To be argued by:
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(Time requested: 20 minutes)

APL No. APL-2022-00161
Appellate Division, Third Department Docket No. 532479
New York State Division of Tax Appeals DTA No. 828304

Court of Appeals

of the

State of New York

THE WALT DISNEY COMPANY AND
CONSOLIDATED SUBSIDIARIES,

Petitioner-Appellant,

– against –

THE TAX APPEALS TRIBUNAL OF THE STATE OF NEW YORK
and THE COMMISSIONER OF TAXATION AND FINANCE OF
THE STATE OF NEW YORK,

Respondents-Respondents.

BRIEF FOR PETITIONER-APPELLANT

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April 10, 2023

CORPORATE DISCLOSURE STATEMENT

Pursuant to New York Court of Appeals Rule of Practice 500.1(f), The Walt Disney Company and Consolidated Subsidiaries ("Disney") states that it: (1) is a for-profit corporation; (2) has no parent company; and (3) maintains various domestic and international subsidiaries. Please find attached a list of subsidiaries pursuant to Disney's Annual Financial Report (Form 10-k) for the fiscal year ending October 1, 2022.

Exhibit 21

Name of Subsidiary	Country of Incorporation
20th Century (Asia) Ltd.	United States
ABC Cable Networks Group	United States
ABC Enterprises, Inc.	United States
ABC Family Worldwide, Inc.	United States
ABC Holding Company Inc.	United States
ABC Kids Europe Holdings, Inc.	United States
ABC News/Starwave Partners	United States
ABC Signature, LLC	United States
ABC, Inc.	United States
Accelerator Investments LLC	United States
American Broadcasting Companies, Inc.	United States
Asianet Star Communications Private Limited	India
BAMTech, LLC	United States
Banner Productions Limited	United Kingdom
Beijing Hulu Software Technology Development Co., Ltd.	China
Buena Vista International, Inc.	United States
Buena Vista Television, LLC	United States
Buena Vista Video On Demand	United States
Buzzer Investments Ltd	Mauritius
BVI Television Investments, Inc.	United States
Cable LT Holdings, Inc.	United States
DCL Maritime LLC	United States
DCL Port Facilities Corporation	United States
Disney Consumer Products, Inc.	United States
Disney Destinations, LLC	United States
Disney DTC LLC	United States
Disney Enterprises, Inc.	United States
Disney FTC Services (Singapore) Pte. Ltd.	Singapore
Disney Magic Company Limited	United Kingdom
Disney Magic Corporation	United States
Disney Networks Group Asia Pacific Limited	Hong Kong
Disney Networks Group Netherlands Holding B.V.	Netherlands
Disney Networks Group Netherlands Holding II B.V.	Netherlands
Disney Online	United States
Disney Shopping, Inc.	United States
Disney Sports DTC, LLC	United States
Disney Streaming Technology LLC	United States
Disney Studio Production Services Co., LLC	United States
Disney Vacation Club Management, LLC	United States
Disney Vacation Development, Inc.	United States
Disney Worldwide Services, Inc.	United States
Disney/ABC International Television, Inc.	United States
Eredivisie Media & Marketing C.V.	Netherlands
ESPN Enterprises, Inc.	United States
ESPN Productions, Inc.	United States
ESPN, Inc.	United States

Euro Disney Associés SAS	France
FX Networks, LLC	United States
FX Productions, LLC	United States
FXX Network, LLC	United States
Hongkong International Theme Parks Limited	Hong Kong
Hudson Square Realty, LLC	United States
Hulu, LLC	United States
International Family Entertainment, Inc.	United States
KABC Television, LLC	United States
KTRK Television, Inc.	United States
LFL Production, LLC	United States
LFL Productions Limited	United Kingdom
Lucasfilm Entertainment Company Ltd. LLC	United States
Lucasfilm Ltd. LLC	United States
Magical Cruise Company, Limited	United Kingdom
Maker Studios, LLC	United States
Marvel Brands LLC	United States
Marvel Characters, Inc.	United States
Marvel Entertainment, LLC	United States
Marvel Studios LLC	United States
MVL Film Finance LLC	United States
National Geographic Partners, LLC	United States
NGC Europe Limited	United Kingdom
NGC Network International, LLC	United States
NGC Network Latin America, LLC	United States
Novi Digital Entertainment Private Limited	India
Pacific 2.1 Entertainment Group, Inc.	United States
Pixar	United States
Playdom, LLC	United States
Searchlight Pictures, Inc.	United States
Shanghai International Theme Park Associated Facilities Company Limited	China
Shanghai International Theme Park Company Limited	China
Star India Private Limited	India
Star ISP Ltd	Mauritius
STAR US Holdings Subsidiary, LLC	United States
STARTV ATC Holding Limited	British Virgin Islands
Streamboat Willie Productions LLC	United States
TFCF America, Inc.	United States
TFCF Cable Ventures, LLC	United States
TFCF Corporation	United States
TFCF Entertainment Group Holdings, LLC	United States
TFCF Entertainment Group, LLC	United States
TFCF Europe, Inc.	United States
TFCF International Channels (US) Inc.	United States
TFCF Latin American Channel LLC	United States
TFCF Movie Channel, Inc.	United States
TFCF SPV, Inc.	United States

The Walt Disney Company (Canada) Ltd.	Canada
The Walt Disney Company (China) Limited	China
The Walt Disney Company (France) S.A.S.	France
The Walt Disney Company (Germany) GmbH	Germany
The Walt Disney Company (Japan) Ltd.	Japan
The Walt Disney Company (Korea), LLC	South Korea
The Walt Disney Company Limited	United Kingdom
The Walt Disney Company Medya Eglence ve Ticaret Limited Sirketi	Turkey
The Woodlands Enterprises, LLC	United States
TWDC Enterprises 18 Corp.	United States
TWDC Investment Enterprises II, LLC	United States
TWDC Investment Enterprises, LLC	United States
Twentieth Century Fox Film Corporation	United States
Twentieth Century Fox Film International, Inc.	United States
Twentieth Century Fox International Television, Inc.	United States
Twentieth Century-Fox Telecommunications International, Inc.	United States
Twentieth Television, Inc.	United States
UTV Software Communications Private Limited	India
WABC Television (New York), LLC	United States
Walt Disney Holdings (Hong Kong) Limited	Hong Kong
Walt Disney Parks and Resorts U.S., Inc.	United States
Walt Disney Pictures	United States
Walt Disney Travel Co., Inc.	United States
WD Holdings (Shanghai), LLC	United States
WPVI Television (Philadelphia), LLC	United States

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PRELIMINARY STATEMENT

This appeal arises from a dispute over the proper construction of N.Y. Tax Law § 208.9(o)(3)[1] (the "Royalty Income Exclusion"). The Royalty Income Exclusion permitted New York taxpayers to exclude royalty payments received from related member royalty payors for the purposes of computing state taxable income ("New York Income"). R. at 3665-3670. During the periods at issue, the Walt Disney Company and Consolidated Subsidiaries (collectively, "Disney") received royalty payments from foreign affiliates ("Alien Affiliates") that it excluded from New York Income pursuant to the Royalty Income Exclusion. R. at 55-58, 390-1067.

The New York State Supreme Court, Appellate Division, Third Department ("Appellate Division") found that Disney was not entitled to deduct the royalty payments under the Royalty Income Exclusion. R. at 4117-4118. The Appellate Division construed the Royalty Income Exclusion statute to predicate the tax benefit on a geographic determinant - whether the royalty payor was subject to tax in New York. *Id*. The Appellate Division denied Disney the Royalty Income Exclusion, determining that a taxpayer is only permitted the exclusion if the related member royalty payor was a New York taxpayer. *Id*. A statute that predicates a

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[1] N.Y. Tax Law § 208.9(o), as enacted by N.Y. 2003 Session Laws, Ch. 62, Part U3, Sec. 1. All citations to N.Y. Tax Law § 208.9(o) herein reference the Tax Law effective during the Audit Period, unless otherwise provided.

tax benefit to a parent-taxpayer based on a geographic determinant – its subsidiary's in-state presence – is facially discriminatory. The Appellate Division's construction of the Royalty Income Exclusion facially discriminates against interstate and foreign commerce because it imposed a geographic determinant on the tax benefit.

Disney proved beyond a reasonable doubt that the Appellate Division's construction of the law imposed a geographic determinant that facially discriminated against interstate and foreign commerce. The Appellate Division failed to comprehend that its inclusion of the geographic determinant facially discriminated against interstate and foreign commerce. R. at 4117-4118. The Appellate Division failed to conclude that the facial discrimination was *per se* invalid. *Id.*

A state may attempt to justify a *per se* invalid facially discriminatory tax. A state must prove that the facially discriminatory statute serves a legitimate local purpose and that the purpose cannot be advanced by a nondiscriminatory alternative. A state's justification of a facially discriminatory law is subject to the strictest scrutiny. The Appellate Division's decision appears to justify the unconstitutional discrimination by reasoning that the burden on interstate and foreign commerce was not constitutionally significant because New York would only tax the royalty income once ("single tax theory"). *Id.*

The U.S. Supreme Court has repeatedly rejected the single tax theory as an insufficient justification to facial discrimination. The Court held that the single tax theory neglects to account for the actual burden on interstate or foreign commerce because it only looks at one state's tax in a vacuum. Under the court's construction of the Royalty Income Exclusion, royalty payments made by non-New York taxpayers would be subject to multiple taxation. Moreover, the nature of the multiple taxation is significantly onerous as to foreclose tax neutral decisions by similarly situated taxpayers, in violation of the Commerce Clause.

