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New Jersey Intangibles Weigh Heavily as Taxpayers Seek a Lift from *AccuZIP*

Peter C. Leonardis
New York
212.326.3770
pleonardis@jonesday.com

Carolyn Joy Lee
New York
212.326.3966
cjlee@jonesday.com

Earlier this month, the New Jersey Supreme Court rendered its decision in *Praxair*, imposing the Corporation Business Tax ("CBT") solely as a result of the taxpayer's licensing of intangibles into New Jersey during periods before adoption of the relevant New Jersey regulation.[1] The main issue in the case,[2] described by the court as "narrow" and based on "the circumstances presented," was whether the 1996 amendment to the New Jersey CBT regulation adding examples of "doing business" without physical presence changed New Jersey's historic law.

In *Lanco*,[3] the New Jersey Supreme Court held that physical presence was not required for taxation under the CBT with respect to years after 1996. The decision in *Praxair* applying the *Lanco* analysis to periods before the 1996 regulation is a further blow to the physical-presence nexus requirement. Even so, future cases will be required to address uncertainties that remain as to the tax implications of licensing intangibles.

Background

The taxpayer, Praxair Technology Inc. ("Praxair"), licensed patents and other intangibles for a fee to its parent corporation for use in its manufacturing facilities in New Jersey and other states. While Praxair's parent filed New Jersey CBT returns, Praxair did not. In 2002, the New Jersey Division of Taxation ("Division") assessed Praxair for the years 1994 through 1999. Praxair subsequently filed a complaint with the New Jersey Tax Court, and the parties made cross-motions for summary judgment regarding the tax years 1994 through 1996. The tax court found in favor of the Division, extending *Lanco* to the 1994 through 1996 tax years at issue in Praxair's case. The New Jersey Superior Court, Appellate Division, subsequently reversed, ruling in favor of Praxair's argument that the 1996 regulation expanded the reach of New Jersey's CBT and

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[1] *Praxair Technology, Inc. v. Director, Div. of Taxation*, No. A-91/92-08, slip op. (Dec. 15, 2009).

[2] The other issues addressed by the court and not addressed herein concern the application of penalties (*i.e.*, late filing (5 percent) and amnesty (5 percent)). The court remanded the penalty issues to the appellate division.

[3] *Lanco, Inc. v. Director, Div. of Taxation*, 908 A.2d 176 (N.J. 2006), *cert. denied*, 551 U.S. 1131, 127 S. Ct. 2974 (2007).

therefore should not apply retroactively.[4] The Division appealed to the New Jersey Supreme Court.

Lanco and the Example

In 1996, the Division added the following example to New Jersey Regulation Section 18:7-1.9:

> Foreign corporation R holds trademarks that were assigned to it by its parent corporation. R receives fees as a result of licensing those trademarks to certain New Jersey companies for use in New Jersey. R is subject to the corporation business tax on its apportioned income as a result of its trademark licensing activities.

The practitioner community largely viewed this regulatory amendment as signifying a change in the Division's policy regarding the requirement for physical presence. The tax court's decision in *Lanco* referenced the apparent change in the Division's policy:

> A finding of nexus without physical presence would clearly reflect a change in applicable law. In these circumstances, this court could reasonably conclude that the novelty of the change and the reliance interests of taxpayers under the former interpretation justify confining the new rule to application only after the effective date of the amendment to the regulation.[5]

In light of the former interpretation requiring physical presence, Praxair challenged the Division's assessment for the years prior to the regulatory change.

The Parties' Positions

In the litigation, Praxair conceded that it was subject to the CBT for tax years after the regulatory change. Praxair argued, however, that the addition of the example in the regulation in 1996 demonstrated a change in the Division's taxing policy, broadening the scope of the applicable imposition statute.[6] Not surprisingly, the Division took the position that the amendment to the regulation merely clarified the applicable statute. In other words, the Division argued that New Jersey's "doing business" standard has never required physical presence.

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[4] *Praxair Technology, Inc. v. Director, Div. of Taxation*, 961 A.2d 738 (N.J. Super. Ct. App. Div. 2008), *rev'g*, N.J. Tax Court, Docket No. 007445-05 (June 18, 2007), *rev'd* A-91/92-08.

[5] N.J. Tax Court, Docket No. 005329-97 (Oct. 23, 2003).

[6] N.J.S.A. § 54:10A-2.

The Decision: Read the Statute

The New Jersey Supreme Court took a simplified approach in its analysis, applying the plain-language canon of statutory construction and highlighting certain portions of the relevant statute:

> *Every* domestic or *foreign corporation which is not hereinafter exempted shall pay an annual franchise tax* for the year 1946 and each year thereafter, as hereinafter provided, for the privilege of having or exercising its corporate franchise tax in this State, or *for the privilege of doing business*, employing or owning capital or property, or maintaining an office, *in this State*. …

N.J.S.A. 54:10A-2 (pre-2002 statute, emphasis supplied by New Jersey Supreme Court).[7]

Influence of Intercompany Scheme?

On appeal, the New Jersey Supreme Court approved the tax court's conclusion that the statute itself exposed Praxair to the CBT, stating, "That conclusion is unassailable." [8] This decision appears to have been influenced by multiple references to the court's perception of an intercompany "tax avoidance scheme."

