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THE TAX COURT COMMITTEE ON OPINIONS

TAX COURT OF NEW JERSEY

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**JUDGE**

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Re: Xpedite Systems, Inc. v. Director, Division of Taxation
Dkt. No. 018847-2010

Dear Counsel:

This letter constitutes the court's opinion as to the parties' partial summary judgment motions. Plaintiff maintains that defendant's Corporation Business Tax ("CBT") assessment for tax years 1998-2000, and 2002, must be struck because defendant applied subsection (c) of regulation N.J.A.C. 18:7-8.10 instead of subsection (a) to determine the portion of plaintiff's receipts from its electronic communication distribution services attributable to New Jersey, thus, includible in the numerator portion of the allocation fraction. Defendant argues that it could have lawfully included 100% of plaintiff's receipts under subsection (a) instead of the 76% used under subsection (c), therefore, plaintiff has no meritorious cause of action.

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The court finds that the CBT assessments are not per se unlawful simply because defendant's auditor relied upon a formula methodology contained in N.J.A.C. 18:7-8.10(c). It is undisputed that plaintiff must attribute its receipts to New Jersey. Both subsections (a) and (c) of N.J.A.C. 18:7-8.10 provide for a methodology that factors in services performed within and without the State, which the plaintiff does. Therefore, while defendant's methodology may be imperfect, it is not aberrant. Even if application of the apportionment formula under subsection (c) is deemed aberrant and unreasonable, the court will not automatically invalidate the assessments. An aberrant methodology will only establish that defendant's final determination is not presumptively correct, which then will require the court to determine the apportionment based on credible evidence, since challenges to the defendant's determinations are examined by this court on a de novo basis. Here, the facts presented in the parties' cross-motions do not suffice to permit this court to conclude that defendant's apportionment should be affirmed especially since discovery is incomplete. Therefore, the court denies both parties' motions for partial summary judgment. The matter will be scheduled for trial on the merits.

**FACTS**

In support of its Statement of Undisputed Material Facts, Plaintiff ("Xpedite") relies upon the allegations in its complaint, as well as defendant's documents which are the Notice of Assessment issued by defendant's auditor, a conference report issued by defendant's conferee which incorporated the auditor's audit findings (but those audit findings were not included in either party's instant motion), and defendant's final determination. Defendant ("Taxation") also relies upon those documents in support of its cross-motion.

Xpedite is headquartered in New Jersey. It conducts a worldwide electronic documents and communication distribution services. These include local and long-distance electronic and

web-based document distribution, and data messaging services, i.e., mass messaging services, via telefax, telephone and e-mail, initiated by or on behalf of Xpedite's customers and targeted to the customers' designated recipients.

For performance of these services, Xpedite maintains and uses a global communications network with more than 25,000 telephone lines, servers, routers, Point-of-Presence ("POP") equipment, and computer equipment. Xpedite also uses third-party communications and network equipment along with third-party switching centers to facilitate its global services. The enumerated equipment is located in New Jersey and worldwide. Outgoing faxes are delivered through POP locations in California, Illinois, Massachusetts, Missouri, New Jersey, New York, Tennessee and Virginia.

New Jersey is the origination point of all information (fax, e-mail, and voice) to be disseminated, with the Core Platform (main Data Center or hub) being located in New Jersey. Either the customer enters information required to be faxed or e-mailed by logging into Xpedite's computer system, or Expedite performs these functions for its customers, and then disseminates the same through its interface. Thus, whether or not Xpedite's customer is located in New Jersey, the disseminated information originate in, and is processed through the New Jersey Data Center. Out-of-State locations are mainly sales offices.

Xpedite's revenues are derived from broadcast deliveries to the telephone numbers assigned to fax machines of the customers' designees. Its billing for faxes are based on time (per-minute) of long distance service usage, and upon volume for e-mail distributions.

