-09 (Tax 2011). The federal Line 28 income is a net amount, i.e., gross income less business expenses such as royalties. Under the BTRA, the royalty-paid deduction is added back after reporting the Line 28 income. The "adjusted" ENI is then offset by net operating losses and further reduced by certain exclusions. This final amount, which is reported on Line 1 of the CBT return, is then allocated to New Jersey based on an allocation factor and taxed at the CBT rate. In an extremely simple example, if the Line 28, thus the ENI, is $100, which is *net of* $10 royalty deduction, the $10 is added back, thus, the ENI subject to allocation is $110.

interpreted this exception by providing that a "deduction shall be permitted . . . [i]f the taxpayer establishes that the adjustments are unreasonable by showing the extent that the payee pays tax to New Jersey on the income stream." N.J.A.C. 18:7-5.18(b)(3) (pre-2020). The intent was to avoid (1) double taxation "since the payee paid tax to New Jersey on the same income stream," and (2) income distortion. 35 N.J.R. 1573(a) (April 2003); 35 N.J.R. 4310(a) (Sep. 2003). This was the only option to prove an exception under the unreasonableness exception.

Part II, Exception 2 of Schedule G-2 to the CBT return provided for the computation of the deductible amount: the CBT on the allocated royalties paid (using the payor's New Jersey allocation percentage) is compared to the CBT on the payee's New Jersey allocated income (lower of the royalty received or its ENI). If the CBT on the affiliate payee's allocated income is greater than the CBT on the allocated royalty payments by the payor, then the payor can deduct 100% of the royalty payments. Else, the payor is allowed a partial deduction.

In 2020 (after this court had decided the matter, and during its appeal), Taxation promulgated a "special amendment" to N.J.A.C. 18:7-5.18(b). The amendments were enacted to "comply with the statutory amendments . . . and . . . case law." 52 N.J.R. 1991(a) (Nov. 2020). The statutory amendments were for tax years after 2018 and as to cases involving foreign tax treaties. The "case law" amendments were "to add five scenarios, outside of an agreement in writing between the Director and the taxpayer, for claiming that a disallowance of an interest deduction would be unreasonable under the exception as set forth at N.J.S.A. 54:10A-4(k)(2)(I)." 52 N.J.R. 1991(a). "The five situations are: 1) unfair duplicative taxation; 2) a technical failure to qualify the transactions under the statutory exceptions; 3) an inability or impediment to meet the requirements due to legal or financial constraints; 4) an unconstitutional result; and 5) the transaction's equivalency to an unrelated loan transaction." *Ibid.* These instances were also incorporated into the royalty addback regulation at issue here. Thus, N.J.A.C. 18:7-5.18(b) and (b)(3) now read as follows (deletions [ ], additions italicized):

> (b) Interest expenses and costs [and] *as well as*, intangible expenses and costs directly or indirectly paid, accrued, or incurred in connection with a transaction with one or more related members shall not be deducted in calculating entire net income, except that a deduction [shall] *may* be permitted:
>
> . . .
>
> (3) If the taxpayer establishes, *to the satisfaction of the Director*, that the adjustments are unreasonable by [showing the extent that the payee pays tax to New Jersey on the income stream; or] *clear and convincing evidence, and any one of the following circumstances applies:*
>
> *i. Unfair duplicate taxation;*
>
> *ii. A technical failure to qualify the transactions under the statutory exceptions;*

> *iii. An inability or impediment to meet the requirements due to legal or financial constraints;*
>
> *iv. An unconstitutional result; or*
>
> *v. The transaction is equivalent to an unrelated loan transaction;*

The instances (i) through (v) were adopted from a case addressing the unreasonableness exception to the addback of interest paid to related members, where the court stated:

> in enacting N.J.S.A. 54:10A-4(k)(2)(I) the Legislature intended that something more than a valid non-tax business purpose and economic substance must be demonstrated to qualify for the unreasonable exception: unfair duplicative taxation; a technical failure to qualify the transactions under the statutory exceptions; an inability or impediment to meet the requirements due to legal or financial constraints; an unconstitutional result; a demonstration that the transaction for all intents and purposes is an unrelated loan transaction.

[*Morgan Stanley & Co. Inc. v. Dir., Div. of Taxation*, 28 N.J. Tax 197, 200 (Tax 2014).][3]

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3. The court noted that "[t]his list is by no means intended to be exhaustive." *Morgan Stanley*, 28 N.J. Tax at 220, n.13. The interest addback was also enacted by the BTRA, and like for royalty payments,

Taxation however did not change Part II, Exception 2 of Schedule G-2 which continues to tie-in, thus, limit, the payor's deduction to the CBT paid by the payee on the royalty addback amount.[4] The instructions for the Schedule G-2 provide as follows:

> Any other exceptions can not be made on the return. The amounts paid to related members as reported on line (a) of Schedule G . . . Part II, must be included in the amount reported on line (c) of Schedule G . . . Part II. A separate Refund Claim (Form A-3730) stipulating all the facts and providing all applicable evidence to support the taxpayer's claim, must be submitted in order to request any other exception.

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provided an unreasonableness exception to the addback. N.J.S.A. 54:10A-4(k)(2)(I). Taxation's pre-2020 regulations treated the interest addback and royalty addback alike as to unreasonableness exception, viz., proof of "the extent the related party pays tax in New Jersey on the income stream." N.J.A.C. 18:7-5.18(a)(2) (interest); 18:7-5.18(b)(3) (royalties). Unlike the royalty addback, the interest addback has a separate exception if the recipient member is subject to, and pays income tax elsewhere, on the interest received. N.J.S.A. 54:10A-4(k)(2)(I)(i)-(iii).

4. Schedule G-2 was amended twice: one applies to taxable years ending on or after July 31, 2007, and one applies to taxable years beginning after January 1, 2018. The 2018 change was due to a change in law as to foreign treaties (*L.* 2018, *c.* 48). In both versions, there was no change to the method of computing the amount excepted from the addback of royalties paid to a related member.

ARGUMENTS PRESENTED

LTC does not attack the addback statute as unconstitutional because, it notes, although the statute denies a 100% deduction for royalties paid to a related member, it also allows a deduction under the unreasonableness exception without any limitations other than a delegation to Taxation for a discretionary determination in this regard. What is problematic, per LTC, is Taxation's regulation conditioning or limiting the unreasonableness exception to the CBT paid by the payee, which in turn is dependent on the payee's New Jersey allocation factor. The more the payee allocates income to New Jersey, the higher is the payor's deduction and vice-versa, thus, per LTC, entities with affiliates in New Jersey that do not allocate income to other states are treated better. Further, LTC argues, Taxation's methodology of matching allocation factors and tacking the difference on to LTC's income is an unconstitutional indirect tax on Licensing's extra-territorial income and a grossly disproportionate taxing of LTC's activities in New Jersey.

Taxation counters thus: the BTRA adds back only what was deducted from *LTC's* income. In other words, a portion of *LTC*'s income is reduced by the royalties paid to Licensing, therefore, when the same is added back, the deducted amount retains the same character – a portion of LTC's income. The addback is *of* LTC's New Jersey allocated royalty payment, thus, *to* LTC's allocated New Jersey income, which means there is no tax on extra-territorial income of Licensing, nor disproportionate taxing of LTC, which then means there is no constitutional violation. Ruling otherwise, Taxation argues, would eviscerate the Appellate Division's holding that N.J.A.C. 18:7-5.18(b)(3) is a reasonable interpretation of the legislative intent underlying the BTRA, viz., preventing artificial reduction of New Jersey source income by it shifting it to a lower-allocation factor related entity.

Taxation's argument appears to be this: if LTC's allocated royalty addback is $10, LTC owes $0.90 CBT (at 9%). The $10 deduction was from LTC's income therefore, the $10 royalty-paid addback is also LTC's income. It is irrelevant if the $0.90 tax is recovered at LTC's level or Licensing's level, but if Licensing pays $0.25 based on its allocation factor, then LTC owes the remaining $0.65 (as translated into the nondeductible amount). This is the meaning of the phrase "to the extent that the payee pays tax to New Jersey on the income stream" in the regulation.

ANALYSIS

Constitutionality of N.J.A.C. 18:7-5.18(b)(3) (pre-2020)

The standard of review on a constitutional issue is de novo because it is solely a legal question. Thus, the court need not defer to Taxation's interpretation. *Abbott v. Burke*, 100 N.J. 269, 298-99 (1985) ("although an agency may base its decision on constitutional considerations, such legal determinations do not receive even a presumption of correctness on . . . review").

Regulations interpreting statutes are presumptively valid. *T.H. v. Div. of Developmental Disabilities*, 189 N.J.

478, 490 (2007). Conversely, a regulation which "offend[s] the State or Federal Constitution" cannot be sustained. *Univ. Cottage Club of Princeton N.J. Corp. v. N.J. Dept. of Envtl. Prot.*, 191 N.J. 38, 48 (2007).

Under the DCC, "state regulations may not discriminate against interstate commerce" and a state "may not impose undue burdens on interstate commerce." *South Dakota v. Wayfair, Inc.*, 138 S. Ct. 2080, 2091 (2018). The prohibited discrimination includes "state taxes" that are facially discriminatory, i.e., those which "explicitly put greater burdens on out-of-state businesses or provide more favorable terms to in-state businesses," or those that "disparately impact[ ] interstate commerce." *Whirlpool Properties, Inc. v. Dir., Div. of Taxation*, 208 N.J. 141, 166 (2011).

A state also cannot tax income not allocable to it. *Id.* at 152 ("Fundamental constitutional principles limit a state's ability to tax out-of-state entities," thus "a state simply cannot tax" income "earned outside its borders") (citation and internal quotation marks omitted). Doing so violates the DCC. *Armco Inc. v. Hardesty*, 467 U.S. 638, 644 (1984) ("A tax that unfairly apportions income from other States is a form of discrimination against interstate commerce."); *Surtees*, 8 So.3d at 977 (the DCC "has been interpreted . . . as prohibiting a state from imposing taxation on income that is not attributable to that state").

