LORILLARD TOBACCO COMPANY,

Plaintiff/Appellant,

v.

DIRECTOR, DIVISION OF TAXATION,

Defendant/Respondent.

SUPERIOR COURT OF NEW JERSEY
APPELLATE DIVISION
DOCKET NOS. A-000595-23 &
A-000596-23

Civil Action

On Appeal From a Final Decision Entered In The Tax Court Of New Jersey

Sat Below:
Honorable Mala Sundar, J.T.C

BRIEF ON BEHALF OF APPELLANT LORILLARD TOBACCO COMPANY

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PRELIMINARY STATEMENT

The issue on appeal is whether Defendant's methodology in taxing Plaintiff violates the U.S. Constitution. Defendant admits that its methodology, requiring Plaintiff to add back its otherwise deductible royalty expense deductions to the extent that the related party recipient of the royalty income conducts activities outside of New Jersey, incentivizes intrastate commerce to the detriment of interstate commerce. A state tax that favors intrastate activity over interstate activity discriminates against interstate commerce in violation of the U.S. Constitution's Commerce Clause. The Tax Court erred in finding that Defendant's methodology does not violate the U.S. Constitution.

This case is before this Court following an Opinion and an Order and Final Judgment (together, the "Remand Decision") by the Tax Court which decided the constitutional issue remanded by this Court, namely whether the regulation adopted by Defendant Director, Division of Taxation ("Defendant"), N.J.A.C. 18:7-5.18(b)(3) (the "Regulation"), and the Schedule G-2 of the New Jersey corporation business tax ("CBT") return implementing the Regulation, violate the U.S. Constitution.

N.J.S.A. 54:10A-4.4(b), (c) (the "Addback Statute") requires taxpayers to add back to taxable income otherwise deductible royalties paid to a related party with an important exception – applicable to Plaintiff Lorillard Tobacco Company

("Lorillard") – when the taxpayer establishes that the adjustments are "unreasonable." N.J.S.A. 54:10A-4.4(c)(1)(b) (the "Unreasonable Exception").

The Regulation, and its implementation through the calculation of the Unreasonable Exception on CBT form Schedule G-2 (i.e., the vehicle of discriminatory taxation), impermissibly limit the exception only to the extent that the payee pays tax to New Jersey. Defendant's application of the Regulation and Schedule G-2 limits Lorillard's New Jersey deduction by the allocation factor of the royalty recipient, here, Lorillard Licensing Company LLC ("Licensing").

The result of Defendant's application of the Regulation and Schedule G-2 in this case is that Lorillard was required to add back to its income the royalties that it paid and deducted when Defendant also required the recipient of the royalties, Licensing, to file CBT returns and pay CBT on the same royalties – simply because Licensing conducted less business in New Jersey than Lorillard conducted in New Jersey. Defendant's actions incentivize intrastate activity over interstate activity. This is a quintessential example of discrimination against interstate commerce in violation of the Commerce Clause. The Tax Court ignored binding U.S. Supreme Court precedent and Lorillard's examples that prove Defendant's methodology results in unconstitutional discrimination. Defendant's actions also impermissibly indirectly tax out-of-state activities of Licensing and result in

taxation that is out of all appropriate proportion to Lorillard's New Jersey activities.

After this Court remanded to the Tax Court the constitutionality question, the Tax Court found that the Regulation was unconstitutional because of its geographic limitation. However, the Tax Court nonetheless determined that the purported deletion of the geographic limitation in a 2020 amendment to the Regulation (the "2020 Amendment") applied retroactively (despite the parties' agreement that it did not) to the tax years at issue (2002-2005 and 2007-2010 (the "Years at Issue")) and purportedly cured the constitutional infirmity.

If this Court agrees with the parties that the 2020 Amendment does not apply retroactively, then what remains of the Tax Court's decision is its conclusion that Defendant's methodology under the Regulation is unconstitutional, and Lorillard is entitled to its full refund claim. Notwithstanding the 2020 Amendment, none of the exceptions to the default rule of prospective application apply to the 2020 Amendment. The constitutional infirmity was not cured because Schedule G-2 remained unchanged (and that schedule carried out the discrimination), no additional refund was paid to Lorillard, and Defendant maintained that the same unconstitutional methodology for adding back royalties applied to Lorillard.

PROCEDURAL HISTORY

A. Docket Number A-000595-23 (Tax Court Docket No. 008305-2007) (Tax Years 2002-2005)

Defendant conducted an audit of Licensing for the 1999 through 2004 tax years and asserted that Licensing had nexus with New Jersey and assessed CBT, penalties, and interest against Licensing. Pa081-82. To compute the asserted CBT liability of Licensing, Defendant included the royalties that Licensing received from Lorillard. Pa082.

Licensing challenged Defendant's assessment in Lorillard Licensing Co. v. Director, Division of Taxation, Tax Court Docket Number 008772-2006. Pa083. Inasmuch as Defendant asserted that Licensing had nexus with New Jersey and issued an assessment against Licensing, Lorillard timely filed refund claims for the tax years 2002-2005 on February 28, 2007 based on the Unreasonable Exception.[1] Ibid. In addition to including Schedule G-2 as part of its refund claims, Lorillard filed Claim for Refund Forms A-3730 for 2002-2005 for the full amounts – i.e., not just the Schedule G-2 geographic limited amounts. Pa277; Pa364; Pa445; Pa559. The Tax Court's statement that Lorillard could have requested other than the

[1] Though Defendant's audit of Licensing did not include the 2005 tax year, Lorillard stated in its refund claim for the 2005 tax year that it "assum[ed] that New Jersey would take the same position in 2005 as in 2002, 2003, and 2004." Pa084. Lorillard's assumption was correct.

Schedule G-2 limited amounts is unsupported by the facts in the record because Lorillard did so request. Pa035-36.

Lorillard's refund claims are reflected in the following table:

Year	Refunds Claimed
2002	$ 1,249,251
2003	$ 1,089,435
2004	$ 976,352
2005	$ 982,664
Total	$ 4,297,702

Pa084.

On April 26, 2007, Defendant denied Lorillard's refund claims. Ibid. Lorillard timely filed its Complaint for the tax years 2002-2005 in Tax Court on July 23, 2007. Pa039. Lorillard filed a Motion for Summary Judgment on September 5, 2008. Pa061.

Under the 2009 Tax Amnesty program, Licensing filed CBT returns and paid CBT for a number of tax years, including for the tax years 2002-2005. Lorillard Tobacco Co. v. Dir., Div. of Tax'n, 31 N.J. Tax 153, 162 (Tax 2019) ("Lorillard I"). Inasmuch as Defendant's Schedule G-2 would calculate some undisputed refund amount based on Licensing paying CBT, Lorillard promptly sought an expedited CBT refund, with interest, to the extent of the exception to the Addback Statute for CBT paid by Licensing as calculated on Defendant's Schedule G-2. Ibid.

In calculating Lorillard's refund using Defendant's Schedule G-2, Lorillard reported the following allocation factors for Licensing: (1) 2002 – 1.8659%; (2) 2003 – 1.6111%; (3) 2004 – 1.4358%; and (4) 2005 – 1.3214%. Ibid. (Table 5).[2]

However, Lorillard continued its challenge in Tax Court for the remainder of its refund claims to the extent its refund claims exceeded the amount of its CBT refund due as calculated on Defendant's Schedule G-2. Ibid.

On or about January 28, 2010, Defendant paid Lorillard the following refunds for the tax years 2002-2005 based on Lorillard's exception to the Addback Statute as calculated on Defendant's Schedule G-2:

Year	**Refunds Claimed**	**Refunds Paid**	**Remaining CBT Amount in Dispute**
2002	$ 1,249,251	$ 829,654.00	$ 419,597.00
2003	$ 1,089,435	$ 711,866.47	$ 377,568.53
2004	$ 976,352	$ 656,009.40	$ 320,342.60
2005	$ 982,664	$ 604,748.45	$ 377,915.55
Total	$ 4,297,702	$ 2,802,278.32	$ 1,495,423.68

Id. at 163.

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[2] The multistate tax concept that the CBT law refers to as "allocation" (i.e., how a corporation divides its income for tax purposes among the states in which it conducts business), the U.S. Supreme Court calls "apportionment." Inasmuch as this brief focuses on Lorillard's U.S. constitutional arguments and the primary legal authorities are U.S. Supreme Court decisions, we refer to this concept as "apportionment" throughout this brief, except when specifically referring to New Jersey's "CBT allocation factor."

After Licensing's case was concluded, the Tax Court heard arguments on Lorillard's Motion for Summary Judgment on January 20, 2017.

On February 27, 2019, the Tax Court issued its opinion in Lorillard I, holding that Lorillard was entitled to the full amount of its refund claims for the tax years 2002-2005 inasmuch as Defendant "did not exercise its discretion fairly by deeming only a portion of the royalties paid by [Lorillard] to [Licensing] as excepted from addback." Lorillard I, 31 N.J. Tax at 174 (the "Tax Court Original Opinion"). In light of the relief granted to Lorillard, the Tax Court found it unnecessary to address Lorillard's arguments that the Regulation and Schedule G-2 violated the U.S. Constitution. Ibid.

On April 12, 2019, Defendant filed a Notice of Appeal in this Court. Pa780-83. On April 26, 2019, Lorillard filed a Notice of Cross Appeal with respect to its constitutional arguments that the Tax Court did not address. Pa695-698.

B. Docket Number A-000596-23 (Tax Court Docket No. 014043-2012) (Tax Years 2007-2010)

On its originally filed CBT returns for the 2008-2010 tax years, Lorillard claimed a partial exception to the Addback Statute to the extent of CBT paid by Licensing as calculated on Defendant's Schedule G-2.[3] Pa662.

Inasmuch as Licensing filed CBT returns for the tax years 2007-2010, Lorillard timely filed refund claims for those tax years on or about October 5, 2012 claiming a full Unreasonable Exception. Ibid.; Pa684-85. Those claims were filed on Claim for Refund Forms A-3730 for the full amounts – i.e., the amounts over the Schedule G-2 geographic limited amounts. Ibid. The Tax Court's statement that Lorillard could have requested other than the Schedule G-2 limited amounts is unsupported by the facts in the record because Lorillard did so request. Pa035-36.

Lorillard's refund claims for 2007-2010 are as follows:

Year	Refunds Claimed
2007	$ 440,577
2008	$ 438,695
2009	$ 529,256
2010	$ 787,496
Total	$ 2,196,024

[3] On its originally filed CBT return for the 2007 tax year, Lorillard added back all of its deductions for royalties paid to Licensing in computing its entire net income. However, in 2010, Defendant paid Lorillard a CBT refund for the 2007 tax year of $593,478, plus interest, based on Lorillard's exception to the Addback Statute as calculated on Defendant's Schedule G-2. Therefore, only the remaining portion of Lorillard's refund claim for the 2007 tax year is reflected in the above table of refunds.

Pa662; Pa684-85.

On October 26, 2012, Defendant denied Lorillard's refund claims. Pa663; Pa685. Lorillard timely filed its Complaint for the tax years 2007-2010 in Tax Court on November 29, 2012 ("Lorillard II"). Pa660-682.

On May 17, 2019, the Tax Court conducted a case management conference for best practices in Lorillard II and instructed Defendant to respond regarding whether he agreed he should be bound for docket number 014043-2012 (Lorillard II – the 2007-2010 tax years) by the Tax Court's decision in docket number 008305-2007 (Lorillard I – the 2002-2005 tax years). Pa699. Defendant initially failed to respond, and the Tax Court issued an Order to Show Cause for the parties to appear and show cause as to "why Lorillard II cannot be disposed on grounds of collateral estoppel if the facts and law in Lorillard I apply equally to Lorillard II." Pa702.

Eventually, Defendant advised that he did not object to the Tax Court's "entry of an Order disposing Lorillard II on the basis of the holding in Lorillard I." Pa704-05. On July 19, 2019, the Tax Court issued an Order and Final Judgment in favor of Lorillard in Lorillard II, concluding "that all material relevant facts concerning the issue of the extent of royalty deduction to be added back are materially similar to the facts in the instant matter, therefore, the court's conclusion in Lorillard I is fully applicable here as to [Lorillard]." Pa645.

On September 3, 2019, Defendant filed a Notice of Appeal in this Court. Pa707-710. On September 12, 2019, Lorillard filed a Notice of Cross Appeal with respect to its constitutional arguments that the Tax Court did not address. Pa711-15. The two sets of appeals (2002 to 2005 and 2007 to 2010) were consolidated by this Court.

C. This Court's Decision and Remand

After oral argument was held in the consolidated cases, this Court issued its opinion on September 21, 2021, reversing the Tax Court's decision in favor of Lorillard on statutory and regulatory grounds. Lorillard Tobacco Co. v. Dir., Div. of Tax'n, 33 N.J. Tax 43, 48 2021 N.J. Super. Unpub. LEXIS 2212, *2 (App. Div. 2021) ("Original Appellate Decision"), Pa805-11. However, inasmuch as this Court determined that the constitutional issues raised by Lorillard "require consideration" and that "[t]he Tax Court should decide them in the first instance," this Court "return[ed] the cases to the Tax Court for consideration of these issues." Original Appellate Decision at **59, *20, Pa811. This Court also stated that it was unable to determine whether the amendments to the Regulation in 2020 and 2021 rendered the constitutional issues moot. Ibid. Lorillard disagrees with the Original Appellate Decision and preserves the issues raised therein (currently interlocutory) for appeal to the New Jersey Supreme Court should the case proceed to that level.

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D. <u>The Remand Decision</u>

The two matters were consolidated at the Tax Court on remand, and the parties again briefed the constitutional issues. Oral argument was held on September 13, 2022. At the Tax Court's direction, the parties submitted supplemental briefs on how, if at all, an Alabama case involving an Alabama add back statute, <u>Surtees v. VJF, Inc.</u>, 8 So.3d 959 (Ala. Ct. of Civ. App. 2008), applied to the present New Jersey cases. Pa020.

The Tax Court then requested that the parties seek to resolve the cases before a decision was issued. <u>Ibid.</u> The parties were unable to do so. Thereafter, at the Tax Court's direction, the parties submitted supplemental briefs addressing whether the 2020 Amendment applied retroactively to the Years at Issue. <u>Ibid.</u> The parties wrote separately and agreed that the 2020 Amendment did <u>not</u> apply retroactively. <u>Ibid.</u>

On September 13, 2023, the Tax Court issued its opinion finding (1) that the Regulation violated the Constitution but (2) determining that the 2020 Amendment applied retroactively to the Years at Issue and "cures the constitutional concern." Pa018. Also on September 13, 2023, the Tax Court issued an Order and Final Judgment dismissing the complaints in Docket Nos. 008305-2007 and 014043-2012. Pa038.

E. Appeal of the Remand Decision and Second Consolidation before this Court

On October 26, 2023, Lorillard filed two notices of appeal in this Court with respect to the Remand Decision, one for Lorillard I and one for Lorillard II, and on November 1, 2023, Lorillard filed two Amended Notices of Appeal in the cases to correct a typographical error. Pa001-14.

On February 13, 2024, with Defendant's consent, Lorillard filed a Motion for Consolidation respectfully requesting that this Court consolidate A-000596-23 into A-000595-23 for all purposes. On February 22, 2024, this Court granted Lorillard's Motion for Consolidation, and this brief addresses Lorillard I and Lorillard II in one consolidated brief.

STATEMENT OF FACTS[4]

The facts are the same as the facts in Lorillard Licensing Co. LLC v. Director, Division of Taxation, 28 N.J. Tax 590 (Tax 2014) and Lorillard Licensing Co. LLC v. Director, Division of Taxation, 29 N.J. Tax 275 (App. Div. 2015), cert. denied, 226 N.J. 212 (2016). We therefore summarize only the salient portions of the facts for context. The facts and the companies' names are discussed as they were during the Years at Issue.

[4] Except where specifically stated otherwise, the Statement of Facts applies to the tax years at issue in docket number 008305-2007 (2002-2005) and the tax years at issue in docket number 014043-2012 (2007-2010).

A. Lorillard and Its Business

Lorillard is a corporation organized under the laws of the State of Delaware and is based in Greensboro, North Carolina. Pa079. Lorillard manufactures, markets, distributes and sells cigarettes at wholesale throughout the United States, Puerto Rico, and various United States Territories. Ibid.

Under a license agreement, Lorillard pays its subsidiary, Licensing, royalties with respect to trademarks and other intellectual property that are owned by Licensing. Ibid.

Lorillard filed federal income tax returns and filed CBT returns in New Jersey for the Years at Issue. Ibid.; Pa662; Pa684.

