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APPROVAL OF THE APPELLATE DIVISION

SUPERIOR COURT OF NEW JERSEY
APPELLATE DIVISION
DOCKET NO. A-2033-13T1

LORILLARD LICENSING COMPANY LLC,

Plaintiff-Respondent,

v.

DIRECTOR, DIVISION OF TAXATION,

Defendant-Appellant.

Argued September 21, 2015 – Decided December 4, 2015

Before Judges Messano, Simonelli and Carroll.

On appeal from the Tax Court of New Jersey, Docket No. 8772-2006.

Marlene G. Brown, Senior Deputy Attorney General, argued the cause for appellant (John J. Hoffman, Acting Attorney General, attorney; Lewis A. Scheindlin, Assistant Attorney General, of counsel; Ms. Brown, on the brief).

Mitchell A. Newmark (Morrison & Foerster, LLP) argued the cause for respondent (Mr. Newmark and Craig B. Fields (Morrison & Foerster, LLP) of the New York bar, admitted pro hac vice, attorneys; Mr. Newmark and Mr. Fields, on the brief).

PER CURIAM

Defendant, the Director, Division of Taxation (the Director and the Division), appeals from the Tax Court's November 15, 2013 order. Among other things, the order granted plaintiff,

Lorillard Licensing Company LLC (Lorillard), partial summary judgment on its complaint challenging the Division's notice of assessment that asserted Lorillard was subject to New Jersey's Corporate Business Tax Act (the CBT), N.J.S.A. 54:10A-1 to -41, for the tax years 1999 through 2004.

Ultimately at issue was application of the "Throw-Out Rule," codified from 2002 through 2010 as part of N.J.S.A. 54:10A-6(B), for tax years 2002, 2003 and 2004 (the years at issue). "The Throw[-]Out Rule relate[d] to the allocation factor used by the Director for purposes of determining what portion of the income of a corporation, having regular places of business in New Jersey and outside of this State, is subject to taxation under the [CBT]." Pfizer Inc. v. Dir., Div. of Taxation, 24 N.J. Tax 116, 121 (Tax 2008), aff'd sub nom. Whirlpool Props. Inc. v. Dir., Div. of Taxation, 25 N.J. Tax 519 (App. Div. 2010). "New Jersey's apportionment methodology utilizes a three-factor formula that weighs a multi[-]state corporate taxpayer's property, payroll and sales, a recognizably common, and constitutionally unremarkable, general approach." Whirlpool Props. Inc. v. Dir., Div. of Taxation, 208 N.J. 141, 150 (2011). As the Court explained in Whirlpool,

> Without application of the Throw-Out Rule, the sales fraction is calculated by dividing the taxpayer's New Jersey receipts by total receipts of the corporate taxpayer.

> N.J.S.A. 54:10A-6(B). The Throw-Out Rule modifies the sales fraction, transforming the fraction into one that divides New Jersey receipts only by taxed receipts. The effect is consistent: By throwing out receipts from the denominator, the sales fraction always increases, causing the apportionment formula and the taxpayer's resultant CBT liability to New Jersey to increase.
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> [Id. at 151.[1]]

With this background in mind, we turn to the issues presented on appeal.

I.

In a complaint filed in November 2006, Lorillard alleged that it was formed in North Carolina and had its offices there. It was wholly-owned by Lorillard Tobacco Company (LTC), a corporation organized in Delaware. Lorillard owned, managed and licensed certain "intellectual property," such as trademarks and trade names, and received royalty payments from LTC for its use.

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[1] The Throw-Out Rule, L. 2002, c. 40, § 8, required that

> if receipts would be assigned to a state . . . or to any foreign country in which the taxpayer is not subject to a tax on or measured by profits or income, or business presence or business activity, then the receipts shall be excluded from the denominator of the sales fraction.
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> [N.J.S.A. 54:10A-6(B) (2002).]