This concern is allayed by using an allocation or "a formula apportionment method" where an entity's income is allocated "between the taxing jurisdiction and the rest of the world on the basis of a formula taking into account objective measures of the corporation's activities within and without the jurisdiction." *Whirlpool*, 208 N.J. at 152 (citation and internal quotation marks omitted).[5] "The test [that] will sustain a state tax using a formula apportionment method [is] (1) when the tax is applied to an activity with a substantial nexus with the taxing State, (2) is fairly apportioned, (3) does not discriminate against interstate commerce, and (4) is fairly related to the services provided by the State." *Id.* at 163 (citation, internal quotation marks and parentheticals omitted).

LTC's attack appears to be focused on the DCC's prongs of (i) discrimination; and (ii) the external consistency part of the "fair apportionment" prong of the DCC which requires the tax at issue be internally and externally consistent.[6] External consistency looks "to the

5. In New Jersey, the allocation factor is determined under N.J.S.A. 54:10A-6 (allocation of ENI is by "the property fraction, plus twice the sales fraction plus the payroll fraction and the denominator of which is four" for tax years prior to 2012). Thus, the sales factor was double weighted or counted for the tax years at issue here.

6. Nexus is not an issue since LTC and Licensing filed CBT returns. Internal consistency is a "hypothetical functioning of a tax formula" and analyzes the "tax at issue to see whether its identical application by every State . . . would place interstate commerce at a disadvantage as compared with commerce intrastate." *Whirlpool*, 208 N.J. at 164-65 (citations and internal quotation marks omitted). Here, the addback statute N.J.S.A. 54:10A-4.4(c)(1)(b), and the corresponding regulations, N.J.A.C. -5.2, and N.J.A.C 18:7-5.18, are internally consistent because they match income attributable to New Jersey with the related-entity deduction attributable to New Jersey so that if every state had a similar statute to New Jersey's than each state would only require in-state royalty income to be reported and only allow for in-state related party deductions.

economic justification for the State's claim upon the value taxed, to discover whether a State's tax reaches beyond that portion of value that is fairly attributable to economic activity within the taxing State." *Okla. Tax Comm'n v. Jefferson Lines, Inc.*, 514 U.S. 175, 185 (1995).

Discrimination

The court finds no facial discrimination, i.e., where domestic entities are treated more favorably than foreign entities, in Taxation's application of the unreasonableness exception of the addback statute under N.J.A.C. 18:7-5.18(b)(3). All entities with related member transactions are included in the royalty addback statute and to the unreasonable exception therein. If a New Jersey domiciled entity pays royalty to its related member the addback applies. If a foreign entity pays royalty to its related member, the addback applies. If the related member payee pays CBT to New Jersey on the allocated royalty deduction (income in the payee's hands), or on a portion of it, then the payor is entitled to the addback exception

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The "fairly related" fourth prong "examines whether the taxpayer received benefits from the taxing state" which is not a "a proportionality requirement between the benefits provided and the tax paid . . . for general revenue taxes like net income taxes." *Whirlpool*, 208 N.J. at 167. Here, this is not an issue because, and based on its CBT returns, LTC did business in New Jersey, thus, benefitted from the State's customers, labor market, government services (fire, police). *See Amerada Hess Corp. v. Dir., Div. of Taxation*, 490 U.S. 66, 79 (1989) ("There is also no doubt that New Jersey's [CBT] . . . is fairly related to the benefits that New Jersey provides . . . which include police and fire protection, the benefit of a trained work force, and the advantages of a civilized society") (citation and internal quotations omitted).

accordingly, regardless of whether the payor or payee is a domestic or foreign entity. In other words, a full or partial deduction will be allowed regardless of the payor or payee's corporate domicile so long as the payee is a related entity. No New Jersey domiciled related-member payee which allocates income within and outside New Jersey is given a special preference or competitive advantage over similar foreign entity in application of a partial addback under the regulation.

Disparate impact on interstate commerce is generally implicated when a State law or regulation has a negative bearing on the free flow of commerce, i.e., where State's statute or regulation has the purpose or effect of barring or limiting a foreign entity from freely engaging in nation-wide commerce. *See e.g.*, *Park Pet Shop v. City of Chicago*, 872 F.3d 495, 501 (7th Cir. 2017) (a facially neutral law can practically have a discriminatory effect, and if it bears so heavily on interstate commerce that it acts as an "embargo on interstate commerce without hindering intrastate sales," it is treated as if it were facially discriminatory).

LTC argues that the negative impact is that Licensing may be forced to lessen its business presence or activities in other (possibly tax-friendly) taxing jurisdictions so as to match LTC's New Jersey allocation factor. Taxation argues that it cannot force Licensing to allocate more than constitutionally permitted, nor is it forcing LTC to allocate more to New Jersey.[7]

7. The royalty recipient, if a foreign entity, is deemed to have an economic presence in, thus, nexus to the State and is required to file CBT returns. *Lanco, Inc. v. Dir., Div. of Taxation*, 188 N.J.

It is difficult to achieve a 100% match of a payor and payee's allocation factors. For instance, here, for the tax years at issue, the allocation factor was an average of the ratio of three business presence indicators in New Jersey: (a) property; (b) payroll; and (c) sales. LTC had property and payroll in New Jersey. Licensing did not. *See Lorillard Licensing Co., LLC v. Dir., Div. of Taxation*, 29 N.J. Tax 275, 278 (App. Div. 2015) (Licensing "had no physical presence or employees in any state outside of North Carolina."). Thus, using LTC's allocation factor would almost always never match Licensing's for purposes of the addback.

Each parties' arguments, while credible, only emphasize the point that what is being sought under N.J.A.C. 18:7-5.18(b)(3) and Part II of Schedule G-2 is not the unachievable perfect match of allocation factors of the LTC and Licensing. Rather, they are a means to determine the deductible amount of the added back royalty payments. Thus, the pre-2020 version of the regulation and the computational methodology do not state a cause of action of disparate impact under the DCC. *See e.g.*, *Whirlpool*, 208 N.J. at 168 n.9 (While "[i]t may be that the state taxes extraterritorially . . . that is a fair apportionment argument.").[8]

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380 (2006). The BTRA did not repeal this requirement. *See Springs Licensing Group, Inc. v. Dir., Div. of Taxation*, 29 N.J. Tax 1 (Tax 2015).

8. A more realistic match may be by comparing LTC's New Jersey gross sales ratio (less sales of services or non-licensed products) to Licensing's New Jersey gross sales ratio. Proof in this regard would be readily available since LTC must pay Licensing

Fair Apportionment

LTC's claim that N.J.A.C. 18:7-5.18(b)(3) and Schedule G-2 operate to indirectly tax Licensing, and/or tax LTC all out of proportion, is addressed by the Appellate Division's decision. *See Lorillard*, 33 N.J. Tax at 58 ("The tax on [LTC's] add back that was not excepted as unreasonable was related to its activity in New Jersey based on its allocation factor."). A payor's *New Jersey allocated royalty payment expense* is deemed to be *the payor's New Jersey source income* for purposes of the addback statute in the first place. It follows that a partial addback continues to be deemed as only the payor's income. Any attempt to increase Licensing's allocation factor to match LTC's allocation factor, would, as Taxation correctly points out, violate the constitutional basis underlying apportionment principles. *See also Surtees*, 8 So.3d at 979 (rejecting an identical argument and holding that Alabama's "add-back statute disallows a deduction sought by the" payor "which does have activities in Alabama sufficient to justify its paying corporate income tax in this state.");

13% royalty on LTC's monthly *net* sales and LTC must "provide" Licensing the "monthly and year-to-date net sales of the licensed tobacco products "broken down by brand." *Lorillard*, 31 N.J. Tax at 158. Since the BTRA deems the apportioned deducted royalties as LTC's apportioned New Jersey income, such a matching appears logical. While a possibly simplistic approach (since fair apportionment is never mathematically precise), which could provide the same result when using the methodology in Schedule G-2, this exercise may better endorse Taxation's position in computing a partial allowance for the royalty paid deduction under the BTRA. The suggested exercise is in keeping with Taxation's policy that the unreasonableness exception applies on a case-by-case basis.

Whirlpool, 208 N.J. at 168 n.9 (rejecting the argument of "extraterritorial taxation" and holding that "[m]ere inclusion of extraterritorial income in the tax base for apportionment is not tantamount to extraterritorial taxation.") (citation omitted). Therefore, Taxation's regulation and Schedule G-2 function constitutionally in this regard.

In this connection, LTC's heavy reliance on *Hunt-Wesson, Inc. v. Franchise Tax Bd.*, 528 U.S. 458 (2000), is misplaced. There, California's interest expense deduction statute limited the amount to that which exceeded an entity's nonunitary business' interest/dividend income. *Id.* at 461. "The parties concede[d] that the relevant income here – that which falls within the scope of the statutory phrase 'not allocable by formula' – is income that . . . by itself bears no 'rational relationship' or 'nexus' to California." *Id.* at 464. The court ruled that therefore, although "California's statute does not directly impose a tax on nonunitary income . . . it simply denies the taxpayer use of a portion of a deduction from unitary income," it was an "impermissible tax." *Ibid.* Here, New Jersey *can* tax the royalty income received by the Licensing. Licensing is deemed to have economic presence, thus, nexus to New Jersey, when its intellectual property (patents, trade secrets, trademarks, and know-how) is employed in New Jersey by, and in, LTC's business activities. *See Lanco*, 188 N.J. at 383 (rejecting the concept that there is a "universal physical-presence requirement for state taxation under the Commerce Clause," and affirming the lower court's decision that Taxation "constitutionally may apply the . . . [CBT] notwithstanding a taxpayer's lack of a physical presence in New Jersey."); *Surtees*, 8 So.3d at 981 (distinguishing *Hunt Wesson* on grounds the Alabama's Tax Department's application of the addback statute "is consistent with the requirements of a nexus between Alabama and the interstate activities, i.e., the royalty payments" and that there is "a rational relationship between the income the Department seeks to add back . . . and the income that is to be included in" determining the payor's "taxable income," plus the plaintiff had failed to prove a distortion of its income or that "the income attributed to" Alabama was "in fact out of all appropriate proportions to the business transacted" in that State). The royalties received by Licensing from LTC's New Jersey sales has nexus to this State, thereby rendering *Hunt-Wesson* inapplicable.