In addition, the Appellate Division failed to strictly scrutinize the justification to facial discrimination. *Id.* The court's construction of the Royalty Income Exclusion does not advance the statute's local purpose, which was to prevent the multiple taxation of royalty income. The court's construction of the law, in fact, does the opposite of what the legislature intended – it results in the multiple taxation of royalty income from non-New York royalty payors. Further, the court failed to find that the law's local purpose could not be advanced by alternative, non-discriminatory means. *Id.* The local purpose of avoiding multiple taxation of royalty income would be achieved when the Royalty Income Exclusion is permitted for royalty payments received from both in-state and out-of-state related member royalty payors.

Therefore, the Appellate Division's facially discriminatory construction of the Royalty Income Exclusion imposes an unconstitutional burden on interstate and foreign commerce, which cannot be justified under strict scrutiny. The Appellate Division's decision must be reversed, and the court's facially discriminatory construction of the Royalty Income Exclusion must be struck.

QUESTIONS PRESENTED

1. Whether U.S. Supreme Court precedent establishes that a state tax law that imposes a geographic determinant facially discriminates against interstate or foreign commerce.

2. U.S. Supreme Court precedent establishes that a facially discriminatory tax law is *per se* invalid. The Appellate Division's construction of the Royalty Income Exclusion imposes a geographic determinant that facially discriminates against interstate and foreign commerce. Did the Appellate Division fail to conclude that the facially discriminatory tax law was *per se* invalid?

3. U.S. Supreme Court precedent establishes that a state can only justify a *per se* invalid tax law with proof that the law served a legitimate local purpose that cannot be advanced by a nondiscriminatory alternative. The Appellate Division did not strictly scrutinize Respondents' justification to evaluate the local purpose and determine whether it could be accomplished by alternative nondiscriminatory means. Did the Appellate Division erroneously find that facial discrimination was justified?

JURISDICTIONAL STATEMENT

This court has jurisdiction to entertain the appeal and to review the question presented pursuant to CPLR § 5601(b)(1) because a substantial Constitutional question is directly involved. This is an appeal from a final judgment of the Appellate Division, entered on October 20, 2022. R. at 4110-4119. On October 31, 2022, Disney timely filed its Notice of Appeal with the Appellate Division and served Respondents with a copy of the Notice. R. at 4108-4109. On November 3, 2022, Disney, pursuant to NYCRR § 500.9(b), provided written notice to the New York State Attorney General that it intended to appeal the Appellate Division's decision on constitutional grounds. R. at C-1-82. On November 14, 2022, Disney timely filed its Preliminary Appeal Statement with the court. R. at C-83-176.

On November 22, 2022, the court initiated a jurisdictional inquiry to examine its subject matter jurisdiction over the appeal. R. at C-177-183. On December 12, 2022, Disney and Respondents timely filed jurisdictional responses with the court. R. at C-184-195. On February 8, 2023, the court terminated its jurisdictional inquiry and permitted the appeal to proceed in the normal course of briefing and argument. R. at C-196-209.

STATEMENT OF FACTS

Business Operations

1. Disney is a corporation organized under the laws of Delaware. R. at 1-33.

2. Disney is the parent company of an affiliated group of entities that produce and license to others content, media, entertainment, and consumer products, among other things. *Id.*

3. Disney licensed certain intellectual property rights to Alien Affiliates pursuant to licensing agreements during the tax periods ending September 27, 2008, October 3, 2009, and October 2, 2010 ("Audit Period"). *Id*.

4. The Alien Affiliates paid Disney royalties in exchange for the right to use the intellectual property during the Audit Period. *Id*.

Royalty Income Exclusion

5. In 2003, New York enacted N.Y. Tax Law § 208.9(o), effective for tax years beginning on or after January 1, 2003. R. at 3665-3670.

6. New York Tax Law § 208.9(o)(3) permitted taxpayers to exclude "royalty payments" received from "related members" to compute New York Income for New York State Corporate Franchise Tax purposes. *Id.*

Federal Tax Filings

7. Disney filed consolidated federal corporate income tax returns (Forms 1120) for the Audit Period. R. at 1-33, 55-58, 60-389, 3111-3625.

8. The Alien Affiliates (non-U.S. entities) were excluded from Disney's federal tax returns for the Audit Period. *Id.*

9. Disney included royalty payments received from Alien Affiliates to compute federal taxable income as reported on its federal tax returns for the Audit Period. *Id*.

<u>New York State Tax Filings</u>

10. Disney filed New York State combined Corporation Franchise Tax returns during the Audit Period. R. at 1-33, 55-58, 60-389, 390-1067.

11. The Alien Affiliates were excluded from Disney's Corporation Franchise Tax returns as required by New York Tax Law in effect during the Audit Period. *Id.*; *see also* N.Y. Tax Law § 211(4)(a)(5).

12. Disney excluded royalties received from the Alien Affiliates from New York Income pursuant to the Royalty Income Exclusion on its amended Corporation Franchise Tax return for the 2008 Tax Year, and its original Corporation Franchise Tax returns for the 2009 and 2010 Tax Years. *Id*.

Royalty Income Exclusion Repeal

13. In 2013, New York amended N.Y. Tax Law § 208.9(o) to eliminate the Royalty Income Exclusion provision effective for tax years beginning on or after January 1, 2013.[2] R. at 3676-3681.

14. The New York State Department of Taxation and Finance – Division of Taxation's ("Division of Taxation") Memorandum in Support of the New York Governor's 2013-2014 Executive Budget advocated for the repeal of the Royalty Income Exclusion provision. R. at 3682-3685.

The Division of Taxation's Audit

15. The Division of Taxation audited Disney for the Audit Period. R. at 1-33, 1336-2039, 2040-2060.

16. The Division of Taxation denied Disney's Royalty Income Exclusion because the Alien Affiliates were not New York taxpayers. *Id.*

17. On May 8, 2017, the Division of Taxation denied Disney's refund claim and issued a Notice of Deficiency for the Audit Period. R. at 2064-2066.

Administrative Trial and Appeal

18. On August 2, 2017, Disney protested the Notice of Deficiency by petitioning the New York State Division of Tax Appeals. R. at 1-33.

[2] The Royalty Income Exclusion was repealed for tax years beginning on or after January 1, 2013. *See* N.Y. Tax Law § 208.9(o), as amended by N.Y. 2013 Session Laws, Ch. 59, Part E, Sec. 2.

19. On May 30, 2019, following an evidentiary hearing, the Division of Tax Appeals Administrative Law Judge issued a determination sustaining the Notice of Deficiency. R. at 60-389, 3792-3813.

20. On July 1, 2019, Disney appealed the Administrative Law Judge determination by filing a Notice of Exception with the New York State Tax Appeals Tribunal. R. at 3814-3824.

21. On August 6, 2020, the Tax Appeals Tribunal issued a decision upholding the Administrative Law Judge determination. R. at 4037-4072.

<u>Article 78 Appeal</u>

22. On December 4, 2020, after exhausting all administrative remedies, Disney filed a Notice of Petition and Verified Petition with the Appellate Division. R. at 4073-4094.

23. On October 20, 2022, the Appellate Division issued a decision upholding the Tax Appeals Tribunal decision. R. at 4110-4119.

24. The Appellate Division decision held that Disney was not entitled to the Royalty Income Exclusion because the royalty payors, its Alien Affiliates, were not New York taxpayers that had, in fact, added back the royalty payments. *Id*.

25. The Appellate Division construed the statute to require the related member royalty payor to be a New York taxpayer for the taxpayer to be permitted the Royalty Income Exclusion. *Id.*

26. Further, the Appellate Division determined that the Division of Taxation and Tax Appeal Tribunal's (collectively, "Respondents") construction of the Royalty Income Exclusion statute does not unconstitutionally discriminate against interstate and foreign commerce in violation of the Commerce Clause. *Id*.

27. On October 20, 2022, counsel for the Respondents, the New York State Attorney General filed a Notice of Entry for the Appellate Division's decision. *Id*.

Appeal to Court of Appeals

28. On October 31, 2022, Disney filed a Notice of Appeal with the State of New York Court of Appeals on the basis that a substantial constitutional question is directly involved to support an appeal as of right to the court. R. at 4108-4109.

29. On November 4, 2022, Disney provided written notification to the New York State Attorney General of its intent to appeal the Appellate Division's decision. R. at C-1-82.

30. On November 14, 2022, Disney filed a preliminary appeal statement with the Court. R. at C-83-176.

31. On November 22, 2022, the court issued a letter to the parties requesting an explanation of the court's subject matter jurisdiction over the appeal. R. at C-177-183.

32. On December 12, 2022, Disney filed with the court its jurisdictional response along with a corporate disclosure statement, the briefs filed with the

Appellate Division, and the record filed with the Appellate Division. R. at C-184-195.

33. In its jurisdictional response, Disney asserted that the court had proper subject matter jurisdiction over the appeal because the Appellate Division's construction of the Royalty Income Exclusion statute unconstitutionally discriminates against interstate and foreign commerce in violation of the Commerce Clause. *Id.*

34. On February 14, 2022, the court terminated its jurisdictional inquiry and issued a scheduling order for briefing and argument to proceed in the normal course. R. at C-196-209.

ARGUMENT

I. FACIAL DISCRIMINATION VIOLATES THE COMMERCE CLAUSE

Legislative pronouncements carry a strong presumption of constitutionality. *Moran Towing Corp. v. Urbach,* 99 N.Y.2d 443, 448 (2003). A taxpayer challenging the constitutionality of a New York statute has a high burden to overcome. *Id.*; *see also Elmwood-Utica Houses, Inc. v. Buffalo Sewer Auth.,* 65 N.Y.2d 489, 495 (1985). Specifically, a challenger must surmount the presumption of constitutionality accorded to legislative enactments by establishing unconstitutionality "beyond a reasonable doubt." *Id.* While the presumption of constitutionality is a high standard to meet, it is rebuttable. *Elmwood-Utica Houses*, 65 N.Y.2d at 495.

