STATE OF NEW YORK

TAX APPEALS TRIBUNAL

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

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

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

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

ISSUES

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

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

FINDINGS OF FACT

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

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

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

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

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

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

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

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

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

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

9. WTC does not have any United States sales.

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

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

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

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

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

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

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

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

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

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

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

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

> marketability, education of users, service and maintenance of IBM Programs and to make such knowledge and technical know-how available to [Alien S&D Affiliate] in the United States of America without separate charge . . . ."

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

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

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

> "WTC . . . grants to [Alien S&D Affiliate] a non-exclusive, nontransferable license under IBM Technology to manufacture or have made (when [Alien S&D Affiliate] acts in its capacity as a manufacturer and not in its capacity as a distributor), for subsequent sale, lease, internal use, or other disposition, Products within Product Families specified [therein], and to practice any method or process used in such manufacture or internal use by [Alien S&D Affiliate].
>
> WTC . . . grants to [Alien S&D Affiliate] . . . a non-exclusive, nontransferable

> license to utilize the now and hereafter existing IBM Trademarks on or in association with Products produced under the grant [above] for the purpose of marketing, selling and leasing such Products and to use in its trade names the IBM Trademark 'IBM' . . . ."

The hardware agreement defines "Technology" as:

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

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

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

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

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

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

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

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

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

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

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

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

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

28. Petitioner timely filed original New York State combined corporation franchise tax

returns (form CT-3-A) for all periods at issue.

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

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

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

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

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

32. For 2008, the $8,768,166,400.00 deduction was composed of $6,426,579,964.00 in software payments pursuant to terms akin to the sample agreement described in finding of fact

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

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

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

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

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

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

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

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

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

38. For 2012, the $7,392,258,177.00 deduction was composed of $5,647,363,014.00 in software payments pursuant to terms akin to the sample agreement described in finding of fact

20; $312,280,649.00 in hardware payments pursuant to terms akin to the sample agreement described in finding of fact 21; $1,328,718,902.00 in service/maintenance payments pursuant to terms akin to the sample agreement described in finding of fact 22; and $103,895,612.00 in buy-in/other payments pursuant to terms akin to the sample agreement described in finding of fact 23.

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

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

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

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

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

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

45. The Division issued a notice of deficiency, notice number L-045504338, on October 5, 2016, asserting additional corporation franchise tax and MTA surcharge in the amount of

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

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

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

THE DETERMINATION OF THE ADMINISTRATIVE LAW JUDGE

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

Next, the Administrative Law Judge addressed the main issue: whether the royalty payments paid to petitioner by the Alien Affiliates were properly excluded from petitioner's ENI pursuant to Tax Law former § 208 (9) (o) (3). The Administrative Law Judge found that the legislature intended for the royalty income exclusion to work in tandem with the royalty payment

add back provision under Tax Law former § 208 (9) (o) (2) to eliminate a common tax avoidance strategy by which corporate taxpayers made deductible royalty payments to controlled affiliates. According to the Administrative Law Judge, the legislature's intent was for such royalty payments to be subject to tax once, by either the payer or the payee, and not to go untaxed. The Administrative Law Judge found that petitioner's interpretation effectively added words to Tax Law former § 208 (9) (o) (3) (i.e., the Alien Affiliates "would" have been subject to Tax Law former § 208 (9) (o) (2) *if they were New York taxpayers*). The Administrative Law Judge observed that the add back provision does not apply to petitioner's Alien Affiliates because such entities were not New York taxpayers. He determined, accordingly, that the income exclusion provision should not apply to petitioner. The Administrative Law Judge reasoned that, otherwise, the royalty payments will not be subject to tax at all, an outcome he deemed contrary to the legislature's intent. The Administrative Law Judge also found support for his statutory interpretation in the legislative history of the 2013 amendments to Tax Law § 208 (9) (o) by which the royalty income exclusion was repealed. The Administrative Law Judge thus concluded that petitioner improperly excluded the payments at issue from its entire net income.