However, there is merit to LTC's argument that limiting proof of double taxation by only accounting for the CBT paid by Licensing to New Jersey is problematic. N.J.A.C. 18:7-5.18(b)(3) (pre-2020) provided only one situation of when a reasonableness exception applies, *viz.*, proof of CBT paid by the royalty recipient *to New Jersey*. Due to the disparity of apportionment factors, Licensing may have reported the royalties received for sales allocable to New Jersey and paid tax on the same. Here, for instance, Licensing filed returns in North Carolina and Iowa (tax year 2002); North Carolina, Iowa, Oklahoma, and South Carolina (tax year 2003); North Carolina, Iowa, Oklahoma, South Carolina, Florida, and Massachusetts (tax year 2004). *Lorillard Licensing Co., LLC*, 29 N.J. Tax at 278. It had a royalty agreement with LTC "in every state." *Id.* at 283. Thus, Licensing's allocation factor may be greater in some other state, and if so, more of Licensing's royalty income could be taxed in that state or in other states, which can mean that LTC warrants a higher deduction. On its face, then, the pre-2020 N.J.A.C. 18:7-5.18(b)(3), did not permit a payor the option to show that there was out-of-state(s) multiple taxation of the royalties received by Licensing from LTC from New Jersey-based sales. Thus, Taxation's arguments that how or whether Licensing it taxed elsewhere "is of no concern" to New Jersey, is not credible.

It is true that the Appellate Division has ruled that the pre-2020 version of N.J.A.C. 18:7-5.18(b)(3) "defines *one means* by which the add back is unreasonable, e.g., to the extent the related entity paid New Jersey taxes," and that LTC is "not precluded from showing that it is unreasonable *in some manner* not to refund the balance of the remaining add back *based on facts special to its situation*," thus, "[i]f further adjustment was needed, [LTC] was not precluded from requesting this." *Lorillard*, 33 N.J. Tax at 58 (emphasis added). Until this pronouncement, there was nothing to this effect in the plain language of the regulation or Schedule G-2, nor was the same inferable. While a payor could have obtained relief if it and Taxation agreed to the "application or use of an alternative method of apportionment," under N.J.A.C. 18:7-5.18(b)(4), that regulation's constitutionality is not at issue here.

In sum, denying LTC a deduction of the amount of royalties paid to Licensing without consideration of whether those same amounts were reported/taxed elsewhere violates the external consistency part of the fair apportionment prong of the DCC.

Applicability of the 2020 Amendments to N.J.A.C. 18:7-5.18(b)(3)

While this matter was on appeal, the geographic limitation was eliminated from N.J.A.C. 18:7-5.18(b)(3) by the 2020 amendments. Thus, the Appellate Division noted that due to "the amendment of N.J.A.C. 18:7-5.18 in the interim, we also are unable to determine on this record if the constitutional issues are now moot." *Lorillard*, 33 N.J. Tax at 59.

If the 2020 version of the regulation applies here, it would pass constitutional muster because LTC can prove unfair double/multiple taxation by showing taxes paid on Licensing's New Jersey-based royalty income elsewhere. Such proof has always been the burden of the payor, therefore, continuance of the same is not new or unexpected. *Ibid.* (disapproving this court's conclusion which "appeared to shift the burden from" LTC to Taxation in violation of the implementing statute, "N.J.S.A. 54:10A-4.4(c)(1)(b)").

The parties' agreement as to a prospective application of the 2020 amendments does not bind the court. The issue is one of law, not facts. Similarly, that the amendments to N.J.A.C. 18:7-5.18(b)(3) are stated to be effective April 2020, does not, in and of itself, prevent retroactive application. *See e.g.*, *Richard's Auto City, Inc. v. Dir., Div. of Taxation*, 12 N.J. Tax 619, 640 (Tax 1992) (agreeing with Taxation "that the effective date of the regulation is irrelevant because the regulation is merely [its] interpretation of the statutory provision at issue"). Therefore, the court can proceed to opine on the issue of retroactivity.

Here, the regulatory clarification (and expansion by way of illustrative instances) of the unreasonableness exception for purposes of the royalty addback, continues to be interpretive of the addback statute inasmuch as it continues to echo the original intent underlying the regulation (unfair duplicative taxation or unconstitutional result). Just as *Morgan Stanley's* decision on statutory construction can apply to the case before it without concerns of retroactivity, so too can Taxation's clarification (and expansion by way of illustrative instances).[9] *See also Richard's Auto City*, 12 N.J. Tax at 641 (a regulation "is no more retroactive in its operation than is a judicial determination construing and applying a statute to a case at hand."). This is especially where both the interest

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9. The tax year at issue in *Morgan Stanley* was year ending November 2003. *Morgan Stanley*, 28 N.J. Tax at 206. The case was decided in 2014. Note that after the decision was rendered, Taxation first amended the interest addback regulation in 2017. *See* 49 N.J.R. 52(b) (Jan. 2017) (amendment to "delete Example 5 and the clause, 'regardless of whether a tax was actually paid on the related method,' because they conflict with N.J.S.A. 54:10A-4(k)(2)(I) as interpreted . . . in the holding of" *Morgan Stanley*). Then in 2020, Taxation included the illustrative examples in *Morgan Stanley* in the interest addback and royalty addback regulations. It is therefore difficult to agree that the 2020 changes should be deemed to be prospective when that case dealt with tax year 2003, and the regulations changed twice because of that case – first in 2017, and then in 2020.

addback and the royalty addback statutes provide for an unreasonable exception; the regulations always interpreted the same in an identical manner, *see* N.J.A.C. 18:7-5.18(a)(2); N.J.A.C. 18:7-5.18(b)(3); and one of the instances of unreasonableness elucidated in *Morgan Stanley* and incorporated by Taxation into the royalty addback regulation was proof of an unconstitutional result. In other words, elimination of the geographic limitation in N.J.A.C. 18:7-5.18(b)(3) and incorporation of the illustrative examples retains the original regulatory intent of unfair duplicative taxation but avoids an unconstitutional result.

Additionally, "retroactive application may be necessary to make the statute workable or to give it the most sensible interpretation." *Johnson v. Roselle EZ Quick, LLC*, 226 N.J. 370, 388 (2016) (alteration in original omitted). Here, the most sensible interpretation of the unreasonableness exception in the royalty addback statute is to have it applied in a constitutional manner. Indeed, this should be a given since it is presumed that a statute or regulation is enacted "with existing constitutional law in mind" and with an intent that it "function[s] in a constitutional manner." *State v. Profaci*, 56 N.J. 346, 349 (1970). Indeed, here, LTC agrees that the addback statute which disallows 100% of the deduction is constitutional because it also allows for an exception to the addback, and also posits that "there may be ways that [Taxation] could apply the unreasonableness exception in a constitutional manner." By eliminating the geographic limitation, N.J.A.C. 18:7-5.18(b)(3) achieves this and furthers the underlying intent of the regulation, i.e., avoiding duplicative tax on the same income and income distortion.

Further, retroactivity is acceptable when a regulation is "ameliorative or curative." *Seashore Ambulatory Surgery Ctr., Inc. v. N.J. Dep't of Health*, 288 N.J. Super. 87, 97-98 (App. Div. 1996) (citations and internal quotations marks omitted). *See also Schiavo v. John F. Kennedy Hosp.*, 258 N.J. Super. 380, 386 (App. Div. 1992) (retroactive application if permissible if it is "curative," that is, "designed to remedy a perceived imperfection in or misapplication of a statute.); *Matter of Appeal by Progressive Cas. Ins. Co.*, 307 N.J. Super. 93, 101 (App. Div. 1997) (if a "regulation is ameliorative or curative" it "may be retroactively applied"); *James v. N.J. Manufacturers Ins. Co.*, 216 N.J. 552, 564 (2014) ("an amendment is curative if it does not alter the act in any substantial way, but merely clarifies the legislative intent behind the previous act.") (citation, internal quotation marks, and alterations omitted).

The 2020 elimination of the geographic limitation cures the prior flaw in the regulation in that it avoids an unconstitutional misapplication of the statutory provision of the unreasonableness exception to the royalty addback. *See id.* at 564 ("Generally, curative acts are made necessary by inadvertence or error in . . . administration" of a statute) (citation omitted); *Johnson*, 226 N.J. at 388 (a curative enactment will "remedy a perceived imperfection in or misapplication of a statute").

Under any of the above principles, the 2020 amendments can be retroactively applied, thus, to the tax years at issue here. In other words, payment of CBT by Licensing continues to be a viable reason for providing a partial deduction, but now consideration of a situation where the New Jersey allocated royalties are taxed elsewhere will also factor into the claim for an unreasonableness exception.

LTC points out that the constitutional concerns remain because Part II of Schedule G-2, the only place where the deduction is computed for purposes of the addback, continues to limit the deduction to the amount of CBT paid by the payee. It is true that the instructions to Schedule G-2 state that no other exceptions can "be made on the return." However, they also provide an opportunity to seek additional deductions, albeit as a separate refund claim (on a separate form). Thus, while administratively tedious, LTC is not deprived of seeking more outside of the Schedule G-2 computation. Of course, this also means that Part II of Schedule G-2 cannot be the be-all and end-all of the partially deductible amount. Rather, it is, and should be a starting point, with LTC having the opportunity to show more in terms of tax actually paid by Licensing in other jurisdictions on the royalties received from LTC on LTC's sales of tobacco products in New Jersey.

