STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition of **THE WALT DISNEY COMPANY AND CONSOLIDATED SUBSIDIARIES** for Redetermination of a Deficiency or for Refund of Corporation Franchise Tax under Article 9-A of the Tax Law for the Tax Periods Ended September 27, 2008, October 3, 2009 and October 2, 2010.	:	DETERMINATION DTA NO. 828304

Petitioner, The Walt Disney Company and Consolidated Subsidiaries, filed a petition for redetermination of a deficiency or for refund of corporation franchise tax under article 9-A of the Tax Law for the tax periods ended September 27, 2008, October 3, 2009 and October 2, 2010.

A hearing was held before Kevin R. Law, Administrative Law Judge, in Albany, New York, on June 28 and 29, 2018, with all briefs to be submitted by November 30, 2018, which date began the six-month period for the issuance of this determination. Petitioner appeared by Pillsbury Winthrop Shaw Pittman, LLP (Marc A. Simonetti, Esq., Andrew D. Appleby, Esq., and Dmitrii Gabrielov, Esq., of counsel). The Division of Taxation appeared by Amanda Hiller, Esq. (Jennifer L. Baldwin, Esq., of counsel).

ISSUES

I. Whether petitioner may exclude royalties received from foreign affiliates in the computation of its entire net income.

II. Whether denying petitioner an exclusion under Tax Law former § 208 (9) (o) for royalties received from its alien affiliates because the alien affiliates are not New York taxpayers violates the dormant Commerce Clause of the United States Constitution.

FINDINGS OF FACT

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

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

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

3. In the Parks and Resorts segment, petitioner owns and operates the Walt Disney World

Resort in Florida, the Disneyland Resort in California, the Disney Vacation Club, the Disney Cruise Line and Adventures by Disney. Petitioner also manages and has ownership interests in Disneyland Paris and Hong Kong Disneyland Resort, and licenses the operations of the Tokyo Disney Resort in Japan.

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

5. The Consumer Products segment engages with licensees, manufacturers, publishers and retailers throughout the world to design, develop, publish, promote and sell a wide variety of products based on existing and new characters and other intellectual property through its merchandise licensing, publishing and retail businesses. Petitioner's worldwide merchandise licensing operations include products such as toys, home décor and furnishings, stationary, accessories, health and beauty, food, footwear and consumer electronics. Petitioner licenses characters from its film, television and other properties and earns royalties, which are usually based on a fixed percentage of the selling price of the products.

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

7. Petitioner’s businesses are affected by its ability to exploit and protect against infringement of its intellectual property, including its trademarks, trade names, copyrights, patents and trade secrets. Petitioner’s intellectual property includes rights in the content of

motion pictures, television programs, electronic games, sound recordings, character likenesses, theme park attractions, books and magazines.

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

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

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

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

12. On petitioner's original form CT-3-A for FYE 2010, petitioner deducted $2,179,325,577.00 on line 15. Of the $2,179,325,577.00 reported on line 15, $575,000.00 is not at issue in this matter. The remaining amount was included on line la and line 7 of petitioner's federal form 1120 for FYE 2010. Petitioner agrees that $5,336,418.00 of the $2,179,325,577.00 reported on line 15 of its FYE 2010 form CT-3-A should not have been deducted.

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

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

"Support and explanation of CT-3A line (15) deduction for the 09/2009, 09/2010 and 09/2011 periods. In the 09/2009 CT-3A the deduction of $1,583,039,067 is described as 'Parent Company Share Adjustment.'

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

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

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

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

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

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

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

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

d. New York Tax Law § 208.9(o)(3) which allows royalty income received from a related corporation to be excluded from the recipient's taxable income provided the deduction for such royalty income is required to be added back to the payer's taxable income under § 208.9(o)(3) supports the deductions taken on the CT-3A line (15) for the periods ending 09/2009 and 09/2010."

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

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

and a breakdown by payer and amount paid.