Lorillard's New Jersey activity was relatively stable during the Years at Issue, and its CBT allocation percentages for the tax years 2002-2005 were as follows:

Year	Property	Payroll	Sales	Allocation Factor
2002	2.1616%	1.4583%	3.7715%	2.7907%
2003	1.8330%	1.5005%	3.2462%	2.4565%
2004	1.4516%	1.4990%	2.8866%	2.1810%
2005	1.5068%	1.5741%	2.6769%	2.1087%

Pa080.

On its originally filed CBT returns for 2002-2005, Lorillard added back to income all of its deductions for royalties paid to Licensing in computing its entire net income, significantly increasing Lorillard's CBT liability for 2002-2005 as

follows:

Year	CBT Without AddBack	CBT with AddBack	Difference	% Increase
2002	$ 1,915,129	$ 3,164,380	$ 1,249,251	65.2%
2003	$ 892,834	$ 1,982,269	$ 1,089,435	122.0%
2004	$ 1,004,346	$ 1,980,697	$ 976,351	97.2%
2005	$ 1,178,855	$ 2,161,519	$ 982,664	83.4%

Ibid.

B. Licensing and Its Business

Licensing is a North Carolina limited liability company that is based in Greensboro, North Carolina. Pa081. Licensing elected to be taxed as a corporation for federal income tax purposes, and as such paid income tax in North Carolina and other states during the Years at Issue. Pa778. Licensing is the owner of various trademarks and intellectual property, which it manages, protects, and licenses to Lorillard and to a third party. Pa081.

Licensing had no physical presence in New Jersey and the trademarks it licensed to Lorillard were applied by Lorillard at Lorillard's factory in North Carolina and, therefore, Licensing did not initially file CBT returns for the tax years 2002-2005.[5] Ibid. As discussed above in Part A of the Procedural History, Licensing subsequently filed CBT returns and paid CBT for the tax years 2002-

[5] The tax years 2002-2005 preceded the New Jersey Supreme Court's decision in Lanco, Inc. v. Director, Division of Taxation, 188 N.J. 380 (2006) (holding that a taxable presence in New Jersey did not require physical presence when the licensee placed licensed trademarks on stores in New Jersey).

2005 and 2007 under the 2009 Tax Amnesty Program though its nexus facts were distinguishable from Lanco. Licensing timely filed CBT returns and paid CBT for the tax years 2008-2010.

ARGUMENT

POINT I

The Standard of Review is De Novo, and The Tax Court is Not Entitled to Deference on its Legal, Constitutional Determinations (not raised below)

The Remand Decision is a determination of the constitutional issues contained in Lorillard's summary judgment motion. Appellate courts review summary judgment orders "de novo, applying the same standard as the trial court." L.A. v. N.J. Div. of Youth & Family Servs., 217 N.J. 311, 323 (2014). Further, in this Court's review of summary judgment orders, the propriety of such an order is a legal question, which is reviewed de novo. Prudential Prop. & Cas. Ins. Co. v. Boylan, 307 N.J. Super. 162, 167 (App. Div.), certif. denied, 154 N.J. 608 (1998); Pressler & Verniero, Current N.J. Court Rules, cmt. 3.2.1 on R. 2:10-2 (2020). This Court remanded the consolidated cases to the Tax Court, and the Remand Decision determined Lorillard's summary judgment motion with respect to the constitutional issues raised in the Lorillard I and Lorillard II complaints, and thus, the legal determinations of the Tax Court are reviewed de novo. Moreover, the constitutional questions raised in this case are subject to de novo review. State v. Galicia, 210 N.J. 364, 381 (2012) (an appellate court reviews "legal

and constitutional questions de novo").

Finally, the Tax Court's determinations are not entitled to any deference. See, e.g., Advance Housing, Inc. v. Township of Teaneck, 215 N.J. 549, 566, (2013) ("we need not defer to [the Tax Court's] interpretation of a statute or legal principles.")

POINT II

The Amended Regulation Does Not Apply Retroactively (Pa033-36; Pa038)

Despite the parties' agreement that the 2020 Amendment applies prospectively, the Tax Court determined that the 2020 Amendment applies retroactively to the Years at Issue.

New Jersey's general rule is that legislation and regulations apply prospectively. Maeker v. Ross, 219 N.J. 565, 578 (2014); Seashore Ambulatory Surgery Center, Inc. v. New Jersey Dept. of Health, 288 N.J. Super. 87, 97 (N.J. Super 1996); citing Frank A. Greek & Sons, Inc. v. Township of South Brunswick, 257 N.J. Super. 94, 106 (App. Div. 1992).

The prospectivity rule is subject to certain exceptions. Courts will apply amendments retroactively only if it is shown that (1) the expressed intent, either explicitly or implicitly, is for the amendment to apply retroactively; (2) the amendment is curative; or (3) the expectations of the parties warrant retroactive application. Schiavo v. John F. Kennedy Hosp., 258 N.J. Super. 380, 385 (App.

Div. July 17, 1992); Seashore Ambulatory Surgery Center, Inc., supra. None of the exceptions to the general rule of prospective application of the 2020 Amendment applies.

First, the 2020 Amendment neither expressly nor implicitly reflects an intent that it applies retroactively. Indeed, the 2020 Amendment expresses the opposite intent. As noted by both the Defendant and this Court, the 2020 Amendment had an effective date of April 8, 2020. Pa807. The intention that the amendment does not apply retroactively was reinforced when Defendant adopted more permanent regulations mirroring the 2020 Amendment which it stated were "effective" April 5, 2021.[6] N.J.A.C. 18:7-5.18(b)(3) (current version).

Moreover, there is no regulatory history that supports an assertion that Defendant intended the 2020 Amendment to apply retroactively and, in fact, at both oral argument and in its briefing, Defendant's counsel represented that Defendant did not intend the 2020 Amendment to apply retroactively. Tr. 62. Thus, there is no doubt that Defendant did not explicitly or implicitly express an intent that the 2020 Amendment was to apply retroactively.

For the same reasons, the expectations of the parties here do not warrant retroactive application of the 2020 Amendment. The parties agree that the 2020

[6] The 2020 Amendment was a stopgap measure which by its own terms expired on October 5, 2020. That the 2020 Amendment applied only temporarily is further evidence that it was not intended to apply retroactively.

Amendment does not apply retroactively to the Years at Issue, and the parties did not expect otherwise. "The expectation of retroactive application should be strongly apparent to the parties in order to override the lack of any explicit or implicit expression of intent for retroactive application." James v. New Jersey Mfrs. Ins. Co., 216 N.J. 552, 573 (2014). Here, it is the opposite: the parties have demonstrated that they expect that the 2020 Amendment does not apply retroactively.

Despite the parties' agreement, and the clear intent reflected in the 2020 Amendment that it does not apply retroactively, the Tax Court found that the 2020 Amendment applies retroactively to the Years at Issue because it was, purportedly, "curative." Pa037. The Tax Court's analysis, however, is flawed. An amendment is curative if it is designed to "remedy a perceived imperfection in or misapplication of a [regulation]." James, 216 N.J. at 564 (2014) (quoting Schiavo, 258 N.J. Super. at 386). A curative amendment does "not alter the act in any substantial way, but merely clarifie[s] the legislative intent behind the [previous] act." James, 216 N.J. at 564 (quoting 2nd Roc-Jersey Assocs. v. Town of Morristown, 158 N.J. 581, 605 (1999) (brackets in original)). Here, Defendant's approach to calculating the Unreasonable Exception when the intangible expense payee files a CBT return and pays CBT was unchanged by the 2020 Amendment. The Tax Court admitted that the Schedule G-2 calculation of the exception amount

when a taxpayer claims an Unreasonable Exception in this factual scenario was not changed. Pa023. Both before and after the 2020 Amendment, Defendant impermissibly calculated the amount of the intangible expense payor's deduction based on the intangible expense payee's New Jersey allocation factor. Ibid. Therefore, the 2020 Amendment did not remedy the constitutional issues raised by Lorillard and, by not changing the Schedule G-2, Defendant did not evidence an intent to "clarify" his approach to calculating the unreasonable exception when the related member payee files CBT returns and pays CBT.

The cases cited by the Tax Court do not support its conclusion that the curative exception applies. In Seashore Ambulatory Surgery Center, Inc. v. New Jersey Dept. of Health, 288 N.J. Super. 87, 97 (N.J. Super 1996), unlike here, language in the regulation did not evidence an intent that it was to apply prospectively, and the court found that retroactive application of the regulations was justified by the parties' course of dealing and their expectations. See also Schiavo v. John F. Kennedy Hosp., 258 N.J. Super. 380, 385 (App. Div. July 17, 1992) (amendment did not apply retroactively because "absolutely nothing" in the text or legislative history "explicitly or implicitly" provides for retroactive application, the amendment was not curative, and there was "no basis for any reasonable expectations of the parties [] warrant[ing] invoking retroactive, as opposed to the customary prospective only, application of the amendment.");

Matter of Appeal by Progressive Cas. Ins. Co., 307 N.J. Super. 93, 101 (App. Div. 1997) (unlike here, history of the adoption of the amendment showed it was intended to apply retroactively); James, 216 N.J. at 564 (2014) (curative exception not applicable); Johnson v. Roselle EZ Quick, LLC, 226 N.J. 370, 388 (2016) (amendment not curative).[7]

Furthermore, a regulation amendment stating that unconstitutionality is a reason why the addback would be unreasonable (as the 2020 Amendment does here) cannot cure unconstitutionality. If the Regulation was unconstitutional, which here it was, an amendment allowing an exception for unconstitutionality is not needed to prevent unconstitutional discrimination because with or without such amendment, Defendant may not violate the U.S. Constitution. Therefore, the 2020 Amendment cures nothing. The inclusion in the 2020 Amendment (should it apply here) of a provision allowing a taxpayer a deduction under the Unreasonable Exception to the extent it establishes that Defendant's adjustments lead to an "unconstitutional result," only means that Lorillard wins under the statute inasmuch as the Tax Court found an unconstitutional geographic limitation.

[7] The Tax Court's citation to Morgan Stanley & Co. Inc. v. Dir., Div. of Taxation, 28 N.J. Tax 197, 200 (Tax 2014) on this point is also unavailing, as that case did not address retroactivity of an amendment.

Defendant's application of the amendment and Schedule G-2 to Lorillard does not cure any constitutional concern as Defendant's methodology still impermissibly allows Lorillard a deduction only to the extent of Licensing's allocation factor, as discussed below. While the 2020 Amendment may have removed the geographic limitation from the Regulation, the fact that Schedule G-2 remained unchanged means that Defendant was still applying the geographic limitation that the Tax Court found unconstitutional. Lorillard claims both a facial and an as applied constitutional challenge to the Regulation and Schedule G-2. So even if the 2020 Amendment purports to cure a facial infirmity in the Regulation, Defendant's actions in denying Lorillard its full Unreasonable Exception deduction is unconstitutional as applied to Lorillard as Defendant still applied the unconstitutional geographic limitation to Lorillard through application of the Schedule G-2. The Tax Court's speculation of how Defendant could potentially apply the 2020 Amendment in a constitutional manner notwithstanding that the Schedule G-2 remained unchanged is unsupported by the record in these cases and is not how Defendant applied the Regulation to Lorillard in these cases. The only way the 2020 Amendment could have cured the unconstitutionality, if it applied retroactively, would have been to remove the geographic limitation from Schedule G-2, as well, which it did not.

Critically, if this Court determines that the 2020 Amendment does not apply

retroactively to the Years in Issue, what is left of the Tax Court's Remand Decision is its holding that the Regulation imposes an unconstitutional geographic limitation on Lorillard's ability to claim an exception to the Addback Statute, and Lorillard should be entitled to its full refund claim. Whirlpool Properties, Inc. v. Director, Div. of Taxation, 208 N.J. 141, 151 (2011) ("A court is duty-bound to give to a statute a construction that will support its constitutionality.").

POINT III

Lorillard's Remaining Refund Claims Should be Granted Because the Regulation and Schedule G-2 are Unconstitutional (Pa025-38)

The U.S. Supreme Court has "sustained a [state] tax against Commerce Clause challenge when the tax is [1] applied to an activity with 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." Complete Auto Transit, Inc. v. Brady, 430 U.S. 274, 279 (1977).

Each part of the Complete Auto test must be satisfied for each taxpayer. If a state tax fails any part of the test, the tax must be struck down as unconstitutional. As the Remand Decision noted, "the only option to prove an exception under the unreasonableness exception" was to satisfy the requirements of the Regulation. Here, the Regulation and Schedule G-2 are unconstitutional inasmuch as they are discriminatory, indirectly tax out-of-state activity that New Jersey cannot tax directly, distort Lorillard's income, and result in taxation that is out of all

appropriate proportion to Lorillard's activities in New Jersey. These conclusions do not change even if the 2020 Amendment is determined to apply to the Years at Issue.

A. The Regulation and Schedule G-2 Discriminate Against Interstate Commerce and Defendant Failed to Prove a Legitimate Local Purpose and No Non-Discriminatory Alternative

1. The Regulation and Schedule G-2 Clearly Discriminate Against Interstate Commerce

The Regulation, which limits the Unreasonable Exception to the extent that the recipient pays tax in New Jersey, and Schedule G-2, which further limits the Unreasonable Exception to the relative allocation factor of the recipient in New Jersey, discriminate against interstate commerce and are unconstitutional. Like an unconstitutional statute, a regulation that discriminates against interstate commerce cannot stand. See, e.g., In re Allegations of Violations of Law & Admin. Code by A. Fiore & Sons, Inc., 158 N.J. 105, 107 (1999). While Lorillard sought to fully deduct its royalty payments to Licensing via its refund claims (Pa277; Pa364; Pa445; Pa559; Pa662; Pa684-85), Defendant insisted on utilizing the geographic restriction contained in Schedule G-2 in calculating the Unreasonable Exception.

The U.S. Supreme Court has explained that "the first step in analyzing any law subject to judicial scrutiny under the negative Commerce Clause is to determine whether it 'regulates evenhandedly with only "incidental" effects on interstate commerce, or discriminates against interstate commerce.'" Or. Waste

Sys., Inc. v. Dep't of Envtl. Quality, 511 U.S. 93, 99 (1994) (quoting Hughes v. Oklahoma, 441 U.S. 322, 336 (1979)). Moreover, "'discrimination' simply means differential treatment of in-state and out-of-state economic interests that benefits the former and burdens the latter." Ibid. Further, when discriminatory, the State has the burden to prove that the challenged regulation advances a legitimate local purpose, and there is no non-discriminatory alternative. Id. at 100-01.

A law "facially discriminates" against interstate commerce if it "tax[es] a transaction or incident more heavily when it crosses state lines than when it occurs entirely within the State." Chem. Waste Mgmt., Inc. v. Hunt, 504 U.S. 334, 342 (1992) (quoting Armco Inc. v. Hardesty, 467 U.S. 638, 642 (1984)).

Here, the Regulation limits the Unreasonable Exception to the Addback Statute solely to "the extent that the payee pays tax to New Jersey on the income stream." N.J.A.C. 18:7-5.18(b)(3) (emphasis added). Additionally, Defendant's Schedule G-2 further limits the Unreasonable Exception to the extent of payee's allocation factor in New Jersey – its relative level of business activity in New Jersey. Therefore, the Regulation and Schedule G-2 discriminate against interstate commerce on their faces because they contain a geographic limitation: the exception applies (i.e., a deduction is allowed) if, and only to the extent, the royalty is paid to a New Jersey taxpayer and then only to the extent that taxpayer allocates income to New Jersey.

Indeed, Defendant concedes that his regulation and Schedule G-2 are facially discriminatory by acknowledging that "[w]hen subsidiary's New Jersey presence increases, parent benefits, thus incentivizing New Jersey activity to the detriment of interstate commerce." Pa814. This critical admission is fatal to Defendant's case.

Moreover, the Regulation and Schedule G-2 result in "differential treatment of in-state and out-of-state economic interests that benefits the former and burdens the latter." Or. Waste, 511 U.S. at 99. For example, compare the tax results in the following two scenarios. In the first scenario, the related member royalty payee operates only in New Jersey and has a 100% CBT allocation factor. In the second scenario, the royalty payee operates in both New Jersey and Pennsylvania and allocates 50% of its income to each state.

The payor in the first scenario is entitled to a full Unreasonable Exception under the Regulation and Schedule G-2, while the payor in the second scenario is entitled only to a partial Unreasonable Exception. The only factual difference, resulting in the higher tax burden in the second scenario, is that the payee is operating in interstate commerce and pays tax to Pennsylvania and New Jersey, not just to New Jersey. The payor in the first scenario benefits from the payee operating only in New Jersey, and the payor in the second scenario is burdened by the payee operating in interstate commerce (Pennsylvania as well as New Jersey).