Finally, the equitable principle of manifest injustice does not apply to defeat application of the 2020 version of the regulation to LTC. *See OFP, L.L.C. v. State*, 395 N.J. Super. 571, 591 (App. Div. 2007) (even if there is no constitutional bar from applying a law retroactively, the court may decline to do so under its "equitable powers" if it "would constitute manifest injustice") (citation and internal quotation marks omitted). It is highly doubtful whether LTC would have altered its franchise agreement with Licensing based on the elimination of the geographic limitation (especially when the agreement applied in all fifty states). In other words, it is not as if LTC relied upon N.J.A.C. 18:7-5.18(b)(3) in contracting with Licensing and agreeing to pay royalties. Indeed, it cannot be so since the royalty addback statute denies 100% deduction to royalties paid by an entity to its related member. Further, the pre-2020 and the 2020 version of the regulation allowed/allows an opportunity for a deduction under other scenarios, and as held by the Appellate Division here. *See* N.J.A.C. 18:7-5.18(b)(4); N.J.S.A. 54:10A-4.4. Therefore, application of the 2020 version of N.J.A.C. 18:7-5.18(b)(3) will not be manifestly unjust to LTC.

CONCLUSION

For the foregoing reasons, the court finds that the pre-2020 version of N.J.A.C. 18:7-5.18(b)(3) is not discriminatory but violates the external consistency part of the fair apportionment prong of the DCC due to its geographic limitation as to proving double or multiple taxation of the same income elsewhere. However, this constitutional concern is allayed under the 2020 amendments which, among others, eliminates the geographic limitation and includes instances of an unconstitutional result as an exception to the royalty addback. As the most sensible interpretation of the royalty addback statute and as a curative measure, the court finds the 2020 amendments are applicable to the tax years at issue here.

The court therefore dismisses the complaints. An Order in accordance with this opinion will be entered.

APPENDIX D — OPINION OF THE SUPERIOR COURT OF NEW JERSEY, APPELLATE DIVISION, FILED SEPTEMBER 21, 2021

SUPERIOR COURT OF NEW JERSEY
APPELLATE DIVISION
DOCKET NO. A-3444-18 A-0002-19

LORILLARD TOBACCO COMPANY,

Plaintiff-Respondent/Cross-Appellant,

v.

DIRECTOR, DIVISION OF TAXATION,

Defendant-Appellant/Cross-Respondent.

Argued December 14, 2020 – Decided September 21, 2021

Before Judges Messano, Hoffman and Suter.

On appeal from the Tax Court of New Jersey, Docket Nos. 008305-2007 and 014043-2012, whose opinion is reported at 31 N.J. Tax 153 (Tax 2019).

The opinion of the court was delivered by

SUTER, J.A.D.

In A-3444-18, the Director of the Division of Taxation (defendant) appeals the February 28, 2019 order granting summary judgment to plaintiff Lorillard Tobacco Company (Lorillard). The order required the Division of

Taxation (Taxation) to pay the remainder of Lorillard's refund claims for tax years 2002 through 2005 with statutory interest. Lorillard cross-appeals the same order to the extent it did not address the constitutional issues it raised. In A-0002-19, defendant appeals the July 19, 2019 order granting judgment to Lorillard. A-0002-19 is consolidated with A-3444-18 because it raises the same issues, although for tax years 2007 through 2010.[1] Lorillard also cross-appealed this order.

For reasons that follow, we reverse the Tax Court orders because defendant's application of N.J.A.C. 18:7-5.18(b)(3) and accompanying schedule was an appropriate exercise of discretion, entitled to deference by the Tax Court, and was consistent with implementing legislation. We remand the case to the Tax Court for consideration of the constitutional issues Lorillard has raised.

I.

A.

Lorillard is a Delaware corporation with its headquarters in North Carolina. *Lorillard Tobacco Co. v. Dir., Div. of Tax'n*, 31 N.J. Tax 153, 158 (Tax 2019). It "manufactures, markets, distributes, and sells cigarettes" in New Jersey and other states. *Ibid.* Lorillard owns Lorillard Licensing Company, LLC, (Subsidiary), which is a North Carolina company with offices in that state.

1. The appeals were consolidated on November 15, 2019.

In 1999, Lorillard assigned its intellectual property to Subsidiary. *Ibid.* Subsidiary licenses the use of this intellectual property to Lorillard. These licenses — which are "perpetual in term" — include the use of trademarks. *Ibid.* Lorillard pays Subsidiary royalties to use this intellectual property. *Ibid.*

Subsidiary alleged that it did not have offices, employees or property in New Jersey. It did not file corporation business tax (CBT) returns in New Jersey, claiming it had no "nexus" to the State. In 2006, Taxation audited Subsidiary, claiming the company did have a nexus to New Jersey and that Subsidiary owed CBT for tax years ending in 1999 through 2004. Taxation assessed Subsidiary for the payment of taxes, penalties and interest. Taxation included the royalties that Subsidiary received from Lorillard in determining the amounts owed. Subsidiary appealed to the Tax Court claiming it did not owe CBT, but this argument was rejected. *See Lorillard Licensing Co., LLC v. Dir., Div. of Tax'n (Lorillard I)*, 28 N.J. Tax 590 (Tax 2014), *aff'd*, 29 N.J. Tax 275, 277-78 (App. Div. 2015).

Lorillard filed CBT returns in New Jersey. *Lorillard*, 31 N.J. Tax at 158. It was required by N.J.S.A. 54:10A-4.4(b) to "add back" to its "earned net income" royalty payments it made to related members, such as Subsidiary. While *Lorillard I* was pending, Lorillard filed an amended CBT return for 2007, requesting a refund of $4,297,701 for the CBT it paid attributable to royalties to Subsidiary from 2002 through 2005. In April 2007, defendant denied this request because *Lorillard I* was still pending. *Ibid.*

In July 2007, Lorillard filed a complaint in the Tax Court against defendant. Count One claims that N.J.S.A. 54:10A-4.4(b) (the Add Back statute) is unconstitutional on its face. Count Two alleges the statute is unconstitutional as applied. Count Three alleges that it was an error to deny Lorillard's request for a refund because the Add Back statute and its implementing regulation are unreasonable. Count Four alleges that defendant abused his discretion by denying Lorillard's refund. Count Five alleges that defendant's denial of its refund claim is unconstitutional. Count Six alleges that defendant's denial "violated the square corners doctrine." Lorillard filed a motion for summary judgment in 2008.

Subsidiary changed course in 2009 by filing CBT returns under the 2009 Tax Amnesty program for tax years 1999 through 2004. Lorillard requested an expedited refund of the CBT it had paid on royalties to Subsidiary. Taxation issued refunds to Lorillard in 2010, but only for a portion of what Lorillard requested. The amount that was not refunded, and which remains in dispute for tax years 2002 through 2005, is $1,495,424.

Once it was resolved that Subsidiary was to file CBT returns, the parties filed additional briefs regarding Lorillard's summary judgment motion, and the Tax Court heard oral argument. On February 28, 2019, it issued an order granting summary judgment and published its decision. *See Lorillard*, 31 N.J. Tax at 153-74. Lorillard was granted a full refund of CBT attributable to the royalties it paid to Subsidiary for tax years 2002 through 2005. Defendant appealed the summary judgment order.

Lorillard filed a new claim seeking a refund of $2,196,024[2] in corporate taxes for tax years 2007 through 2010 based on the same reasons. Defendant denied this request. Lorillard filed a complaint in the Tax Court. On July 19, 2019, the Tax Court entered an order and final judgment, disposing of the case on the same bases as the February 28, 2019 summary judgment order because “all material relevant facts concerning the issue of the extent of royalty deduction to be added back are materially similar to the facts in the instant matter.” Defendant appealed the order and Lorillard cross-appealed.

B.

The Corporate Business Tax Act (CBTA), N.J.S.A. 54:10A-1 to -40, imposes a CBT on non-exempt domestic or foreign corporations that have a nexus with New Jersey. N.J.S.A. 54:10A-2. The CBT “is assessed based on a corporation’s entire net worth and entire net income.” *Whirlpool Props., Inc. v. Dir., Div. of Tax’n*, 208 N.J. 141, 153 (2011). A corporation pays CBT based on its allocation factor that is determined by taking into consideration its New Jersey payroll, property and sales. N.J.S.A. 54:10A-6. “The purpose of the allocation factor is to limit application of the [CBTA] to only that income that has a sufficient nexus to New Jersey to satisfy constitutional constraints on State taxation.” *Lorillard I*, 28 N.J. Tax at 599. N.J.S.A. 54:10A-8 (Section Eight) “authorizes [defendant] to exercise discretion to adjust a taxpayer’s apportionment formula.” *Whirlpool*, 208 N.J. at 145.

2. We use the figure set forth in Lorillard’s brief.

The starting point in the calculation is the corporation's "entire net income" as defined in N.J.S.A. 54:10A-4(k). This is deemed by the CBTA to be "equal in amount to the taxable income, before net operating loss deduction and special deductions, which the taxpayer is required to report. . . ." *Whirlpool*, 208 N.J. at 155.

In 2002, the Business Tax Reform Act (BTRA) amended the CBTA. L. 2002, c. 40; *see Lorillard*, 31 N.J. Tax at 164. The sponsor's statement for the Senate bill stated it "revises and updates the corporation business tax to close a number of loopholes and limit certain tax benefits." Sponsor's Statement to S. 1556 51 (May 30, 2002). It was critical of tax loopholes which do not allow the CBT to "reach some out-of-state companies that do business here," and permit "multi-state corporations to transfer their profits to related out-of-State and offshore companies" and "reduce their net income to little or nothing, thus avoiding the New Jersey taxation." The purpose was to provide "a level playing field for all businesses, large and small, that invest in New Jersey, employ our citizens and do business here." The sponsor's statement for the Assembly bill expressed similar objectives. Sponsor's Statement to A. 2501 51 (June 6, 2002).

