STATE OF NEW YORK

DIVISION OF TAX APPEALS

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

Petitioner, International Business Machines Corporation and Combined Affiliates, filed petitions for redetermination of deficiencies or for refunds of corporation franchise taxes under article 9-A of the Tax Law for the tax periods January 1, 2007 through December 31, 2012.

On, December 17, 2018 and December 21, 2018, respectively, petitioner, appearing by Baker & McKenzie LLP (Scott Brandman, Esq., and David Pope, Esq., of counsel), and the Division of Taxation appearing by Amanda Hiller, Esq. (Jennifer L. Baldwin, Esq., of counsel), waived a hearing and agreed to submit the matter for determination based on documents and briefs to be submitted by June 21, 2019, which date commenced the six-month period for the issuance of this determination. After review of the evidence and arguments presented, Kevin R. Law, Administrative Law Judge, renders the following determination.

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 except for stipulated facts which set forth undisputed procedural matters whose recitation is unnecessary for the resolution of this matter.

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.

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 which 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 to 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 the 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 percent) 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].
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> 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.
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> [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 the 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 . . ."
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> "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	$8,878,166,400.00
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 in 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	$7,392,158,177.00

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 in 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 the 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.

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]).[1]

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 income (***see*** Tax Law former §§ 210 [1] [a]; [3]; 208 [8], [9]; 209 [1]). In turn, the corporation's

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[1] 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).

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 BAP (Tax Law former § 210 [3] [a]), with the resulting amounts totaled to arrive at the corporation's ENI 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. First, addressing whether the amounts petitioner deducted from ENI were royalties, the Division has taken the position that not all of the payments in question were royalty payments. As noted in the findings of fact, the payments in question fall into four categories; to wit: (i) hardware payments; (ii) software payments; (iii) service payments: and (iv) buy in/other payments. In its brief, the Division appears to accept that the hardware payments and service payments are royalties but contends that the software payments and buy/in other payments do not qualify as royalties. Specifically the Division contends that "[t]he difference in rates IBM and WTC charged the Alien S&D Affiliates pursuant to the Software Agreements (60 percent) as opposed to the Hardware and Services Agreements (2 to 15 percent) shows that the software payments are comprised of more than just payments for the use of trademarks, copyrights, mask works, et cetera, and are more akin to a revenue sharing arrangement for the sale of IBM software abroad. As such, the software payments go beyond the definition of 'royalty payments' in Tax Law 208(9)(o)(1)(C)." As to the buy-in other payments, the Division asserts that petitioner has not proven that these payments qualify as royalties. The Division's arguments are rejected.

E. Tax Law § 208 (9) (o) (1) (C) defines 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 include 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]) .

With respect to the software payments, the stipulated facts provide that they were 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. These payments fall directly within the definition of a royalty. The Division's argument that the consideration paid by the Alien S&D Affiliates is inflated and is really a revenue sharing arrangement is purely speculative and there is nothing in the record to suggest otherwise. Likewise, with respect to the buy-in/other payments, these payments were 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, and were based on varying percentages of revenue from sales of IBM hardware products and IBM software products. Again, these payments fall squarely within the definition of a royalty contained in Tax Law § 208 [9] [o] [1] [C]. It is noted that under the Treasury's transfer pricing regulations, a buy-in payment may take the form of a royalty (***see*** Treas Reg § 1.482-7A [g]). It is therefore concluded that the Alien Payments were royalties for purposes of Tax Law § 208 [9] [o] [1] [C].

F. Having found that the Alien Payments were 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."

G. Petitioner contends that under the plain wording of the statute, the Alien Payments would not have to be added back to ENI if the Alien S&D Affiliates were New York taxpayers because they 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. In contrast, the Division argues that since the Alien S&D Affiliates were not New York taxpayers nor were they federal taxpayers, the Alien Payments would never have to be added back to taxable income and therefore the exceptions do not apply.

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***, 83 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, and do 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 ENI. 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. Likewise, there is no indication that the Alien S & D Affiliates paid tax in their home country such that they would qualify for the treaty exemption.

Although petitioner argues that resort to legislative history is inappropriate as the statute is clear, courts have recognized that the absence of facial ambiguity is rarely, if ever, conclusive and, where the plain meaning is at variance with legislative purpose, sound principles may require examination of a statute's legislative history and context (***see generally New York State Bankers Assn. v Albright***, 38 NY2d 430 [1975] ***mod. on other grounds***, 38 NY2d 953 [1976], [where the court found that while the statute was "literally unambiguous," the legislative history in context established that the Legislature never intended to authorize savings banks to provide checking account services through NOW accounts]); ***Matter of Meyer***, 209 NY 386 [1913] [where Court found literal reading of tax statute must give way to judicial construction in order to prevent unintended results]). In this case, under petitioner's interpretation, the royalty income would escape taxation altogether, a result that the Legislature surely did not intend.

H. 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.

I. 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' 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' 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]).

J. 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]). Citing ***Kraft General Foods, Inc. v Iowa Department of Revenue*** (505 US 71 [1992]), petitioner argues that allowing the royalty income exclusion to the taxpayer only if the payer is a New York taxpayer is facially discriminatory and is per se invalid.

K. 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). Here, petitioner has not set forth a constitutional violation as applied. 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]). Thus, petitioner's reliance on ***Kraft General Foods*** is misplaced. In ***Kraft General Foods***, the Supreme Court held that an Iowa statute that taxed only the dividends paid by foreign corporations out of their foreign earnings facially discriminated against interstate commerce in violation of the Commerce Clause. Unlike the statute at issue in ***Kraft General Foods***, 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. 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. Thus, it cannot be said that Tax Law former § 208 (9) (o) has a discriminatory intent nor has petitioner established that its application herein unduly burdens interstate commerce.

L. Accordingly, the petitions of International Business Machines Corporation and Combined Affiliates are denied; the October 7, 2015, and September 28, 2016, notices of disallowance are sustained; and notice of deficiency L-045504338 is sustained.

DATED: Albany, New York
December 19, 2019

/s/ Kevin R. Law
ADMINISTRATIVE LAW JUDGE