Lorillard had no offices, employees or bank accounts in New Jersey.

In September 2006, the Director served Lorillard with a notice of assessment asserting that it owed a balance of $24,251,739 in CBT for tax years 1999 through 2004, during which Lorillard admittedly had filed no CBT returns. Lorillard specifically asserted that for the years at issue, the Director applied the Throw-Out Rule and "removed substantial receipts from the denominator of the receipts fraction," and "[t]he removed receipts ha[d] no connection with New Jersey." Lorillard further asserted that it was subject to taxation on its business activities in other states.

While the complaint was pending, in 2009, the Legislature enacted a tax amnesty program. Lorillard filed CBT returns for the years contained in the assessment, and entered into a stipulation of partial settlement with the Director. Pursuant to that stipulation, Lorillard paid nearly $6 million in CBT, based on its interpretation of the Throw-Out Rule as applied to its business. Lorillard dismissed certain counts of its complaint, and the stipulation limited the issues in the litigation going forward to the Director's "assessment arising from the application of the 'Throw-Out Rule'" for the years in question, and any interest and penalties incurred thereon.

In 2012, Lorillard filed a motion for summary judgment supported by a statement of material undisputed facts and the certification of Randelle Smith, LTC's Director of Taxes since 2005. Smith's statements supported the allegations in the complaint and stated that Lorillard had no physical presence or employees in any state outside of North Carolina. In tax year 2002, Lorillard filed returns and paid income taxes in North Carolina and Iowa; in tax year 2003, it filed returns and paid income taxes in those states and additionally in Oklahoma and South Carolina; and, in tax year 2004, Lorillard also filed returns and paid income taxes in those four states, as well as Florida and Massachusetts. Smith further stated that, pursuant to a licensing agreement, LTC paid royalties to Lorillard for the use of its intangible property based on LTC's sales in all fifty states, the District of Columbia and other possessions of the United States.

The Director did not necessarily deny much of what was contained in Smith's certification. However, the Director stated that Smith's assertions regarding the payment of taxes in certain states was unsupported by actual tax returns, and a copy of the licensing agreement was not included in the motion record. The Director also averred that Smith admitted that

Lorillard "earned royalty income from New Jersey" for tax years 2002, 2003 and 2004.

In reply, Lorillard's counsel noted that the license agreement was contained in the more than eight hundred pages of documents turned over to the Director in discovery. Further, Lorillard denied that it earned any income in New Jersey, noting that only LTC earned income from its sales of cigarettes in New Jersey and the other states and possessions.

The parties appeared for oral argument before Judge Patrick D. DeAlmeida, P.J.T.C., on August 9, 2013, and the central issue was application of the decision in Whirlpool to the facts at hand. Lorillard contended that the Throw-Out Rule did not apply because it derived its income from LTC's sales of cigarettes that were subject to the license agreement in all fifty states.

The Director posited several procedural arguments, i.e., that Lorillard had not certified the CBT returns filed as part of the stipulation were final, nor did the Division have the opportunity, if it chose, to audit those returns. The Director argued that based upon the audit, and pursuant to the holding in Whirlpool, New Jersey would be entitled to "throw out" sales in other states that were not taxed but "should have been taxed." The Director also argued that Smith's certification and the

motion record as a whole were inadequate for summary judgment purposes.

Judge DeAlmeida rendered an oral decision concluding the motion record was adequate and the Throw-Out Rule did not apply. He granted Lorillard partial summary judgment. He also ordered the Director to audit Lorillard's filed CBT returns to determine whether any additional tax payments were due.

There were no additional adjustments, and on November 15, 2013, Judge DeAlmeida entered a final order and judgment. The judgment reversed the Director's assessment and vacated any potential claims therein, dismissed with prejudice the Director's claims with respect to the Throw-Out Rule, and dismissed Lorillard's remaining claims without prejudice.[2] This appeal followed.

II.

