NOT FOR PUBLICATION WITHOUT APPROVAL OF
THE TAX COURT COMMITTEE ON OPINIONS

TAX COURT OF NEW JERSEY

Kathi F. Fiamingo
Judge

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RE: Canon Financial Services, Inc. v. Director, Division of Taxation
Docket No. 000404-2014

Dear Counsel:

This letter constitutes the court's opinion with respect to the motion for summary judgment filed by Canon Financial Services, Inc. ("plaintiff") demanding judgment 1) that for calendar years 2004 through 2010 it is entitled to allocate its income utilizing the three-factor formula otherwise applicable to corporations maintaining a regular place of business outside the State of New Jersey, although its sole place of business is located within the State; 2) that for calendar years 2004

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through 2009 it is entitled to deduct all interest paid to related parties; and 3) that the late payment and amnesty penalties imposed by defendant ("Director") should be abated.

The Director opposes plaintiff's motion and cross-moves for judgment dismissing plaintiff's complaint, contending that the use of the three-factor formula to allocate plaintiff's income is distortive of its business in New Jersey and that the imposed allocation of 100% of the plaintiff's income to the State of New Jersey with a credit for taxes paid to other states is a fair and proper allocation of its income. Without prejudice to these arguments the Director asks that the matter be remanded for consideration of alternative allocation factors. The Director further contends that for 2004 through 2009 plaintiff should be denied the deduction for interest paid to related parties, and that the underpayment and amnesty penalties imposed by the Director should be upheld.

For the reasons expressed below, the court denies the motions filed by the parties and remands this matter to the Director for further consideration of plaintiff's request for relief under N.J.S.A. 54:10A-8. The court retains jurisdiction.

I. Findings of Fact and Procedural History

Plaintiff is a commercial financial services company headquartered in Mount Laurel, NJ. It is a wholly owned subsidiary of Canon U.S.A., Inc. ("Canon U.S.A"), which is a wholly owned subsidiary of Canon, Inc. Canon, Inc. manufactures digital multifunction devices, copy machines, printers and cameras. Canon U.S.A. is the exclusive importer and distributor of Canon, Inc. products in the United States. During all of the years in question, Canon U.S.A. sold the Canon products directly to large corporations and federal, state and local governments, to independent authorized dealers and resellers, and to its subsidiary Canon Solutions America, Inc. In turn, the

independent dealers and resellers and Canon Solutions America, Inc. resold the Canon products to their customers.

Plaintiff offered lease financing to the customers of its parent, Canon U.S.A. and Canon Solutions America, Inc. In addition, leasing through plaintiff was available to the customers of the independent dealers and resellers. All of plaintiff's office functions were performed at its headquarters in Mount Laurel, NJ and all lending decisions were made in New Jersey. Plaintiff maintained no other offices either inside or outside the State. Plaintiff's business activities included the establishment of its lease rates and terms, the review and approval/denial of lease applications, the administration of the leases during their terms (including the collection of monthly lease payments), as well as the facilitation of the final disposition of the leased property upon lease termination.

Once a lease application was approved and a lease agreement executed, plaintiff purchased the equipment to be leased and transferred possession to the customer. Although it does not appear plaintiff ever took physical possession of the leased equipment, it obtained and retained title for the duration of the lease agreement. Upon lease termination, plaintiff would arrange for the final disposition of the leased property by way of sale to the lessee or other purchaser, or by way of recycling of the property.

Plaintiff had customers in all 50 states during the years under review and thus collected monthly lease payments in all States. The value of the equipment owned by plaintiff and leased to the customers located in the various states was between $0.7 billion and $1.2 billion.

In order to finance its operations plaintiff borrowed funds from its parent, Canon U.S.A. Plaintiff would determine the amount it needed to fund its operations based on projected cash needs. Canon U.S.A. would lend the needed funds to plaintiff generally on the last business day

of a month. The loans were documented by a single page document, referred to by plaintiff and herein as a "Note".