In this case, specifically, Licensing's allocation factor for 2002 was 1.8659% whereas Lorillard's allocation factor was 2.8148%. Lorillard I, 31 N.J. Tax at 162-163. Because Licensing's allocation factor was less than Lorillard's allocation factor (because Licensing engaged in less activity in New Jersey than did Lorillard), Lorillard received only a partial Unreasonable Exception. If Licensing engaged in more New Jersey activity (at least as much as Lorillard), Lorillard would have received a full Unreasonable Exception. So, here, Lorillard was unconstitutionally burdened because Licensing engaged in interstate commerce.

The unconstitutional provision at issue in Fulton is similar to the Regulation and Schedule G-2 inasmuch as the amount of the tax benefit provided to a shareholder (there, a deduction from North Carolina's intangibles tax) was determined by reference to the apportionment percentage in North Carolina of the corporation in which it owned stock. Fulton Corp. v. Faulkner, 516 U.S. 325, 327-28 (1996). Here, the amount of the tax benefit provided to the royalty payor (i.e., the Unreasonable Exception) is determined by reference to the apportionment percentage in New Jersey of the royalty payee. The unconstitutional geographic limitation that was struck down by the U.S. Supreme Court in Fulton is likewise present in the Regulation and Schedule G-2.

The Regulation and Schedule G-2 are also similar to the unconstitutional provision in Oregon Waste Systems. There, a higher tax burden was imposed on

waste produced outside of Oregon than waste produced inside of Oregon. Or. Waste Sys., 511 U.S. at 96. Here, application of the Regulation and Schedule G-2 result in a higher tax burden on companies paying royalties to related members producing income outside of New Jersey than related members producing income inside of New Jersey.

The Tax Court failed to even address the Supreme Court's binding precedent in Fulton and Oregon Waste. Had the Tax Court done a proper analysis under those cases, it would have come to the conclusion that the Regulation and Schedule G-2 are both discriminatory.

The Tax Court erred when it found neither facial discrimination nor discriminatory impact. The Tax Court contradicts itself on the issue of whether the Regulation discriminates on its face because, despite finding no facial discrimination, the Remand Decision describes the Regulation as containing an unconstitutional geographic limitation. Pa018; Pa027. An unconstitutional geographic limitation expressly stated in the text of the Regulation is the essence of facial discrimination. Moreover, the Remand Decision ignores that the Regulation and Schedule G-2 favor intrastate activity over interstate activity. As the Supreme Court stated in Comptroller of the Treasury v. Wynne, 575 U.S. 542, 545 (2015), a tax scheme that "creates an incentive for taxpayers to opt for intrastate rather than interstate economic activity" is discriminatory and unconstitutional. In Wynne, as

here, the tax scheme has the same economic effect as a tariff, "the quintessential evil targeted by the dormant Commerce Clause." Ibid.

The fact that, as noted by the Tax Court, the Regulation and Schedule G-2 treat New Jersey domiciled payors and non-New Jersey domiciled payors the same in determining their Unreasonable Exception is not relevant here because the extent of the Unreasonable Exception permitted to either payor is not determined by reference to their own activities. Instead, it is determined solely by reference to the level of activities in New Jersey by the payees. Therefore, the relevant comparison for the discrimination analysis is between two payors (wherever domiciled), one that pays royalties to a payee with a substantial amount of activities in New Jersey and one who pays royalties to a payee with less activities in New Jersey. It is clear that the Regulation and Schedule G-2 impermissibly favor the payor who pays royalties to a payee with a substantial amount of activities in New Jersey over the payor who pays royalties to the payee with less activities in New Jersey.

In addition to ignoring binding Supreme Court precedent, the Tax Court also ignored the examples provided above which illustrate how the Regulation and Schedule G-2 act to impermissibly incentivize intrastate activity. For these reasons, the Regulation and Schedule G-2 result in unconstitutional discrimination against Lorillard inasmuch as they result in a higher tax burden on Lorillard based

solely on the fact that Licensing operates in interstate commerce. Further, the fact that the Schedule G-2 remained unchanged after the effective date of the 2020 Amendment means that the unconstitutional discrimination described above persisted, and the constitutional infirmity found to exist by the Tax Court was not cured, even if the 2020 Amendment applies to the Years at Issue.

2. Defendant Failed to Carry His Heavy Burden to Prove a Legitimate Local Purpose and No Non-Discriminatory Alternative

Further, Defendant has not even attempted to meet his heavy burden of proving that: (1) the Regulation and Schedule G-2 advance a legitimate local purpose; and (2) there is no non-discriminatory alternative. The Regulation and Schedule G-2 do not permit an Unreasonable Exception for those taxpayers that pay affiliates that pay tax in any other jurisdiction. Because the Regulation and Schedule G-2 are clearly discriminatory, they "must be invalidated unless [Defendant] can show that [they] advance[] a legitimate local purpose that cannot be adequately served by reasonable nondiscriminatory alternatives…. [the] burden of justification is so heavy that facial discrimination by itself may be a fatal defect." Or. Waste Sys., 511 U.S. at 100-101 (internal citations and quotations omitted); confirmed by Camps Newfound/Owatonna v. Town of Harrison, 520 U.S. 564 (1997).

Here, Licensing pays tax to New Jersey and to other states on its royalty income stream, yet the Regulation considers only the taxes paid to New Jersey. Such a geographic limitation violates the principles of antidiscrimination. See Fulton, 516 U.S. at 327 (1996) (finding tax forcing shareholders in out-of-state corporations to pay tax on a higher share of value than shareholders of corporations operating solely in North Carolina to be unconstitutionally discriminatory).

B. The Regulation and Schedule G-2 Indirectly Tax the Out-of-State Activities of Licensing that New Jersey Cannot Tax Directly

The Regulation and Schedule G-2 are also unconstitutional because they are an impermissible indirect tax on activity that New Jersey cannot tax directly, which is prohibited by the U.S. Supreme Court. Hunt-Wesson, Inc. v. Franchise Tax Bd., 528 U.S. 458 (2000).

As an initial matter, the Tax Court sought to dispense with Lorillard's argument that Defendant's methodology unconstitutionally taxes values, indirectly, that Defendant is prohibited from taxing directly, by incorrectly stating that this Court already addressed Lorillard's argument that the Regulation and Schedule G-2 "operate to indirectly tax Licensing, and/or tax [Lorillard] all out of proportion…." Pa029. In support of this statement, the Tax Court cites to language in the Original Appellate Decision: "The Tax on Lorillard's add back that was not excepted as unreasonable was related to its activity in New Jersey based on its allocation factor." Ibid. This Court, however, expressly did not address

Lorillard's constitutional arguments. Pa811. Moreover, the language cited by the Tax Court does not address Lorillard's argument that because an add back is permitted only to the extent of Licensing's allocation factor, there is an indirect unconstitutional tax on Licensing. For the reasons discussed in this section and the next section, the Regulation and Schedule G-2 operate as an unconstitutional indirect tax on Licensing, tax Lorillard out of proportion to its New Jersey activities, and result in gross distortion.

In Hunt-Wesson, the U.S. Supreme Court held that a State cannot tax indirectly activity that it cannot tax directly. Id. at 460, 463-64. The Hunt-Wesson Court rejected California's interest expense deduction limitation. Id. at 460. Under the California law at issue in Hunt-Wesson, a multistate corporation could deduct its interest expense, but the amount of interest expense that could be deducted from California unitary income was limited to the amount by which the interest expense exceeded interest and dividend income that the corporation received from a nonunitary business or investment (i.e., income that California could not tax). Id. at 461. So, if a corporation had $150,000 in interest expense and it received $100,000 in dividend income from a nonunitary subsidiary (which dividend California could not directly tax), the corporation could only deduct $50,000 notwithstanding that it had $150,000 in total interest expense. Id. at 461-62.

The Court concluded that California's interest expense deduction limitation was an impermissible indirect tax on activity that California otherwise was prohibited from taxing under the U.S. Constitution. Id. at 460, 463-64, 468. The Court explained that "[u]nder our precedent, this 'nonunitary' income may not constitutionally be taxed by a State other than the corporation's domicile," and although "California's statute does not directly impose a tax on nonunitary income[,] . . . it simply denies the taxpayer use of a portion of a deduction from unitary income . . . , income which does bear a 'rational relationship' or 'nexus' to California." Id. at 464. In so doing, California imposed a tax upon constitutionally protected nonunitary income. Id. at 466.

The Tax Court sought to distinguish Hunt-Wesson finding that, in Hunt-Wesson, the income at issue did not have nexus to California, whereas, here, New Jersey is permitted to tax the royalty income received by Licensing. Pa030. The Tax Court failed to recognize, however, that New Jersey may only tax the royalty income received by Licensing to the extent of Licensing's allocation factor.

It is well understood that New Jersey cannot constitutionally tax income earned outside its borders. Whirlpool Props., Inc. v. Dir., Div. of Tax'n, 208 N.J. 141, 152 (2011). By denying the deduction to Lorillard for amounts for which Licensing did not pay New Jersey tax, New Jersey is attempting to tax Licensing's income earned outside New Jersey's borders, because the deduction limitation

corresponds to amounts that New Jersey could not tax. If a payee such as Licensing has 100% of its activity in New Jersey, then a payor such as Lorillard would get a 100% royalty deduction. However, if payee Licensing moves 20% of its business to Pennsylvania, then New Jersey can tax 80% of its activity and the 20% that it cannot tax will be indirectly taxed by New Jersey as a denied deduction for payor Lorillard. Specifically, here, Licensing's allocation factor for 2002 was 1.8659% whereas Lorillard's 2002 allocation factor was 2.8148%. Because Licensing's allocation factor was lower than Lorillard's, Defendant is indirectly unconstitutionally taxing Licensing's income based on the difference between the allocation factors (i.e., the difference between 2.8148% and 1.8659%, or an additional 0.9489%). Based on its methodology in calculating the Unreasonable Exception, Defendant is taxing income of Licensing it could not have otherwise taxed.

The U.S. Supreme Court explained in Hunt-Wesson that "a 'tax on sleeping measured by the number of pairs of shoes you have in your closet is a tax on shoes.'" Hunt-Wesson, 528 U.S. at 464 (quoting Trinova Corp. v. Mich. Dep't of Treasury, 498 U.S. 358, 374 (1991)). Here, a tax increase on Lorillard measured by the portion of Licensing's income that New Jersey cannot constitutionally tax or a tax benefit for Lorillard limited by the portion of Licensing's income that New Jersey can tax is an unconstitutional indirect tax on Licensing.

Given that Defendant does not dispute the accuracy or reasonableness of Licensing's CBT allocation factor, New Jersey may not constitutionally impose any additional CBT on Licensing. Therefore, Defendant cannot now assert that Lorillard must pay CBT on those amounts which New Jersey cannot tax directly through Licensing. As in Hunt-Wesson, this results in an impermissible and unconstitutional indirect tax because the Regulation and Schedule G-2 tax income which is outside of New Jersey's jurisdictional reach. Therefore, Defendant's Regulation and Schedule G-2 are unconstitutional.

C. The Regulation and Schedule G-2 Result in Gross Distortion and Taxation that Is Out of All Appropriate Proportion to Lorillard's Activities in New Jersey

A tax must not attribute income to a state that is "out of all appropriate proportions to the business transacted . . . in that State" or that "le[ads] to a grossly distorted result." Container Corp. of America v. Franchise Tax Bd., 463 U.S. 159, 170 (1983) (citations omitted).

By not granting Lorillard a full Unreasonable Exception, Defendant increased Lorillard's CBT liability for the tax years 2002-2005 as follows:

Year	CBT Liability with Full Unreasonable Exception[8]	Additional CBT Due with Only Partial Exception[9]	% Increase in CBT Liability
2002	$ 1,915,129	$ 419,597	21.9%
2003	$ 892,834	$ 377,569	42.3%
2004	$ 1,004,346	$ 320,342	31.9%
2005	$ 1,178,855	$ 377,916	32.1%

The chart above shows the substantial percentage increase in Lorillard's CBT liability resulting from Defendant not granting Lorillard a full Unreasonable Exception. As a result of the Regulation and Schedule G-2, Lorillard is paying a substantially higher amount of tax to New Jersey despite no change to its allocation factor or any assertion by Defendant that its allocation factor has been improperly calculated. By interpreting the Addback Statute in the manner that it has, Defendant has created up to 42% more CBT liability for Lorillard without any change to the amount of Lorillard's activities conducted in New Jersey.

Moreover, as discussed above, the Regulation and Schedule G-2 result in taxation of Lorillard, in part, based on Licensing's activities in New Jersey rather

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[8] Lorillard I, 31 N.J. Tax at 162 (Table 4).

[9] The additional CBT is calculated as Lorillard's refund claim amount with a full Unreasonable Exception, ibid. (Table 4), less the amount of CBT refund by Defendant to Lorillard based on Defendant permitting only a partial Unreasonable Exception. Id. at 163.

than Lorillard's own activities in New Jersey. This is the result from applying the Regulation and Schedule G-2 because Licensing's CBT allocation factor is used to determine the amount of Lorillard's entire net income that is apportioned to New Jersey.

Defendant's actions result in Lorillard being taxed out of all appropriate proportions to the business it transacted in New Jersey and leads to a grossly distorted result. The Regulation and Schedule G-2 improperly take into account Licensing's New Jersey activities in taxing Lorillard. This creates up to 42% more CBT for Lorillard during the 2002-2005 tax years without any change to the amount of Lorillard's own activities conducted in New Jersey. This is "out of all appropriate proportions to the business transacted" in New Jersey by Lorillard and creates a "grossly distorted result" in violation of the U.S. Constitution. Container, 463 U.S. at 170. The Tax Court did not address Lorillard's argument on this point.

The Tax Court did acknowledge that "limiting proof of double taxation by only accounting for the CBT paid by Licensing to New Jersey is [constitutionally] problematic," and found that "denying Lorillard a deduction of the amount of royalties paid to Licensing without consideration of whether those same amounts were reported/taxed elsewhere violates the external consistency part of the fair apportionment prong of the DCC." Pa031-32. The Remand Decision, however, found that application of the 2020 Amendment cured this problem. Pa035. This

cannot be true, however, because the unconstitutional end result – Defendant denying Lorillard its full Unreasonable Exception based on Licensing's New Jersey activity – is the same both under the Regulation and under the 2020 Amendment.

The Tax Court's reliance on Surtees is also unavailing. Lorillard's constitutional challenge is fundamentally different from the constitutional challenge that the Alabama Court of Civil Appeals addressed in Surtees. The Surtees court dealt with the issue of whether Alabama's addback statute itself was unconstitutional. Surtees, 8 So.3d at 976-77. Here, Lorillard asserts that Defendant's interpretation and application to Lorillard of the Unreasonable Exception in New Jersey's addback statute, through the Regulation and Schedule G-2 are unconstitutional. Furthermore, unlike the Regulation at issue here, the statute at issue in Surtees explicitly provided an exception to the addback to the extent the income of the payee is taxed "in Alabama or any other state of the United States." Id. at 982 (emphasis added). Moreover, unlike Defendant's methodology here, the statute in Surtees did not require computation of the unreasonable exception for the royalty payor solely by reference to the payee's apportionment factor. These crucial differences make Surtees inapplicable here.

Application of the Regulation and Schedule G-2 (or even the 2020 Amendment) is unconstitutional because the income Defendant seeks to tax by not

permitting Lorillard the full unreasonable exception does not actually reflect income generated in New Jersey. Container, 463 U.S. at 169. Instead, by permitting the unreasonable exception only to the extent of Licensing's allocation factor, Defendant impermissibly taxed income generated outside New Jersey and the tax is not fairly apportioned. This results in gross distortion and taxation of income out of all appropriate proportion to Lorillard's activities in New Jersey.

CONCLUSION

For the foregoing reasons, it is respectfully requested that this Court rule that (1) the 2020 Amendment does not apply retroactively to the Years in Issue, (2) the Regulation and Schedule G-2 are unconstitutional, (3) the 2020 Amendment does not cure the constitutional infirmity in the Regulation, even if it did apply, and (4) Defendant is ordered to pay Lorillard the remaining unpaid portion of Lorillard's refund claims.

Respectfully submitted,

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LORILLARD TOBACCO, COMPANY, Petitioner/Appellant, v. DIRECTOR, DIVISION OF TAXATION, Defendant/Respondent.	: : : : : : :	SUPERIOR COURT OF NEW JERSEY APPELLATE DIVISION DOCKET NOS. A-000595-23 & A-000596-23 <u>Civil Action</u> ON APPEAL FROM A FINAL DECISION ENTERED IN THE TAX COURT OF NEW JERSEY Sat Below: Hon. Mala Sundar, P.J.T.C.