The Commerce Clause of the U.S. Constitution affirmatively grants Congress the power "to regulate Commerce with foreign nations, and among the several States, and with the Indian Tribes." U.S. CONST. art. I, § 8, cl. 3. The Framers intended to grant Congress plenary authority to promote interstate commerce, protect free trade, and prevent the balkanization of the United States national marketplace. *See generally* The Federalist No. 42 (James Madison); *see also Oregon Waste Sys., Inc. v. Dep't. of Env't Quality of the State of Oregon et al.*, 511 U.S. 93 (1994); *Armco Inc. v. Hardesty*, 467 U.S. 638 (1984); *Hughes v. Oklahoma*, 441 U.S. 322 (1979); *Boston Stock Exchange v. State Tax Comm'n*, 429

U.S. 318 (1977). In addition to the affirmative grant of Congressional authority, the clause has also been interpreted as containing a "further, negative command" known as the Dormant Commerce Clause. *See Oklahoma Tax Comm'n v. Jefferson Lines, Inc*., 514 U.S. 175, 179 (1995); *Prudential Ins. Co. v. Benjamin*, 328 U.S. 408, 422-423 (1946).

The Dormant Commerce Clause imposes certain restraints on the state taxation of interstate commerce, even when Congress has failed to legislate on the subject. *Oklahoma Tax Comm'n,* 514 U.S. at 179-180; *Hughes*, 441 U.S. at 326. The U.S. Supreme Court has held that the Dormant Commerce Clause imposes restraints on state taxation to prohibit the taxation of commerce more heavily when it crosses state lines than when it occurs entirely within the state. *Armco*, 467 U.S. at 642. The Court's precedent has established that a state tax survives Commerce Clause scrutiny only if it: (1) applies to an activity with a substantial nexus to the taxing State; (2) is fairly apportioned; (3) <u>does not discriminate against interstate commerce</u>; and (4) is fairly related to the services provided by the State. *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977).

Further, when a Foreign Commerce Clause violation is alleged, not only do those same principles apply but additional scrutiny is applied. *Kraft Gen. Foods, Inc. v. Iowa Dep't of Revenue & Fin.*, 505 U.S. 71, 79 (1992)*; Japan Line, Ltd. v. Cnty. of Los Angeles*, 441 U.S. 434, 445-446 (1979). The Court has found that the

Foreign Commerce Clause requires additional scrutiny because matters concerning the entire nation are involved. *Kraft*, 505 U.S. at 79. Accordingly, when evaluating a constitutional challenge to a state tax that implicates foreign commerce, in addition to the standard four factors articulated in *Complete Auto*, the test includes an analysis of "enhanced risk of multiple taxation" and whether the tax "prevents the Federal Government from speaking with one voice" in foreign affairs. *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159, 193 (1983); *Japan Line*, 441 U.S. at 451. Accordingly, the Commerce Clause prohibits discriminatory state taxation of interstate and foreign commerce.

Unconstitutional "discrimination" is defined as the "differential treatment of in-state and out-of-state economic interests that benefits the former and burdens the latter." *Oregon Waste*, 511 U.S. at 99. A tax discriminates against interstate or foreign commerce in violation of the Commerce Clause if it is facially discriminatory, has a discriminatory intent, or a discriminatory effect. *See Amerada Hess Corp. v. Dir., Div. of Tax., New Jersey Dep't of Treas.,* 490 U.S. 66, 75 (1979). As a threshold question, a court must determine:

> [W]hether the challenged statute regulations evenhandedly with only "incidental" effects on interstate commerce, or discriminates against interstate commerce either on its face or in practical effect. . . .

Hughes, 441 U.S. at 336. Therefore, the type of discrimination dictates the proper inquiry.

A. Facial Discrimination Standard

A state tax statute is facially discriminatory if the tax benefit hinges on a "geographic determinant" such that the taxpayer or transaction is subject to greater tax when it crosses state lines than when it occurs entirely within the state. *See Oregon Waste*, 511 U.S. 99-100 (quoting *Armco,* 467 U.S. at 642); *see also Kraft*, 505 U.S. 71; *Westinghouse Elec. Corp. v. Tully*, 466 U.S. 388; *Boston Stock Exchange*, 429 U.S. 318. A "geographic determinant" is a statute that draws a distinction between in-state versus out-of-state activities. *See Id*. Accordingly, to prove facial discrimination, a taxpayer need only establish that the statute imposes a geographic determinant or location-based distinction that causes similarly situated taxpayers to be treated differently.

In a facial challenge, a taxpayer is not required to prove actual discrimination against interstate or foreign commerce. *Armco*, 467 U.S. at 644; *Westinghouse*, 466 U.S. at 407. The Court has held that "[w]hen a tax, on its face, is designed to have discriminatory economic effects, the Court 'need not know how unequal the Tax is before concluding that it unconstitutionally discriminates.'" *Westinghouse*, 466 U.S. at 407 (citing *Maryland v. Louisiana*, 451 U.S. 725, 760 (1981)). In contrast, a statute that even-handedly taxes interstate or foreign commerce may be deemed discriminatory if, in its "practical operation" or effect, burdens interstate or foreign commerce. *See Pike v. Bruce Church, Inc.,*

397 U.S. 137, 142 (1970); *Best & Co. v. Maxwell*, 311 U.S. 454, 455-456 (1940). A taxpayer that challenges the constitutionality of a statute as discriminatory in effect is required to prove an "actual discriminatory impact" on interstate or foreign commerce. *See Armco*, 467 U.S. at 644. The key difference between challenges alleging facial discrimination versus discrimination in effect is whether proof of an actual burden on interstate or foreign commerce is required. *See Id*. Therefore, a taxpayer that demonstrates facial discrimination is not required to prove an actual burden on interstate or foreign commerce.

Statutes that facially discriminate against interstate or foreign commerce are virtually *per se* invalid. *Oregon Waste*, 511 U.S. at 99-100; *Chemical Waste Management Inc. v. Hunt*, 504 U.S. 334, 344 n.6 (1992); *see also Philadelphia v. New Jersey*, 437 U.S. 617, 623-624 (1978). The term "*per se*" is defined as "as a matter of law" and "of, it, or by itself; standing alone, without reference to additional facts." *See* Black's Law Dictionary (11th ed. 2019). The term "*per se*" establishes that in a facial challenge, the statute "standing alone," *i.e.*, by its very terms, creates an unconstitutional distinction which burdens interstate or foreign commerce. *See e.g.*, *Kraft*, 505 U.S. 71; *Westinghouse*, 466 U.S. 388; *Oregon Waste*, 511 U.S. 93; *Boston Stock Exchange*, 429 U.S. 318. Once a statute is found to be facially discriminatory against out-of-state commerce, "it is typically struck down <u>without further inquiry</u>." *Chemical Waste,* 505 U.S. at 342 (emphasis

added); *see also Kraft*, 505 U.S. 71; *Westinghouse*, 466 U.S. 388. Therefore, a statute that includes a geographic determinant that disparately treats similarly situated taxpayers unconstitutionally burdens interstate or foreign commerce resulting in facial discrimination. *Id.* If a statute is deemed to be facially discriminatory, it is *per se* invalid, and the discriminatory geographic element of the law must be struck.

In a series of seminal decisions, the U.S. Supreme Court has invalidated as facially discriminatory and *per se* invalid state tax statutes that discriminate against interstate or foreign commerce by explicitly granting a tax benefit or imposing a tax burden on a taxpayer, product, service, or transaction based on a geographic determinant. *See e.g.*, *Oregon Waste*, 511 U.S. 93; *Kraft*, 505 U.S. 71; *Westinghouse*, 466 U.S. 388; *Armco*, 467 U.S. 638; *Boston Stock Exchange*, 429 U.S. 318. Furthermore, in related member transactions between in-state taxpayers and out-of-state subsidiaries, the Court has struck down as facially discriminatory state tax schemes that predicate a tax benefit to the parent-taxpayer based on a geographic determinant related to the subsidiary's presence in the state, as addressed in greater detail in § II, A, *infra*. *See Westinghouse*, 466 U.S. 388; *Kraft*, 505 U.S. 71.

In *Boston Stock Exchange*, the Court evaluated the constitutionality of an amendment to a New York stock transfer tax statute that reduced tax on sales of

securities based on a geographic determinant. 429 U.S. at 330-331. Prior to the amendment, New York imposed an identical tax on both in-state and out-of-state sales of stock, regardless of whether the stock transfer occurred in New York or not. *Id*. at 330. In response to fears that the New York Stock Exchange would relocate outside the state, the legislature adopted an amendment that reduced the tax rate if both the sale and transfer of stock occurred in-state. *Id.* at 324.

On appeal, the Court struck down the New York statute as facially discriminatory on the grounds that it impermissibly predicated the lower tax rate based on a geographical determinant, which favored sales on a New York exchange over sales on exchanges located outside the state. *Id*. at 332. Because of the geographic distinction, the Court sustained the taxpayer's facial challenge and found that the statute unconstitutionally discriminated against interstate commerce because it favored local commercial interests (New York exchanges) over out-of-state commercial interests (regional exchanges). *Id.* at 334-335. The Court noted that the New York statute violated the Commerce Clause because it extended "a financial advantage to sales on the New York exchanges at the expense of the regional exchanges" and "foreclose[d] tax-neutral decisions" by creating both an advantage for the New York exchanges and imposing a burden on commerce transacted outside New York. *Id.* at 331.