Pursuant to Rule 2:5-1(b), Judge DeAlmeida filed a comprehensive written opinion supplementing his oral decision. The judge concluded that certain facts were undisputed. Lorillard was a foreign entity without physical presence in New Jersey, which owned trademarks and trade names associated with

[2] It is unclear what remaining claims in the complaint had continued vitality, but, in any event, neither party has asserted that the order was not final for purposes of our review. We therefore consider the merits of the Director's appeal.

tobacco products. During the years in question and pursuant to an agreement, Lorillard authorized LTC to use that intangible property to sell LTC's tobacco products in all fifty states, the District of Columbia and other United States possessions, and Lorillard received royalty payments from LTC based upon LTC's sales in New Jersey and the other locations. For purposes of deciding the motion, Judge DeAlmeida credited the Director's assertion that based upon LTC's sales of tobacco products in New Jersey, Lorillard had a "sufficient nexus" with New Jersey for purposes of the CBTA.

Judge DeAlmeida cited our decision, and the Supreme Court's affirmance of our decision, in Lanco, Inc. v. Director, Division of Taxation, 379 N.J. Super. 562 (App. Div. 2005), aff'd. o.b., 188 N.J. 380 (2006), cert. denied, 551 U.S. 1131, 127 S. Ct. 2974, 168 L. Ed. 2d 702 (2007). In Lanco, the plaintiff, an intangible holding company (IHC) with no physical presence in New Jersey, received royalty payments from sales made by its licensee in New Jersey. Lanco, supra, 379 N.J. Super. at 564. We discussed the United States Supreme Court's holding in Quill Corporation v. North Dakota, 504 U.S. 298, 311, 112 S. Ct. 1904, 1912, 119 L. Ed. 2d 91, 105 (1992), and, in particular the four-part test applied to Commerce Clause challenges to state taxation. Id. at 565. The first and fourth prong of that test

"'require a substantial nexus [with the taxing state] and a relationship between the tax and state-provided services' . . . ." Ibid. (quoting Quill, supra, 504 U.S. at 313, 112 S. Ct. at 1913, 119 L. Ed. 2d at 107).

We held that unlike sales and use taxes, which under Quill required the taxpayer's physical presence in the taxing state, a CBT could be "constitutionally applied to impose a tax on [the] plaintiff's income from licensing fees attributable to New Jersey." Id. at 567. The Court "affirm[ed] [our] determination that the Director constitutionally may apply the [CBT] notwithstanding a taxpayer's lack of a physical presence in New Jersey." Lanco, supra, 188 N.J. at 383.

Judge DeAlmeida turned to the "limiting construction" of the Throw-Out Rule crafted by the Court in order to pass constitutional muster. Whirlpool, supra, 208 N.J. at 151.

> The Throw-Out Rule operates constitutionally when the category of receipts that may be thrown out is limited to receipts that are not taxed by another state because the taxpayer does not have the requisite constitutional contacts with the state or because of congressional action . . . . Although the Throw-Out Rule clearly operates in a constitutional manner in that situation, it does not in the situation of receipts that are not taxed by another state because the state chooses not to impose an income tax. Faced with a tax formula that predictably operates unconstitutionally in some circumstances, we will interpret the

> statute narrowly so that it generally operates constitutionally.
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> [Id. at 172-73 (emphasis added).]

Rejecting the Director's arguments that "being 'subject to tax' under Lanco differs from being 'subject to tax' under Whirlpool," Judge DeAlmeida reasoned:

> In Lanco, the Court held that a State has the authority to tax a trademark holding company with no physical presence in the State based on the company's receipt of royalty payments from sales in the State by a trademark licensee. The Court held that this activity is sufficient nexus to permit taxation under the United States Constitution. It is precisely this inquiry — whether a taxpayer has "the requisite constitutional contacts with a state" — that is the lynchpin of the Court's analysis in Whirlpool. 208 N.J. at 168. Where a taxpayer has "the requisite constitutional contacts with a State" to authorize taxation under the United States Constitution, receipts from that State cannot be removed from the denominator of the receipts fraction under the Throw-Out Rule. Ibid.