18. For FYE 2009, petitioner responded as follows:

Legal Entity	Description	Amount
Disney Enterprises, Inc.	DEI-CP Parent Company Share	$498,598,200
Disney Enterprises, Inc.	DEI -Corp Royalty from Magical Cruise Co Ltd	$28,877,289
Disney Enterprises, Inc.	DEI-Corp Royalty from Euro Disneyland	$30,369.733
Buena Vista International, Inc.	BVI Parent co Share	$1,025,193,844
	Total Foreign Royalty Revenue From Related Entities Not in Federal Consolidated Return	$1,583,039,067

19. For FYE 2010, petitioner responded as follows:

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

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

21. The auditor's handwritten notes contained in the audit file indicate that she believed that petitioner's response to IDR#3 Item 5 did not provide much detail. On the auditor's copy of IDR#3 her handwritten notes that indicate this item was "Done" and that petitioner had responded on January 26, 2016. The audit file makes no mention of petitioner failing to adequately substantiate the royalty income exclusion claimed or that the amounts claimed were royalties. The auditor's notes state:

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

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

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

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

25. Petitioner owned at least 30%, directly or indirectly, of the capital, profits, or beneficial interest in each of its alien affiliates during the entire audit period.

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

27. At the hearing in this matter, petitioner presented the testimony of its tax principal, Aaron Solomon. Mr. Solomon oversees the teams that prepare petitioner's federal and state tax

returns and manage federal and state tax audits. Mr. Solomon explained the general nature of the licensing agreements and how the payments received by petitioner from its alien affiliates pursuant to these agreements were accounted for on petitioner's books and records and for tax purposes.

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

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

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

31. Agreements in the motion picture or television programming category include those relating to film distribution. The foreign affiliate pays petitioner for the right to advertise, promote, produce and license the product incorporating licensed property for distribution in a territory. Payment is based on an undisclosed percentage of gross revenues less distribution expenses. If distribution expenses exceed the payment, petitioner would be required to reimburse the alien affiliate for the shortfall. Mr. Solomon did not believe that the merchandise licensing or theme park and cruise ship license agreements allowed the payment owed to

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

petitioner to be reduced by the alien affiliate's distribution expenses. Pursuant to these types of agreements, petitioner was required to deliver to the alien affiliate: "[a] new or used, complete, final, full timed 35mm or 16mm positive print and/or non-theatrical video cassettes of the Picture, fully cut, main and end titled, edited, scored and assembled with soundtrack printed thereon in synchronization with the photographic action and fit and ready for exhibition and distribution."

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

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

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

audit period.

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

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

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

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

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

39. The alien affiliates' federal informational returns (IRS forms 5471, 8858 and 8865)

during the audit period included the alien affiliate royalty payments as expenses in the "Rents, royalties, and license fees paid" and/or "Parent Company Share-Intercompany" line-items.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

CONCLUSIONS OF LAW

A. Article 9-A of the Tax Law imposes a franchise tax on all domestic and foreign corporations doing business, employing capital, owning or leasing property, or maintaining an office in New York State (Tax Law former § 209 [1]).[4]

B. In New York, corporate taxpayers report their tax liability based on their computation of the highest of four income bases, one of which is their entire net income (ENI) base (Tax Law former § 210 [1] [a-d]). A corporation's ENI is computed by calculating its entire net income, generally consisting of its investment income (Tax Law former § 208 [6]) and its business

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[4] An additional surcharge tax is imposed, per Tax Law former § 209-B, upon corporations located or doing business within the Metropolitan Commuter Transportation District (MCTD).

income (Tax Law former § 208 [8]; ***see*** Tax Law former §§ 210 [1] [a]; [3]; 208 [9]; 209 [1]). In turn, the corporation's investment income and business income are allocated to New York pursuant to the corporation's investment allocation percentage (IAC) (Tax Law former § 210 [3] [b]) and its business allocation percentage (BAP) (Tax Law former § 210 [3] [a]), with the resulting amounts totaled to arrive at the corporation's entire net income base.