In *Armco*, the Court struck down a West Virginia gross receipts tax statute as facially discriminatory because the law subjected out-of-state wholesalers to a gross receipts tax while no tax was imposed on sales by in-state wholesalers. 467 U.S. at 642. The Court found that under the law, "two companies selling tangible property at wholesale in West Virginia will be treated differently depending on whether the taxpayer conducts manufacturing in the State or out of it." *Id*. The Court struck down the West Virginia law as facially discriminatory and *per se* invalid because of the law's geographic determinant. *Id*. The Court has made perfectly clear that "a State may not tax a transaction or incident more heavily when it crosses state lines than when it occurs entirely within the State." *Id*.

In *Oregon Waste*, the Court analyzed the constitutionality of an Oregon statute, which imposed a higher tax on operators of solid waste disposal facilities for out-of-state waste while imposing a significantly lower tax on such facilities for in-state waste. 511 U.S. at 96-97. The Court found that under the statute's express terms, Oregon solid waste disposal facilities that accepted waste from other states were subject to a fee "almost three times greater" than the fee imposed for in-state waste. *Id*. at 99. The Court held that the "statutory determinant for which fee applies to any particular shipment of solid waste to an Oregon landfill is whether or not the waste was 'generated out-of-state.'" *Id*. The Court found that the Oregon statute imposed a burden on interstate commerce based on a geographic

determinant. *Id*. at 99-100. The Court held that by making a "geographic distinction," the Oregon statute was facially discriminatory and *per se* invalid. *Id*. at 100, 108.

Therefore, the Court's precedent clearly establishes that a state tax law that conditions a tax benefit based on a geographical determinant is facially discriminatory and *per se* invalid.

B. State Justification to Facially Discriminatory Laws

Once a taxpayer has proved facial discrimination, the state may attempt to justify such discrimination. A state is required to set forth a justification to the discrimination that "advances a legitimate local purpose that cannot be adequately served by reasonable nondiscriminatory alternatives." *New Energy Co. of Indiana v. Limbach*, 486 U.S. 269, 278 (1988) (citing *Hughes*, 441 U.S. at 336-337). A state must justify the statute "both in terms of the local benefits flowing from the statute and the unavailability of nondiscriminatory alternatives adequate to preserve the local interests at stake." *Hughes*, 441 U.S. at 336 (quoting *Hunt v. Washington Apple Advertising Comm'n*, 432 U.S. 333, 353 (1977)) (emphasis added). The state's justification to a facially discriminatory law is subject to the strictest scrutiny. *Oregon Waste*, 511 U.S. at 101 (quoting *Hughes*, 441 U.S. at 337). The state's burden of establishing a legitimate justification is so heavy,

especially with respect to a facial challenge, that "discrimination by itself may be a fatal defect." *Id.*; *see also Westinghouse*, 466 U.S. at 406-407.

II. THE APPELLATE DIVISION'S CONSTRUCTION OF THE LAW IS FACIALLY DISCRIMINATORY

The Appellate Division's decision misconstrued the statutory language of the Royalty Income Exclusion to restrict the tax benefit solely to taxpayers that receive royalty payments from related member royalty payors that are subject to tax in New York. R. at 4117. The Appellate Division interpreted the law to impose a geographic determinant by requiring the royalty payment be from a New York taxpayer. *Id*. The Appellate Division's inclusion of a geographic determinant into the statute results in a facially discriminatory tax law. *See Boston Stock Exchange*, 429 U.S. 318; *Westinghouse*, 466 U.S. 388; *Kraft*, 505 U.S. 71; *Armco*, 467 U.S. 648; *Oregon Waste,* 511 U.S. 93.

Moreover, the Appellate Division failed to recognize the *per se* invalidity of the facially discriminatory tax. R. at 4117-4118. The Appellate Division held that Disney had not established that the statute burdened interstate or foreign commerce. *Id*. The Appellate Division erroneously placed the burden on Disney to prove an actual burden on interstate and foreign commerce, in direct conflict with the proper standard to evaluate a facially discriminatory tax law.

A. Facial Discrimination is Defined by a Geographic Determinant

The U.S. Supreme Court has made clear that a state "may not discriminate between transactions on the basis of some interstate element." *Boston Stock Exchange*, 429 U.S. at 332 n.12. In analyzing facial challenges to the

constitutionality of state tax laws, the Court has focused on whether the law has a geographical component – in-state versus out-of-state – that triggers the differential treatment of similarly situated taxpayers. *See Id; see also Armco*, 467 U.S. at 642; *Oregon Waste,* 511 U.S. at 99-100. The Court has held that a statutory determinant based on geographic location results in a facially discriminatory tax. *Id.* More specifically, in the context of related member transactions, a state tax law cannot discriminate against a parent-taxpayer based on the extent of its subsidiary's in-state presence. *See Westinghouse*, 466 U.S. at 400; *Kraft*, 505 U.S. at 78.

In *Westinghouse*, the Court struck down as facially discriminatory a New York law, which imposed a geographic determinant on the availability of a tax credit to a parent-taxpayer based on the extent of in-state shipping export activities conducted by a subsidiary, a Domestic International Sales Corporation ("DISC") entity. 466 U.S. at 407. The New York statute granted a larger tax credit to a parent-taxpayer if its subsidiary conducted more export activities in New York and decreased the tax credit if the subsidiary conducted less export activities in New York. *Id.* at 400. The Court struck down the New York law as facially discriminatory and *per se* invalid because the statute intentionally granted taxpayers a credit that was premised on its subsidiary's level of shipping export activities conducted within the state. *Id.* at 400, 407. The Court held that "not

only does the New York tax scheme 'provide a positive incentive for increased business activity in New York State,' . . . but also it penalizes increases in the DISC's shipping activities in other States." *Id.* at 400-401. The Court chastised New York for its economic protectionist measure, holding that the state had "violated the prohibition in *Boston Stock Exchange* against using discriminatory state taxes to burden commerce in other States in an attempt to induce 'business operations . . . in the home State . . . .'" *Id.* at 406. Therefore, the Court held that the statute was facially discriminatory and *per se* invalid because it imposed a geographical determinant on whether the taxpayer received the tax benefit of the New York credit. *Id.* at 407.

Similarly in *Kraft*, the Court struck down as facially discriminatory an Iowa statute that granted a taxpayer a deduction for dividends received from domestic subsidiaries but not for dividends received from foreign subsidiaries. 505 U.S. at 72-73, 82. In evaluating whether the Iowa statute facially discriminated against foreign commerce, the Court noted that:

> It is indisputable that the Iowa statute treats dividends received from foreign subsidiaries less favorably than dividends received from domestic subsidiaries. Iowa includes the former, but not the latter, in its calculation of taxable income.

Id. at 75. The Court analyzed the geographic determinant by comparing the tax impact on a taxpayer that received a dividend from a domestic affiliate versus a foreign affiliate. *Id.* The Court found that the tax treated similarly situated

taxpayers differently because it conditioned the tax benefit (the dividend deduction) on the subsidiary's in-state activities. *Id.* at 78-79. Crucially, the Court noted that the key determinative factor under the Iowa statute, which prompted the differential treatment resulted solely from "the location of [the subsidiary's] activities." *Id*. at 78.

The Court found that the Iowa statute predicated the benefit of the dividends received deduction on a geographic determinant, which placed an undue tax burden on taxpayers with foreign subsidiaries, which was absent on taxpayers with domestic subsidiaries. *Id.* at 78-80. In rejecting the burden imposed on foreign commerce, the Court held:

> [A] State's preference for domestic commerce over foreign commerce is inconsistent with the Commerce Clause even if the State's own economy is not a direct beneficiary of the discrimination. As the absence of local benefit does not eliminate the international implications of the discrimination, it cannot exempt such discrimination from Commerce Clause prohibitions . . . . [T]he fact remains that Iowa imposes a burden on foreign subsidiaries that it does not impose on domestic subsidiaries.

Id. at 79-80 (emphasis added). Accordingly, the Court invalidated the Iowa law as facially discriminatory and *per se* invalid. *Id.* at 82.

Therefore, the Court's precedent makes clear that a statutory determinant based on geographic location results in a facially discriminatory tax. In related member transactions, the Court has held that a state is prohibited from taxing a transaction more heavily when it crosses state lines than when it occurs entirely

within the state. A state statute that predicates a tax benefit to a parent-taxpayer while burdening another based solely on the taxpayer's subsidiary's in-state presence is facially discriminatory against interstate or foreign commerce in violation of the Commerce Clause, and *per se* invalid.

B. The Appellate Division's Construction of the Royalty Income Exclusion Imposes a Geographic Determinant

Generally, a taxpayer must calculate the portion of its income apportionable to the state ("New York Income") to determine its state tax liability. *See* N.Y. Tax Law § 208(9). The starting point to calculate New York Income is federal taxable income, which is then subject to certain state-specific modifications. *Id.* In 2003, New York enacted two state-specific modifications. The first modification required taxpayers to add back royalty payments made to a related member to calculate New York Income ("Royalty Expense Add Back"). *See* N.Y. Tax Law § 208.9(o)(2). The second modification permitted taxpayers to exclude royalty payments received from a related member to calculate New York Income (Royalty Income Exclusion). *See* N.Y. Tax Law § 208.9(o)(3). Specifically, New York Tax Law provided:

> Royalty income exclusions. For the purpose of computing entire net income or other taxable basis, a taxpayer shall be allowed to deduct royalty payments directly or indirectly received from a related member during the taxable year to the extent included in the taxpayer's federal taxable income unless such royalty payments would not be required to be added back under subparagraph two of this paragraph [Royalty Expense Add Back] or other similar provisions in this chapter.