BRIEF AND APPENDIX ON BEHALF OF RESPONDENT, DIRECTOR, DIVISION OF TAXATION
SUBMITTED: June 18, 2024

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PRELIMINARY STATEMENT

This matter involves a parent corporation's improper attempt to avoid its New Jersey tax obligations by paying its subsidiary royalties, contrary to the Business Tax Reform Act ("BTRA"). The Legislature enacted the BTRA to close a loophole: Company A creates Company B to hold intellectual property, pays B royalties to use the intellectual property, and deducts the amounts paid to B as business expenses to reduce A's tax liability. To close this loophole, the BTRA requires – with exceptions – that companies making related-entity royalty payments add those payments back to Entire Net Income ("ENI"), the number used to calculate New Jersey Corporation Business Tax liability ("CBT"). If no exceptions apply, the royalty addback brings a company's tax liability back to what it would have been prior to a related-entity royalty payment.

One way to establish an exception to the addback requirement is by proving unreasonableness ("Unreasonableness Exception") through N.J.A.C. 18:7-5.18 and Schedule G-2. Neither the regulation nor the G-2 causes unlawful double taxation, disproportionately taxes activities in New Jersey, or burdens or discriminates against interstate commerce. Appellant, Lorillard Tobacco ("Lorillard") obtained a partial Unreasonableness Exception using the G-2 but thinks it is entitled to an exception for all of its royalty addback. Lorillard does

not challenge the constitutionality of New Jersey's addback statute, but rather Taxation's regulation and Schedule G-2.

The N.J.A.C. 18:7-5.18/G-2 framework, while not the only way for a taxpayer to obtain an Unreasonableness Exception, was properly applied to Lorillard, which has no special facts to distinguish it from any other royalty payor whose related-entity payee has nexus with New Jersey. This court previously held that N.J.A.C. 18:7-5.18 and the Schedule G-2 are appropriate applications of the Unreasonableness Exception, but remanded this matter for the Tax Court to consider the constitutional issues and whether those issues are now moot due to the 2020 amendment to N.J.A.C. 18:7-5.18.

After more briefing and argument, the Tax Court held that N.J.A.C. 18:7-5.18(b)(3) (pre-2020) was not discriminatory, and it did not indirectly tax Lorillard's subsidiary or tax Lorillard out of proportion. But, the court found the geographic language "problematic" for failing to consider the amount of royalties Lorillard paid to its subsidiary that was taxed elsewhere. Taxation maintains that the regulation is valid because the geographic specificity simply served to identify and eliminate any overlap, avoiding any specter of double taxation. But, even if the geographic language were problematic, the 2020 amendment cured any defect and, as the Tax Court found, applies retroactively.

Just as Taxation argued when this matter was previously before this court, the Tax Court found that Schedule G-2 is the starting point and one way for Lorillard to seek relief, but Lorillard has the ability to seek more outside of the G-2. In fact, as this court has recognized "Lorillard is not precluded from showing that it is unreasonable in some manner not to refund the balance of the remaining add back based on facts special to its situation." Lorillard has simply failed to provide any basis for additional relief.

Finally, even if N.J.A.C. 18:7-5.18 were constitutionally defective, and its amendment does not apply retroactively, the remedy to cure such defect would be to allow Lorillard to show the amount of the royalties it paid to its subsidiary that was actually taxed elsewhere – not simply refund the entire addback.

PROCEDURAL HISTORY AND COUNTERSTATEMENT OF FACTS[1]

A. CBT Overview

New Jersey's CBT Act imposes a tax on every non-exempt corporation that has nexus with New Jersey

> for the privilege of having or exercising its corporate franchise in this State, or for the privilege of deriving receipts from sources within this State, or for the privilege of engaging in contacts within this State, or for the privilege of doing business, employing or owning capital or property, or maintaining an office, in this State.

[1] Because they are closely related, the procedural history and facts are presented together for efficiency and the court's convenience.

[N.J.S.A. 54:10A-2.]

Corporations subject to CBT pay in accordance with their allocation factor, which considers a corporation's New Jersey payroll, property, and receipts for the years at issue. N.J.S.A. 54:10A-6.

CBT is imposed on a corporation's ENI. N.J.S.A. 54:10A-4(k). ENI calculation begins with line 28 of a taxpayer's Federal income tax return ("Taxable income before net operating loss deduction and special deductions"). Ibid.; see Kraft Foods Global, Inc. v. Dir., Div. of Taxation, 29 N.J. Tax 224, 232 (Tax 2016). New Jersey required that certain items that are deducted to arrive at Federal line 28 be added back to ENI, including related-entity royalty payments pursuant to the BTRA. N.J.S.A. 54:10A-4.4(b).[2] The Legislature enacted the BTRA in part to prevent "'proliferating loopholes that have permitted many profitable companies to avoid paying virtually any' CBT by 'allow[ing] multi-state corporations to transfer their profits to related out-of-State . . . companies,' and 'reduc[ing]' their corporate 'net income to little or nothing,' an unfair and inequitable result." (Pa768, citing Sponsor's Statement to A. 2501 1 (L. 2002, c. 40); A. Budget Comm. Statement to A. 2501 1 (June 27, 2002) ("large corporations with apparently substantial economic activity in

[2] N.J.S.A. 54:10A-4.4 was repealed by L. 2023, c. 96, § 14, effective July 3, 2023 following New Jersey's change to combined reporting in 2019.

this State and substantial profit have managed to avoid having any of this income become taxable by New Jersey," a "trend . . . in so-called 'separate entity' states like New Jersey," due to intercompany transactions "to avoid tax.")).

One such "loophole closer[]" was the "[d]isallowance of deduction of intangible expenses [e.g., royalties] paid to a related party." A. Budget Comm. Statement to A. 2501 2. As the Tax Court noted, quoting ibid.:

> [Disallowing intangible expense deductions] was to be achieved by: limit[ing] the ability of a taxpayer to deduct royalties . . . when paid to affiliates. The provision addresses, but does not solely apply to, a tax avoidance device that allows a multicorporate structure to export income from a state where the income is generated as a form of expense (for example, as a royalty payment to an out-of-state affiliate that the paying corporation deducts from its income) and then import the income back (for example as a tax-free dividend or as a loan).
>
> [Pa768-69.]

Accordingly, the BTRA established the general rule that royalty expenses are added back to taxable income. N.J.S.A. 54:10A-4.4(b).

B. The Unreasonable Exception

N.J.S.A. 54:10A-4.4(c) provides three exceptions to royalty addback. Relevant here, the Unreasonableness Exception provides that addback is not required if "the taxpayer establishes by clear and convincing evidence, as determined by [Taxation], that the adjustments are unreasonable." N.J.S.A. 54:10A-4.4(c)(1)(b). Consistent with the BTRA's purpose to prevent CBT

avoidance through related-entity royalty payments, Taxation applies the Unreasonableness Exception to prevent multi-entity businesses from artificially reducing their CBT liability by shifting income from higher to lower allocation factor related entities.

As authorized by the Legislature, ibid., Taxation adopted regulations that interpret the Unreasonableness Exception. See N.J.A.C. 18:7-5.2 and N.J.A.C. 18:7-5.18. Under these regulations, Taxation determined that the "clear and convincing evidence" required for the Unreasonableness Exception is the extent that a related-entity payee pays tax in New Jersey on the royalties. Specifically, N.J.A.C. 18:7-5.18(b)(3) provided that the addback of royalties was not required "[i]f the taxpayer establishes that the disallowance of a deduction is unreasonable by showing the extent the related party pays tax in New Jersey on the income stream." Ibid. The regulation allowed matching the in-state CBT that would have been required to be paid by the payor to the CBT paid by the related party on the royalty payments to avoid duplicative taxation.

Taxation developed Schedule G-2 in 2003 when the regulation was adopted. See L. 2002, c. 40; 35 N.J.R. 1573(a) (April 7, 2003). The G-2 measures the amount of a payor's royalty expense that would be equal to "the extent" of tax paid by a payee on royalty income, "so that a taxpayer, by completing the schedule, can determine whether or not certain related party

transactions, in fact, do qualify for deductibility as exceptions to the add back rule." 35 N.J.R. 1573(a). It provides a formula that calculates the Unreasonableness Exception allowed to the royalty payor based on the allocation factor for each entity to ensure that the payor only removes from addback the amounts that correspond with the payee's CBT payment. See 35 N.J.R. 1573(a) ("(b)3 allows the exception from addback of costs if disallowance would be unreasonable since the payee paid tax to New Jersey on the same income stream. See Schedule G-2, Part II, Exception 2.").

For example, if both entities had the same allocation factor, the payor would be entitled to a full exception. But, if the payor had a 40 percent factor and the payee a 30 percent factor, the payor would be limited to an exception of 75 percent of the royalties paid. In other words, Schedule G-2 provides an exception to the extent the payee bears at least the same tax burden as the payor. If the factor for the payee is less than that of the payor, the payor's exception is limited to an amount proportionate to the payee's New Jersey tax burden.

In 2014, the Tax Court decided Morgan Stanley & Co. v. Dir., Div. of Taxation, 28 N.J. Tax 197, 218-21 (Tax 2014), which addressed the Unreasonable Exception with respect to the related party interest addback. The Tax Court found the following may provide grounds for claiming an Unreasonable Exception based on legislative intent:

> unfair duplicative taxation; a technical failure to qualify the transactions under the statutory exceptions; an inability or impediment to meet the requirements due to legal or financial constraints; an unconstitutional result; a demonstration that the transaction for all intents and purposes is an unrelated loan transaction.
>
> [Id. at 220.]

In 2016, Taxation issued a Technical Advisory Memorandum ("TAM"), advising of the Morgan Stanley decision, including that

> the following situations may provide grounds for claiming that the disallowance of the deduction would be unreasonable:
>
> 1. Unfair duplicative taxation;
> 2. A technical failure to qualify the transactions under the statutory exceptions;
> 3. An inability or impediment to meet the requirements due to legal or financial constraints;
> 4. An unconstitutional result;
> 5. Transaction for all intents and purposes is an unrelated loan transaction.
>
> [TAM 2011-13R (Feb. 24, 2016).]

In 2018, the Legislature made significant changes to the CBT Act starting with L. 2018, c. 48, which also authorized Taxation to issue temporary regulations without undergoing the normal rule adoption process.

Thereafter, Taxation addressed the CBT Act changes, as well as Morgan Stanley. On April 8, 2020, Taxation filed a specially adopted amendment to N.J.A.C. 18:7-5.18. See 52 N.J.R. 5(1) (April 14, 2020). Relevant here, the

special amendment removed the "to the extent" language in N.J.A.C. 18:7-5.18(b)(3) and added the Tax Court's language from Morgan Stanley. The regulation was amended, in relevant part, as follows:[3]

> 3. If the taxpayer establishes**, to the satisfaction of the Director,** that the adjustments are unreasonable by [showing the extent that the payee pays tax to New Jersey on the income stream; or] **clear and convincing evidence, and any one of the following circumstances applies:**
>
> **i. Unfair duplicate taxation;**
> **ii. A technical failure to qualify the transactions under the statutory exceptions;**
> **iii. An inability or impediment to meet the requirements due to legal or financial constraints;**
> **iv. An unconstitutional result; or**
> **v. The transaction is equivalent to an unrelated loan transaction; or**
>
> 4. If the taxpayer and the [director] **Director** agree in writing to the application or use of an alternative method of apportionment[;]**.**
>
> [52 N.J.R. 1025 (May 4, 2020); see also 52 N.J.R. 5(1).]

The specially amended regulation was filed and effective April 8, 2020. See 52 N.J.R. 1025; 52 N.J.R. 5(1). In November 2020, Taxation proposed the exact language that was instituted under the temporary special amendment. 52 N.J.R. 1991(a) (Nov. 2, 2020). Taxation adopted the language March 5, 2021, effective April 5, 2021. 53 N.J.R. 544(a) (April 5, 2021).

[3] New language in bold; deleted language inside brackets.

C. Lorillard's Tax Returns

Lorillard sold cigarettes in New Jersey and elsewhere. (Pa762). It pays royalties through a licensing agreement with its wholly owned subsidiary, Lorillard Licensing Co., LLC ("Licensing"), an intellectual property holdings company, for use of trademarks and other intellectual property. (Pa762-63). Lorillard filed CBT returns in New Jersey for 2002-2005. (Pa763). Lorillard deducted and added back royalties paid to Licensing, which was not a CBT filer in New Jersey at that time. (Pa763-64). In 2006, Taxation audited Licensing and assessed CBT for 1999-2004 for the royalties paid by Lorillard. (Pa764). Licensing appealed (Lorillard Licensing Co., LLC v. Dir., Div. of Taxation, 28 N.J. Tax 590 (Tax 2014), aff'd, 29 N.J. Tax 275, 277-78 (App. Div. 2015)), arguing, in part, that it did not have nexus with New Jersey and thus was not required to pay CBT. (Pa764-65). In 2009, under Tax Amnesty legislation, Licensing conceded nexus and paid CBT for 2002-2005 and other tax years. (Pa766).

Meanwhile, in 2007, before Licensing conceded nexus and became a New Jersey tax filer, Lorillard filed refund claims for 2002-2005, claiming an exception to adding back the royalties paid to Licensing. (Pa765). These refund claims included Form A-3730, in which Lorillard claimed "it would be improper, unreasonable and unconstitutional if it is denied a deduction for the

royalties that it paid to [Licensing] while, at the same time, New Jersey subjected [Licensing] to tax on such amounts." (Pa277; Pa364; Pa445; Pa559). Taxation denied the claims as "protective" because the lawsuit with Licensing was not resolved, i.e., Licensing had not conceded nexus nor paid any tax to New Jersey. (Pa766). Lorillard appealed to the Tax Court. Ibid.

In 2008, Lorillard filed a motion for summary judgment, which the court held in abeyance pending the outcome of Licensing's case. Ibid. In 2009, Lorillard sought an expedited CBT refund based on Licensing's filing and payment of CBT under the 2009 Tax Amnesty. Ibid. Taxation then refunded all of the CBT requested by Lorillard for 2002-2005, with interest to the date of the refund. (Pa767). Lorillard reserved its challenge to the remainder of the addback. Ibid. In 2012, Lorillard filed another complaint regarding Taxation's denial of refund claims for 2007-2010 based on the same reasoning. (Pa806).

After Licensing's case concluded, the parties in this case submitted additional briefing, and the Tax Court heard arguments. Ibid. On February 27, 2019, the Tax Court issued a published decision, in favor of Lorillard, holding that denying Lorillard the Unreasonableness Exception for the full amount of royalties paid to its subsidiary was not a reasonable exercise of Taxation's discretion. (Pa762). The Tax Court did not reach Lorillard's constitutional challenges to Taxation's regulation. (Pa779).

Taxation appealed to this court, and Lorillard cross-appealed, re-asserting its constitutional challenges. (Pa805). On July 19, 2019, the Tax Court issued a final judgment on Lorillard's 2012 complaint based on its reasoning regarding the 2007 complaint. (Pa806). Both parties again appealed, and the matters were consolidated by the Appellate Division. (Pa805-06). On September 21, 2021, this court reversed the Tax Court's decision granting Lorillard summary judgment, holding that "[t]he purpose of the BTRA — as the Tax Court acknowledged — was to close a loophole on tax avoidance. There was nothing unreasonable about [Taxation's] decision to grant the exception only to the extent of the New Jersey taxes paid by Subsidiary." (Pa810). This court noted that "[t]he tax on Lorillard's add back that was not excepted as unreasonable was related to its activity in New Jersey based on its allocation factor." Ibid. Further, beyond the Schedule G-2, "Lorillard is not precluded from showing that it is unreasonable in some manner not to refund the balance of the remaining add back based on facts special to its situation." Ibid. This court then remanded to the Tax Court for consideration of the constitutional issues, including whether such issues were now moot in light of the 2020 amendment to N.J.A.C. 18:7-5.18. (Pa811).

On September 13, 2022, the Tax Court heard oral argument following submission of the parties' supplemental briefs addressing the constitutional

issues. (Pa20). Then, at the court's direction, the parties submitted supplemental briefing to address Surtees v. VJF, Inc., 8 So.3d 959 (Ala. Ct. of Civ. App. 2008), and whether the 2020 amendments to N.J.A.C. 18:7-5.18(b)(3) were retroactive. Ibid.

On September 13, 2023, the Tax Court issued its decision dismissing Lorillard's complaints. (Pa38). The court held that Taxation's application of N.J.A.C. 18:7-5.18(b)(3) (pre-2020) was not facially discriminatory, as both foreign entities and New Jersey domiciled entities are treated equally. (Pa27). The royalty addback applies if a foreign entity or a New Jersey domiciled entity pays royalties to a related member. Ibid. And the payor is entitled to a deduction according to the related member's payment of CBT to New Jersey on the allocated royalty deduction regardless of whether the payor or payee is a foreign or domestic entity. (Pa27-28). A related-member payee domiciled in New Jersey that allocates income to New Jersey and other states is not given any special preference or advantage over a foreign payee with respect to the application of the regulation. (Pa28). Further, the regulation and Schedule G-2 did not cause a disparate impact under the Dormant Commerce Clause ("DCC"), as they do not seek the "unachievable perfect match of allocation factors" between payor and payee, but rather "are a means to determine the deductible amount of the added back royalty payments." (Pa29).