For tax periods 1998 through 2002, Xpedite allocated receipts from its business services based on the billing address of a customer, which resulted in 3% to 9% of the total receipts as

being attributable to New Jersey. This method is recognized under Example 2 of N.J.A.C. 18:7-8.10(a), which reads as follows:

> Taxpayer earns income from the sale of long distance telephone communications service. It bills the originators of long distance telephone calls directly and for all calls placed by them. The appropriate method of allocating its long distance toll revenues attributable to services performed in New Jersey is based upon billings for calls originating in New Jersey.[1]

Pursuant to an audit, Taxation determined that Xpedite used computer equipment located in New Jersey to perform its document distribution services. The auditor's findings were based on, among others, discussions with Xpedite's management personnel who opined that 89% to 100% of Xpedites' receipts were New Jersey based since most of the data to be transmitted originated in the State. He also relied upon a July 2006 letter issued by Taxation to Xpedite, that "all transactions involving New Jersey customers of Xpedite [are] considered taxable since both origination and service address[es] would exist within this State." Also considered taxable were transactions involving an out-of-State customer, where "the fax is sent by Xpedite . . . to a New Jersey recipient. In the latter case both origination and termination would exist within this state thereby providing two of the three necessary (sic) to meet the sourcing rules . . . ."[2]

The auditor thereafter recalculated the receipts portion of the allocation fraction. He used the 25-50-25 formula found in N.J.A.C. 18:7-8.10(c) (25% of receipts allocated to the State in which costs originate; 50% of receipts allocated to the State in which the service is performed; and 25% of the receipts allocated to the State in which the transaction terminates). That regulation applies to "service fees from transactions having contact with this State."[3] The auditor

[1] Prior to the regulation's amendment in 1997, this example was in the subsection (c) of N.J.A.C. 18:7-8.10.
[2] The letter apparently cited to an article in The State Tax News (Winter 1992), and Goldberg v. Sweet, 488 U.S. 252 (1989), as authority for Taxation's conclusions.
[3] N.J.A.C. 18:7-8.10(c) provides as examples, (1) use of a taxpayer's computer located outside New Jersey to run credit checks on its customers to whom the taxpayer issued credit cards, noting that the taxpayer is deemed to have

determined the termination percentage as 1.36%, therefore, concluded the receipts portion of the allocation fraction to be 76.36% (25+50+1.36). The audit effectively increased Xpedite's allocation of business receipts from about 5% to about 76%. No adjustments were made for tax year 2001.

On September 28, 2007, Taxation issued a Notice of Assessment. The notice demanded tax, interest and penalties of $4,923,285. The CBT demanded per year was $495,288 (1998); $848,170 (1999); $1,006,898 (2000); and $35,176 (2002).

In response to Xpedite's December 2007 protest, Taxation held an administrative conference in January 2010. Xpedite contended that the 25-50-25 formula in N.J.A.C. 18:7-8.10(c) was inapplicable, and that Example 2 of N.J.A.C. 18:7-8.10(a) controlled.

The conferee agreed that N.J.A.C. 18:7-8.10(a) should apply based on United Parcel Services Co. v. Director, Div. of Taxation, 25 N.J. Tax 1 (Tax 2009), aff'd, 430 N.J. Super. 1 (App. Div. 2013), aff'd, 220 N.J. 90 (2014). However, there the court had applied the prior version of N.J.A.C. 18:7-8.10(a) (i.e., pre-1997), which simply provided that "[r]eceipts from services performed within New Jersey are allocable to New Jersey." Further, pre-1997 amendment, there was no 25-50-25 formula. Rather, N.J.A.C. 18:7-8.10(c) read as follows:

> Where a lump sum is received by the taxpayer in payment for services within and without New Jersey, the amount attributable to services performed within New Jersey is to be determined on the basis of the relative values of, or amounts of time spent in the performance of those services within and without New Jersey, or by some other reasonable method which should reflect the trade or business practice and economic realities underlying the generation of the compensation for services. Full details must be submitted with the taxpayer's return.

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"nexus with New Jersey through physical presence" in the State; and (2) use of a taxpayer's physical equipment to permit on-line internet access to customers located within and without the State, and notes that the taxpayer is deemed to have "physical presence through a home office located in New Jersey."

Example 2 of the regulation showed how income from sale of long distance telephone toll revenues attributable to services performed in New Jersey should be allocated.[4]

The court agreed with the taxpayer that revenues from data processing services (processing and storing data) "attributable to services and equipment provided by or from [taxpayer's] Kentucky facility" should "be excluded from the [data processing] revenue allocated to New Jersey." Id. at 35. However, it disagreed with the taxpayer that only a portion of the amounts allocable to New Jersey should be included in the numerator of the receipts fraction under pre-1997 N.J.A.C. 18:7-8.10(c). Based on the evidence, the court held that the numerator portion should include 100% of the receipts under pre-1997 N.J.A.C. 18:7-8.10(a) because "the data processing services . . . were performed in New Jersey and not 'within and without' this State," and further because the "equipment performing the data processing was located in New Jersey, and the personnel necessary to operate, maintain and repair the equipment also were located in this State." United Parcel, supra, 25 N.J. Tax at 35-36. The court supported its conclusion based on the examples in the 1997 amended version of N.J.A.C. 18:7-8.10(c) which provided that if the essential equipment was located outside the State, then revenue from services using that equipment can be allocated within and without New Jersey. It noted that the examples supported the inference "that location of the equipment in New Jersey would have rendered" the post-1997 version of N.J.A.C. 18:7-8.10 (c) "inapplicable, and [N.J.A.C. 18:7-8.10] (a) applicable, to the revenue generated by the services." United Parcel, supra, 25 N.J. Tax at 36.