Id. (emphasis added). The Royalty Income Exclusion permits royalty income to be excluded from New York Income unless a narrowly tailored restriction applies. *Id.* The narrowly tailored restriction applies only to royalties that "would" not be required to be added back under the Royalty Expense Add Back provision. *Id.*

The Royalty Expense Add Back provision requires royalty payments to be added back unless one of the express statutory exceptions apply. N.Y. Tax Law § 208.9(o)(2). More specifically, the Royalty Expense Add Back provided only three statutory exceptions in the Tax Law:

> (1) the related member royalty payor is included in a combined report with the taxpayer-recipient;
> (2) the taxpayer-recipient subsequently pays the royalty to an unrelated party; or
> (3) the royalty payments are made to a non-U.S. related member located in a country with a comprehensive tax treaty with the U.S.

Id. The three statutory provisions are the only instances when royalty payments "would" not be required to be added back to New York Income. *Id*. Accordingly, if any of the exceptions to the Royalty Expense Add Back applied, a taxpayer would not be permitted the Royalty Income Exclusion. If none of the exceptions to the Royalty Expense Add Back applied, a taxpayer would be permitted the Royalty Income Exclusion.

Disney took the benefit of the Royalty Income Exclusion on its New York tax returns for the Audit Period. R. at 55-56, 390-1067. The Division of Taxation

denied Disney the Royalty Income Exclusion. R. at 1336-2039, 2040-2060, 2064-2066. The Division of Taxation asserted that Disney was not permitted the Royalty Income Exclusion because it did not satisfy the statutory requirement that the royalty payments "would" be required to be added back. R. at 34-36, 3730-3759, 3917-3944. The Division of Taxation interpreted the word "would" to mean "must" and asserted that because the Alien Affiliates were non-New York taxpayers and did not add back the royalty payments on their New York returns, Disney was not permitted the Royalty Income Exclusion. *Id*.

Disney objected to the Division of Taxation's mischaracterization of the law. Disney responded that it was permitted the Royalty Income Exclusion because the royalty payments "would" be required to be added back under the Royalty Expense Addback. R. at 1-33, 3686-3729, 3760-3791, 3830-3916, 3945-3990. Disney explained that the term "would" did not require proof that the royalty payment was, in fact, added back on a New York tax return under the Royalty Expense Add Back. *Id*. Disney maintained that the New York legislature's intentional use of the word "would" in crafting the Royalty Income Exclusion required a taxpayer to analyze whether the related member royalty payment would, hypothetically, be added back under the Royalty Expense Add Back. *Id*. Because the parties agreed that none of the exceptions to the Royalty Expense Add Back applied, it was Disney's position that the foreign royalty payments "would" be required to be

added back. R. at 4037-4072. Therefore, Disney asserted, it was entitled to the Royalty Income Exclusion.

The Appellate Division sustained the Division of Taxation's interpretation of the law. R. at 4117-4118. The Appellate Division construed the Royalty Income Exclusion to be limited to taxpayers that received royalty payments from related members that were New York taxpayers. R. at 4117. The Appellate Division found that the plain meaning of the statute supported its construction of the Royalty Income Exclusion. *Id*. The court noted that Disney would be entitled to deduct royalty payments received from its Alien Affiliates only if the foreign affiliates had in fact added back the royalty payments pursuant to the Royalty Expense Addback in New York "on their own tax returns." *Id*.

The Appellate Division determined that Disney's Alien Affiliates did not add back the royalty payments on New York tax returns. *Id*. The court held that Disney was not entitled to the Royalty Income Exclusion because the royalty income was received from a related member that was not a New York taxpayer. *Id*. Accordingly, the court held that Disney was statutorily prohibited from deducting royalty payments pursuant to the Royalty Income Exclusion. *Id*.

The Appellate Division's decision imposes a restriction that differentially treats a taxpayer's receipt of royalty income based on a geographic determinant – whether the royalty payor is a New York taxpayer. *Id*. The geographic

determinant operates to permit the Royalty Income Exclusion for in-state royalties and to deny it for out-of-state royalties resulting in the differential treatment of taxpayers similarly situated in all other respects. The Appellate Division held that the geographic determinant is a crucial element to qualify for the Royalty Income Exclusion, and Disney's failure to satisfy it prevents it from receiving the tax benefit. *Id*. The Appellate Division's geographic determinant results in a facially discriminatory tax law that is *per se* invalid.

C. The Appellate Division's Construction Predicates the Royalty Income Exclusion on In-State Presence

The Appellate Division construed the Royalty Income Exclusion based on an impermissible geographic determinant. R. at 4117-4118. The Appellate Division framed the facial challenge to the Royalty Income Exclusion as follows:

> Petitioner argues that the statute discriminates against out-of-state commerce because petitioner is not permitted to deduct royalty payments received from its foreign affiliates that do not file taxes in New York, while it would be able to deduct royalty payments for any affiliates that do file New York tax returns.

R. at 4118. There is no dispute that the Appellate Division framed Disney's facial challenge clearly as it relates to the geographic determinant.

The Appellate Division's decision makes evident that the Royalty Income Exclusion is only available to a taxpayer if its related member royalty payors were a New York taxpayer. R. at 4117-4118. Pursuant to the court's interpretation of the Royalty Income Exclusion, a taxpayer that receives royalty payments from a

related member royalty payor that is a New York taxpayer (files a New York tax return) is permitted the Royalty Exclusion. R. at 4117. In contrast, a taxpayer that receives royalty payments from a related member royalty payor that is not a New York taxpayer (does not file a New York tax return) is denied the Royalty Income Exclusion. *Id*.

The U.S. Supreme Court has repeatedly struck down state tax statutes as facially discriminatory – *per se* invalid – when they are found to discriminate against interstate or foreign commerce by explicitly granting a tax benefit or imposing a tax burden on a taxpayer, product, service, or transaction based on a geographic determinant. *See Oregon Waste*, 511 U.S. 93, *Boston Stock Exchange*, 429 U.S. 318; *Armco*, 467 U.S. 638. Specifically in the context of related member transactions, the Court has held that a state tax law cannot predicate a tax benefit to similarly situated parent-taxpayers based on the extent of their subsidiary's in-state presence. *See e.g.*, *Kraft*, 505 U.S. 71; *Westinghouse*, 466 U.S. 388. Therefore, state tax laws that create a geographic distinction (in-state versus out-of-state) are facially discriminatory and *per se* invalid. *See Id*. The Appellate Division's construction of the Royalty Income Exclusion is no different than the state tax regimes found to be facially discriminatory and *per se* invalid in violation of the Commerce Clause in *Boston Stock*, *Westinghouse*, *Kraft, Armco,* and *Oregon Waste.*

The Appellate Division's construction of the Royalty Income Exclusion is facially discriminatory because the court overtly the law based on an impermissible geographic distinction. R. at 4117-4118. The Appellate Division did not attempt to obscure the geographic determinant in its interpretation of the law. *Id*. The court spends a significant portion of its analysis highlighting as a key feature the New York versus non-New York geographic distinction for related member royalty payors. *Id*. In fact, the court hinges the very application of the Royalty Income Exclusion on the geographic determinant, *i.e.*, the related member royalty payors must be subject to tax in New York. R. at 4117-4118. As a result of its construction of the Royalty Income Exclusion, the Appellate Division favors in-state licensing transactions with domestic royalty payors subject to tax in New York to the detriment of licensing transactions with foreign royalty payors not subject to tax in New York.

Therefore, the Appellate Division's construction of the Royalty Income Exclusion is facially discriminatory and *per se* invalid because it impermissibly predicates the benefit of the Royalty Income Exclusion on the geographic location of the related member royalty payors.

There is no doubt that the Appellate Division's construction of the Royalty Income Exclusion facially discriminates against interstate and foreign commerce because it differentially treats similarly situated taxpayers based on a geographic

determinant, namely, the in-state presence of the royalty payor. *Id*. The court's construction of the law predicates the benefit of Royalty Income Exclusion to parent-taxpayers that receive royalties from related member royalty payors that are located within New York, and would deny the benefit if the payor is not located within New York. R. at 4117. The New York versus non-New York geographic distinction as it relates to the related member royalty payor is a critical feature of the court's construction of the statute. *Id*. Therefore, the Appellate Division's construction of the Royalty Income Exclusion is facially discriminatory and *per se* invalid.

III. THE APPELLATE DIVISION'S FACIALLY DISCRIMINATORY CONSTRUCTION OF THE LAW IS NOT JUSTIFIED

The Appellate Division failed to properly analyze Respondents' justification to its facially discriminatory construction of the Royalty Income Exclusion. A state may attempt to salvage a facially discriminatory tax, which is *per se* invalid, by putting forth a justification to the discrimination. *See Oregon Waste*, 511 U.S. at 100-101 (citing *New Energy Co*., 486 U.S. at 278). The U.S. Supreme Court's precedent establishes that the state must "advance a legitimate local purpose that cannot be adequately served by reasonable nondiscriminatory alternatives." *Id*.; *see also Hughes*, 441 U.S. at 336. Any state attempt to salvage a facially discriminatory tax is subject to strict scrutiny. *See Oregon Waste*, 511 U.S. at 101. The Court has held that economic protectionism does not constitute a legitimate local purpose that can justify a facially discriminatory statute. *See Maine v. Taylor*, 477 U.S. 131, 148 (1986). Respondents cannot justify the facially discriminatory construction of the Royalty Income Exclusion.

First, the Appellate Division failed to properly weigh the burden on interstate and foreign commerce. Disney proved that, under the court's construction of the law, parent-taxpayers that receive royalties from non-New York related member royalty payors are subject to an additional tax burden as compared to parent-taxpayers that receive royalties from New York related member royalty payors. The Appellate Division minimized the constitutional significance of the

burden by erroneously relying on a justification – its “single tax” theory. R. at 4118. The U.S. Supreme Court has roundly rejected the “single tax” theory. Therefore, the Appellate Division failed to properly recognize the actual burden on interstate and foreign commerce that results from its construction of the Royalty Income Exclusion.

