NJ court rules royalty addback does not avoid subsidiary filing obligation

Overview

The Tax Court of New Jersey (Tax Court) recently held that a non-New Jersey subsidiary corporation was obligated to file a Corporate Business Tax (CBT) return to report and pay tax on royalty income received from its parent company.[1] The Tax Court reasoned that the subsidiary's filing requirement was not alleviated by the parent corporation's failure to claim a CBT benefit for the corresponding royalty payments.[2] The period for filing an appeal in the case remains open as of the date of this Tax Alert.[3] Accordingly, the case is not yet final.

This Tax Alert summarizes the Tax Court's decision and offers some taxpayer considerations.

Background

In 2002, the New Jersey Legislature enacted the Business Tax Reform Act (BTRA), which included a provision that denied deductions for royalty payments made to a related corporate member. The denial of such deductions is accomplished under the BTRA by requiring taxpayers to "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."[4]

For tax years 2000 and 2001, the taxpayer, Spring Licensing Group (Springs),[5] filed CBT returns and paid CBT on taxable income proportionate to its New Jersey receipts related to its royalty income. For the 2002 tax year, Springs filed its CBT return, marking it as a "final" return and leaving blank all line items of income or expense with the exception of a request for a refund of $165,747. As part of its 2002 tax year return filing, Springs explained that pursuant to the BTRA, income from intercompany royalty transactions will be added back on future CBT returns to be filed by Springs' parent company, Spring Industries, Inc. (SII).[6] Springs also asserted:

> [U]nder new *N.J.A.C.* 18:7-5.18(b), a regulation promulgated to interpret the BTRA, its prior CBT filings under *N.J.A.C.* 18:7-1.9(b) (which subjected to CBT, a foreign entity "doing business" in the State), were "technically incorrect." Therefore, it noted, its 2002 return was being filed as final, with "future intercompany royalty payments" to be reported on SII's CBT returns.[7]

In accordance with the addback provisions of the BRTA, SII added back royalty payments for tax years 2002 and 2003.[8]

In January 2004, the Division of Taxation (Division) issued Springs the requested $165,747 refund applicable to the 2002 tax year.[9] However, in January 2005, the Division requested repayment of the refund, explaining that

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[1] *Spring Licensing Group, Inc. v. Director, Div. of Taxation*, Tax Court of New Jersey, Dkt. No. 010001-2010 , Aug. 14, 2015, at 16-17. A copy of the case is available here.
[2] *Id.*
[3] N.J. Rules of Court §2:4-1(a) provides that: "Appeals from final judgments of courts … shall be taken within 45 days of their entry."
[4] N.J. Stat. Ann. §54:10A-4.4(b).
[5] Spring was incorporated in South Carolina and had no offices, employees, or property in New Jersey for tax years 2000 and 2001. Spring is in the business of licensing trademarks that it owns.
[6] *Spring Licensing Group, Inc.*, at 3. SII is incorporated in South Carolina and is authorized to do business in New Jersey. SII licenses trademarks from Springs.
[7] *Id.*
[8] *Id.*
[9] *Id.*

because Springs' refund claim was based upon *Lanco v. Director, Div. of Taxation*,[10] the Division required additional information before the claim could be granted.[11] The Division also advised Springs that the add-back of royalty expenses under the BTRA "does not have any impact on the subjectivity or taxability of the intangible holding company."[12] Springs refused to return the refund until *Lanco* was reversed or modified.[13] Springs filed additional refund claims for 2000 and 2001.

Finally, the Division audited Springs' CBT returns for 2000 through 2003. In the audit narrative, the Division noted that "Springs should have filed a 2002 CBT return reporting royalty income and allocating the same, while SII should have claimed an exception to the royalty payment add-back on Schedule G, Part II[,]"[14] which would have allowed SII a deduction.

The Tax Court's decision

The issue before the Tax Court was whether "Springs must file CBT returns and pay tax on royalties received from SII for 2002 and 2003, even if SII added back such royalty payments on its CBT returns in calculating SII's … [entire net income for CBT purposes]."[15]

In addressing this issue, the Tax Court began by rejecting Springs' filing position asserted on its final 2002 return by pointing out that "the BTRA expanded the reach [of the CBT] to a foreign corporation which was deriving receipts from New Jersey … to the full extent permitted under the United States Constitution …."[16] The Tax Court also noted the relevance of the decision in *Lanco*, wherein the New Jersey Superior Court (Appellate Division) concluded that the CBT "'may be constitutionally applied to … licensing fees attributable to New Jersey,' and earned by a foreign corporation that has no physical presence, employees or property in the State."[17] The Tax Court pointed out that Springs' complaint "did not allege that royalty payments it received from SII were immune from the ruling in *Lanco* or that it was otherwise constitutionally protected from being subject to CBT."[18] The Tax Court noted further that there is no indication that the "subjectivity provision" (economic nexus pursuant to N.J. Stat. Ann. §54:10A-2) or the add-back provision (N.J. Stat. Ann. §54:10A-4.4) were to be applied in the alternative, nor were there cross references or exceptions "to the application of one statute from the other."[19]