Taxation's conferee stated that Xpedite's electronic distribution services originated and were performed from New Jersey through the New Jersey Data Center where the equipment is located, therefore 100% of Xpedite's receipts from its services should be allocated to New Jersey

[4] By a 1997 amendment, the example is now contained in subsection (c) of N.J.A.C. 18:7-8.10. See supra n.1.

under the first sentence of the post-1997 N.J.A.C. 18:7-8.10(a). That sentence reads: "[t]he numerator of the receipts fraction developed in accordance with this section includes receipts from services not otherwise apportioned under this section."[5] She rejected Xpedite's reporting method of allocating receipts under Example 2 of N.J.A.C. 18:7-8.10(a), i.e., based on the billing address of its customers, as being non-reflective of the "underlying economic reality." In the "Conclusion" portion of her report she reiterated:

> In my opinion, Regulation 18:7-8.10(a) should be applied as most of the faxes originate in NJ and all the services are performed in NJ. The equipment, where the data or fax originate and processed, is located in NJ and based on the [United Parcel, supra,] case 100% of the receipts should be sourced to NJ.

However, and despite repeatedly insisting upon a 100% allocation of receipts from Xpedite's services to New Jersey, the conferee concluded that the "audit assessment based on Regulation 18:7-8.10(c) is upheld where auditor apportioned 76% of receipts to NJ."

On August 6, 2010, Taxation issued a final determination upholding the audit and demanding $6,160,750 as CBT plus interest and penalties for fiscal years ending 1998; 1999; 2000 and 2002. Xpedite filed a timely complaint.

Discovery is ongoing. Xpedite owes responses to Taxations interrogatories and document production request of 2011. Taxation provided a copy of its audit file in March 2014, but still owes production of four computer discs of non-duplicative documents which it undertook to deliver to Xpedite in 2014. Xpedite then filed this motion in April 2015.

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[5] The remaining two sentences of the post-1997 N.J.A.C. 18:7-8.10(a) reads:

> If the service is performed both within and outside this State, the numerator of the receipts fraction includes receipts from services based upon the cost of performance or amount of time spent in the performance of such services or by some other reasonable method which should reflect the trade or business practice and economic realities underlying the generation of the compensation for services. Cost of performance is defined as all direct costs incurred in the performance of the service, including direct costs of subcontractors.

As is evident, these two sentences include a large portion of the language from the pre-1997 version of N.J.A.C. 18:7-8.10(c). See supra p.5.

**ANALYSIS**

The issue here is whether the CBT assessments should be invalidated in toto because they were based on the application of an incorrect or inapplicable regulation. Xpedite does not challenge the validity of the regulations at issue here. Rather, it argues that since the assessments were made pursuant to N.J.A.C. 18:7-8.10(c), and Taxation conceded to the inapplicability of that subsection, the assessments should be struck down in their entirety. Upholding the same, according to Xpedite, would be tantamount to Taxation implementing administrative policies without going through the formalities of promulgating regulations as required by Metromedia Inc. v. Director, Div. of Taxation, 97 N.J. 313 (1984).

Taxation argues that what is undisputed is the applicability of N.J.A.C. 18:7-8.10(a) and the holding in United Parcel, supra. Since pursuant to these authorities, Xpedite would be required to allocate 100% of its revenues to New Jersey, the assessments are undeniably valid, even if the allocated revenue was beneficial to Xpedite by being less than 100%.