Second, the Appellate Division failed to strictly scrutinize whether the facially discriminatory tax served a local purpose. *Id*. The asserted local purpose of the Royalty Income Exclusion is to prevent the multiple taxation of royalty income received by New York taxpayers. *See* Letter from New York State Dept. of Taxation and Finance, at 19, Bill Jacket, L. 2003, ch. 62 (“Commissioner’s Letter”). Given the state’s local purpose for enacting the Royalty Income Exclusion, the court failed to strictly scrutinize whether the local purpose was served by the facially discriminatory construction of the law. R. at 4118. Furthermore, the Appellate Division failed to strictly scrutinize whether the local purpose could be adequately advanced by alternative, nondiscriminatory means. *Id*. The court erroneously measured the burden on interstate and foreign commerce and ignored the multiple taxation of royalty income that results from its construction of the law. There is no doubt that the local purpose of the Royalty Income Exclusion to avoid multiple taxation could be reasonably served by

nondiscriminatory means. Therefore, the local purpose does not necessitate a facially discriminatory tax law.

Therefore, the court's facially discriminatory construction of the Royalty Income Exclusion imposes an unconstitutional burden on interstate and foreign commerce that cannot be justified under strict scrutiny.

A. The Appellate Division's Construction of the Law Burdens Interstate and Foreign Commerce

The Appellate Division practically conceded the differential treatment of domestic versus foreign related member royalty payors under its construction of Royalty Income Exclusion. R. at 4118. However, the court disregarded the burden on interstate and foreign commerce because it found that New York would only tax the income once. *Id*. Specifically, the court held:

> Since similarly situated entities would also be paying taxes on the royalty income once in either scenario, whether or not such commerce is from an out-of-state source, [Disney] has failed to show differential treatment between in-state and out-of-state economic interests that rises to the level of unconstitutional discrimination.

Id. (emphasis added). The Appellate Division reasoned that the "single tax" theory nullifies the burden on interstate and foreign commerce because a taxpayer with an in-state related member royalty payor and a taxpayer with an out-of-state related member royalty payor would both be subject to New York tax only once on the royalty income. *Id*. The Court relied on its single tax theory to conclude there was no unconstitutional discrimination.

The Appellate Division's single tax theory fails to accurately weigh the burden on interstate and foreign commerce. A facial discrimination challenge under the Commerce Clause requires a court to assume that every other jurisdiction imposes a like tax to the tax scheme being challenged. *See Armco*, 467 U.S. at 644-645. When New York's Royalty Income Exclusion and Royalty Expense Add Back regime is duplicated, there is multiple taxation of the out-of-state royalty income, which unconstitutionally discriminates against interstate and foreign commerce in violation of the Commerce Clause.

Further, the Appellate Division's single tax theory is not novel. The U.S. Supreme Court has repeatedly rejected the single tax theory, including in the context of related party transactions, as an insufficient justification to facial discrimination. *See Westinghouse*, 466 U.S. 388; *Kraft*, 505 U.S. 71. In these cases, the Court has held that the single tax theory neglects to recognize the tax burden on interstate or foreign commerce due to the imposition of tax by other states and foreign jurisdictions. *See Id*. Accordingly, the court's single tax theory is erroneous because it does not accurately capture the burden on interstate or foreign commerce.

Therefore, the Appellate Division's single tax theory must be rejected.

1. The U.S. Supreme Court Has Rejected the Single Tax Theory

The Appellate Division's single tax theory fails to account for the fact that, pursuant to its construction of the Royalty Income Exclusion, foreign royalty income would be subject to multiple taxation. Specifically, the Appellate Division's single tax theory is based on the assumption that New York's tax scheme must be viewed in a vacuum. When viewed in such a vacuum, the court asserts that the royalty income would only be taxed once. The Appellate Division's single tax theory rests on the false assumption that New York is the only jurisdiction that would attempt to tax the foreign royalty income.

The court's single tax theory may be summarized as follows: in a transaction involving a taxpayer and a New York related member royalty payor, the taxpayer would be permitted the Royalty Income Exclusion because it receives royalty income from an in-state royalty payor. The in-state royalty payor would be subject to tax by New York on the royalty income it was required to add back. Conversely, in a transaction involving a taxpayer and a non-New York related member royalty payor, the taxpayer would not be permitted the Royalty Income Exclusion because it receives royalty income from an out-of-state royalty payor. The taxpayer would be subject to tax in New York on the royalty payment it was required to add back. As a result, the court finds that the royalty income is only taxed once in either transaction.

When analyzing whether a state tax discriminates against interstate or foreign commerce, a court must consider the taxes imposed by other jurisdictions on the income at issue. *Armco*, 467 U.S. at 644-645. In *Armco*, the Court evaluated a facial challenge raised by an Ohio wholesaler to a West Virginia gross receipts tax. *Id*. at 639-640. West Virginia imposed a gross receipts tax only on out-of-state wholesalers, and not on local wholesalers. *Id*. The Court held that the West Virginia statute was facially discriminatory and *per se* invalid because it disparately treated in-state versus out-of-state wholesalers. *Id.* at 642. The state argued that the statute did not favor in-state wholesalers over out-of-state wholesalers (such as the Ohio challenger) because West Virginia subjected in-state wholesalers that manufactured within the state to a higher manufacturing tax. *Id*. at 642-643.

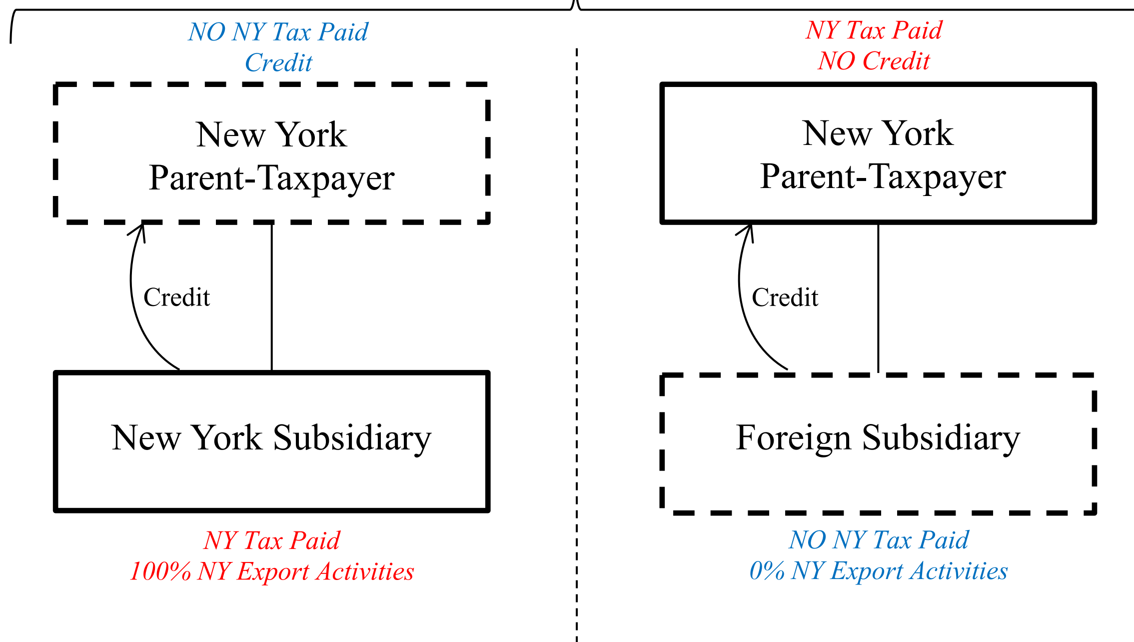
The Court found that the statute was nonetheless facially discriminatory because, assuming another state such as Ohio imposed a like manufacturing tax on in-state manufacturers as West Virginia did, the out-of-state Ohio taxpayer would be subject to tax twice: once by the hypothetical Ohio manufacturing tax on in-state manufacturers and once by West Virginia's gross receipts tax on out-of-state wholesalers. *Id*. at 644-645 In contrast, a seller that conducted manufacturing operations wholly within West Virginia would only be subject to the West Virginia manufacturing tax on in-state manufacturers. *Id.* Accordingly, to properly

evaluate the burden on interstate and foreign commerce under the Appellate Division's facially discriminatory construction of the statute, it is necessary to assume that every U.S. state and foreign jurisdiction where the royalty payor is located has adopted New York's tax regime.

In addition, the U.S. Supreme Court has rejected the Appellate Division's single tax theory in the context of a parent-subsidiary transaction. *See Westinghouse*, 466 U.S. 388; *Kraft*, 505 U.S. 71.