The Tax Court also held that N.J.A.C. 18:7-5.18(b)(3) (pre-2020) and Schedule G-2 did not result in an indirect tax on Licensing or tax Lorillard out of proportion. (Pa29, citing Lorillard Tobacco Co. v. Dir., Div. of Taxation , 33 N.J. Tax 43, 58 (App. Div. 2021) ("The tax on Lorillard's add back that was not excepted as unreasonable was related to its activity in New Jersey based on its allocation factor.")). "A payor's New Jersey allocated royalty payment expense is deemed to be the payor's New Jersey source income for purposes of the addback statute in the first place." (Pa29-30). Because any addback is still the payor's income, the Tax Court rejected Lorillard's argument. (Pa30, citing Surtees, 8 So.3d at 979 ("rejecting an identical argument and holding that Alabama's 'add-back statute disallows a deduction sought by the' payor 'which does have activities in Alabama sufficient to justify its paying corporate income tax in this state.'"); Whirlpool Properties, Inc. v. Dir., Div. of Taxation, 208 N.J. 144, 168 n.9 (2011) ("rejecting the argument of 'extraterritorial taxation' and holding that '[m]ere inclusion of extraterritorial income in the tax base for apportionment is not tantamount to extraterritorial taxation.'")).

The Tax Court also rejected Lorillard's reliance on Hunt-Wesson, Inc. v. Franchise Tax Bd., 528 U.S. 458 (2000), as inapplicable. (Pa30-31). While the income at issue in Hunt-Wesson in relation to California's interest expense deduction bore no rational relationship or nexus to California, "New Jersey can

tax the royalty income received by . . . Licensing" because Licensing has an economic presence in, thus nexus to, New Jersey. (Pa30, citations omitted).

However, the court found the geographic language in the regulation "problematic." (Pa31). It found "denying [Lorillard] a deduction of the amount of royalties paid to Licensing without consideration of whether those same amounts were reported/taxed elsewhere violates the external consistency part of the fair apportionment prong of the DCC." (Pa32).

The Tax Court went on to explain that the geographic language was removed by the 2020 amendment. (Pa32). Though the parties agreed that the amendment was prospective, the court found that it was retroactive under several legal principles, each supporting the court's ruling on its own merit. (Pa33-35). The court explained that "payment of CBT by Licensing continues to be a viable reason for providing a partial deduction, but now consideration of a situation where [] New Jersey allocated royalties are taxed elsewhere will also factor into the claim for an unreasonableness exception." (Pa35). While the G-2 remained the same after the 2020 amendment and still ties the deduction to the CBT paid by the payee without allowing for other exceptions, the instructions provide for a separate refund claim using Form A-3730. (Pa35-36). So, while the G-2 is the starting point, Lorillard "is not deprived of seeking more outside of the Schedule G-2 computation" by showing "tax actually paid by Licensing in other

jurisdictions on the royalties received from [Lorillard] on [Lorillard's] sales of tobacco products in New Jersey." (Pa36). To date, Lorillard has not shown that Licensing actually paid taxes elsewhere on the amount of royalties it paid to Licensing.

This appeal followed, and A-000595-23 (tax years 2002 to 2005) and A-000596-23 (tax years 2007 to 2010) were consolidated on February 22, 2024.

ARGUMENT

POINT I

THE TAX COURT'S RULINGS ARE ENTITLED TO DEFERENCE.

The Tax Court's decision is entitled to deference. Our courts have long recognized the Tax Court's expertise in cases adjudicating tax disputes, including those raising "constitutional objections." See, e.g., Gen. Motors Corp. v. City of Linden, 143 N.J. 336, 349 (1996). Further, the Tax Court is designated as New Jersey's specialized trial court with expertise in tax matters. N.J.S.A. 2B:13-2, -6. In fact, this court remanded this matter to the Tax Court to consider the constitutional issues in the first instance, and to determine whether the 2020 amendment to the regulation rendered those issues moot. (Pa811). Lorillard's assertion that this court owes no deference to the Tax Court, (Pb16), is, at best, overstated and, at worst, an erroneous nullification of the Tax Court's role in New Jersey.

Further, it is well established that taxpayers bear the burden of proof, Superior Air Prods. Int'l, Inc. v. Taxation Div. Dir., 9 N.J. Tax 463 (Tax), aff'd, 10 N.J. Tax 238 (App. Div. 1988), especially in the context of deductions from tax, given that the "general rule" is taxability and "tax exemptions are to be strictly construed against the claimant." See Quest Diagnostics, Inc. v. Dir., Div. of Taxation, 387 N.J. Super. 104, 109 (App. Div. 2006).

Lorillard cannot overcome its burden. The Tax Court properly determined that N.J.A.C. 18:7-5.18 (pre-2020) was not facially discriminatory and that neither it, nor Schedule G-2, resulted in an indirect tax on Licensing or taxed Lorillard out of proportion. The Tax Court also correctly determined that the 2020 amendment to N.J.A.C. 18:7-5.18 cured the only "problematic" constitutional issue – Taxation's denial of a deduction of the amount of royalties paid without considering whether those same amounts were reported and taxed elsewhere. (Pa32). Even if Lorillard could vault the hurdle of showing that the Tax Court erred in finding the 2020 amendment applied retroactively, the remedy would be for Taxation to consider the amounts actually taxed outside of New Jersey, which the regulatory amendment provides for in the first place.

POINT II

THE TAX COURT CORRECTLY DETERMINED THAT THE 2020 AMENDMENT TO N.J.A.C. 18:7-5.18 APPLIES RETROACTIVELY.

New Jersey's addback statute, N.J.S.A. 54:10A-4.4(b), requires taxpayers to add back to entire net income "otherwise deductible interest expenses and costs and intangible expenses and costs," paid to a related entity. N.J.S.A. 54:10A-4.4(c) provides three exceptions to this addback. Relevant here is the Unreasonable Exception, i.e., "if . . . the taxpayer establishes by clear and convincing evidence, as determined by the director, that the adjustments are unreasonable." N.J.S.A. 54:10A-4.4(c)(1)(b).

Taxation adopted regulations interpreting the Unreasonable Exception. See N.J.A.C. 18:7-5.2 and -5.18. N.J.A.C. 18:7-5.18(b)(3) provided that the addback will not apply "[i]f the taxpayer establishes that the disallowance of a deduction is unreasonable by showing the extent the related party pays tax in New Jersey on the income stream." Here, Lorillard received an Unreasonable Exception to the extent that Licensing paid CBT to New Jersey, matching Lorillard's allowed deduction to the New Jersey tax paid by Licensing.

Taxation amended N.J.A.C. 18:7-5.18(b)(3) through a special amendment filed and effective April 8, 2020. See 52 N.J.R. 1025; 52 N.J.R. 5(1). Generally, regulations have a prospective effect. Seashore Ambulatory Surgery Ctr., Inc.

v. N.J. Dep't of Health, 288 N.J. Super. 87, 97 (App. Div. 1996) (citations omitted). This is so because a retroactive application of a new law "carries a high risk of unfairness. But the judicial quest is ultimately to ascertain legislative intent." Schiavo v. John F. Kennedy Hosp., 258 N.J. Super. 380, 384 (App. Div. 1992). Indeed, there are situations when a regulation should, or must, be applied retroactively. Retroactive application of an amendment is compelled when there is expressed intent, explicitly or implicitly, it shall apply retroactively; it is ameliorative or curative; or the expectations of the parties warrant retroactive application. Id. at 384; Seashore, 288 N.J. Super. at 97 (citations omitted). Additionally, a court may find retroactive application of an amendment is needed "to make the statute workable or to give it the most sensible interpretation." Johnson v. Roselle EZ Quick, LLC, 226 N.J. 370, 388 (2016).

Here, the Tax Court correctly determined that the 2020 amendment to N.J.A.C. 18:7-5.18 applies retroactively. (Pa33-35). First, as the Tax Court explained, the amendment with the illustrative grounds for the Unreasonable Exception clarified the original intent of the regulation – to avoid unfair duplicative taxation or an unconstitutional result. (Pa33). Further, the amendment was a direct response to the court's interpretation of the Unreasonable Exception in Morgan Stanley, which was decided in 2014 and

applied retroactively to tax year 2002. See 28 N.J. Tax at 208 (plaintiff amended its 2002 CBT return to deduct all of its related interest addback in calculating its ENI and requested a refund). Just as the court's interpretation of the Unreasonable Exception in Morgan Stanley applied to prior tax years, Taxation's adoption of that identical language applies to the open tax years here.

Second, to the extent that this court finds N.J.A.C. 18:7-5.18(b)(3) (pre-2020) to be an unconstitutional interpretation of the addback statute, retroactive application is necessary to make the statute workable and give it the most sensible interpretation. No one argues that the addback statute itself is unconstitutional, (Pa34), so to be workable and sensible, the Unreasonable Exception should be interpreted in a constitutional manner.

Finally, if this court finds the pre-2020 regulation is an unconstitutional interpretation of the statute, then retroactive application of the amended regulation is compelled as curative. "A curative amendment's 'purpose is to remedy a perceived imperfection in or misapplication of a statute and not to alter the intended scope or purposes of the original act.'" Schiavo, 258 N.J. Super. at 386 (quoting Kendall v. Snedeker, 219 N.J. Super. 283, 288 (App. Div. 1987)). The purpose of a curative amendment is to bring 'the law into harmony with what the Legislature originally intended.'" Ibid. It is designed to "remedy a perceived imperfection in or misapplication of a [regulation]." James v. New

Jersey Mfrs. Ins. Co., 216 N.J. 552, 564 (2014) (quoting Schiavo, 258 N.J. Super. at 386)).

Here, the regulatory amendments to N.J.A.C. 18:7-5.18 were in direct response to the court's assertion in Morgan Stanley as to the legislative intent for claiming an Unreasonable Exception. Thus, the amendment adopting the court's interpretation was curative, as it brought the regulation into harmony with the legislative intent of the statute and remedied the court's perceived imperfection of the regulation. And, to the extent the geographic language is deemed facially unconstitutional, the amendment must be viewed as curative.

Lorillard's arguments to the contrary are misplaced. Not changing the Schedule G-2, (Pb18-19), is of no consequence because this court and the Tax Court both recognized the G-2 is but one way for a taxpayer to seek relief, as "Lorillard is not precluded from showing that it is unreasonable in some manner not to refund the balance of the remaining add back based on facts special to its situation," (Pa810), and "is not deprived of seeking more outside of the Schedule G-2 computation," (Pa36).

Lorillard's criticism of the cases cited by the Tax Court is also misguided. (Pb19-20). The cases stand for the legal proposition that a regulation may be applied retroactively when it is "ameliorative or curative," as it is here. Further, Seashore supports the Tax Court's ruling. In Seashore, the regulation at issue

was adopted September 10, 1993, effective October 4, 1993. 25 N.J.R. 2790 (June 21, 1993); 288 N.J. Super. at 96. Appellant argued that the use of the term "new" in the phrase "new surgical facility" evinced the legislative intent for it to apply "purely prospective[ly]." Id. at 98. The court rejected that argument and found that retroactive application of the regulation (to April 1992) was "necessary in order to achieve legislative intent." Id. at 96, 98-99. The court also found that applying the regulation, which actually subjected the appellant to a certificate of need review, did not result in manifest unjustness. Id. at 100.

Here, as in Seashore, nothing in the amended regulation itself expresses a purely prospective application. See N.J.A.C. 18:7-5.18. Further, as in Seashore, the amendment conformed the regulation to the legislative intent. Morgan Stanley asserted grounds for claiming an Unreasonable Exception "based on legislative intent." 28 N.J. Tax at 220. Those grounds were adopted by Taxation in amending N.J.A.C. 18:7-5.18, thus mirroring the court's assertion of the legislative intent. Additionally, applying the regulation retroactively does not cause manifest unjustness, as it provides taxpayers with illustrative examples for claiming a tax exemption.

Lorillard's argument that if the amendment applies retroactively it "cures nothing" because the "Tax Court found an unconstitutional geographic limitation," (Pb20), is flawed because the amendment not only added an

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exception for an "unconstitutional result," but it also removed the geographic language that the Tax Court found problematic.

Lorillard's as applied argument, (Pb21), also fails because Lorillard was not precluded from other means of proving unreasonableness outside of the G-2. Lorillard's argument about Form A-3730 is misplaced. (Pb4, Pb8). Lorillard claimed a refund on the A-3730 arguing "it would be improper, unreasonable and unconstitutional if it is denied a deduction for the royalties that it paid to [Licensing] while, at the same time, New Jersey subjected [Licensing] to tax on such amounts." (Pa277; Pa364; Pa445; Pa559). That is a double taxation argument, discussed below in Point III. Lorillard did not seek a refund based on Licensing's payment of taxes elsewhere, nor did it provide any basis to distinguish it from a straight application of the Schedule G-2.

Finally, as Lorillard notes, (Pb22), if the amendment is not retroactive, the only constitutional issue remaining from the Tax Court's decision is that the regulation contained a geographic limitation. If this court finds the geographic language unlawful, the remedy is to strike that language from the regulation and allow Lorillard to show the tax Licensing actually paid everywhere on the royalties.

POINT III

N.J.A.C. 18:7-5.18 AND SCHEDULE G-2 DO NOT RESULT IN UNLAWFUL DOUBLE TAXATION.

If this court determines that the amendment is not retroactive, then the issue is whether Taxation could validly use N.J.A.C. 18:7-5.18[4] and Schedule G-2 as one way to apply the Unreasonableness Exception. To understand the regulation and G-2, first consider how the BTRA would operate without applying the Unreasonableness Exception, illustrated in Graph 1. (Ra1).[5]

The large circles represent parent and subsidiary's ENI, that is, their taxable income. See N.J.S.A. 54:10A-4(k). The small circles represent the amounts at issue in the royalty transaction. On parent's side, the small circle is the income (from sales or other sources) that the parent used to pay royalties to the subsidiary. On subsidiary's side, the small circle is the royalties received. Note the small circle is included in ENI for both entities, meaning that it is taxable to both entities.[6] The slice on each side of Graph 1 represents each

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[4] References to N.J.A.C. 18:7-5.18 refer to pre-2020 unless otherwise specified.

[5] "Ra" refers to Respondent's appendix.

[6] The small circle is included in parent's ENI because even though the amount parent paid as a royalty is deductible on parent's federal return, for CBT purposes, parent must add it back to ENI. See N.J.S.A. 54:10A-4(k), -4.4(b). The small circle is included in subsidiary's ENI because royalties are taxable income. See N.J.S.A. 54:10A-4(k); 26 C.F.R. § 1.61-2.

entity's New Jersey allocation factor – the amount of income that corresponds to each entity's New Jersey activity. See N.J.S.A. 54:10A-6. Parent's slice is larger than subsidiary's because its allocation factor is larger.

Under the BTRA, if the Unreasonableness Exception is not applied, Taxation could impose tax on each entity's entire New Jersey slice. This is precisely what happened in Springs Licensing Group, Inc. v. Dir., Div. of Taxation, 29 N.J. Tax 1 (Tax 2015). In Springs, a royalty payor added back the entire amount of income paid to a related entity as a royalty and failed to timely apply for an Unreasonableness Exception. Id. at 2. The royalty payee argued that since Taxation had already taxed the royalty payor for the amounts paid as a royalty, it could not also impose tax on the payee. Ibid. The Tax Court disagreed and found that Taxation properly imposed CBT on both entities for the entire amount. Id. at 2-3. The court explained at length the appropriateness of taxing both the payor and payee for amounts payed as royalties. Ibid.

Springs also found that taxing both entities for the entire amount paid as a royalty was not unlawful double taxation. Id. at 2-3. Unlawful double taxation occurs when one entity is taxed twice on the same income base. Aetna Burglar & Fire Alarm Co. v. Dir., Div. of Taxation, 16 N.J. Tax 584, 590 (Tax 1997) ("Double taxation is not ipso facto prohibited. Double taxation, in the objectionable sense, exists only when there is imposition of the same tax, during

the same taxing period, by the same sovereign, upon the same subject matter.") (quotation omitted). By contrast, "Duplication of reporting" by related entities for "item[s] such as . . . royalty payments" is not unlawful, or even unusual. Springs, 29 N.J. Tax at 12. To the extent there could be any "specter" or "allegation" of double taxation under the BTRA, N.J.S.A. 10A-4.4 and -8 alleviate those concerns. Id. at 3, 13.