The Senate Budget and Appropriations Committee's statement noted that one of the loopholes to be closed by the legislation was a deduction for "royalties and other intangible expenses and costs . . . when paid to affiliates." *S. Budget & Approps. Comm. Statement to S. 1556* 2 (June 27, 2002). They would remain permissible "in areas that are established as 'non-tax avoidance' situations." *Ibid.*

To close loopholes, the legislation included language "limit[ing] the ability of a taxpayer to deduct royalties . . . when paid to affiliates." *Lorillard*, 31 N.J. Tax at 164 (quoting from *Assembly Budget Comm. Statement to A. 2501* 2 (June 27, 2002)). The Director "would have the 'authority to determine . . . whether a taxpayer has met its evidentiary burden of establishing by clear and convincing evidence that the addback of an expense is unreasonable.'" *Ibid.* The Director also could determine "that it is appropriate to enter into agreements or compromises with the taxpayer to produce an equitable level of taxation." *Ibid.*

The CBTA defines "intangible expenses and costs" to include royalties. N.J.S.A. 54:10A-4.4(a). Effective in July 2002, the CBTA was amended by the BTRA to provide that

> [f]or purposes of computing its [ENI] . . . , a taxpayer shall add back otherwise deductible . . . intangible expenses and costs directly or indirectly paid, accrued or incurred to, or in connection directly or indirectly with one or more direct or indirect transactions with, one or more related members.

[N.J.S.A. 54:10A-4.4(b) (the Add Back statute).]

There are three exceptions to the Add Back statute. Relevant here, the add backs required in subsection b "shall not apply if . . . the taxpayer establishes by clear and convincing evidence, as determined by the director, that the adjustments are unreasonable . . . ." N.J.S.A. 54:10A-4.4(c)(1)(b). Thus, the add back can be reduced for amounts that are "unreasonable." *Ibid.*

Defendant promulgated regulations in 2003 to address the CBTA's exception for unreasonableness in related party transactions. *See* N.J.A.C. 18:7-5.18(b). "The purpose of the . . . regulation is avoidance of double taxation." *Lorillard*, 31 N.J. Tax at 168. The regulation restates the statutory criteria. N.J.A.C. 18:7-5.18(a)(1). N.J.A.C. 18:7-5.18(b) provides that "intangible expenses and costs directly or indirectly paid . . . in connection with a transaction with one or more related members shall not be deducted in calculating [ENI]" with certain exceptions. The add back is not required "[i]f the taxpayer establishes, to the satisfaction of the [d]irector, that the disallowance of a deduction is unreasonable by showing the extent the related party pays tax in New Jersey on the income stream." N.J.A.C. 18:7-5.18(b)(3).[3] Thus, as

3. This regulation was amended effective April 8, 2020. Currently, the add back may not be required,

> [i]f the taxpayer establishes, to the satisfaction of the [d]irector, that the adjustments are unreasonable by clear and convincing evidence, and any one of the following circumstances applies:
>
> i. Unfair duplicate taxation;
>
> ii. A technical failure to qualify the transactions under the statutory exceptions;
>
> iii. An inability or impediment to meet the requirements due to legal or financial constraints;

defendant argued, "clear and convincing evidence" as referenced in the Add Back statute could be shown to "the extent that a related-entity payee pays tax in New Jersey on the royalties." Defendant argues the regulation was to prevent multi-entity businesses from reducing the amount of their CBT by artificially shifting income from a higher allocation factor company to a related company with a lower allocation factor.

Taxation developed a new tax reporting schedule in connection with promulgation of the regulation. Schedule G-2 measures the "extent that the payee pays tax" to avoid double taxation by providing a formula that "can determine whether or not certain related party transactions, in fact, do qualify for deductibility as exceptions to the addback rule." 35 N.J.R. 1573(a) (April 7, 2003).

Schedule G-2 calculates the "unreasonableness exception" for the payor — in this case, Lorillard — based on the allocation factors of the payor and payee. The payor can take exception as unreasonable from the add back to the extent the payee paid tax to New Jersey on the royalty income. *See* N.J.A.C. 18:7-5.18(b)(3). If the payor and payee have the same allocation factors, then the payor can take exception to the add back. If the payor's allocation factor is larger than the payee, then the payor will only have a partial exception to the addback based

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iv. An unconstitutional result; or

v. The transaction is equivalent to an unrelated loan transaction;

[N.J.A.C. 18:7-5.18(b)(3).]

on the payee's taxes. *Lorillard*, 31 N.J. Tax at 161. Here, Lorillard claimed a refund for tax years 2002 through 2005 of $4,297,701 but was refunded $2,802,277 because Subsidiary had a lower allocation factor than Lorillard. *Lorillard*, 31 N.J. Tax at 162-63.

C.

The Tax Court granted Lorillard's motion for summary judgment. *Lorillard*, 31 N.J. Tax at 174. In reaching its decision, the Tax Court found that it was not "realistic" for a parent and a subsidiary to have the same allocation factors. *Lorillard*, 31 N.J. Tax at 172. The Tax Court found that BTRA's goals were not "frustrated because Subsidiary's allocated royalty income does not match [Lorillard's] royalty deduction solely due to the difference in their respective allocation factors . . . ." *Ibid.* However, it found this was not a reason to allow only a portion of the royalty deduction to be added back. *Ibid.*

The Tax Court was critical of Taxation for not explaining why the difference between the allocation factors raised concerns under the BTRA. It found "absent" certain allegations and claims such as that Subsidiary's "reporting and tax payments on the royalty deduction" in other states was not "clear and convincing evidence"; that what Subsidiary paid in CBT was irrelevant to any inquiry about unreasonableness; or that Lorillard must provide some clear and convincing evidence. *Ibid.* In the absence of these, the Tax Court found that Taxation's "determination to deny a portion of [Lorillard's] refund claims [was] not well-founded. " *Ibid.*

The Tax Court found that Subsidiary paid CBT to New Jersey using its allocation factor based on the royalty payments from Lorillard. Because defendant was not arguing that Subsidiary's allocation factor did not "properly represent its allocable income to New Jersey," the Tax Court rejected defendant's argument that "there was a mismatch of income and expense solely due to the difference in the unchallenged allocation factors of [Lorillard] and Subsidiary." *Ibid.* The Tax Court concluded defendant did not "exercise its discretion fairly by deeming only a portion of the royalties paid by [Lorillard] to Subsidiary as excepted from addback." *Ibid.*

On February 28, 2019, the Tax Court granted summary judgment to Lorillard requiring defendant to refund the remainder of Lorillard's claim for tax years 2002 through 2005. On July 19, 2019, the Tax Court entered an order and final judgment in Lorillard's favor for tax years 2007 through 2010 based on its reasoning in Lorillard. 31 N.J. Tax at 166-74.

D.

Defendant appeals the Tax Court orders raising these issues:

POINT I

THE TAX COURT INCORRECTLY INTERPRETED THE STATUTE AND TAXATION'S REGULATION AND GAVE INSUFFICIENT DEFERENCE TO TAXATION.

A. The Tax Court Misinterpreted the Plain Language of the Statute and Regulation.

B. The Tax Court Accorded Taxation Insufficient Deference.

POINT II

THE TAX COURT'S HOLDING UNDERMINES THE PURPOSE OF THE BTRA TO PREVENT SHIFTING INCOME AWAY FROM NEW JERSEY THROUGH RELATED-ENTITY ROYALTY PAYMENTS.

Lorillard files a cross-appeal from the Tax Court orders because they do not address the constitutional issues it raised in the summary judgment motion. It argues:

POINT I

THE STANDARD OF REVIEW IS *DE NOVO*

A. The Review of a Summary Judgment Order Is a Legal Question.

B. The Standard of Review Is *De Novo* and the Tax Court Is Entitled to Deference on Questions of Law.

C. Defendant's Interpretation of Tax Statutes Is Not Binding as Ruled in the Supreme Court's Decisions.

POINT II

DEFENDANT'S REGULATION AND SCHEDULE G-2 ARE NOT REASONABLE INTERPRETATIONS OF THE ADDBACK STATUTE AND UNLAWFULLY NARROW THE UNREASONABLE EXCEPTION AS APPLIED TO LORILLARD

POINT III

THE TAX COURT CORRECTLY INTERPRETED THE UNREASONABLE EXCEPTION IN THE ADDBACK STATUTE.

A. The Tax Court Did Not Endorse an "All-or-Nothing" Unreasonable Exception.

B. Though Defendant Received Deference from the Tax Court, Defendant's Position Was Not a Fair Exercise of Its Discretion.

C. The Tax Court's Proper Interpretation of the Addback Statute Does Not Undermine the Purpose of the BTRA.

POINT IV

ALTERNATIVELY, LORILLARD'S REMAINING REFUND CLAIMS SHOULD BE GRANTED BECAUSE DEFENDANT'S REGULATION AND SCHEDULE G-2 ARE UNCONSTITUTIONAL

A. Defendant's Regulation and Schedule G-2 Are Unconstitutional Because They Are Discriminatory

B. Defendant's Regulation and Schedule G-2 Are Unconstitutional Because They Indirectly Tax the Out-of-State Activities of Licensing that New Jersey Cannot Tax Directly.

C. Defendant's Regulation and Schedule G-2 Are Unconstitutional Because They Result in Gross Distortion and Taxation that Is Out of All Appropriate Proportion to Lorillard's Activities in New Jersey.

POINT V

DEFENDANT'S CONTINUED DENIAL OF LORILLARD'S REMAINING REFUND CLAIMS IS A FAILURE TO TURN SQUARE CORNERS.

II.

We review a court's grant of summary judgment de novo, applying the same standard as the trial court. *Conley v. Guerrero*, 228 N.J. 339, 346 (2017). Summary judgment must be granted if "the pleadings, depositions, answers to interrogatories and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact challenged and that the moving party is entitled to a judgment or order as a matter of law." *Templo Fuente De Vida Corp. v. Nat'l Union Fire Ins. Co. of Pittsburgh*, 224 N.J. 189, 199 (2016) (quoting *R.* 4:46-2(c)). We do not defer to a trial court's "interpretation of the law and the legal consequences that flow from established facts." *State v. Harris*, 181 N.J. 391, 419 (2004) (quoting *Manalapan Realty v. Twp. Comm. of Manalapan*, 140 N.J. 366, 378 (1995)).