C. In determining a corporation's ENI, Tax Law § 208 (9) provides that ENI means "total net income from all sources, which shall be presumably the same as the entire taxable income" subject to certain modifications. The modifications at issue in this proceeding are contained in Tax Law former § 208 (9) (o), which provided that a taxpayer was allowed to deduct royalty payments received from a related member during the taxable year, to the extent such was included in the taxpayer's federal taxable income, unless the royalty payments were not required to be added back under the expense disallowance provisions or other similar provisions of the Tax Law. Royalty payments to related members were not required to be added back if: (I) the related members were part of a combined report (combined reporting exception); or (ii) the related member paid the royalty during the same tax year to a non-related member for a valid business purpose in an arm's-length deal (the conduit exception); or (iii) the royalty payments were paid to a related member organized under the laws of a foreign country subject to a comprehensive tax treaty with the United States and the payments were taxed in that country at a rate equal to or greater than the rate in New York (treaty exception) (Tax Law former § 208 [9] [o] [2] [B]). A related member was defined as a controlling interest in a corporation or other entity (Tax Law former § 208 [9] [o] [1] [A]). A controlling interest meant either 30 percent or more of the total combined voting power of all classes of stock in a corporation or 30 percent or more of the capital, profits, or beneficial interest in that voting stock (Tax Law former § 208 [9] [o] [1] [B]).

D. In defending the deficiency, the Division has taken the position that petitioner has not met its burden of proving that the payments it received from its alien affiliates were royalties as defined in Tax Law § 208 (9) (o) (1) (C). In response, petitioner argues that this issue was never examined at audit nor was this a basis for the notice of deficiency. According to petitioner, the Division bears the burden of establishing that the payments did not constitute royalties. Contrary to petitioner's assertion, the Division is entitled to assert an alternative basis for the deficiency provided that petitioner is afforded notice of such basis and the opportunity to be heard (***see Matter of Clark***, Tax Appeals Tribunal, September 14, 1992 [where the Tax Appeals Tribunal held that an amended answer would have put the taxpayers on notice of the alternative grounds for assessment]. The Division's answer clearly raised this as a basis and this claim was also brought up as an issue by the Division's representative in her opening statement at the hearing in this matter. Notwithstanding, it is determined the payments petitioner received from its alien affiliates and claimed as an exclusion in computing its ENI were royalties. Tax Law § 208 (9) (o) (1) (C) define royalties as:

> "[P]ayments directly connected to the acquisition, use, maintenance or management, ownership, sale, exchange, or any other disposition of licenses, trademarks, copyrights, trade names, trade dress, service marks, mask works, trade secrets, patents and any other similar types of intangible assets as determined by the commissioner, and includes amounts allowable as interest deductions... to the extent such amounts are directly or indirectly for, related to or in connection with the acquisition, use, maintenance or management, ownership, sale, exchange or disposition of such intangible assets" (Tax Law § 208 [9] [o] [1] [C]) .

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

E. Having found that the payments received by petitioner from its related members constitute royalties, the next issue to be addressed is whether such amounts may be properly excluded from ENI. Specifically, the statute provides that:

> "For the purpose of computing entire net income or other taxable basis, a taxpayer shall be allowed to deduct royalty payments directly or indirectly received from a related member during the taxable year to the extent included in the taxpayer's federal taxable income unless such royalty payments would not be required to be added back under subparagraph two of this paragraph or other similar provision in this chapter"
> (Tax Law former § 208 [9] [o] [3]).

Petitioner contends that its alien affiliates would not be required to add back the royalty payments under subparagraph two of former section 208 (9) (o) of the Tax Law, which provides as follows:

> "(A) [F]or the purpose of computing entire net income or other applicable taxable basis, a taxpayer must add back royalty payments to a related member during the taxable year to the extent deductible in calculating federal taxable income.
>
> (B) The add back of royalty payments shall not be required if and to the extent that such payments meet either of the following conditions:
>
>> (i) the related member during the same taxable year directly or indirectly paid or incurred the amount to a person or entity that is not a related member, and such transaction was done for a valid business purpose and the payments are made at arm's length
>>
>> (ii) the royalty payments are paid or incurred to a related member organized under the laws of a country other than the United States, are subject to a comprehensive income tax treaty between such country and the United States, and are taxed in such country at a tax rate at least equal to that imposed by this state."