Here, two separate entities are taxed on two different income bases. Lorillard (parent) is taxed on its own income (from sales, for instance). It uses a portion of that income, represented by the small circle, to pay a royalty to Licensing (subsidiary). Licensing is also taxed on its own income, which includes the royalty it receives from Lorillard. Consequently, Taxation's imposition of tax here cannot, and does not, constitute double taxation.

As Graph 1 shows, and Springs confirms, if the Unreasonableness Exception does not apply, Taxation could lawfully tax both entities for the entire amount of income paid as royalties. But here, Taxation applied the Unreasonableness Exception through the Schedule G-2, illustrated in Graph 2. (Ra1).

The white cutout from parents' New Jersey slice represents the Unreasonableness Exception. The G-2 excepts parent's New Jersey net income slice from taxation to the extent it taxes subsidiary's New Jersey net income

slice. This result obtains because Taxation determined it would be unreasonable to require parent to pay CBT on its income that was used to pay royalties on which subsidiary paid CBT to New Jersey. N.J.A.C. 18:7-5.18(b)(3).

Lorillard claims that because Taxation imposes tax on subsidiary's New Jersey slice, it can tax none of parent's slice, as illustrated in Graph 3. (Ra2). Lorillard's argument relies on a false assumption: that when parent pays income (for instance, from sales) to its subsidiary, parent's income is transformed into subsidiary's royalty income. Assuming this falsehood, Lorillard argues that it is unconstitutional for Taxation to tax both entities on "the same royalties." (Pb2). However, parent and subsidiary are separate entities, and the income is characterized as different types of income to each entity. When parent pays its own income to subsidiary as a royalty, that does not transform the parent's income into royalty income as well, nor does the royalty constitute sales income to subsidiary. Lorillard's position is akin to saying that a mother's wages is the same as her child's allowance because she pays some of her wages to her child. Just because the mother pays some of her wages to her child does not transform her wages into the child's allowance such that the wages are not taxable to the mother. All of the wages are still taxable to the mother even though she pays some to her child. Likewise, parent's income is still taxable to parent even

though it paid a portion to its subsidiary as a royalty. Parent's business income is taxable to parent, and subsidiary's royalty income is taxable to subsidiary.

A comparison of Schedule G-2 and Lorillard's argument is illustrated in Graph 4. (Ra2). Lorillard cannot show that Taxation's application of the Unreasonableness Exception through Schedule G-2 is unconstitutional, especially since, but for the Unreasonableness Exception, Taxation would have validly taxed parent's entire New Jersey net income slice. Further, as this court and the Tax Court have both recognized, Lorillard is not precluded from showing that it is unreasonable not to refund more of the add back beyond the Schedule G-2. (Pa810; Pa36).

POINT IV

N.J.A.C. 18:7-5.18 AND SCHEDULE G-2 DO NOT VIOLATE THE DCC AS THEY DO NOT BURDEN INTERSTATE COMMERCE.

A tax will withstand scrutiny under the Commerce Clause if the tax (1) "is applied to an activity with 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." Complete Auto Transit Inc. v. Brady, 430 U.S. 274, 279 (1977). Taxation's regulation and Schedule G-2 satisfy all four prongs of the Complete Auto test.

A. There is No Dispute That the Tax Satisfies Prongs One and Four.

Lorillard does not challenge prong one and four. Regardless, the tax meets these prongs. With respect to prong one, Lorillard has nexus – otherwise, Lorillard would not have paid CBT in the first instance. (Pb13). With respect to prong four, the Tax Court has held that an entity's ability to "avail itself of the State judicial system for redress" and the entity's use of computer and phone lines is sufficient to satisfy the requirement that the tax be fairly related to services provided. See Telebright Corp., Inc. v. Dir., Div. of Taxation, 25 N.J. Tax 333, 340-41, 350-51 (Tax 2010), aff'd, 424 N.J. Super. 384 (App. Div. 2012). Thus, both of these prongs are met.

B. The Tax is Fairly Apportioned and Satisfies Prong Two.

A tax is "fairly apportioned" if it is both "internally consistent" and "externally consistent." Container Corp. of Am. v. Franchise Tax Bd., 463 U.S. 159, 169 (1983). N.J.A.C. 18:7-5.18 and Schedule G-2 satisfies both tests.

1. N.J.A.C. 18:7-5.18 and Schedule G-2 are internally consistent.

To be internally consistent, "a tax must be structured so that if every State were to impose an identical tax, no multiple taxation would result." Goldberg v. Sweet, 488 U.S. 252, 261 (1989). The court must look "to the structure of the tax at issue to see whether its identical application by every State in the Union would place interstate commerce at a disadvantage as compared with commerce

intrastate." Okla. Tax Comm'n v. Jefferson Lines, 514 U.S. 175, 185 (1995). "[I]nternal consistency analysis examines the hypothetical functioning of a tax formula, not its real world effects on a taxpayer." Whirlpool, 208 N.J. at 165.

Here, N.J.A.C. 18:7-5.18 and Schedule G-2 are internally consistent. If every state were to provide an exception for a payor to the extent that a payee paid tax to that state, no double taxation would occur. The payor would be entitled to a Utah exception for payee's taxes paid to Utah, and so on for each state. Thus, the regulation and G-2 satisfy internal consistency.

2. N.J.A.C. 18:7-5.18 and Schedule G-2 are externally consistent.

a. Taxation's interpretation only taxes value that is fairly attributable to parent's New Jersey activity.

External consistency looks "to the economic justification for the State's claim upon the value taxed, to discover whether a State's tax reaches beyond that portion of value that is fairly attributable to economic activity within the taxing" jurisdiction. Jefferson Lines, 514 U.S. at 185. Apportionment methods are "necessarily imperfect." Container, 463 U.S. at 183. "That the apportionment may not result in mathematical exactitude is certainly not a constitutional defect. Rough approximation rather than precision is, as a practical matter, the norm" in any tax system. Illinois C. R. Co. v. Minnesota, 309 U.S. 157, 162 (1940). Indeed, the Tax Court acknowledged that formula-based apportionment schemes like New Jersey's are necessarily imperfect.

Lorillard, 31 N.J. Tax at 172 ("However, 'even the three-factor formula is necessarily imperfect,' and income allocation is akin 'to slicing a shadow,' thus, 'absolute consistency, even among taxing authorities whose basic approach to the task is quite similar' is impractical.") (citing Container, 463 U.S. at 183).

Here, Lorillard's New Jersey tax liability determined through the regulation and G-2 is fairly related to its New Jersey activity because Lorillard earned taxable income in New Jersey, including the amounts at issue here. Lorillard was permitted under federal law to deduct amounts paid to its subsidiary as a business expense. But the Legislature expressly passed the BTRA to close a loophole by "limit[ing] . . . the ability of a taxpayer to deduct royalties and other intangible expenses and costs and related interest when paid to affiliates." S. Budget & Approp. Comm. Statement to S. 1556 1, 2 (June 27, 2002). So Lorillard added back the income and paid CBT on the entire amount. But once Licensing paid CBT on the royalties, Taxation granted Lorillard a refund for those amounts corresponding to Licensing's CBT, using Schedule G-2. The CBT that was not refunded was the CBT paid on Lorillard's own income related to its own New Jersey activity according to its own allocation factor. This court has already determined as much: "[t]he tax on Lorillard's add back that was not excepted as unreasonable was related to its activity in New Jersey

based on its allocation factor." (Pa810). Therefore, the tax was fairly related to Lorillard's New Jersey activity.

Lorillard argues that the N.J.A.C. 18:7-5.18(b)(3)/G-2 framework results in the parent paying beyond what it should owe to New Jersey under its apportionment factor, resulting in distortion. (Pb36-38). In fact, Taxation promulgated N.J.A.C. 18:7-5.18(b)(3) to avoid distortion. Springs, 29 N.J. Tax at 13. Lorillard's distortion argument again relies on its income-transformation, as Lorillard erroneously assumes that when parent pays its own income to subsidiary as a royalty, parent's income is transformed into subsidiary's royalty income. Having made this assumption, Lorillard concludes that when Taxation taxes parent's addback, it is not taxing parent's New Jersey income, but subsidiary's non-New Jersey income. This is not so. When Taxation taxes parent's non-excepted addback, it is taxing income fairly related to the parent's activity in New Jersey according to parent's undisputed allocation factor. But for the Unreasonableness Exception, Taxation could have taxed the entire addback. In applying the Unreasonableness Exception, Taxation is not distorting parent's tax liability but lessening it from an amount that Taxation could otherwise lawfully tax.

Because Taxation imposes tax on parent's income that is fairly related to parent's New Jersey activity, this court can quickly dispose of Lorillard's Hunt-

Wesson argument, (Pb30-34), just as the Tax Court did, (Pa30-31). Because Lorillard incorrectly assumes that when the parent pays its income to Licensing as a royalty, the parent's income is somehow transformed into the subsidiary's income, Lorillard concludes that Taxation is not permitted to impose tax on the parent's income that corresponds with the subsidiary's non-New Jersey activity. But the New Jersey slice of the parent's income that it pays to its subsidiary as a royalty is directly taxable to New Jersey by definition. It is precisely that income that New Jersey may tax because it is parent's own income that accords with the parent's allocation factor. If New Jersey can tax all of parent's New Jersey slice, certainly it may tax some of parent's New Jersey slice. By making an exception, New Jersey is simply imposing a tax on the parent's income according to the parent's allocation factor, minus the exception.

In arguing that Taxation is using Schedule G-2 to tax indirectly what it cannot tax directly, Lorillard relies exclusively on Hunt-Wesson, which is readily distinguishable. Unlike here, the income at issue in Hunt-Wesson was income that California was not permitted to tax. Id. at 460. Hunt-Wesson demonstrated the effects of California's unconstitutional statute using the illustration of an Illinois tin can manufacturer doing business in California. Id. at 461-62. The Court explained that if the tin can manufacturer receives dividend income from a subsidiary operating a sheep farm in New Zealand that

does not do business in California, California cannot tax that income. Id. at 461-62. This is so because the sheep-farm income is generated from an unrelated business activity of a discrete business enterprise, meaning that there is no nexus with California with respect to the sheep-farm income. Id. at 464. Thus, the dividend income could not be taxed by California.

By contrast, New Jersey can directly tax parent's income that it used to pay the royalties. As the Tax Court observed, "New Jersey can tax the royalty income received by Licensing," as Licensing has nexus to New Jersey from employing its intellectual property in New Jersey. (Pa30). There is no indirect or back-door tax on the subsidiary. Rather the Unreasonableness Exception operates to reduce otherwise taxable income. The income New Jersey is taxing is not non-New Jersey income received from a related entity engaged in unrelated business activity, but rather that portion of the parent's income that corresponds to its own New Jersey activity. Because the tax is fairly related to the parent's New Jersey activity, Taxation meets the external consistency test.[7]

Contrary to Lorillard's contention, (Pb37), Surtees supports the Tax Court's rulings. Lorillard's distortion, indirect tax, and taxing out of proportion arguments are identical to those in Surtees. (Pa30). The fact that the exceptions

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[7] The Tax Court's suggestion that N.J.A.C. 18:7-5.18 violates the DCC due to the geographic language is addressed below in Point II, C.

in Surtees were statutory and here they are regulatory does not affect the analysis under Surtees, which is directly on point. Just as there was no distortion of payor's income in Surtees, 8 So.2d at 971, there is no distortion of Lorillard's income relative to its New Jersey activities through application of N.JA.C. 18:7-5.18(b)(3) and the G-2.

Further, as in Surtees, any denial of the Unreasonable Exception to Lorillard does not constitute an indirect tax on Licensing. The disallowed deduction "sought by the taxpayer, [payor], which does have activities in [the state] sufficient to justify its paying corporate income tax in [the state]." Surtees, 8 So.2d at 979. "[D]eductions are a matter of legislative grace," and disallowing a deduction for an expense paid does not constitute a tax on the payees. Ibid.

Surtees also found no showing that the addback resulted in a tax that was disproportionate to the payor's activities in the state, that it led to a grossly distorted result, or that it went beyond the value that was fairly attributable to the state. Id. at 981. Unlike in Hunt-Wesson, there was a rational relationship between the income the state sought to addback and the income to be included in the payor's taxable income. Ibid. Thus, unlike the deduction limitation in Hunt-Wesson, the addback resulted in taxation of income that was fairly attributable to the state. Ibid.

Similarly, Lorillard's New Jersey tax liability through the addback and N.J.A.C. 18:7-5.18/G-2 is fairly related to its New Jersey activity because it is based on Lorillard's earned taxable income in New Jersey. There is nexus and a rational relationship between New Jersey and Lorillard's income that New Jersey has taxed, including the deduction denial amounts for royalty payments. Thus, the addback through Taxation's regulation and the G-2 is fairly apportioned and attributable to New Jersey. (Pa810) ("The tax on Lorillard's add back that was not excepted as unreasonable was related to its activity in New Jersey based on its allocation factor.").

Finally, Lorillard's contention about Surtees is misplaced insofar as Alabama's "subject-to-tax" exception allowing for an exception to the addback when a related member's income is taxed by Alabama or any other state relates to the court's analysis as to discrimination, not fair apportionment. Surtees, 8 So.2d at 982. If this court finds Taxation's regulation was constitutionally required to allow an exception for taxes paid to other states, the court should, similar to Surtees, limit the exception to the amount of correlative intangible income Licensing actually reported and paid tax on in other states, not including any offsets or other eliminated income by virtue of filing combined/consolidated returns with Lorillard. As argued below in Point IV, allowing an exception based on a pre-apportionment basis (the amount reported by a payee), would

eviscerate, or at least frustrate, the New Jersey's addback statute as a measure reasonably designed to close loopholes. See Surtees, 8 So.2d at 976 (allowing an exception to the addback "to apply on a pre-apportionment basis would effectively negate the operation of the add-back statute."). Such interpretation would allow payor to easily avoid the addback by paying a related member with a relatively insignificant apportionment factor, which would be unreasonable and nonsensical, as it would "serve to place [the state] back in the position it was in before the enactment of the add-back statute." Ibid.

b. Lorillard's argument would necessarily invalidate the entire royalty addback statute as unconstitutional.

To invalidate an act of the Legislature, a party must overcome the highest presumption of constitutional validity. "[J]udicial decisions from the time of Chief Justice Marshall reveal an unswerving acceptance of the principle that every possible presumption favors the validity of an act of the Legislature." N.J. Sports & Exposition Auth. v. McCrane, 61 N.J. 1, 8 (1972). This presumptive constitutionality can be rebutted "only upon a showing that the statute's repugnancy to the Constitution is clear beyond a reasonable doubt." Hamilton Amusement Ctr. v. Verniero, 156 N.J. 254, 285 (1998). Particularly in "the field of taxation," courts have long "accorded great deference to legislative judgments." Town of Secaucus v. Hudson Cnty. Bd. of Taxation, 133 N.J. 482, 493 (1993). As the New Jersey Supreme Court explained, "[s]ince the members

of a legislature necessarily enjoy a familiarity with local conditions which this Court cannot have, the presumption of constitutionality" in tax matters "can be overcome only by the most explicit demonstration that a classification is a hostile and oppressive discrimination against particular persons and classes." Salorio v. Glaser, 82 N.J. 482, 515 (1980). Further, "when 'a statute may be open to a construction which would render it unconstitutional or permit its unconstitutional application, it is the duty of this Court to so construe the statute as to render it constitutional if it is reasonably susceptible to such interpretation.'" Whirlpool, 208 N.J. 169 at 172 (quoting State v. Profaci, 56 N.J. 346, 350 (1970) (citation omitted)).

Although Lorillard is not challenging the constitutionality of the addback statute, if Lorillard's income-transformation argument is correct, then the royalty addback statute is necessarily unconstitutional in its entirety. Because, using Lorillard's logic, any addback to parent will always be the equivalent of the subsidiary's non-New Jersey value.[8] This further underscores the argument's absurdity. This court should not permit such a result.

Because the parent's non-excepted addback is fairly related to its New Jersey activity and is not transformed into subsidiary's non-New Jersey royalty

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[8] Indeed, under Lorillard's argument, any addback to parent would also unconstitutionally "distort" the parent's tax burden because any addback would necessarily result in a higher tax liability for the parent.

income, N.J.A.C. 18:7-5.18 and the G-2, which this court has already deemed reasonably interpret the BTRA, satisfy the external consistency test.