The starting place is the BTRA. It was "enacted to address declining revenues despite economic expansion based on 'evidence that large corporations with apparently substantial economic activity in this State and substantial profit have managed to avoid having any of this income become taxable by New Jersey.'" *Springs Licensing Grp., Inc. v. Dir., Div. of Tax'n*, 29 N.J. Tax 1, 8-9 (Tax 2015) (quoting *Statement to Assembly No. 2501*). The BTRA was intended to close loopholes.

One such closure was "limit[ing] the ability of a taxpayer to deduct royalties . . . when paid to affiliates." *Ibid.* The Add Back statute requires a taxpayer to "add back" to its earned net income the royalties that it paid to a related entity. N.J.S.A. 54:10A-4.4(b). However, because New Jersey is a "separate entity state," the royalty income received by the related entity payee also is taxed. *Springs Licensing*, 29 N.J. Tax at 12. "[T]he Legislature's response to the specter of double taxation [was] the ability of the payor to claim an exception to the add-back as being 'unreasonable.'" The statute permits a taxpayer to reduce the add back by amounts, which are "unreasonable," but the Legislature did not define what type or amount of an add back was unreasonable.

"When an administrative agency that is charged with enforcing a statute interprets that statute, we give substantial deference to the agency's interpretation."

Oberhand v. Dir., Div. of Tax'n, 193 N.J. 558, 568 (2008). This applies "when the Director's expertise is exercised in the 'specialized and complex area' of the tax statutes." *Taylor v. Dir., Div. of Tax'n*, 422 N.J. Super. 336, 341 (App. Div. 2011) (quoting *Metromedia v. Dir., Div. of Tax'n*, 97 N.J. 313, 327 (1984)). However, an agency cannot interpret a statute to extend it beyond that permitted by the language of the statute. *Oberhand*, 193 N.J. at 568. "Thus, if the agency interpretation of a statute is plainly at odds with the plain meaning of the statute, the agency interpretation will be set aside." *Ibid.* Where the agency's interpretation "is consistent with a plain reading of the statute," the reviewing court should "give deference to the [agency]'s interpretation of the" statute and "accept that interpretation as the one intended by the Legislature." *Id.* at 569.

Defendant promulgated regulations to implement the Add Back statute's exception for amounts that are "unreasonable." Lorillard argues defendant's regulations and tax form Schedule G-2 are not reasonable interpretations of the statute.

Regulations that are "consistent with statutory authority are presumptively valid and should also receive deference." *United Parcel Gen. Servs. Co. v. Dir., Div. of Tax'n*, 430 N.J. Super. 1, 8 (App. Div. 2013). The presumptive validity of administrative actions means that "the burden of proving otherwise is on those challenging such action." *Hills Dev. Co. v. Twp. of Bernards*, 103 N.J. 1, 45 (1986). However, "an administrative agency may not, under the guise of interpretation, extend a statute to give it a greater effect than its language permits." *GE Solid State v. Dir., Div. of Tax'n*, 132 N.J. 298, 306 (1993). Nor may an agency issue a regulation that is outside "the fair contemplation of the delegation of the enabling statute." *N.J. State League of Mun. v. Dep't of Cmty. Affs.*, 158 N.J. 211, 222 (1999) (quoting *N.J. Guild of Hearing Aid Dispensers v. Long*, 75 N.J. 544, 561 (1978)).

Applying these standards, we conclude the Tax Court erred by granting summary judgment to Lorillard. There is nothing unreasonable about allowing an exception to the add back to the extent the related party paid taxes in New Jersey to avoid possible double taxation. Defendant's regulation defines one means by which the add back is unreasonable, e.g., to the extent the related entity paid New Jersey taxes. Defendant granted Lorillard's refund request, corresponding to Subsidiary's CBT payments, by using a comparison of the allocation factors between the payor (Lorillard) and payee (Subsidiary). As the State described it, "Taxation granted parent a refund for those amounts corresponding to [S]ubsidiary's CBT payments because Taxation determined, using Schedule G-2, that it would be unreasonable for parent to pay CBT on income paid to [S]ubsidiary as royalties to the extent that the [S]ubsidiary paid CBT on the royalties." The tax on Lorillard's add back that was not excepted as unreasonable was related to its activity in New Jersey based on its allocation factor.

The purpose of the BTRA — as the Tax Court acknowledged — was to close a loophole on tax avoidance. There was nothing unreasonable about defendant's decision to grant the exception only to the extent of the New Jersey taxes paid by Subsidiary. This was a balanced approach. It considered the need to achieve the intent of the BTRA to close loopholes and the need by the filer to avoid an unreasonable add back. Lorillard is not precluded from showing that it is unreasonable in some manner not to refund the balance of the remaining add back based on facts special to its situation.

The Tax Court appeared to shift the burden from Lorillard to defendant. The statutes give the taxpayer the burden of establishing an exception to the disallowance of deductions: "adjustments . . . shall not apply if . . . the taxpayer establishes by clear and convincing evidence, as determined by the director, that the adjustments are unreasonable. . . ." N.J.S.A. 54:10A-4.4(c)(1)(b). If further adjustment was needed, Lorillard was not precluded from requesting this.

Lorillard claims that Schedule G-2, which is a tax form referenced in the rule proposal, should have been promulgated as a regulation because of its reference to and then application of allocation factors. *See* 35 N.J.R. 1573, 1575 (April 7, 2003) (providing with reference to subsection "(b)3" of the N.J.A.C. 18:7-5.18 that this subsection "allows the deduction of costs if disallowance would be unreasonable since the payee paid tax to New Jersey on the same income stream," citing "Schedule G-2, Part II, Exception 2"). We disagree. It could be fairly inferable from the Add Back statute that the amount up to the tax paid by a related party payee might be considered as unreasonable and subject to exception, and thus that a regulation was not needed to allow an exception for this amount. *See Metromedia*, 97 N.J. at 329 (providing that rulemaking generally is not necessary for "[a]n agency determination that is . . . obviously inferable from the specific language of the enabling statute"). Lorillard obtained a refund for the amount of tax that was paid by its related party. What is in dispute is the amount of a refund beyond this amount.

The Tax Court never reached the constitutional issues because of its determination that defendant did not exercise appropriate discretion. *Lorillard*, 31 N.J. Tax at 174. In light of our decision, these constitutional issues require consideration. The Tax Court should decide them in the first instance. We decline to exercise our original jurisdiction to decide the constitutional questions that were raised. We have determined to return the cases to the Tax Court for consideration of these issues because its familiarity with the tax issues in this context will be helpful. Given the amendment of N.J.A.C. 18:7-5.18 in the interim, we also are unable to determine on this record if the constitutional issues are now moot.

Reversed and remanded for further proceedings. We do not retain jurisdiction.

APPENDIX E — OPINION OF THE TAX COURT OF NEW JERSEY, FILED FEBRUARY 27, 2019

TAX COURT OF NEW JERSEY

DOCKET NO. 008305-2007

LORILLARD TOBACCO COMPANY,

Plaintiff,

v.

DIRECTOR, DIVISION OF TAXATION,

Defendant.

Decided: February 27, 2019

SUNDAR, J.T.C.

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

Defendant argues that its regulation, N.J.A.C. 18:7-5.18(b), which allows a refund to the royalty payor to the extent of the CBT paid by the royalty recipient, is a proper exercise of its discretion, and unless the expense (payor's deduction amount) matches the income (recipient's reported amount), the deduction can only be of a partial amount, to wit, the extent of the CBT paid by the royalty recipient on its New Jersey allocable royalty income.

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

FACTS AND PROCEDURAL HISTORY

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

Parent's wholly-owned subsidiary is Lorillard Subsidiary Co., LLC ("Subsidiary"), which was organized under the laws of North Carolina in November 1999. After it was created, Parent assigned all of its intellectual property (patents, trade secrets, trademarks, and know-how) to Subsidiary by agreements dated December 22, 1999. On the same date, Parent and Subsidiary entered into a Licensing Agreement, perpetual in term, and governed by the laws of North Carolina. Therein, Subsidiary, as sole owner of the assigned intellectual property, granted Parent the right to use the same in Parent's nation-wide business.[1] Parent is obligated to pay Subsidiary a royalty of 13% of its monthly net sales (invoiced amount less certain separately stated expenses). Royalties accrue when Parent ships cigarettes to its customers, and are payable within 30 days after the end of each "Royalty Period" (defined as the end of each month). Along with the royalty payments, Parent is to provide monthly and year-to-date net sales of the "licensed products" (all cigarettes sold by Parent, bearing the licensed trade-marks, or

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

cigarettes manufactured by Parent using the licensed patents, know-how, trade secrets), broken down by brand.

(A) Parent's Income Tax Returns

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

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

Thus, its Line 28 income, which is the starting point of its New Jersey ENI, was net of these deductions. Pursuant to N.J.S.A. 54:10A-4.4(b), which requires an addback of royalties paid by a taxpayer to one or more of its related member/s in computing the taxpayer's ENI, Parent added back these payments to its ENI for each tax year. Parent then computed its CBT based on a percentage of its ENI allocable to New Jersey, which was based on the ratio of its property, payroll, and sales receipts in New Jersey to those same factors everywhere, and then averaged, thus:

Tax Year	Property (A)	Payroll (B)	Receipts (C)	Receipts[2] (D)	Average (A+B+ C+D÷4
2002	2.1616%	1.4583%	3.8196%	3.8196%	2.8148%[3]
2003	1.8330%	1.5005%	3.2877%	3.2877%	2.4772%
2004	1.4516%	1.4990%	2.8866%	2.8866%	2.1810%
2005	1.5068%	1.5741%	2.7347%	2.7347%	2.1376%

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

(B) CBT Assessment on Subsidiary

In 2006, and after Parent had filed its CBT returns, defendant ("Taxation"), assessed Subsidiary $18,405,410 in CBT (which, with interest and penalties, totaled $24,251,739), for tax years 1999-2004. For 2002-2004 (three of the years at issue here), Taxation deemed Subsidiary's federal Line 28 income as its New Jersey ENI, allocated 50% of it to New Jersey, and computed CBT on the same

2. The sales factor was double weighted or counted for the tax years at issue.

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

at 9%, reduced it by certain amounts of "maximum throw out" and Parent's "throw out." The allocated ENI was not further apportioned (*i.e.*, was taxed 100% by New Jersey) since Taxation deemed almost 99% of Subsidiary's everywhere income as being "non-sourced."[4]

Subsidiary promptly, in 2006, appealed to the Tax Court claiming it received royalties from Parent "based on Parent's sales" nation-wide; it filed corporate income tax returns in six other states for tax years 2002-2004; and it "had no physical presence or employees in any state outside of North Carolina." *See Lorillard Licensing Co., LLC v. Dir., Div. of Taxation*, 28 N.J. Tax 590 (Tax 2014), *aff'd*, 29 N.J. Tax 275, 277-78 (App. Div. 2015), *certif. denied*, 226 N.J. 212, 141 A.3d 297 (2016).[5]

(C) Parent's Initial Refund Claim

After Taxation assessed Subsidiary, Parent promptly filed refund claims in 2007 for tax years 2002-2005 by filing amended CBT returns and including Schedule G-2

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

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

("Exceptions to the Addback of Intangible Expenses and Costs"). Parent claimed "it would be improper, unreasonable and unconstitutional" to deny it a deduction if "at the same time," New Jersey subjected Subsidiary "to tax on such amounts."