The Administrative Law Judge then addressed petitioner's contention that the Division's interpretation of Tax Law former § 208 (9) (o) violates the dormant Commerce Clause of the United States Constitution. The Administrative Law Judge noted petitioner's claim that the statute is unconstitutional on its face and that the Division of Tax Appeals' jurisdiction does not extend to such claims. He further observed that the Division of Tax Appeals has authority to rule on as-applied constitutional claims, but found that petitioner did not establish that the relevant statute was unconstitutional as applied here. The Administrative Law Judge

determined that Tax Law former § 208 (9) (o) does not impose a heavier burden on royalty payments based on the location of the payer. Rather, the Administrative Law Judge found that the statute subjects royalty payments to tax once regardless of whether the payer is a New York taxpayer. The Administrative Law Judge also noted that the add back and exclusion provisions are triggered only if the payer and payee are related parties as defined in the statute. The Administrative Law Judge thus concluded that the statute, as applied, does not discriminate against interstate commerce.

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

ARGUMENTS ON EXCEPTION

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

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

Contrary to the Administrative Law Judge's conclusion, petitioner asserts that the

subsequent amendments to the royalty income exclusion statute demonstrate that prior law permitted exclusion of royalty income under the circumstances present here.

Petitioner also contends that the royalty income exclusion provision as interpreted and applied by the Administrative Law Judge results in different treatment for royalties received from New York taxpayers and non-New York taxpayers and thereby discriminates against interstate and foreign commerce contrary to the Commerce Clause of the United States Constitution.

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

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

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

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

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

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

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

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

OPINION

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

ENI is generally a taxpayer's entire federal taxable income modified by specific additions or subtractions (Tax Law former § 208 [9]). During the years at issue, ENI consisted of

investment income and business income (Tax Law former § 208 [6], [8]). Investment income was allocated to New York using the investment allocation percentage (Tax Law former § 210 [3] [b]). Business income was allocated to New York using the business allocation percentage (BAP) (Tax Law former § 210 [3] [a]). These allocated amounts were totaled to arrive at the ENI base, which was subject to tax at the applicable rate (Tax Law former § 210 [1] [a]).

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

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

Tax Law former § 208 (9) (o) (2), referenced above, is the royalty expense add back, an addition modification that requires a taxpayer to add back royalty payments made to a related member in computing ENI, to the extent such payments were deductible in calculating federal taxable income, unless one of the following exceptions apply: (1) the taxpayer-royalty payer is included in a combined report with the related member-royalty payee; (2) the related member-royalty payee later pays the royalty amounts to an unrelated party during the taxable year; or (3) the royalty payments are made to a non-U.S. related member that is subject to a comprehensive tax treaty with the United States. None of these exceptions apply here.

As to the correct standard of construction of Tax Law former § 208 (9) (o) (3), where, as in the present matter, "the question is whether taxation is negated by a statutory exclusion or exemption, . . . 'the presumption is in favor of the taxing power'" (***Matter of Wegman's Food Markets, Inc. v Tax Appeals Trib. of the State of N.Y.*** (33 NY3d at 592 quoting ***Matter of***

Mobil Oil Corp. v Finance Adm'r of City of N.Y., 58 NY2d 95, 99 [1983]). This means that any ambiguity or uncertainty in the meaning of the statute must be resolved against the taxpayer and that the taxpayer's interpretation of the statute must be not only plausible, but must be the only reasonable construction (***Matter of Charter Dev. Co., L.L.C. v City of Buffalo***, 6 NY3d 578, 582 [2006]).

The language of the statute "is the clearest indicator of legislative intent and courts should construe unambiguous language to give effect to its plain meaning" (***Matter of DaimlerChrysler Corp. v Spitzer***, 7 NY3d 653, 660 [2006]). The statutory language "must be read in [its] context, and words, phrases, and sentences of a statutory section should be interpreted with reference to the scheme of the entire section" (McKinney's Cons Laws of NY, Book 1, Statutes § 97). Ultimately, proper statutory construction focuses on "the precise language of the enactment in an effort to give a correct, fair and practical construction that properly accords with the discernable intention and expression of the Legislature [citation omitted]" (***Matter of 1605 Book Ctr. v Tax Appeals Trib. of State of N.Y.***, 83 NY2d 240, 244, 245 [1994], ***cert denied*** 513 US 811 [1994]).