C. The Tax Does Not Discriminate Against Interstate Commerce and Satisfies Prong Three.

A discrimination claim under the Commerce Clause requires a "two-tiered analysis." Brown-Forman Distillers Corp. v. N.Y. State Liquor Auth., 476 U.S. 573, 578-79 (1986). Under Tier 1, a statute violates the Commerce Clause if it facially discriminates against interstate commerce, that is, if it "directly regulates or discriminates against interstate commerce" or if "its effect is to favor in-state economic interests over out-of-state interests." Id. at 579. If a statute passes muster under Tier 1 because the statute "has only indirect effects on interstate commerce and regulates evenhandedly," then the court must apply a Tier 2 analysis, the Pike test. Ibid. Under Pike, a statute is upheld unless the burden on interstate commerce is "clearly excessive in relation to the putative local benefits." Pike v. Bruce Church Inc., 397 U.S. 137, 142 (1970). Here, Lorillard stakes its claim on a Tier 1 (facial) analysis. (Pb24). Therefore, Lorillard cannot prevail unless the court finds that Taxation's interpretation of the BTRA facially discriminates against interstate commerce.

1. Taxation's interpretation of the BTRA does not discriminate against interstate commerce.

In order to prevail under Tier 1, Lorillard must prove that Taxation's regulation and Schedule G-2 facially discriminate against interstate commerce, meaning that they "explicitly put greater burdens on out-of-state businesses or provide more favorable terms to in-state businesses." Whirlpool, 208 N.J. at 166; see also Ampro Fisheries, Inc. v. Yaskin, 127 N.J. 602, 613 (1992) (under Tier 1 analysis, law must "affirmatively discriminate" against interstate commerce). Lorillard cannot meet its burden. Nothing in Taxation's regulation or Schedule G-2 explicitly puts greater burdens on out-of-state businesses or provides more favorable terms to in-state businesses. New Jersey imposes the same tax burden on out-of-state businesses as it does on its own residents who also engage in commerce among the states. Contrary to Lorillard's argument, (Pb25), there is no differential treatment of in-state and out-of-state companies – both incur the same tax burden to New Jersey based on the payor's income and New Jersey allocation factor. As a result, Taxation's regulation and Schedule G-2 fully satisfy Complete Auto's discrimination prong.

Further, there is no burden on interstate commerce, as the regulation and Schedule G-2 have a neutral impact on interstate commercial interests. When the subsidiary's New Jersey presence increases, its New Jersey tax burden increases, and the parent's New Jersey tax burden correspondingly decreases.

The converse scenario is also true: when the subsidiary's New Jersey presence decreases, its New Jersey tax burden decreases, and the parent's New Jersey tax burden correspondingly increases. Regardless of whether the subsidiary's presence increases or decreases, the net impact is neutral. Stated differently, interstate commerce is neither benefited nor harmed by subsidiary's allocation factor because the tax burden to New Jersey is ultimately determined by the allocation factor of the entity generating income in New Jersey, here Lorillard.

Lorillard's argument that Taxation made a fatal admission in its prior appellate brief is misleading. (Pb25). The next sentence in that brief stated, "But when parent's New Jersey presence increases, parent is harmed, thus discouraging New Jersey activity to the benefit of interstate commerce." (Pa814). The point was that there is neither a harm nor a benefit to interstate commerce – as one side of the equation goes up the other goes down and vice versa, with the total amount set by the tax liability incurred by the payor on its New Jersey allocation factor and related income. Further, there is no incentive from either entity's perspective to increase its New Jersey activities – if Lorillard's increases, it owes more taxes to New Jersey, and if Licensing's increases, it owes more taxes to New Jersey.

Because there is no discrimination, Taxation need not prove a non-discriminatory alternative. However, it should be noted with respect to

Lorillard's legitimate local purpose argument, (Pb29-30), our courts have already recognized the legitimate purpose – i.e., avoiding an unfair advantage by closing "the loopholes of tax avoidance schemes or mechanisms whereby legitimate New Jersey sourced income escaped tax to the detriment of New Jersey and other small businesses unable to use such corporate shields." Springs, 29 N.J. Tax at 16.

2. Mere geographic language does not, without more, violate the DCC.

Lorillard argues that the reference to New Jersey in N.J.A.C. 18:7-5.18 and Schedule G-2 is facially discriminatory. (Pb24). But mere geographic language without a burden on interstate commerce does not amount to discrimination under the DCC. Here, Taxation's regulation and Schedule G-2 do not burden interstate commerce and so do not discriminate in violation of the DCC. The geographic language in the regulation and Schedule G-2 is benign.

Geographic language is often necessary in apportionment-related laws. For example, without geographic specificity, a statute cannot properly identify or apportion the CBT tax base. The allocation factor set forth in N.J.S.A. 54:10A-6 repeatedly references the "State." Such apportionment formulas, as well as laws with geographic language, are common throughout the United States and frequently upheld against DCC challenges. See, e.g., Trinova Corp. v. Mich. Dep't of Treasury, 498 U.S. 358 (1991); Container, 463 U.S. at 183;

Metromedia, Inc. v. Dir., Div. of Taxation, 97 N.J. 313, 322-323 (1984) (noting the three-factor allocation formula ensures that "only those portions of . . . net income . . . that are fairly attributable to the corporation's activities in New Jersey are used in the measure of the tax" and as averaged are "applied to the taxpayer's . . . net income . . . to determine the . . . portion of . . . net income properly attributable, and thus taxable, to New Jersey.").

Likewise, here, the reference to New Jersey is not in and of itself discriminatory. Taxation determined that it would be unreasonable for New Jersey to collect tax from payor on the income it used to pay royalties to payee to the extent the payee paid tax to New Jersey on the royalty. The geographic specificity does not make the tax discriminatory but simply serves to designate the amount that would be unreasonable to tax under these facts.

In making its "geographical limitation" argument, Lorillard relies on Fulton Corp. v. Faulkner, 516 U.S. 325, 331 (1996), in which the U.S. Supreme Court held that a North Carolina tax exemption for resident stockholders that was proportionate to the corporation's in-state presence violated the DCC. As a threshold matter, the Court swiftly concluded that the challenged statute was facially discriminatory because it "favor[ed] domestic corporations over their foreign competitors . . . and tends, at least, to discourage domestic corporations

from plying their trades in interstate commerce." Id. at 333.[9] Thus, the statute in Fulton Corp. clearly favored domestic over foreign corporations, was facially unconstitutional, and discouraged interstate commerce. By contrast, the geographic language in N.J.A.C. 18:7-5.18 did not discourage interstate commerce. Rather, it applied neutrally, allowing for a reduction in payor's New Jersey tax burden based on payee's payment of tax to New Jersey.

Lorillard also relies on Or. Waste Sys. v. Dep't of Envtl. Quality, 511 U.S. 93 (1994), in which the Supreme Court struck a statute with geographic language because it actually burdened interstate commerce. The Court found it "obvious" that the statute discriminated because it "subject[ed] waste from other States to a fee almost three times greater than the $ 0.85 per ton charge imposed on solid in-state waste." Id. at 99. The statute directly burdened interstate commerce by explicitly charging more on waste from out-of-state. Here, by contrast, there is no differential treatment of in-state and out-of-state companies, thus no burden on interstate commerce. As the Tax Court explained,

> a full or partial deduction will be allowed regardless of the payor or payee's corporate domicile so long as the payee is a related entity. No New Jersey domiciled related-member payee which allocates income within and outside New Jersey is given a special preference or competitive advantage over similar foreign entity in application of a partial addback under the regulation.

[9] Indeed, the statute was so obviously discriminatory that North Carolina "practically concede[d]" so. Fulton Corp., 516 U.S. at 333.

[Pa28.]

Contrary to Lorillard's argument, (Pb27), it was unnecessary for the Tax Court to address Fulton and Or. Waste because the statutes in those cases directly imposed a burden on interstate commerce. In contrast, Taxation's regulation and Schedule G-2 impose no burden on interstate commerce, rather the focus is on the relative relationship between related entities' allocation factors, which has a neutral effect on interstate commerce.

Further, Taxation's regulation and G-2 do not have "the same economic effect as a tariff," as Lorillard argues. (Pb28, citing Comptroller of the Treasury v. Wynne, 575 U.S. 542 (2015)). In Wynne, the Court found the tax scheme "inherently discriminatory and operates as a tariff" because it violated the internal consistency test. Id. at 565; see also id. at 567 ("the internal consistency test and economic analysis—indeed, petitioner's own concession—confirm that the tax scheme operates as a tariff and discriminates against interstate commerce."). As demonstrated above, Taxation's regulation and schedule easily passes the internal consistency test and does not discriminate.

Lorillard thus has not pointed to any case in which geographic language that does not burden interstate commerce is nevertheless found discriminatory in violation of the DCC. The words "New Jersey" do not make a demonstrably non-discriminatory law discriminatory.

Lorillard's argument that "[t]he regulation and Schedule G-2 do not permit an Unreasonable Exception for those taxpayers that pay affiliates that pay tax in any other jurisdiction," (Pb29), is a mere variation on the geographic limitation argument and fails for the same reason. N.J.A.C. 18:7-5.18 and Schedule G-2 gives the parent an Unreasonableness Exception for the subsidiary's tax payments to New Jersey, not for the subsidiary's tax payments to other jurisdictions, as a counter-balance to subsidiary's New Jersey tax burden based on subsidiary's New Jersey activity. Any incentive to the parent to increase New Jersey activity on the subsidiary's side is counter-balanced by a disincentive to the subsidiary to increase its New Jersey activity. Again, because there is no burden on interstate commerce, there is no discrimination. And, Lorillard was not limited to the Schedule G-2, but never provided any evidence showing the amount of the royalties it paid to Licensing that Licensing reported and actually paid taxed on to other states.

Taxation's interpretation of the BTRA in its regulation and Schedule G-2 satisfies all of the Complete Auto prongs and therefore does not violate the DCC.

POINT V

LORILLARD'S ARGUMENTS WOULD FRUSTRATE THE PURPOSE OF THE BTRA AND EVISCERATE THE ADDBACK.

A legislative purpose of the BTRA was to prevent tax avoidance by exporting income from New Jersey. See A. Budget Comm. Statement to A. 2501 2. Because Lorillard paid income to a subsidiary with a lower allocation factor, Lorillard did export income from New Jersey to the exact extent that Licensing's non-New Jersey presence exceeded Lorillard's. That subsidiary paid CBT on the royalty according to its allocation factor did not close the loophole with respect to the parent and its obligation to pay tax on its own income.

Lorillard contends that it is unlawful to require it to add back royalties that it paid to Licensing "simply because Licensing conducted less business in New Jersey than Lorillard." (Pb2). Lorillard inexplicably assumes that if a subsidiary has any allocation factor other than 0%, then the entire amount of income that parent paid as a royalty must be excepted. Lorillard's interpretation is unjustified. Taxation may constitutionally apply a partial exception in Lorillard's circumstances. Lorillard can only claim otherwise by relying on its income-transformation argument. Lorillard conflates parent's business income with subsidiary's royalty income, arguing that because subsidiary paid tax on its own royalty income according to its allocation factor, parent should not pay tax

on its own income according to its own allocation factor. A partial exception is not only permissible, but appropriate under Lorillard's facts. Taxation's reasonable interpretation of the BTRA in applying Schedule G-2 to Lorillard, as this court already determined, should be upheld as constitutional.

Additionally, allowing parent a complete unreasonableness exception no matter how small the subsidiary's allocation factor (except zero), undercuts and undermines the intent of the BTRA to avoid a payor from exporting income from New Jersey. Here, a comparison of Lorillard's and Licensing's allocation factors demonstrates this point:

Year	Lorillard	Licensing	Difference	%Difference
2002	2.7907	1.8659	0.9248	33.138639
2003	2.4565	1.6111	0.8454	34.414818
2004	2.1910	1.4358	0.7552	34.468279
2005	2.1087	1.3214	0.7873	37.335799

[Pb6; Pb13]

Despite both having low allocation factors, the relative size of the allocation factors to each other is substantially disparate, with Licensing's factor over a third lower than Lorillard's. This disparity is significant, as can be seen by Lorillard's own argument that its tax liability substantially increased because it only received an Unreasonable Exception to the extent that subsidiary paid tax to New Jersey. (Pb35). Disparate allocation factors such as these allow multi-entity businesses to skirt the intended loophole closure by funneling royalty and

other intangible payments to related entities with lower allocation factors. Allowing corporations to avoid tax this way not only harms New Jersey but also creates an unfair advantage to the detriment of small businesses that cannot use such tax shields. This is not what the BTRA intended. See Springs, 29 N.J. Tax at 16 ("The thrust of the BTRA was to close the loopholes of tax avoidance schemes or mechanisms whereby legitimate New Jersey sourced income escaped tax to the detriment of New Jersey and other small businesses unable to use such corporate shields.").

Finally, Lorillard's argument that any time a related-entity-royalty payee has nexus with New Jersey the payor's entire addback must be excepted – i.e., if payee has nexus, there is no addback – would gut the royalty addback. In practice, the payee will almost always have nexus because any New Jersey sales by payor will likely make use of intellectual property from payee, establishing payee's nexus. Lanco, Inc. v. Dir., Div. of Taxation, 21 N.J. Tax 200 (Tax 2003), rev'd, 379 N.J. Super. 562, 22 N.J. Tax 636 (App. Div. 2005), aff'd, 188 N.J. 380 (2006). Thus, under Lorillard's argument the addback will very likely not apply at all, eviscerating royalty addback. The exception, as interpreted by Lorillard, would swallow the rule. This court should not permit that outcome.

CONCLUSION

For these reasons, N.J.A.C. 18:7-5.18 and Schedule G-2 should be deemed constitutional in all regards and the Tax Court's decision dismissing Lorillard's complaints should be affirmed.

Respectfully submitted,

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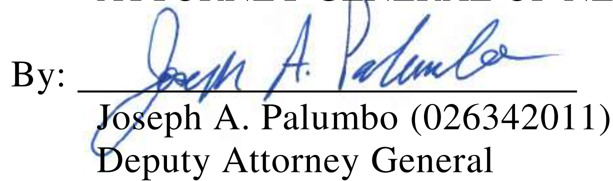
By: 

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LORILLARD TOBACCO COMPANY, Plaintiff/Appellant, v. DIRECTOR, DIVISION OF TAXATION, Defendant/Respondent.	SUPERIOR COURT OF NEW JERSEY APPELLATE DIVISION DOCKET NOS. A-000595-23 & A-000596-23 Civil Action On Appeal From a Final Decision Entered In The Tax Court Of New Jersey Sat Below: Honorable Mala Sundar, P.J.T.C.

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PRELIMINARY STATEMENT

Lorillard[1] submits this Reply Brief. Defendant, Director, Division of Taxation, erroneously required Lorillard to add back to its income the royalties that it paid and deducted when Defendant also required the recipient of the royalties in the same transaction, Licensing, to file CBT returns and pay CBT on the same royalties — which Defendant did simply because Licensing conducted less business in New Jersey than Lorillard did. Defendant asserts that she may increase Lorillard's CBT liability for the sole reason that Licensing conducts more of its business outside of New Jersey than Lorillard does. This is unconstitutional.

The Regulation, calculated in Schedule G-2, improperly limits the Unreasonable Exception to only "the extent that the payee pays tax to New Jersey on the income stream." N.J.A.C. 18:7-5.18(b)(3) (pre-2020). Defendant defines "the extent" by requiring use of Schedule G-2. Defendant's Regulation and Schedule G-2 are unconstitutional because together they are discriminatory, indirectly tax the out-of-state activities of Licensing that New Jersey cannot tax directly and result in taxation out of all appropriate proportions to Lorillard's activities in New Jersey. A state tax that favors intrastate activity over interstate activity, as the one at issue here, discriminates against interstate commerce in violation of the U.S. Constitution's Commerce Clause.

[1] Capitalized terms shall have the same meaning as in Lorillard's Opening Brief.

The Tax Court found that the Regulation was unconstitutional because of its geographic limitation but determined that the purported deletion of the geographic limitation in the 2020 Amendment applied retroactively (despite the parties' agreement that it did not) and purportedly cured the constitutional infirmity, despite the fact that Schedule G-2 with its geographic limitation and Defendant's methodology remained unchanged. None of the exceptions to the default rule of prospective application apply to the 2020 Amendment. What remains of the Remand Decision is the conclusion that Defendant's methodology under the Regulation is unconstitutional, and Lorillard is entitled to its full refund.

ARGUMENT

POINT I

The Standard of Review is *De Novo*, and The Tax Court is Not Entitled to Deference on its Legal, Constitutional Determinations

The authorities cited by Defendant do not support her position that the Remand Decision is entitled to deference. Rather, as discussed in Lorillard's Opening Brief, this Court's review of the Tax Court's ruling in the context of a summary judgment motion is de novo, as is this Court's review of legal, constitutional determinations. Pb15-16. The Tax Court's determinations are not entitled to any deference. Defendant cites to no authority stating otherwise.

POINT II

The Amended Regulation Does Not Apply Retroactively

Though Defendant originally, correctly asserted that the 2020 Amendment applied prospectively and that it was improper to retroactively apply it up to 18 years back in this case (see, e.g., Tr. 62), Defendant reverses course in briefing to suit her current argument. For the reasons discussed in Lorillard's Opening Brief (Pb16-21), the general rule that regulations apply prospectively controls.