Exception 2 in Schedule G-2 provides the computation for determining whether and how much an exception will be permitted for intangible expenses such as royalties. The computation compares the CBT on the allocated amount of royalties paid (using the taxpayer's New Jersey allocation percentage) with the CBT on the related member's allocated income (lower of the royalty payment or its ENI using the related member's New Jersey allocation percentage). If the CBT on the related member's allocated income is more than the CBT on the allocated royalty payments by the taxpayer, then the taxpayer is permitted to deduct the entire royalty payment amounts (*i.e.* it does not have to addback the deducted amount). If not, the taxpayer is only allowed a partial exception from the addback. That amount is computed by dividing the lower CBT by the 9% CBT rate (which converts the tax to the related member's New Jersey allocated income), and dividing that result by the taxpayer's allocation factor (*see infra* p.7 for such a computation). No exception is provided if (1) the related member did not include the royalty payments as income on a CBT return; or, (2) the related member included the royalty payments as income but its "tax liability" was not "greater than the statutory minimum tax;" or (3) the related member's ENI as reported on its CBT return was "zero or less."

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

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

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

(D) Parent's Expedited Refund Claim

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

Promptly thereafter, Parent sought an "expedited payment of a portion of the CBT refunds because [Subsidiary] recently paid CBT and the payments result in an allowed expense deduction for [Parent]." Parent noted that it nonetheless "continue[d] to challenge the remainder of the royalty add back." This meant that Parent would continue its appeal in Tax Court on the remainder of its refund claims originally made in 2007. The partial refund immediately sought totaled $2,786,860, with the Schedule G-2 now using Subsidiary's reported (as opposed to audited) allocation factors and ENI as follows:

<table>
<tr><th>Tax Year</th><th>Royalty Amount</th><th>ENI</th><th>Allocation</th></tr>
<tr><td>2002</td><td>$493,127,808</td><td>$510,534,251</td><td>1.8659%</td></tr>
<tr><td>2003</td><td>$488,649,907</td><td>$491,752,373</td><td>1.6111%</td></tr>
<tr><td>2004</td><td>$497,402,778</td><td>$498,730,036</td><td>1.4358%</td></tr>
<tr><td>2005</td><td>$510,782,834</td><td>$515,938,340</td><td>1.3214%</td></tr>
<tr><td colspan="2">CBT</td><td colspan="2">Excepted From Addback</td></tr>
<tr><td colspan="2">$828,114</td><td colspan="2">$326,888,826</td></tr>
<tr><td colspan="2">$708,538</td><td colspan="2">$317,804,152</td></tr>
<tr><td colspan="2">$642,754</td><td colspan="2">$327,451,220</td></tr>
<tr><td colspan="2">$607,454</td><td colspan="2">$315,750,790</td></tr>
</table>

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

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

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

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

D. Expedited refund sought was 9% of $326,888,826 = $828,114.[6]

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

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

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

ANALYSIS

(A) Appropriateness of Summary Judgment

Summary judgment will be granted "if the pleadings, depositions, answers to interrogatories and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact challenged and that the moving party is entitled to a judgment or order as a matter of law." *R.* 4:46-2(c); *Brill v. Guardian Life Ins. Co. of Am.*, 142 N.J. 520, 523, 666 A.2d 146 (1995). The only issue is whether Parent is entitled to the balance of its refund claims made in 2007, or in other words, whether Parent is entitled to deduct the full amount of royalty fees paid to Subsidiary. There being no material facts in dispute, summary judgment is appropriate.

(B) Addback Provisions and its Exceptions

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

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

> limit[ing] the ability of a taxpayer to deduct royalties . . . when paid to affiliates. The provision addresses, but does not solely apply to, a tax avoidance device that allows a multicorporate structure to export income from a state where the income is generated as a form of expense (for example, as a royalty payment to an out-of-state affiliate that the paying corporation deducts from its income) and then import the income back (for example as a tax-free dividend or as a loan).
>
> [*Ibid.*]

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

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

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

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

Taxation's regulations reiterate the Royalty Addback statute. Thus, N.J.A.C. 18:7-5.18(b) provides that "intangible expenses and costs directly or indirectly paid . . . in connection with a transaction with one or more related members shall not be deducted in calculating [ENI]." However, "a deduction shall be permitted . . . [i]f the taxpayer establishes that the adjustments are unreasonable by showing the extent that the payee pays tax to New Jersey on the income stream." N.J.A.C. 18:7-5.18(b)(3) (hereinafter the "Royalty U-E-T-A regulation.").[7]

C. Validity of Providing a Partial Addback Exception

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

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

(1) Standard of Review

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

Initially, the court rejects Parent's argument that zero deference must be afforded to Taxation's actions. The issue before this is court the validity of the Royalty U-E-T-A regulation wherein Taxation has exercised its discretion by providing relief from double taxation. The standard of review is not devoid of deference. *See GE Solid State, Inc. v. Dir., Div. of Taxation*, 132 N.J. 298, 306, 625 A.2d 468 (1993) ("Agency regulations are presumptively valid . . . and should not be invalidated unless they violate the enabling act or its express or implied legislative policies . . . [however,] an administrative agency may not, under the guise of interpretation, extend a statute to give it a greater effect than its language permits."). Courts have also "recognized" Taxation as having "expertise, particularly in specialized and complex areas of" the tax laws, and while not a "total . . . deference," Taxation's "interpretation will prevail as long as it is not plainly unreasonable." *Koch v. Dir., Div. of Taxation*, 157 N.J. 1, 8, 722 A.2d 918 (1999) (citation and internal quotation marks omitted).

Zero deference is also inappropriate because the "shall not apply" language in the Royalty U-E-T-A statute is contingent upon Taxation's discretionary determination. *See Kraft Foods Global, Inc. v. Dir., Div. of Taxation*, 29 N.J. Tax 224, 239 (Tax 2016) (plain language of the Interest U-E-T-A statute shows that "the Legislature intended to delegate to [Taxation] . . . in the first instance the authority to evaluate the [taxpayer's] evidence . . . and to determine whether it would be unreasonable to deny an exception," therefore, Taxation's determinations are entitled to deference); *Morgan Stanley & Co. Inc. v. Dir., Div. of Taxation*, 28 N.J. Tax 197, 220 (Tax 2014) (providing, as non-exhaustive examples, circumstances likely to establish unreasonableness, some if not many of which could involve a fact-sensitive inquiry and an exercise of Taxation's discretion).[8]

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

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

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

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

The purpose of the Royalty U-E-T-A regulation is avoidance of double taxation. *See* 35 N.J.R. 1573(a) (April 7, 2003) (proposed regulation allows a "deduction" of intangible costs or interest expenses paid to related members "if disallowance would be unreasonable since the payee paid tax to New Jersey on the same income stream" and Taxation's regulations attempts to address equitable concerns of double taxation and income distortion); 35 N.J.R. 4310 (a) (Sep. 15, 2003) ("Exception 2" of Schedule G "implements a discretionary exception to prevent the double payment of tax"). It cannot be credibly argued that allowing relief from dual taxation is an invalid exercise of Taxation's discretion. *See, e.g., Morgan Stanley*, 28 N.J. Tax at 220 (one example of unreasonableness under the Interest U-E-T-A statute would be "unfair double taxation"). Parent also does not dispute that the basis for its expedited demand for a portion of the refund claimed, and its repayment by Taxation, was double payment of CBT on the royalty amount which Parent claimed as a deduction, and which Subsidiary included as its New Jersey allocated income.

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

However, there is nothing in the Royalty U-E-T-A regulation to indicate that even if the amounts reported by each the payor and the payee are identical, the addback would only be partial. Rather, the plain language of the Royalty U-E-T-A regulation indicates that as long as the royalty recipient pays CBT to New Jersey on the royalty income, an addback is not required for the royalty payor. It is only after completion of the computation on Schedule G-2 (which is not incorporated into or referenced in the Royalty U-E-T-A regulation although alluded to in the regulatory history), is it known that unless the royalty recipient (related member) pays 9% CBT on the entire royalty deduction amount, the royalty payor will not receive a full deduction for the same. Taxation argues that this is reasonable because (1) the deduction amount must match the royalty income amount; (2) there is double taxation only if the CBT paid is on an amount that matches the deduction amount; (3) here, there is no expense-income matching because Parent's allocated royalty expense is greater than Subsidiary's allocated income; (4) Taxation refunded the amounts of dual tax to Parent; and (5) allowing a full deduction will frustrate the BTRA's intent.