In *Westinghouse*, the Court invalidated a New York statute that calculated a taxpayer's tax credit based on the in-state export activities of its DISC. 466 U.S. at 400, 407. Under the New York tax regime, a New York parent-taxpayer received a tax credit when its DISC had in-state activity and was subject to tax in New York. *See Id.* at 400. A New York parent-taxpayer did not receive a tax credit when its DISC did not have in-state activity and was not subject to tax in New York. *See Id.* Although the state acknowledged that the law differentially treated similarly situated taxpayers based on their subsidiaries' in-state activities, it attempted to justify the discrimination by asserting that the burden on interstate commerce was not constitutionally significant because New York would only tax the DISC income once, to the extent the subsidiary conducted either all or no export activities in New York. *Id.* at 405-406. The state's single tax argument is illustrated below:

New York's Argument in *Westinghouse*:
No Discrimination Because Income Only Taxed Once

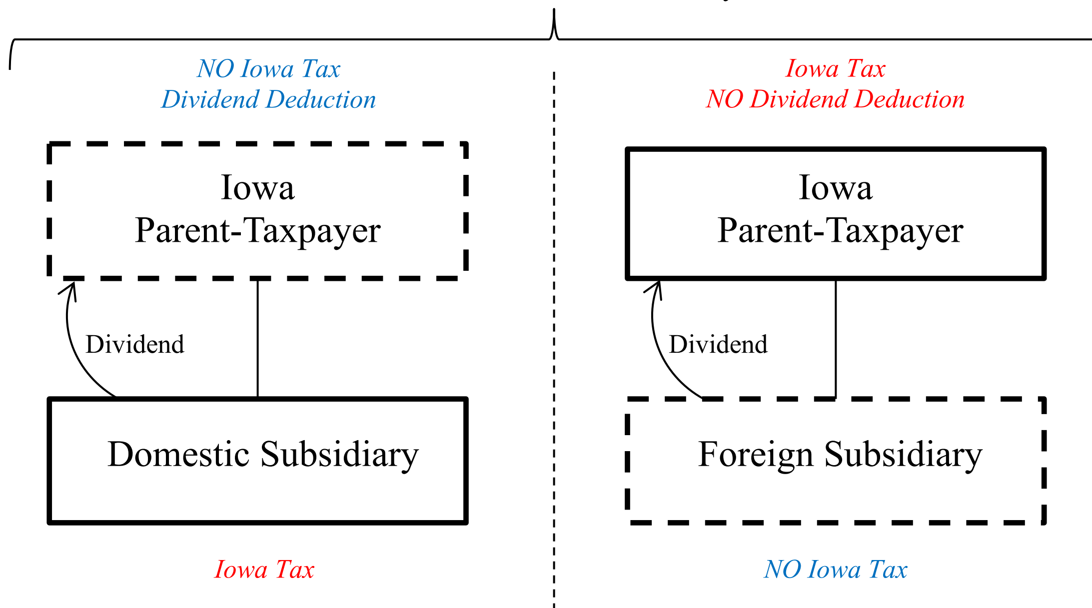


In addition, the state asserted that the detrimental impact on taxpayers adversely affected by the tax scheme was minor because New York had "a relatively high franchise tax [rate] and . . . the effect of the credit, when viewed in terms of the whole New York tax scheme, [was] slight." *Id.*

The Court rejected the state's single tax defense and held that the law was unconstitutionally discriminatory against similarly situated parent-taxpayers regardless of whether New York only taxed the income once. *See Id.* Specifically, the Court held that the law "'forecloses tax-neutral decisions and . . . creates . . . an advantage' for firms operating in New York by placing 'a discriminatory burden on commerce to its sister States.'" *Id.* at 406 (quoting *Boston Stock Exchange*, 429 U.S. at 331). Therefore, the Court held that the New York statute was facially discriminatory and *per se* invalid in violation of the Commerce Clause because it

predicated the credit on the extent of a subsidiary's in-state export activities. *Id*. at 406-407.

In *Kraft*, the Court struck down an Iowa statute that permitted a deduction for dividends received from domestic affiliates, but not from foreign affiliates as facially discriminatory. 505 U.S. at 72-73, 82. The state acknowledged that the statute resulted in differing treatment of parent-taxpayers with domestic affiliates versus parent-taxpayers with foreign affiliates. *See Id*. at 78-80. However, the state argued that the differing treatment did not rise to the level of unconstitutional discrimination because there was no preferential treatment of domestic economic activity over foreign economic activity. *Id.* at 79-81. The state contended that the dividend income of a taxpayer with a domestic subsidiary and the dividend income of a taxpayer with a foreign subsidiary were treated similarly – the income was only taxed once under Iowa's tax statute, as illustrated in the diagram below. *Id.* at 79-81.



The Court rejected Iowa's "single tax" argument. *Id*. at 80-82. It held that pursuant to the Commerce Clause's anti-discrimination mandate, it was clear that the law placed a burden on foreign commerce that was absent on domestic commerce. *Id.* at 80. Specifically, the Court found that the law operated to treat unfairly a parent-taxpayer with a foreign dividend payor by denying it a deduction for dividends received by the foreign subsidiary while a similarly situated parent-taxpayer that received a dividend from a domestic dividend payor would be permitted the deduction. *Id.* The Court's analysis of the "burden" on foreign commerce over domestic commerce also made reference to the fact that the foreign dividend income would be subject to tax twice: once by the foreign dividend payor's jurisdiction, and a second time by Iowa. *Id.* at 73-74.

The Court noted that the resulting double taxation of the foreign dividend income was not alleviated because Iowa law did not grant a credit to the parent-taxpayer for foreign taxes paid by the foreign subsidiary on underlying foreign earnings, including dividends. *Id.* Therefore, the court rejected the state's "single tax" argument as facially discriminatory in violation of the Commerce Clause. *Id.* at 81-82.

2. The Appellate Division Failed to Recognize the Burden on Interstate and Foreign Commerce

The Appellate Division's construction of the Royalty Income Exclusion is facially discriminatory and imposes an actual burden on interstate and foreign commerce. However, the Appellate Division failed to properly recognize the discriminatory burden on such similarly situated taxpayers under its construction of the Royalty Income Exclusion.

The Appellate Division examined the differential treatment that would result from applying the Royalty Income Exclusion to similarly situated taxpayers to determine whether its construction of the law was facially discriminatory. R. at 4118. Although the court practically conceded that its construction of the law results in the disparate treatment of taxpayers with domestic versus foreign related member royalty payors, it nonetheless found that the differential treatment did not "rise to the level of unconstitutional discrimination." *Id.* The Appellate Division's

conclusion failed to properly recognize the actual burden on interstate and foreign commerce under its construction of the Royalty Income Exclusion.

First, the Appellate Division's construction of the Royalty Income Exclusion results in multiple taxation of income. As required by the Court's holding in *Armco*, to properly evaluate whether a tax statute burdens interstate or foreign commerce, it is necessary to assume that every U.S. state and foreign jurisdiction where the foreign royalty payor is located has adopted New York's tax regime. *See Armco*, 467 U.S. at 644-645. If the Appellate Division's construction of New York's Royalty Expense Add Back and Exclusion regime is adopted by every other U.S. state or foreign jurisdiction, the foreign royalty income would be subject to multiple taxation. A foreign royalty payor would be required to add back the royalty income in every U.S. jurisdiction that it has a presence in, and in the foreign jurisdiction in which it is domiciled. In addition, the royalty recipient would be required to include the royalty income in its calculation of New York taxable income. The result is the multiple taxation of the foreign royalty income. Therefore, there is no doubt that the Appellate Division's construction of the Royalty Income Exclusion results in multiple taxation, which imposes a direct burden on interstate and foreign commerce.

Second, the actual impact of the multiple taxation by other jurisdictions, including New York, is substantial. Pursuant to the court's interpretation of the

Royalty Income Exclusion, it is undoubtedly clear that a significant tax benefit is granted to a New York taxpayer that received royalty payments from an affiliate that is also a New York taxpayer. On the contrary, a significant tax burden is placed on a New York taxpayer that received royalty payments from an affiliate that is not a New York taxpayer. When undertaking a comparative analysis of similarly situated taxpayers with the same Federal taxable income that participated in the same transaction with a related member royalty payor (in-state versus out-of-state), the facial discrimination is obvious. The schedule below highlights the magnitude of the actual discrimination on interstate and foreign commerce.

New York - New York	
Taxpayer - Royalty Recipient	**New York**
Federal Taxable Income	$10,000,000
Royalty Exclusion	-$4,000,000
Entire Net Income	$6,000,000
Tax Rate	10%
Tax	$600,000
Tax on Royalty	$0
Royalty Payor	**New York**
Federal Taxable Income	$ 5,000,000
Royalty Addback	$ 4,000,000
Entire Net Income	$ 9,000,000
Tax Rate	10%
Tax	$ 900,000
Tax on Royalty	$ 400,000
TOTAL Tax on Royalty	$400,000
TOTAL Tax	$1,500,000

New York - New Jersey	
Taxpayer - Royalty Recipient	**New York**
Federal Taxable Income	$10,000,000
Royalty Exclusion	$0
Entire Net Income	$10,000,000
Tax Rate	10%
Tax	$1,000,000
Tax on Royalty	$400,000
Royalty Payor	**New Jersey**
Federal Taxable Income	$ 5,000,000
Royalty Addback	$ 4,000,000
Entire Net Income	$ 9,000,000
Tax Rate	10%
Tax	$ 900,000
Tax on Royalty	$ 400,000
TOTAL Tax on Royalty	$800,000
TOTAL Tax	$1,900,000

Tax Difference: $400,000

The actual tax burden on royalty income paid to a taxpayer by a New York royalty payor versus the tax burden on royalty income paid to a taxpayer by a non-New York royalty payor is illustrated on the line titled "TOTAL Tax on Royalty." Specifically, when a taxpayer receives a $4 million royalty payment from a related member royalty payor that is a New York taxpayer, the royalty income is subject to a $400,000 tax burden. However, when a taxpayer receives an identical royalty payment from a related member royalty payor that is not a New York taxpayer (e.g., a New Jersey taxpayer), the royalty income is subject to an $800,000 tax burden. The reduced tax burden is the result of the taxpayer receiving the Royalty Income Exclusion while its related member is subject to New York's Royalty Expense Add Back. The increased tax burden is the result of the taxpayer being denied the Royalty Income Exclusion while its related member is subject to the out-of-state Royalty Expense Add Back.

The significant difference in total tax due that results from the Appellate Division's construction of the Royalty Income Exclusion burdens interstate and foreign commerce in contravention to the Commerce Clause's anti-discrimination directive. The Appellate Division's construction of the Royalty Income Exclusion, which very clearly predicates the availability of the exclusion on a geographic determinant, imposes an actual and substantial burden on interstate and foreign commerce. Under the court's construction of the law, there is greater tax imposed

on licensing transactions entered with foreign subsidiaries versus licensing transactions entered with domestic subsidiaries.