F. Petitioner contends that under the plain wording of the statute, the alien affiliates royalty payments would not have to be added back to entire net income if the alien affiliates were New York taxpayers because the alien affiliates did not meet the combined reporting exception, the conduit exception, or the tax treaty exception of Tax Law § 208 (9) (o) (2). Petitioner argues that the definition of "related member," which includes corporations with a controlling interest whether such entity is a taxpayer or not, indicates that the Legislature intended that the royalty income exclusion apply regardless of whether the payer was a taxpayer or not. As noted by the Division, the purpose of the statute was to address a common tax avoidance strategy whereby a corporation transferred its intangible assets, such as trademarks, to a related corporation and paid a royalty for the use of those intangible assets thereby reducing its taxable earnings in New York (***see*** New York Bill Jacket, 2003 S.B. 5725, Ch. 686 Part M [Clarifies the provisions of law which eliminate tax loopholes concerning royalty payments and certain interest payments to exclude royalty payments made to certain foreign corporation related members]). Bearing in mind that the statute should be administered to effectuate the intent of the Legislature (***see Matter of 1605 Book Center v Tax Appeals Tribunal***, 3 NY2d 240 [1994]), excluding royalty income from petitioner's ENI in this instance does not advance this legislative purpose. The addback and exclusion provisions contained in Tax Law former § 208 (9) (o) work in tandem to ensure that royalty transactions between related members are taxed only once, not escape taxation altogether. Petitioner's interpretation of the statute effectively adds words that are not present (i.e., *if the payer were a New York taxpayer)*. Here, petitioner may not exclude royalty payments received from its alien affiliates in computing entire net income. Petitioner's arguments overlook that the foreign affiliates payments would not be required to be added back to federal taxable income because the foreign affiliates were not New York taxpayers, much less United States taxpayers.

G. Petitioner also argues the 2013 amendments to Tax Law § 208 (9) (o) which removed the royalty income exclusion provision and made other changes to the statute, supports its interpretation. Specifically, petitioner points to the Statement in Support of Chapter 59, Part E of the Laws of 2013, which explained that the pre-2013 version of the statute had been interpreted by some taxpayers in ways that were "inconsistent" with "the Department's interpretation," including the interpretation of "eligibility for the income exclusion provision" and "the scope of the 'related members' definition." Petitioner's argument is misplaced as it takes statements out of context from the other portions of the statement in support which provides as follows:

> "The current add-back and exclusion system under the Tax Law and in the NYC Administrative Code has been subject to exploitation by taxpayers. Under the current system, the recipient of royalty payments can exclude these payments as long as the payor is also a New York taxpayer. This creates an incentive for taxpayers to take advantage of the income exclusion provision by allowing the

> income exclusion for a payment received from a related member with a small New York presence (i.e. a very low business allocation percentage [BAP]), even if the recipient has a large BAP and large royalty income, resulting in significant tax savings.
>
> The provisions of the current statute also have been interpreted by some taxpayers in ways that are inconsistent with the intent of the statute and the Department's interpretation. For example, issues have been raised regarding eligibility for the income exclusion provision, as well as the scope of the 'related members' definition.
>
> This bill would eliminate those inconsistent readings with clear language on the applicability of the required add-back, and the exceptions thereto, in order to prevent tax avoidance while allowing for fair and equitable administration. The bill, which is based upon a Multistate Tax Commission model statute, would modify the royalty income add-back and exclusion provisions of the Tax Law, and in corresponding sections of the NYC Administrative Code, by eliminating the exclusion of royalty income received if the related member who made the royalty payment was required to add back the payment to its income. Instead, the bill would create several new exceptions to the add-back requirement."

Thus, contrary to petitioner's assertions, the amendment to Tax Law § 208 (9) (o) does not support its interpretation, it actually bolsters the Division's position that Tax Law former § 208 (9) (o) (3) required the related member royalty payer to be a New York taxpayer in order for the payee to be qualified for the royalty income exclusion.

