

Reed Smith Teleseminar Series

# Defending New Jersey Audits of VDA Returns

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# Background

- Hundreds of IHCs did VDAs to deal with throwout exposure
- Standard terms in 2008 allowed taxpayers to file returns without throwout
- Division retained right to audit; assessment capped at 9% of NJ source royalties
- Division currently auditing and assessing VDA returns

# Status of *Whirlpool* and Other Cases

- NJ Supreme Court: throwout constitutional if a state lacks sufficient connection or P.L. 86-272
- Remand to Tax Court
  - ✓ Is throwout constitutional as applied?
  - ✓ Does NJ nexus standard apply in other states?
  - ✓ Motion scheduled for July 2012
- Other throwout cases
  - ✓ Sales where taxpayer P.L. 86-272 protected
  - ✓ Foreign royalties

# What If You're Under Audit?

- Division's throwout policy:
  - ✓ "Subject to tax" means actually file return
  - ✓ Eliminated receipts get thrown out
- Dealing with auditor
  - ✓ Are you always "subject to tax" in HQ state?
  - ✓ Net worth and gross receipts taxes
  - ✓ Offset issues for affiliated operating company
  - ✓ Sourcing receipts

# Sourcing Receipts

- Reconsider licensee's NJ sales fraction
  - ✓ COP, market, or where service performed?
  - ✓ 25:50:25 rule
  - ✓ Dock sales and drop shipments
- Distinguishing your IHC from Lanco
  - ✓ What if licensee doesn't retail in NJ?
  - ✓ Can any royalties be sourced to NJ?
- Potential game changer—pending litigation on sourcing receipts from intangibles

# Patent Versus Other IP Royalties

- Auditors generally source both based on licensee's NJ sales
- But that's not what regulation provides
  - ✓ Patent and copyright royalties—look to where IP is used
  - ✓ What does “use” mean?
- Allocating royalty stream between trademarks and know-how

# Taxpayer Options

- Try to settle or wait for *Whirlpool*?
  - ✓ Division actively settling throwout appeals
  - ✓ Years away from final court decision on throwout
- Impact of royalty addback on licensee
- VDA doesn't preclude filing refund claim
  - ✓ File claim based on sourcing
  - ✓ In general, taxpayers only had to concede nexus
  - ✓ Claim due 4 years from when VDA return filed

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