The Appellate Division's construction of the law blatantly disregards the U.S. Supreme Court's warning in *Boston Stock Exchange* against state tax laws that foreclose tax neutral decisions by granting a direct financial advantage or tax benefit to in-state commerce and imposing a burden on interstate or foreign commerce. Given the substantial difference in tax that results based solely on whether the affiliate is a foreign entity or domestic entity, New York taxpayers would be coerced to modify their business decisions because of the tax consequences. Therefore, the Appellate Division's interpretation would foreclose tax neutral decisions, in express violation of constitutional precedent.

Lastly, the court's differential treatment of similarly situated taxpayers cannot withstand constitutional scrutiny. *See Kraft*, 505 U.S. at 80; *Westinghouse*, 466 U.S. at 400. In both *Kraft* and *Westinghouse*, the single tax theory was asserted by the states to defend facially discriminatory tax statutes, which granted tax benefits to a parent-taxpayer that were solely premised on a subsidiary's in-state presence. *See* 505 U.S. 71; 466 U.S. 388. The New York and Iowa tax statutes were found to be *per se* invalid because they imposed an undue burden on interstate and foreign commerce in violation of the Commerce Clause. *See Id*.

Importantly, the Court rejected the states' single tax reasoning as an insufficient justification to unconstitutional discrimination. *See Id.*

Therefore, the Appellate Division's construction of the Royalty Income Exclusion unconstitutionally burdens interstate and foreign commerce. The court's single tax rationale to justify its facially discriminatory construction of the law cannot withstand strict scrutiny.

B. The Appellate Division Failed to Analyze Whether the Facially Discriminatory Law Serves a Local Purpose

Once a taxpayer establishes that a state statute is facially discriminatory, the discrimination must be eliminated unless the state can justify the law. *See New Energy*, 486 U.S. at 278 (citing *Hughes*, 441 U.S. at 336-337). Respondents' facially discriminatory construction of the Royalty Income Exclusion can only be saved by proof of an acceptable justification. *See Id.* Specifically, Respondents must prove a justification that (1) demonstrates that their construction of the law serves a local purpose, and (2) that the purpose could not be served as well by nondiscriminatory means. S*ee Maine*, 477 U.S. 131; *Hughes*, 441 U.S. 322. Respondents' justification defense is subject to strict scrutiny. *See Oregon Waste*, 511 U.S. 93; *Hughes*, 441 U.S. 322. Respondents have not proven that the local purpose of the law is served by their facially discriminatory construction of the Royalty Income Exclusion. R. at 3792-3813, 4037-4072, 4117-4118.

Furthermore, Respondents have failed to prove that the local purpose could not be accomplished by nondiscriminatory means. *Id*.

Therefore, Respondents' facially discriminatory construction of the Royalty Income Exclusion cannot be justified, and the discriminatory feature of the law must be stuck.

1. The Law's Local Purpose Is Not Served by the Facially Discriminatory Construction

Respondents failed to prove that that the local purpose of the Royalty Income Exclusion was served by the facially discriminatory construction of the law. The relevant legislative history to the Royalty Income Exclusion establishes that the local purpose of the statute was to prevent the multiple taxation of royalty income received by New York taxpayers. *See* Commissioner's Letter at 19. This purpose is not served by Respondents' construction of the Royalty Income Exclusion because royalty income received from a foreign royalty payor is subject to multiple taxation.

Once a taxpayer establishes that a state statute is facially discriminatory, the burden falls on the state to justify the discrimination. *Oregon Waste*, 511 U.S. at 100-101; *New Energy*, 486 U.S. at 278 (citing *Hughes*, 441 U.S. at 336-337). Specifically, the state must set forth a justification to the discrimination that demonstrates that the statute advances a legitimate local purpose. *Maine*, 477 U.S. at 138; *see also Hughes*, 441 U.S. at 336-337. The state's justification to a facially

discriminatory law is subject to the strictest scrutiny. *Oregon Waste*, 511 U.S. at 101 (quoting *Hughes*, 441 U.S. at 337). The state's burden of establishing a legitimate justification is so heavy, especially with respect to a facial challenge, that "discrimination by itself may be a fatal defect." *Id.*; *see also Westinghouse*, 466 U.S. at 406-407.

The local purpose of the Royalty Income Exclusion was the avoidance of multiple taxation of royalty income received by a New York taxpayer. The New York legislature enacted the Royalty Income Exclusion to authorize a corporation "to reduce the income it reports to New York <u>by the amount of any royalty payments required to be added back by the other related taxpayer</u>." Commissioner's Letter at 19 (emphasis added). The local purpose is clear from the plain language of the statute. The Tax Law provides that the Royalty Income Exclusion applies unless an exception to the Royalty Expense Add Back would apply. *See* N.Y. Tax Law § 208.9(o)(3). Therefore, the New York legislature's intended local purpose in enacting the Royalty Income Exclusion was to prevent the multiple taxation of royalty income received by a New York taxpayer.

The Royalty Income Exclusion accomplishes the legislature's intended local purpose under the plain meaning of the statute. On its face, the Royalty Income Exclusion allows New York taxpayers to exclude royalty payments received from a related member unless such royalty payments would not be required to be added

back under the Royalty Expense Addback. *See* N.Y. Tax Law § 208.9(o)(3). The Royalty Expense Add Back provided three statutory exceptions, which were the only instances when royalty payments "would" not be required to be added back to income. *See* N.Y. Tax Law § 208.9(o)(2). If none of the Royalty Expense Add Back exceptions applied, the taxpayer was permitted the Royalty Income Exclusion. *See Id.* Accordingly, the plain language of the statute establishes that the legislature's objective was to prevent the multiple taxation of royalty income. *See Id.*

The Appellate Division's construction of the Royalty Income Exclusion frustrates the local purpose of the law to cause facial discrimination that results in multiple taxation of royalty income when received from a royalty payor that is not a New York taxpayer. *See supra* § III A(2); *see also Armco*, 467 U.S. 638. Under Respondents' construction of the law, the Royalty Income Exclusion is only available to parent-taxpayers that receive royalty payments from a related member royalty payor that is a New York taxpayer. R. at 3792-3813, 4037-4072, 4117-4118. Assuming every jurisdiction where the foreign royalty payor is located adopts New York's tax regime, foreign royalty income would be subject to multiple taxation. A foreign royalty payor would be required to add back the royalty income in every U.S. jurisdiction that it has a presence in, and in the foreign jurisdiction in which it is domiciled. In addition, the royalty recipient

would be required to include the royalty income in its calculation of New York taxable income. Therefore, under Respondents' construction of the law, royalty income is subject to multiple taxation and does not advance the statute's intended local purpose.

2. <u>The Law's Local Purpose Can Be Accomplished by Nondiscriminatory Means</u>

The Appellate Division failed to analyze whether the Royalty Income Exclusion's local purpose could be served through available nondiscriminatory means. R. at 4118; *see Maine*, 477 U.S. 131; *Hughes*, 441 U.S. 322. A state must prove that a facially discriminatory statute serves a local purpose that cannot be advanced by nondiscriminatory means to justify a facially discriminatory law. *Maine*, 477 U.S. at 138; *see also Hughes*, 441 U.S. at 336-337. The local purpose of the Royalty Income Exclusion to avoid multiple taxation can be accomplished through nondiscriminatory means.

Under the court's construction of the law, the Royalty Income Exclusion is only available to a taxpayer if its related member royalty payor is a New York taxpayer. R. at 4117. Respondents construed the Royalty Income Exclusion using an impermissible geographic determinant that makes the statute facially discriminatory. *Id*. The local purpose of the Royalty Income Exclusion is the avoidance of multiple taxation. Commissioner's Letter at 19. The statute's local purpose can be accomplished by nondiscriminatory means. Specifically, the

Appellate Division's construction of the law could have avoided imposing an impermissible geographic determinant that differentially treats taxpayers based on their subsidiary's in-state presence. Instead, the court could have permitted the Royalty Income Exclusion for all royalty payments, regardless of whether the payments were from in-state related member royalty payors or out-of-state related member royalty payors.

Disney's construction of the Royalty Income Exclusion accomplishes the legislature's intended local purpose without imposing a facially discriminatory geographic determinant. Specifically, under Disney's construction of the law, a parent-taxpayer is permitted the Royalty Income Exclusion when it receives royalty payments from a related member royalty payor that would be required to be added back regardless of whether the related member is a New York taxpayer. When the Royalty Income Exclusion is construed without an impermissible geographic determinant, it operates as the legislature intended – by preventing royalty income from being subject to multiple taxation.

Therefore, the Royalty Income Exclusion's local purpose can be accomplished by nondiscriminatory means by eliminating the geographic determinant. Respondents failed to demonstrate that their facially discriminatory construction of the Royalty Income Exclusion served the statute's local purpose and that such purpose could not be served by nondiscriminatory means. R. at

3792-3813, 4037-4072, 4117-4118. The legislature's local purpose for the Royalty Income Exclusion could be served as well through nondiscriminatory means. Therefore, Respondents failed to justify their facially discriminatory construction of the Royalty Income Exclusion and the facially discriminatory construction of the law must be struck.

CONCLUSION

The Appellate Division's construction of the Royalty Income Exclusion facially discriminates against interstate and foreign commerce and is *per se* invalid, which cannot be justified under strict scrutiny. Disney respectfully requests that the court reverse the Appellate Division's decision and strike the Appellate Division's facially discriminatory construction of the Royalty Income Exclusion.

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New York, New York

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NEW YORK STATE COURT OF APPEALS
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I hereby certify pursuant to 22 NYCRR PART 500.13 that the foregoing brief was prepared on a computer using Microsoft Word.

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