The judge also rejected the Director's claim that summary judgment was not appropriate until there was an opportunity to investigate whether Lorillard actually filed returns or paid tax in other states.

> Whether or not the other States actually collected a tax from [Lorillard] does not control the inquiry. It is the ability to tax, not actual taxation, which determines if the Throw-Out Rule applies under Whirlpool. It matters not, as the Director claims, whether [Lorrilard] may have failed

> to file a return in a State where one was due or whether a State may have failed to audit a [Lorrilard] return that underreported its liability. As the Supreme Court pointed out in Whirlpool, New Jersey has no legitimate interest in considering the tax policy and practices of other States when determining whether to apply the Throw-Out Rule.

Judge DeAlmeida recognized that the Director's interpretation and application of the tax statutes was entitled to deference. See, e.g., Metromedia, Inc. v. Dir., Div. of Taxation, 97 N.J. 313, 327 (1984) ("[T]he agency's interpretation of the operative law is entitled to prevail, so long as it is not plainly unreasonable."). However, the Director's interpretation of the Throw-Out Rule was erroneous, and therefore, unreasonable.

III.

Before us, the Director argues we must reverse because Lorillard's motion for summary judgment was "procedurally and substantively deficient," and Lorillard's arguments against the Throw-Out Rule as applied to its CBT returns for the years at issue were "unsubstantiated and lacked merit." We disagree and affirm for the reasons expressed by Judge DeAlmeida. We add only these brief comments.

The Director contends Smith's certification was insufficient because she had no personal knowledge of the company's tax returns prior to 2005. Smith was the director of

LTC's tax division, and LTC was Lorillard's parent company. The fact that she did not hold the position from 2002 to 2004 is meaningless. The Director's other claims of deficiencies are equally unavailing. For example, the Director argues Smith failed to supply information about the returns Lorillard filed in other states. However, we agree with Judge DeAlmeida's interpretation of Whirlpool, and, as a result, whether Lorillard actually paid taxes elsewhere was irrelevant. In short, these procedural arguments lack sufficient merit to warrant any further discussion. R. 2:11-3(e)(1)(E).

The Director also reasserts the argument made before Judge DeAlmeida, that Lanco and Whirlpool address different issues. The Director argues Lanco only addressed New Jersey's ability to impose a tax on activities within its borders pursuant to N.J.S.A. 54:10A-2, but Judge DeAlmeida imposed Lanco "and New Jersey's nexus standard on other states." We disagree.

Judge DeAlmeida correctly understood that Lanco was premised on our Court's understanding of the limits placed upon state taxation by the Commerce Clause of the United States Constitution. Lanco held that the United States Constitution is not offended when the taxing state applies a CBT to an out-of-state IHC receiving income from a licensee in the taxing state. That nexus was sufficient, along with other factors, to make the

tax constitutional. In Whirlpool, the Court fashioned a limiting construction on the Throw-Out Rule so it could withstand a challenge that it was facially unconstitutional. Whirlpool limited application of the Throw-Out Rule "to receipts that are not taxed by another state because the taxpayer does not have the requisite constitutional contacts with the state." Whirlpool, supra, 208 N.J. at 172 (emphasis added).

We understand the Director's argument that the two cases dealt with different issues and different statutes. Nevertheless, the Director fails to provide any practical example of how the distinction makes a difference. What law, other than the United States Constitution, would determine whether another state could impose a CBT "based upon the [company's] requisite constitutional contacts with the state[?]" Ibid. As Judge DeAlmeida noted, under Whirlpool, it does not matter if a foreign state imposed a tax but only that it constitutionally could. Since Lorillard had a licensing agreement with LTC in every state, the Throw-Out Rule did not apply.

Affirmed.