In footnote 2 of the decision, the court concluded that "the tax avoidance scheme adopted by plaintiff here—whereby a subsidiary/licensor licenses intellectual property to a parent/licensee for use in New Jersey—plainly results in New Jersey corporate business tax liability to both the parent licensee and the subsidiary/licensor."[9] Later in the decision, the court noted that the 1996 addition of the example in the regulation "precisely mirrored the tax avoidance relationship plaintiff and its corporate parent intentionally developed."[10]

In response to the perception of an intercompany tax avoidance scheme, the court approved the tax court's reasoning that "form would not trump substance" and that "the use of intangible property for income-producing purposes in New Jersey renders that property's owner subject to taxation either as one who is 'doing business, [or] employing or owning capital or property … in this state.' "[11] Using similarly strong language, the court concluded that the regulation, prior to the 1996 amendment, "leads in a straight, unbroken line to the conclusion that [Praxair] was 'doing business' in New Jersey."[12] Therefore, the principles articulated in *Lanco* were applied to periods prior to the 1996 regulatory amendment.

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[7] *Praxair*, A-91/92-08 (noting that in 2002, N.J.S.A. 54:10A-2 was amended to include "deriving receipts from sources within this State").

[8] *Praxair*, A-91/92-08.

[9] *Id*.

[10] *Id*.

[11] *Id*.

[12] *Id*.

Summary Rejection of Expanded Scope

As to Praxair's argument that the regulatory change broadened the scope of the CBT, starting in 1996, the court stated that it was beyond the power of the Division to achieve such a result.[13] The power to tax is a legislative power not expandable through regulation. The "legislative intent behind the CBT is to give the tax its broadest reach constitutionally permissible."[14] Accordingly, the court held that Praxair was liable for the CBT for tax years 1994 through 1996 on the basis of the text of the statute, and not because the regulation "expanded" the scope of the CBT.

The Other Side of the Coin

Interestingly, the language in *Praxair* may be helpful to taxpayers in other circumstances. The New Jersey Supreme Court repeatedly articulated in the decision its conclusion that the Executive Branch cannot by regulation expand the scope of a tax statute. For example, the court characterized Praxair's attempt to limit the regulation to prospective application as "premised on a fallacy, an unspoken but nonetheless incorrect assumption that tax liability somehow can flow from a regulatory change."[15] The court further concluded that "the proposition that the taxing power can be expanded by the Executive Branch via the adoption of regulations is simply erroneous."[16] We can remember SO many times we have argued that exact point. Now we have a citation!

What Now?

Because the United States Supreme Court denied certiorari in *Lanco,*[17] a different result seems unlikely for *Praxair,* a case generally limited to the interpretation of state law. While the scope of *Lanco* was broadened in *Praxair*, that scope is not all-encompassing. Licenses of intangibles do not necessarily constitute "doing business" in New Jersey for the CBT, even in the opinion of the New Jersey Tax Court.

The "Real Object" of *AccuZIP*

Earlier this year, the New Jersey Tax Court analyzed whether two non-New Jersey corporations selling and licensing software to third parties had sufficient nexus with New Jersey to support the imposition of the CBT.[18] In the cases of *AccuZIP* and *Quark*, the court concluded that the "real object" of the taxpayers' sales of copyrighted software was the sale of tangible personal property, not a license of intangibles for a royalty. Accordingly, neither seller of software was held to be

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[13] *Id.* (citing the provision in the New Jersey Constitution that "[a]ll bills for raising revenue shall originate in the General Assembly").

[14] *Id.* (citing *Roadway Express, Inc. v. Director, Div. of Taxation*, 50 N.J. 471, 483 (1967)).

[15] *Praxair,* A-91/92-08.

[16] *Id.*

[17] 551 U.S. 1131 (2007).

[18] See *AccuZIP, Inc. v. Director, Div. of Taxation*, N.J. Tax Court, Docket No. 005744-2003 (Aug. 13, 2009); *Quark Inc. v. Director, Div. of Taxation*, N.J. Tax Court, Docket No. 004692-2002 (Aug. 13, 2009).

doing business or generating income from the use of intangible property in New Jersey merely from sales of software to third parties in New Jersey. The court noted that "Quark and AccuZIP are actual corporations and not holding companies created for the purpose of generating a tax benefit."[19] While the court found Quark to be doing business through an in-state representative, it held that AccuZIP was "not doing business in New Jersey and therefore does not satisfy the substantial nexus requirement of the Commerce Clause in order for the Director to impose a tax based on AccuZIP's corporate income."[20]

The Case for Waiver of Penalty

Query, then, whether *Praxair* is another instance of tough cases making bad law. Unfortunately, for taxpayers facing exposure from the *Praxair* decision, New Jersey's amnesty program concluded on June 15, 2009. New Jersey's Voluntary Disclosure Program is an option, but the post-amnesty rules call for the imposition of an unabateable penalty of 5 percent for failure to take advantage of the tax amnesty program, as well as a 5 percent late-payment penalty. Perhaps the remand in *Praxair* will offer some relief on the issue of the post-amnesty penalty, particularly in light of the tax court's waiver of post-amnesty penalties in the recent *United Parcel Service* decision.[21] Stay tuned. ■

[19] *Id*.

[20] *Id*.

[21] *United Parcel Service General Services Co. v. Director, Div. of Taxation*, N.J. Tax Court, Docket Nos. 007845-2004, 007879-2004, 007889-2004 (June 5, 2009).