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

As noted, petitioner argues that, as none of the statutory exceptions to the add back are applicable, then the royalty payments at issue are the type that "would be required" to be added

back under Tax Law former § 208 (9) (o) (2). According to petitioner, the payments thus meet the requirement for the income exclusion under Tax Law former § 208 (9) (o) (3) (royalty payments from related member excluded from ENI unless they would *not* be required to be added back under the add back provision).

While the present matter was pending, this Tribunal issued our decision in ***Matter of Walt Disney Co.*** (Tax Appeals Tribunal, August 6, 2020), where we held that the royalty income exclusion under Tax Law former § 208 (9) (o) (3) was not available to a taxpayer where, as here, the related member-alien affiliates were not New York taxpayers. We also determined that this interpretation of Tax Law former § 208 (9) (o) (3) as applied to the facts in ***Disney*** did not discriminate against foreign commerce as asserted by petitioner in that case and thus did not violate the dormant Commerce Clause. The royalty transactions between petitioner and its Alien Affiliates are not materially different than the royalty transactions at issue in ***Disney***. Accordingly, pursuant to the following discussion, we reject petitioner's arguments and we sustain the Administrative Law Judge's conclusions on the issues presented herein.

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

We also found that our interpretation of the statutory language, i.e., that the income exclusion was conditioned on a corresponding expense add back, comported with the overall

statutory scheme. We noted that both the add back and exclusion provisions were enacted together and that the add back was expressly intended to eliminate a loophole by which a corporation reduced its ENI base by transferring intangible assets to a related corporation and paid a royalty for the use of such assets (***see*** L 2003, chs 62, 63, 686; New York Bill Jacket, 2003 SB 5725, Ch 686 Part M). By denying a deduction, the add back subjects a taxpayer-royalty payer to franchise tax on royalties paid to a related member (with certain exceptions not relevant here). Where both the royalty payer and payee are New York taxpayers, the add back and income exclusion together simply shift the incidence of tax on the royalties from payee to payer and thereby avoid subjecting the same revenue to franchise tax twice. Considering the language of Tax Law former § 208 (9) (o) as a whole, and the express intent of the add back provision, we concluded in ***Disney*** that the legislature did not intend for a taxpayer to gain the benefit of the income exclusion under subparagraph (3) without the accompanying cost to a related member of the add back under subparagraph (2).

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

As noted, we also determined in ***Disney*** that our interpretation of Tax Law former § 208 (9) (o) (3) as applied therein did not discriminate against foreign commerce and thus did not violate the dormant Commerce Clause. In reaching this conclusion, we followed the principle of taking the "whole scheme of taxation into account" (***Halliburton Oil Well Cementing Co. v***

Reily, 373 US 64, 69 [1963]). We further noted that case law defines dormant Commerce Clause discrimination in terms of economic interests, as opposed to the interests of taxable entities (***e.g. Oregon Waste Sys., Inc. v Dept. of Envtl. Quality of Oregon***, 511 US 93, 99 [1994] ["'discrimination' simply means differential treatment of in-state and out-of-state economic interests that benefits the former and burdens the latter"]; ***New Energy Co. of Indiana v Limbach***, 486 US 269, 273 [1988] [discrimination defined generally as "regulatory measures designed to benefit in-state economic interests by burdening out-of-state competitors"]). We also observed that the income exclusion and the expense add back provision apply only in the context of related member transactions and that related members, by definition, share the same economic interest. Accordingly, we considered the impact of both the income exclusion and the expense add back components of Tax Law former § 208 (9) (o) on the shared economic interest of the petitioner in ***Disney*** and its related member alien affiliates. We thus concluded that Tax Law former § 208 (9) (o) (3) as applied did not violate the dormant Commerce Clause.

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

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

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

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

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

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

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

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

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

DATED: Albany, New York
March 5, 2021

/s/ Dierdre K. Scozzafava
Dierdre K. Scozzafava
Commissioner

/s/ Anthony Giardina
Anthony Giardina
Commissioner