Taxation's assessments are presumptively correct. L & L Oil Service, Inc. v. Director, Div. of Taxation, 340 N.J. Super. 173, 183 (App. Div. 2001). The court will defer to Taxation's conclusions on factual issues, and the taxpayer has the burden of overcoming that presumption with clear, competent and cogent evidence. TAS Lakewood v. Director, Div. of Taxation, 19 N.J. Tax 13, 140-41 (Tax 2000). The same standards apply where a taxpayer attacks the reasonableness of Taxation's data or methodology. Yilmaz, Inc. v. Director, Div. of Taxation, 22 N.J. Tax 204, 231-32, 236 (Tax 2005), aff'd, 390 N.J. Super. 435 (App Div.), certif. denied, 192 N.J. 69 (2007). However, an "aberrant methodology will overcome the presumption of correctness . . . [a]n imperfect methodology will not." 22 N.J. Tax at 236. Additionally, if Taxation's determination is based upon findings "not supported by substantial, credible evidence

in the record," then the court will reverse the same. AccuZIP, Inc. v. Director, Div. of Taxation, 25 N.J. Tax 158, 167 (Tax 2009).

The essence of Xpedite's partial summary judgment motion is an attack on the legal authority for Taxation's methodology of arriving at the correct New Jersey allocable receipts (Xpedite's income from its services). The court finds that the conferee's repeated insistence on the applicability of N.J.A.C. 18:7-8.10 (a) but upholding the assessments based on the 25-50-25 formula of N.J.A.C. 18:7-8.10 (c) is not aberrant or beyond the pale of reason such that the assessments are deemed per se invalid so as to be struck down summarily. First, the substance of the assessments is the quantum of apportionment of Xpedite's business receipts. Thus, there is no question that Xpedite must attribute some or all of its receipts to New Jersey either under subsection (a) or subsection (c) since both provisions recognize allocation of receipts in-State versus out-of-State. Thus, the assessments are not per se void.

Second, throughout the audit and administrative hearing process, Xpedite sought an allocation of its receipts based on the billing address of its customers, and used regulatory Example 2 as support. Until 1997, that Example was contained in subsection (c) of N.J.A.C. 18:7-8.10. Xpedite's insistence on application of subsection (a) of the same regulation is only because the Example is now contained subsection (a). Indeed, the conferee "found" that the nature of Xpedite's services was not akin to a long distance telephone communication service for the Example to apply, therefore, the Example, whether contained in former subsection (c) or the current subsection (a) of N.J.A.C. 18:7-8.10 did not form the basis of the assessments. Thus, Xpedite's contention that the assessments are illegal, is unpersuasive.

Third, the underlying audit, although fashioned under the 25-50-25 formula, was based upon alleged facts, without resistance from Xpedite, that almost all services were performed in

New Jersey. This is in line with the intent of N.J.A.C. 18:7-8.10(a) that receipts "not otherwise apportioned," must be attributed to New Jersey. See also United Parcel, supra, 25 N.J. Tax 35-36 (subsection (a) of the "amended regulation required attribution to New Jersey of all receipts resulting from a service performed in New Jersey").

Although the auditor's addition of a smaller percentage (State/s where Xpedite's services allegedly terminated) may have been an incorrect pursuant to United Parcel, or the regulatory language itself, due to the choice of the methodology, it is not aberrant. This is especially where it appears that equipment used by Xpedite to perform services are located in New Jersey and worldwide, and faxes are delivered through POP locations outside this State. While subsection (a) of the post-1997 N.J.A.C. 18:7-8.10 appears to apply only where "a service [is] performed" in New Jersey, and subsection (c) applies only where a particular transaction has "contact with this State," there is no question that subsection (a) also takes into account fees for services performed within and without the State, as is evident from the remaining sentences therein, the substance of which was formerly (i.e., pre-1997) contained in subsection (c) of N.J.A.C. 18:7-8.10. See also 29 N.J.R. 3426(a) (Aug. 4, 1997) (Taxation "update[d] and restructure[d]" N.J.A.C. 18:7-8.10, the regulation at issue here, "to show more clearly [Taxation's] emphasis on the cost of performance for sourcing purposes for receipts from services . . . tak[ing] into account the use of the locations of the origination and termination in these transactions . . . [and] describ[ing] a formula for the proper treatment of receipts as the result of use of certain machines through credit cards and internet access where the taxpayer otherwise has nexus with New Jersey").[6]

[6] The 1997 amendments were promulgated to conform to the change in the CBT law in 1995 which required double weight be given to the "receipts fraction of the [CBT] income allocation formula" for tax years beginning on or after July 1, 1996. See 29 N.J.R. supra

The above reasons also render unpersuasive Xpedite's argument that Taxation's assessments are an impermissible or ad hoc rule-making in violation of Metromedia, supra. Unlike in that case where Taxation employed a methodology generally applicable to a particular business but which was never notified or otherwise publicized to the taxpayers, here, the auditor and the conferee applied a regulation that was in existence during the audit process. Thus, Metromedia's application is unwarranted. Further, pursuant to Middlesex Water Co. v. Director, Div. of Taxation, 3 N.J. Tax 233, 251-254 (Tax 1981), Taxation can defend its assessments on any legal theories available (including application of other appropriate regulations) even if not raised during and until the final determination is issued, provided they do not rely upon new or unknown facts to the prejudice or surprise of the taxpayer, Here, based on the parties' motions, no new facts are being asserted to defend Taxation's assessments.