Defendant does not (nor could she) argue that the 2020 Amendment explicitly or implicitly reflects an intent that it is to apply prospectively. Indeed, at oral argument below and in briefing, Defendant's counsel represented that Defendant did not intend the 2020 Amendment to apply retroactively. Tr. 62. Moreover, the expectations of the parties do not warrant retroactive application. The parties demonstrated that they both expected that the 2020 Amendment does not apply retroactively. Finally, the 2020 Amendment is not curative. While Defendant argues that the 2020 Amendment "removed the [unconstitutional] geographic language" (Db23), the constitutional infirmity was not cured because the geographic limitation in Schedule G-2 remained unchanged (Pa023), no additional refund was paid to Lorillard, and Defendant maintained that the same unconstitutional methodology for adding back royalties applied to Lorillard.

If the Regulation now purportedly allows for more than one ground for qualifying for an exception, that does not change the fact that the exception calculated on Schedule G-2's geographic limitation still discriminates against interstate commerce. The mere existence of other grounds that do not discriminate against interstate commerce do not "cure" the remaining unconstitutional ground. Defendant asserts that, under the "cured" regulation, Lorillard could have proved that it qualified for an unreasonable exception on other grounds, such as that denying the exception would have created an "unconstitutional result." However, this is what Lorillard has already been doing for years in this case. Defendant implicitly admits that she was not considering whether the Unreasonable Exception was being applied in an unconstitutional manner before the 2020 Amendment.

Finally, Defendant is incorrect that Lorillard is only entitled to an additional refund to the extent that Licensing paid tax to other states. The Regulation and Schedule G-2 make no reference to tax paid to other states. The paradigm established by Defendant is one by which the unreasonable exception provided to Lorillard is based solely on Licensing's New Jersey allocation factor. That methodology is what is at issue as either constitutional or not. Defendant is asking this Court to rewrite the Regulation and Schedule G-2 to create a different type of exception that is not the exception in the Regulation and Schedule G-2. The Court should not and cannot rewrite the Regulation and Schedule G-2, and Lorillard is

entitled to a full Unreasonable Exception to avoid taxation by unconstitutional means. US Bank, N.A. v. Hough, 210 N.J. 187, 199 (2012) ("[w]hether construing a statute or a regulation, it is not our function to 'rewrite a plainly-written enactment,'" and "[w]e cannot rearrange the wording of the regulation . . . we must construe the regulation as written").

POINT III

Application of the Regulation and Schedule G-2 in this Case Results in Unconstitutional Double Taxation

Springs Licensing Group, Inc. v. Director, Division of Taxation, 29 N.J. Tax 1 (Tax 2015) fails to support Defendant's position that its taxing methodology in this case does not result in double taxation. Db25. In Springs Licensing, the payor filed CBT returns and added back royalties it paid to the payee, and paid CBT, but the payee did not so file and pay CBT. Springs Licensing decided the issue of whether the out-of-state payee had nexus and must file CBT returns and pay CBT pursuant to Lanco, Inc. v. Director, Division of Taxation, 21 N.J. Tax 200 (Tax 2003), rev'd, 379 N.J. Super. 562 (App. Div. 2005), aff'd, 188 N.J. 380 (2006), even when the related member payor added back its intangible expenses pursuant the Addback Statute. Springs Licensing, 29 N.J. Tax 1, 2.

In deciding that the payee must nonetheless file CBT returns when payor files and pays tax, Springs Licensing observed that options remained to avoid double taxation, including that the payor could claim the Unreasonable Exception.

Id. at 13. The Tax Court explained that "claims of unconstitutional double taxation are questionable" when the payor "chooses not to use the statutorily available remedies to alleviate issues of double taxation." Id. at 17 (emphasis added).

However, the Tax Court did not affirm the Regulation or Schedule G-2 or hold that there is no unconstitutional double taxation in the absence of the Unreasonable Exception if Defendant were to require taxation of 100 percent of the royalties at both payor and payee. To the contrary, Springs Licensing expressly contemplated the risk of unconstitutional double taxation by applying the Addback Statute and concluded only that a payor that did not use statutory payor remedies to address that risk (and asserted (unlike here) that payee did not have to file CBT returns) is hard pressed to make the constitutional argument. However, unlike in Springs Licensing, it is undisputed that Lorillard (payor) did avail itself of the statutory remedy, i.e., claiming the Unreasonable Exception, and the sufficiency of the operation of that remedy as it is interpreted and applied by Defendant is now before this Court. Such was not before the court in Springs Licensing.

Defendant admits that it is "the duty of this Court to so construe the statute as to render it constitutional if it is reasonably susceptible to such interpretation." Db38 (quoting Whirlpool Props., Inc. v. Dir., Div. of Tax'n, 208 N.J. 144, 172 (2011). If the Legislature provided no exceptions to the Addback Statute, this Court would still be required to construe the Addback Statute in a manner that

avoided unconstitutional double taxation if the Addback Statute was reasonably susceptible to such interpretation or, failing an ability to so construe it, strike it down. The exceptions provided by the Legislature do not exist solely as a matter of legislative grace if Defendant's application of those exceptions leads to unconstitutional double taxation.[2]

POINT IV

Defendant Misapplies *Complete Auto*

A. Defendant's Regulation and Schedule G-2 Discriminate Against Interstate Commerce

The Regulation and Schedule G-2 are discriminatory on their faces and as applied because they provide for differential treatment for a taxpayer-royalty payor depending on whether and how much the related member payee conducts its business in New Jersey and files CBT returns. If the related member payee conducts more business in New Jersey, the tax benefit to the payor increases. Defendant previously conceded that the Regulation and Schedule G-2 are facially discriminatory acknowledging that "[w]hen subsidiary's New Jersey presence increases, parent benefits, thus incentivizing New Jersey activity to the detriment

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[2] Defendant's graphs do not provide support. There is no foundation laid and they are not in evidence. Moreover, however sliced, Defendant improperly calculates Lorillard's Unreasonable Exception based on Licensing's allocation factor. Lorillard does not "transform" Lorillard's income into Licensing's royalty income. The economic reality is taxing Licensing on its royalty income and having Lorillard add the same royalties to its income to tax them again is double taxation.

of interstate commerce." Pa814.[3] Contrary to Defendant's assertion, the parent is incentivized to increase its New Jersey activities relative to its out-of-state activities or else face an increased tax burden by New Jersey.

Defendant erroneously asserts that the amount of New Jersey activities of the royalty payee should be considered as part of the discrimination analysis of payor because then the net impact is neutral. Db40. First, that is not an argument that the Regulation and Schedule G-2 geographic limitation do not discriminate. The amount of New Jersey activities of the royalty payor has no effect on the amount of the royalty payor's Unreasonable Exception under the Regulation and Schedule G-2. The amount of the Unreasonable Exception permitted under the Regulation and Schedule G-2 is wholly a function of the royalty payee's New Jersey activities, which Defendant concedes incentivizes New Jersey activity to the detriment of interstate commerce.

With per se discrimination, the burden now shifts to Defendant. When a state tax law facially discriminates against interstate commerce, "the burden falls

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[3] Defendant avers that she also stated that when parent's in-state activity increases, parent is harmed by paying more tax. This does not justify facial discrimination in the Regulation and Schedule G-2 geographic limitation. Defendant's statement is an admission of facial discrimination made in a document filed in court. Camps Newfound/Owatonna v. Town of Harrison, 520 U.S. 564, 578 (1997) (finding a statute facially discriminatory where "it tended 'to discourage domestic corporations from plying their trades in interstate commerce.'") (internal citations omitted).

on the State 'to justify it both in terms of [1] the local benefits flowing from the [tax law] and [2] the unavailability of nondiscriminatory alternatives adequate to preserve the local interests at stake.'" Chem. Waste Mgmt., Inc. v. Hunt, 504 U.S. 334, 342 (1992) (internal citations omitted). Defendant does not assert the unavailability of nondiscriminatory alternatives. And, while Defendant weakly points to the local purpose of closing a purported loophole (Db41-42), the local benefit may not be achieved by employing an unconstitutional tax, without showing the unavailability of nondiscriminatory alternatives. The U.S. Supreme Court explained "the purpose of, or justification for, a law has no bearing on whether it is facially discriminatory." Or. Waste Sys., Inc. v. Dep't of Env't. Quality, 511 U.S. 93, 100 (1994). Indeed, as this is the first time Defendant even attempts to assert a local benefit, this Court need not address this argument. Camps Newfound/Owatonna, 520 U.S. 564, at 581-582 ("[p]erhaps realizing the weight of its burden, the Town has made no effort to defend the statute under the *per se* rule, and so we do not address this question").

Defendant further argues that a geographic limitation, "without more," does not violate the Constitution. Db42. However, the Tax Court found the geographic limitation in the Regulation unconstitutional. Pa018. Defendant overlooks that there is "more" here because the geographic limitation in the Regulation and Schedule G-2 results in a tax benefit (i.e., the Unreasonable Exception) available

only to the extent of the royalty payee's New Jersey activities and CBT paid – if payee does more in New Jersey, then payor gets to pay less tax.

Defendant's argument that apportionment-related provisions need "geographic specificity" (Db42) is irrelevant because the Addback Statute and the Unreasonable Exception are not apportionment-related provisions. Rather, they relate to the expansion of the pre-apportioned entire net income of the payor company, i.e., they are part of the tax base and not part of the allocation factor. There is a clear distinction between: (a) geographic language used to divide one company's income for tax purposes among the states in which it operates; and (b) geographic language used to calculate (or, as here, inflate) the taxable base and provide a tax benefit with respect to companies with activities in a preferred geographic location. The former is constitutional while the latter is not.

Defendant fails in her unsupported attempts to distinguish Defendant's Regulation and Schedule G-2 from the facially discriminatory tax laws at issue in Fulton and Oregon Waste. Db43-45. The unconstitutional provision at issue in Fulton was comparable to the Regulation and Schedule G-2 because the amount of the tax benefit provided to a shareholder (there, a deduction from North Carolina's intangibles tax on shareholders) was determined by reference to the apportionment percentage in North Carolina of the corporation in which the shareholder owned stock. Fulton, 516 U.S. at 327-28. North Carolina could have provided no

intangibles tax deduction – the Fulton issue was the way in which the deduction was calculated. Like Defendant, North Carolina argued in Fulton that the net impact on interstate commerce was neutral because the corporation in which the shareholders owned stock was subject to North Carolina corporate income tax and North Carolina had "assured substantial equivalence" by measuring the shareholder's deduction by the corporation's North Carolina apportionment percentage. Id. at 339.

The U.S. Supreme Court rejected North Carolina's argument, explaining that this argument was only a defense of a facially discriminatory provision and, therefore, "the State has the burden to show that the requirements of the compensatory tax doctrine are clearly met." Id. at 344. The Court further stated: "we doubt that such a showing can ever be made outside the limited confines of sales and use taxes." Id. Defendant has made no such showing here inasmuch as, like North Carolina did, she has merely asserted the failing argument that equivalence has been achieved by using Licensing's New Jersey allocation factor to measure the amount of Lorillard's deductible royalties.

Defendant's regulation and Schedule G-2 are also like the unconstitutional provision in Oregon Waste. The U.S. Supreme Court in Oregon Waste rejected Oregon's argument that taxes on waste produced out of state were valid compensatory taxes. The Court explained that Oregon's argument was merely an

insufficient attempt to save a facially discriminatory tax on the purported grounds that it achieved a legitimate local purpose that could not be achieved through nondiscriminatory means. Oregon Waste, 511 U.S. at 102. The Tax Court here was wrong to fail to even address the Supreme Court's binding precedent in Fulton and Oregon Waste.

Further, Defendant errs by asserting the Pike balancing test. Db39. As she concedes, the Pike balancing test applies only when a tax law is not facially discriminatory and "has only indirect effects on interstate commerce and regulates evenhandedly." Brown-Forman Distillers Corp. v. N.Y. State Auth., 476 U.S. 573, 579 (1986)). With Defendant's facially discriminatory regulation and Schedule G-2 geographic limitation, the Pike balancing test does not and cannot apply.

Finally, Defendant seeks to distinguish this case from Comptroller of the Treasury v. Wynne, 575 U.S. 542 (2015), but in that case, just like here, the tax scheme "create[d] an incentive for taxpayers to opt for intrastate rather than interstate economic activity" and was determined to be discriminatory and unconstitutional. Id. at 545. Just like this case, in Wynne, the taxing authority conceded that the tax discriminated against interstate commerce. Id. at 567.

B. Defendant's Regulation and Schedule G-2 Indirectly Tax the Out-of-State Activities of Licensing that New Jersey Cannot Tax Directly

A "tax on sleeping measured by the number of pairs of shoes you have in your closet is a tax on shoes." Hunt-Wesson, Inc. v. Franchise Tax Board, 528 U.S.

458, 464 (2000) (internal citations omitted). Here, under the U.S. Supreme Court's reasoning, a tax increase for Lorillard measured by the CBT allocation factor of Licensing is a tax on Licensing. Under Hunt-Wesson, a tax increase on Lorillard that is (a) measured by the portion of Licensing's income that New Jersey cannot constitutionally tax or (b) limited by the portion of Licensing's income that it can tax is an unconstitutional indirect tax on Licensing. Defendant cannot tax more of Licensing's income and instead grabs more of Lorillard's income.

Defendant's attempt to distinguish Hunt-Wesson fails because it erroneously focuses on whether Lorillard has nexus with New Jersey. Db33. In Hunt-Wesson, Hunt-Wesson did not dispute that it had nexus with California and that California could tax, if it chose to do so, its apportionable income without providing an interest expense deduction. The issue in Hunt-Wesson arose because Hunt-Wesson had certain non-unitary out-of-state discrete income (i.e., income it could not apportion to itself) that California could not constitutionally tax (like Licensing's income that cannot be apportioned to New Jersey under Licensing's CBT allocation factor). Hunt-Wesson, 528 U.S. at 463.

In both Hunt-Wesson and the cases before this Court, the constitutional infirmity arises from requiring those taxes to be measured based on income amounts that the state cannot constitutionally tax. Hunt-Wesson concluded that the tax there was an unconstitutional indirect tax on income that California could not

constitutionally reach. Id. at 468. On all fours with Hunt-Wesson, Defendant's regulation and Schedule G-2 are an unconstitutional indirect tax on the income of Licensing that New Jersey cannot constitutionally reach if it were done directly.

Inasmuch as the constitutional infirmity that Lorillard alleges arises from how Defendant requires the Unreasonable Exception to be calculated, Defendant's argument that Lorillard seeks to invalidate the Addback Statute itself is erroneous. The Legislature left it to Defendant to determine what constitutes unreasonableness. However, Defendant is not free to determine what constitutes unreasonableness in a manner that is unconstitutional.[4]

C. Defendant's Regulation and Schedule G-2 Result in Gross Distortion and Taxation that Is Out of All Appropriate Proportion to Lorillard's Activities in New Jersey

Contrary to Defendant's assertions (Db30), the Regulation and Schedule G-2 result in taxation of Lorillard that is not fairly related to Lorillard's activities in New Jersey. The actual effect of the Regulation and Schedule G-2 is that Lorillard is taxed, in part, based on Licensing's activities in New Jersey rather than its own activities in New Jersey. This is Defendant's own "income-transformation" thinking. Db32. Licensing's CBT allocation factor is used to determine the amount of Lorillard's entire net income that is apportioned to New Jersey.

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[4] The issue of whether the Unreasonable Exception is constitutionally required is not before this Court. The issue here is whether, once enacted, the Unreasonable Exception must be applied constitutionally. The obvious answer is yes.

The Regulation and Schedule G-2 create up to 42% more CBT for Lorillard during the tax years 2002-2005 without any change to the amount of Lorillard's own activities conducted in New Jersey. Pb35. This distortion of income subjected to tax is "out of all appropriate proportions to the business transacted" in New Jersey by Lorillard and creates a "grossly distorted result" in violation of the U.S. Constitution. Container Corp. of Am. v. Franchise Tax Bd., 463 U.S. 159, 170 (1983) (citations omitted).

Finally, Defendant's arguments that a ruling for Lorillard would frustrate the purpose of the Addback Statute (Db47-49) is a non sequitur because she argues that the U.S. Constitution should not frustrate New Jersey's purpose. Db34-35. Defendant is not above the Constitution.

CONCLUSION

For the foregoing reasons, it is respectfully requested that this Court rule that (1) the 2020 Amendment does not apply retroactively to the Years in Issue, (2) the Regulation and Schedule G-2 are unconstitutional, (3) the 2020 Amendment does not cure the constitutional infirmity in the Regulation, even if it did apply, and (4) Defendant is ordered to pay Lorillard the remaining unpaid portion of Lorillard's refund claims.

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