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

> The [CBT] does not reach some out-of-state companies that do business here. Instead,

> these companies are able to take advantage of the state's lucrative market, extensive infrastructure, and geographic prominence, while paying no corporate taxes to New Jersey. . . . [The BTRA] closes numerous loopholes that allow profitable companies to reduce their net New Jersey income on paper and avoid their true tax liability and avoid paying their fair share. . . .
>
> [*Statement to Assembly 2501.*]

See also 35 N.J.R. 1573(a) (The BTRA "was designed to prevent income shifting by multi-state taxpayers," such as where intangibles owned by a "holding company in a low tax or no tax state, [are] license[d] . . . back to its New Jersey . . . subsidiary," which would deduct "royalty payments") (citing to certain cases from Massachusetts). To this extent then, an addback is required if the transaction generating the expense controvert the goals of the BTRA. *See Senate Budget & Approp. Comm. Statement to Senate No. 1556* at 3 (" . . . [a]s with the similar provision for intangible costs, the disallowance [of an interest deduction] is unreasonable if it would violate the policy goals of the disallowance."). Thus, if a claimed deduction, or even a portion of the same, would frustrate or defeat the underlying goals and intent of the BTRA, then it could, and should be disallowed. Therefore, if there is evidence that the royalty payor is still exporting its income from New Jersey to an out-of-state related member which is in a zero or "low tax" state, with the related member (royalty recipient) claiming immunity from being subject to the CBT, then, exceptions from the addback need not automatically be permitted.

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

It is true that Royalty Addback statute does not have the same subject-to-tax provision as the Interest Addback statute. *See* N.J.S.A. 54:10A-4(k)(2)(I) (allowing deduction of interest paid to a related member provided, among others, the related member have been subject to tax on that interest income, at an effective tax rate of at least 6%, which measure of tax includes the interest income). This however, does not automatically permit an inference that the 9% CBT must be collected on the entire amount of the royalty deduction claimed for the Royalty U-E-T-A statute to apply. *See, e.g.*, *Senate Budget & Approp. Comm. Statement to Senate No. 1556* 3 (Taxation can enter into agreements "with the taxpayer to produce an *equitable level of taxation*") (emphasis added).

What is of more concern to the court here is that the alleged mismatch of the allocated royalty expense versus royalty income arises solely due to differing allocation factors of Parent and Subsidiary respectively. The BTRA's concerns arose because New Jersey, as a separate reporting State, allowed members to move income earned in and allocable to New Jersey (by claiming deduction of certain expenses and reducing the ENI, thus, the CBT), to a state where that same New Jersey-sourced, but non-taxed income would also be non-taxed to the royalty recipient related member under that state's tax laws. Here, however, Subsidiary, the royalty recipient related member, complied with the requirements of separate reporting by filing its own CBT returns, and paying CBT, and using its own allocation factor.[9] Under such a

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

Note that of the six states in which Subsidiary filed tax returns, *see supra* n.6, North Carolina, South Carolina, Florida, Iowa, and Massachusetts are separate reporting jurisdictions such circumstance, Taxation cannot, *without more*, credibly maintain that Parent and Subsidiary's allocation factor should be the same for Parent to obtain a deduction of the full amount of royalties paid.

Moreover, the purpose of the allocation factor, utilizing a typically accepted three-factor formula using property, payroll and receipts/sales, is that it fairly reflects a corporation's "share of the activities by which value is generated" and avoids large income allocation "distortions." *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159, 183, 103 S.Ct. 2933, 77 L.Ed.2d 545 (1983); *Metromedia, Inc. v. Dir., Div. of Taxation*, 97 N.J. 313, 322-323, 478 A.2d 742 (1984) (noting that the three-factor allocation formula applicable to the "net income tax bases" ensures that "only those portions of . . . net income . . . that are fairly attributable to the corporation's activities in New Jersey are used in the measure of the tax" and as averaged are "applied to the taxpayer's . . . net income . . . to determine the . . . portion of . . . net income properly attributable, and thus taxable, to New Jersey."). Allocation of multi-state income is thus a legally required consequence of, and pre-requisite to, its taxability.

However, "even the three-factor formula is necessarily imperfect," and income allocation is akin "to slicing a shadow," thus, "absolute consistency, even among taxing authorities whose basic approach to the task is quite

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as New Jersey. *See* Bogenschneider & Heilmeier, 16 *Houston Bus. & Tax L.J.* at 42-43 (providing a list of states which are separate reporting jurisdictions). Florida, Oklahoma, and South Carolina have no addback statutes. *Ibid.*

similar" is impractical. *Container Corp. of Am.*, 463 U.S. at 183, 192, 103 S.Ct. 2933. *See also Metromedia*, 97 N.J. at 323, 478 A.2d 742 ("It is the implicit premise of the [CBT] Act that the statutory three-ply formula can only approximate the taxpayer's true net worth and income generated by its New Jersey activities."). Consequently, it is not necessarily surprising that related members will not have the same allocation factors.

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

Indeed, the BTRA recognized that the addback could cause economic distortion or other inequity in valid, non-tax avoidance situations. This is why it allowed for compromises or agreements as to apportionment, and also vested authority with Taxation to make adjustments under N.J.S.A. 54:10A-8 ("Section 8") to allow for equitable apportionment and consequent taxation. *See* N.J.S.A. 54:10A-4.4(c)(1)(c); 4.4(d). *See also F.W. Woolworth Co. v. Dir., Div. of Taxation*, 45 N.J. 466, 497, 499, 213 A.2d 1 (1965) (Taxation is obligated to consider Section 8 adjustments because "taxation of multi-state businesses should be administered on a basis which is equitable, and not merely constitutional, to the corporate taxpayer as well as to the State."). Nothing of that sort was even attempted here. To the contrary, Taxation accepted Subsidiary's allocation factor for each tax year. *See Lorillard*, 28 N.J. Tax at 596 (Taxation reviewed Subsidiary's CBT returns "for all other issues and elected to make no further adjustments to Subsidiary's CBT obligations.").

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

Through use of an addback, "though the taxing authority does not directly pursue the out-of-state [Intellectual Property] holding company, the result is the same: Apportioned royalty income is subject to state taxation." Xuan-Thao N. Nguyen, *Holding Intellectual*

Property, 39 *Ga. L. Rev.* 1155, 1192-1194 & n.198 (Summer 2005). Here, Subsidiary included in its income base, the royalty payments from Parent, and paid CBT to New Jersey under its allocation factor. In the absence of any allegations that Subsidiary's allocation factor does not properly represent its allocable income to New Jersey, the court is hard pressed to accept Taxation's argument that there was a mismatch of income and expense solely due to the difference in the unchallenged allocation factors of Parent and Subsidiary. Therefore, Taxation did not exercise its discretion fairly by deeming only a portion of the royalties paid by Parent to Subsidiary as excepted from addback.

CONCLUSION

For the aforementioned reasons, and under the facts presented here, the court grants summary judgment to Parent. Taxation should issue the remainder of Parent's refund claims for tax years 2002-2005, with the statutorily permitted interest. In light of this relief, the court finds it unnecessary to address Parent's constitutional attacks on the Royalty U-E-T-A regulation.[10]

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

APPENDIX F — CONSTITUTIONAL, STATUTORY, AND REGULATORY PROVISIONS INVOLVED

UNITED STATES CONSTITUTION

Article I, Section 8, Clause 3:

> The Congress shall have Power . . . To regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes; . . .

* * *

Appendix F

UNITED STATES CONSTITION

AMENDMENT XIV

SECTION 1.

> . . . nor shall any State deprive any person of life, liberty, or property, without due process of law. . . .

* * *

2002 N.J. Stat. § 54:10A-4.4

Definitions relating to computing entire net income and related member transactions

* * *

b. For purposes of computing its entire net income under section 4 of P.L. 1945, c. 162 (C. 54:10A-4), a taxpayer shall add back otherwise deductible interest expenses and costs and intangible expenses and costs directly or indirectly paid, accrued or incurred to, or in connection directly or indirectly with one or more direct or indirect transactions with, one or more related members.

c.

(1) The adjustments required in subsection b. of this section shall not apply if: * * * (b) the taxpayer establishes by clear and convincing evidence, as determined by the director, that the adjustments are unreasonable.

* * *

Appendix F

N.J.A.C. 18:7–5.18

[Effective June 19, 2017]

* * *

(b) Interest expenses and costs and intangible expenses and costs directly or indirectly paid, accrued, or incurred in connection with a transaction with one or more related members shall not be deducted in calculating entire net income, except that a deduction shall be permitted:

* * *

3. If the taxpayer establishes that the adjustments are unreasonable by showing the extent that the payee pays tax to New Jersey on the income stream;

* * *

Appendix F

N.J.A.C. 18:7–5.18

[Effective April 8, 2020]

* * *

(b) Interest expenses and costs, as well as, intangible expenses and costs directly or indirectly paid, accrued, or incurred in connection with a transaction with one or more related members shall not be deducted in calculating entire net income, except that a deduction may be permitted:

* * *

3. If the taxpayer establishes, to the satisfaction of the Director, that the adjustments are unreasonable by clear and convincing evidence, and any one of the following circumstances applies:

i. Unfair duplicate taxation;

* * *

iv. An unconstitutional result; or

v. The transaction is equivalent to an unrelated loan transaction;

APPENDIX G — RELEVANT PAGES FROM DEFENDANT'S RESPONSE AND REPLY BRIEF, FILED MARCH 14, 2024

SUPERIOR COURT OF NEW JERSEY
APPELLATE DIVISION

DOCKET NO. A-003444-18T1

Civil Action

On Appeal From A Final Decision Entered
In The Tax Court Of New Jersey

Sat Below:
Hon. Mala Sundar, J.T.C.

LORILLARD TOBACCO COMPANY,

Respondent/Cross-Appellant,

v.

DIRECTOR, DIVISION OF TAXATION,

Appellant/Cross-Respondent.

APPELLANT/CROSS-RESPONDENT'S
RESPONSE AND REPLY BRIEF

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* * *

C. The Tax Does Not Discriminate Against Interstate Commerce and Satisfies Prong Three.

* * *

1. Taxation's interpretation of the BTRA does not discriminate against interstate commerce.

* * *

When subsidiary's New Jersey presence increases, parent benefits, thus incentivizing New Jersey activity to the detriment of interstate commerce.

* * * *