All that said, the court will not automatically affirm the assessments. While Taxation's final determination comes to this court with a presumptive correctness, challenges to the same merit a de novo hearing. Weintraub v. Director, Div. of Taxation, 19 N.J. Tax 65, 83-84 (Tax 2000) (this court "reviews proceedings de novo") (citations omitted). Additionally, summary judgment will be granted only "if the pleadings, depositions, answers to interrogatories and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact challenged and that the moving party is entitled to a judgment or order as a matter of law." R. 4:46-2(c); Brill v. Guardian Life Ins. Co. of Am., 142 N.J. 520, 523 (1995).

Taxation, in its statement of material facts in support of its motion, agreed that Xpedite "maintains and utilizes a global network of telephone lines and computer equipment located in New Jersey and throughout the world to perform its electronic distribution," which was in addition to Xpedite's use of third-party communication equipment (emphasis added). If per

United Parcel, supra, (which Taxation claims controls and Xpedite has not seriously contested this contention), location of the equipment performing the services is the most essential factor for attribution of the service fees under N.J.A.C. 18:7-8.10, then the court needs facts to establish or flesh out the percentage of the same. Taxation also agreed with Xpedite's materially undisputed fact that Xpedite conducts a "worldwide electronic document and communication distribution services business." This tends to show that Xpedite performed services within and outside of New Jersey. The court needs proof to decide whether the global services would reveal a 76% receipts factor or something else.[7] If Xpedite can show that the 25-50-25 methodology produces an incorrect amount or percentage attribution to New Jersey (in the numerator portion), versus that developed under N.J.A.C. 18:7-8.10(a), and the court finds the evidence credible so that Taxation's "interpretation is inconsistent with the plain meaning of" N.J.A.C. 18:7-8.10(a), and "is inconsistent with" the court's fact findings, then the court is "not bound by [Taxation's] interpretation." Mayer & Schweitzer, Inc. v. Director, Div. of Taxation, 20 N.J. Tax 217, 230 (Tax 2002).[8]

Discovery is incomplete. The court does not have adequate facts to conclude, de novo, the proper receipts portion of the numerator. The parties did not dispute each other's statement of facts, however, this was "solely" for purposes of their partial summary judgment motions. With such caveats, incomplete discovery, and the lack of any stipulated facts, summary judgment is inappropriate.

[7] It should be noted that additional taxes cannot be assessed "after the expiration of more than four years from the date of the filing of a return." N.J.S.A. 54:49-6(b).

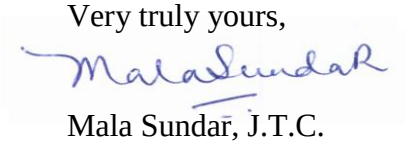
[8] In that case, as here, the parties had initially moved for summary judgment on the issue whether the New Jersey domiciled taxpayer's business was "integrated" with an out-of-state business for purposes of N.J.A.C. 18:7-8.12, and whether the receipts from such business were earned "at the location of the trader employed by the plaintiff or at the location of plaintiff's customers." 20 N.J. Tax at 218. The court denied the motions for development of the facts for a considered conclusion on these issues. Ibid.

It should be noted that the same denial would entail even if this court were to hold that Xpedite has overcome the presumptive correctness of Taxation's final determination because on its face, it was based on a methodology that Taxation itself disclaimed during the administrative conference. See e.g. Charley O's, Inc. v. Director, Div. of Taxation, 23 N.J. Tax 171, 186-88 (Tax 2006) (proofs showed that taxpayer's records were "adequate" pursuant to Taxation's regulations, thus establishing the "aberrant methodology" employed by Taxation in its audit of the taxpayer's business, which in turn overcame the presumptive correctness of Taxation's final determination, allowing the court to decide the correct amount of the tax liability).

**CONCLUSION**

For the above stated reasons, the court denies both parties' motions for partial summary judgment. The matter will be set for trial. An Order in this regard accompanies this opinion.

Very truly yours,



Mala Sundar, J.T.C.