The Tax Court also rejected Springs' argument that requiring both subsidiary (recipient) and parent (payor) to file tax returns would result in unconstitutional double taxation. Springs argued that "the BTRA did not contemplate taxation of the foreign payee, since by capturing the income shifted out-of-State via the add-back, New Jersey is made whole."[20] The Tax Court disagreed, and went on to point out that the Division "was also cognizant of the possibility of dual taxation" and promulgated regulations to address such circumstances.[21] For example, as noted by the court, the Division allows an "exception to the add-back situations where the 'payee pays tax to New Jersey on the income stream.'"[22]

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[10] This was 2005, when the appeal of the Tax Court's decision in *Lanco* was still pending before the Superior Court of New Jersey, Appellate Division. The case involved a foreign corporation that lacked physical presence in New Jersey, but received income from intangibles used in a New Jersey business conducted by an affiliated corporation. The Tax Court had determined that "the state may not assert nexus, absent physical presence, against a corporation that receives income from the use of trademarks or other intangibles employed in a New Jersey business conducted by an affiliated corporation." *Lanco v. Director, Div. of Taxation*, 21 N.J. Tax 200, 219 (Tax Ct., 2003). On this basis, the Tax Court concluded that: "physical presence is a necessary element of Commerce Clause nexus for taxation, [and that, accordingly,] judgment shall be entered in favor of plaintiff Lanco invalidating the Director's determination that it is subject to the New Jersey Corporation Business Tax." Id. at 220. On Aug. 24, 2005, the Appellate Division of the Superior Court reversed the Tax Court's decision. *Lanco*, *rev'd* and *remanded*, 379 N.J. Super. 562 (App. Div., 2005). As noted in the Appellate Division's holding, "We are satisfied that the physical presence requirement applicable to use and sales taxes is not applicable to income tax and that the New Jersey Business Corporation Tax may be constitutionally applied to income derived by plaintiff from licensing fees attributable to New Jersey." Id., at 573. In 2006, the New Jersey Supreme Court affirmed the Appellate Division's decision, holding that "the director constitutionally may apply the Corporation business Tax notwithstanding a taxpayer's lack of a physical presence in New Jersey…." *Lanco*, *aff'd*, 188 N.J. 380, 383 (2006). The US Supreme Court denied further review in 2007. *Lanco*, *cert. denied*, 551 U.S, 1131 (2007).

[11] *Spring Licensing Group, Inc.*, at 3-4.

[12] *Id.* at 4.

[13] *Id.* As noted previously, in 2005 (when the Division sought repayment of the refund) the Tax Court's *Lanco* decision in favor of the taxpayer in that case was still pending on appeal before the Appellate Division of the Superior Court. Thus, at that time the *Lanco* decision was still favorable from a taxpayer perspective.

[14] *Id.*

[15] *Id.* at 6.

[16] *Id.* at 6-7.

[17] *Id.* at 7, citing *Lanco*, 379 N.J. Super. at 573.

[18] *Spring Licensing Group, Inc.*, at 7.

[19] *Id.* at 9.

[20] *Id.* at 10.

[21] *Id.* at 13.

[22] *Id.*, quoting N.J. Admin. Code §18:7-5.18(b)(3).

Finally, the Tax Court pointed out that "there is nothing in the add-back statute that prevents a payee from obtaining relief under [N.J. Stat. Ann. §54:10A-8] [(]Section 8[)]."[23] This provision authorizes the Division to consider "an alternative method of apportionment."[24] The Tax Court noted further that the facts in the case show that "Springs was well aware of SII's ability to file amended CBT returns for 2002 and 2003 to claim an exception to the add-back on grounds Springs paid the CBT."[25] The Tax Court also pointed out that the Division can negotiate agreements or compromises "otherwise allowed by law."[26] Viewing these various remedies in the context of Springs' double taxation argument and the failure of both Springs and SII to avail themselves of such remedies, the Tax Court explained:

> Law allows alleviation of a potential double taxation by the payor having to seek an exception from the add-back, or the payor and/or payee seeking relief under Section 8. [The Division] … must ensure that income is taxed only once, but it cannot do so if it has no returns to even consider Section 8 adjustments. Where, as here, a foreign [intangible holding company] … chooses not to use the statutorily available remedies to alleviate issues of double taxation, but instead opts to simply not file CBT returns, claims of unconstitutional double taxation are questionable.[27]

Based on the foregoing, the Tax Court concluded that the Division's "actions in requiring Springs to file CBT returns to report the royalty income from its in-state related member is [sic] not arbitrary or unlawful."[28]

Considerations

As noted previously, the period for filing an appeal in the case remains open as of the date of this Tax Alert. Although this case is not final, taxpayers may wish to consult with their qualified tax adviser regarding the impact of this decision relative to potential filing positions involving intercompany royalties or other relevant transactions. Where applicable, that consultation may also consider situations where Section 8 relief may be appropriate and fact patterns that could create double tax, or whipsaw, outcomes.

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[23] *Spring Licensing Group, Inc.*, at 14.
[24] *Id.* at 12.
[25] *Id.* at 15.
[26] *Id*. at 12, citing N.J. Stat. Ann. §54:10A-4.4 (c)(1)(c).
[27] *Spring Licensing Group, Inc.*, at 16-17.
[28] *Id.* at 17.