H. Petitioner next argues that the Division's interpretation of Tax Law § 208 (9) (o) violates the dormant Commerce Clause of the United States Constitution. Article I, Section 8, clause 3 of the United States Constitution gives Congress the power "to regulate commerce with foreign Nations, and among the several States...." In addition to Congress's express power to regulate commerce, the dormant or negative commerce clause is a legal principle developed by the Supreme Court that gives the adjudicative body the power to "protect the free flow of commerce, and thereby safeguard Congress's latent power from encroachment by the several States" when Congress has not affirmatively exercised its Commerce Clause power (***Merrion v***

Jicarilla Apache Indian Tribe, 455 US 130, 154 [1982]). Simply stated, the dormant Commerce Clause prohibits states from imposing taxes that "benefit in-state economic interests by burdening out-of-state competitors" (***Fulton Corp. v Faulkner***, 516 US 325, 330 [1996]). In ***Complete Auto Transit, Inc. v Brady***, 430 US 274, 279 (1977) the Supreme Court set forth a four-pronged test to determine whether a state tax violates the Commerce Clause. Pursuant to this test, a state tax will withstand a Commerce Clause challenge if the tax: (1) is applied to an activity having a substantial nexus with the taxing state; (2) is fairly apportioned; (3) does not discriminate against interstate commerce; and (4) is fairly related to the services provided by the state. Heightened scrutiny is required if foreign commerce is implicated (***see Japan Line, Ltd. v County of Los Angeles***, 441 US 434, 451 [1979]).

I. In this matter, petitioner argues that the dormant Commerce Clause is violated under the third prong of the ***Complete Auto*** test, the anti-discrimination requirement. A tax violates the Commerce Clause anti-discrimination requirement if it is "facially discriminatory, has a discriminatory intent, or has the effect of unduly burdening interstate commerce" (***Amerada Hess Corp. v Director, Div. of Taxation, NJ Dept of the Treasury***, 490 US 66, 75 [1989]). According to petitioner, providing the royalty income exclusion to the taxpayer only if the payer is a New York taxpayer is facially discriminatory and is per se invalid.

J. First, it is noted that at the administrative level, statutes are presumed constitutional. The Division of Tax Appeals' jurisdiction as prescribed by its enabling legislation, does not include a challenge that a statute is unconstitutional on its face (***Matter of Fourth Day Enterprises***, Tax Appeals Tribunal, October 27, 1988; ***Matter of Unger***, Tax Appeals Tribunal March 24, 1994). Nonetheless, the Division of Tax Appeals can determine the constitutionality of a statute as applied to the specific facts of the case (***Matter of Waste Conversion***, Tax

Appeals Tribunal, August 25, 1994). Thus, addressing petitioner's constitutional challenge as applied, it is determined that petitioner has not sustained its burden of the proving a constitutional violation. As explained in the preceding conclusions of law, the addback and exclusion provisions work in tandem to ensure that the royalty transaction is only taxed once. "'[D]iscrimination' simply means differential treatment of in-state and out-of-state economic interests that benefits the former and burdens the latter" (***Oregon Waste Sys., Inc. v Department of Envtl. Quality of Oregon***, 511 US 93, 99 [1994]). Tax Law former § 208 (9) (o) does not impose a heavier burden on the royalty transaction based upon where the payer is located. The transaction is subject to tax once and only once regardless of whether the payer is a New York taxpayer. What petitioner conveniently overlooks is that the addback and exclusion provisions are only triggered if the payer and payee are related parties as defined in the statute. If the payer is not a related party, the royalty payments are included in the payee's ENI based on federal conformity regardless of whether the payer is a New York taxpayer. Similarly, if the royalty payer is not a related party, the payer is not denied a deduction for this expense. Under petitioner's interpretation, the royalty payments escape taxation altogether. In this case, petitioner has failed to make a showing that in-state economic interests are benefitted to the detriment of out-of-state interests.

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

DATED: Albany, New York
May 30, 2019

/s/ Kevin R. Law
ADMINISTRATIVE LAW JUDGE