Each such Note contained a reference line which read: "Re: US $ [XXX] Long Term Loan." Below the reference line was the heading "Notification of terms of the loan," under which were listed the following "terms": 1) Loan amount[1]; 2) Effective Date; 3) Maturity Date; 4) Interest rate; 5) Repayment [of principal]; and 6) Interest Payment. Each Note contained the following statement: "Confirmation: Please confirm your agreement to the terms stated in this notice by return facsimile." Below the confirmation appeared a printed statement "We authorize you the terms of loan as above" and a space for the signature of a representative of Canon Financial Services, Inc.,[2] and a date.

Each of the Notes with effective dates of June 30, 2008 through August 31, 2010 contained the following statement not present in the other documents: "Note: In addition to the above Long Term Note, as of [the effective date of the note] CUSA holds a S/T Loan payable to CFS in the amount of [$XXX]."[3] These additional S/T loans had principal amounts ranging from $1,823,052.20 to a high of $24,956,166.95.

None of the Notes identifies the lender. Although the portion of each of the Notes specifying the terms of the loans is signed by someone identified as "Finance Manager," "Sr. Finance Manager," "Assistant Director," "Director/General Manager," or "Sr. Director," there is no identification of the entity on whose behalf such signatories are acting.

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[1] On a number of the Notes for loans made during the period 8/31/2007 through 4/30/2008, the "Loan Amounts" were blank, however, each of these Notes had the reference line indicating the amount of the loan being provided.

[2] Approximately 50% of the Notes did not contain a signature of a representative of plaintiff confirming the terms of the loans.

[3] The court assumes CUSA is a reference to Canon USA and CFS is a reference to plaintiff, Canon Financial Services, Inc.. It is not at all clear if plaintiff is the lender to whom the S/T Loan is payable, as indicated in this statement, or is the Borrower. No specific reference was made to these additional loans by the parties and it was not clear if these additional loans are in contention.

Both the "Repayment" provision and the "Interest Payment" provision indicate that payments are due monthly on the last business day of each month beginning on the date of the loan "and ending on the maturity date. As set forth in the attached 'Schedule.'" The referenced schedules were not attached. With two exceptions, each of the loans contained a "maturity date" of three years from the "effective date" of the loan. The principal amount of each of those loans ranged from $9,540,000 to $55,260,000.

One note effective October 31, 2008, in the amount of $113,100,132.02, matured two years from the effective date on October 29, 2010 and was issued in addition to one issued on the same date for $46,440,000 maturing October 29, 2011. Similarly, in July 2010, a Note for $19,407,031.91 with a maturity date of July 31, 2012, was issued at the same time as a Note for $42,120,000 maturing July 31, 2013. Further in November 2008, two Notes with effective dates of November 29, 2008, and maturity dates of November 30, 2011, were issued, one for $22,171,966 and one for $43,740,000.

An undated Loan Agreement "made and entered into, as of July 1st 2010," was executed by Canon U.S.A. and plaintiff which set forth the general terms for a $920,000,000 line of credit made available to plaintiff. Among other things, the Loan Agreement specified the borrowing procedure to be employed by the parties, the manner in which the interest rate was established and the principal repayment schedule.

Plaintiff filed New Jersey Corporation Business Tax ("CBT") returns for the tax years 2004 through 2010. Plaintiff also filed returns for those years in separate reporting States, or was included in combined or consolidated tax returns filed by Canon USA and its subsidiaries in combined reporting states, such that its income was taxed or taken into account in all 47 States imposing a corporate income or franchise tax during such years.

On each of the CBT returns plaintiff filed for the years in question, plaintiff deducted all of the interest it paid to its parent and other related parties and calculated its taxable income by utilizing a three factor allocation formula. On audit, the Director determined that plaintiff, having no regular place of business located outside the State, was required to allocate 100% of its income to New Jersey. Pursuant to the authority provided in N.J.S.A. 54:10A-8, the Director considered plaintiff's request to allocate its income in a manner other than the 100% allocation required under the applicable statute, and considered several alternatives. Ultimately, the Director allocated 100% of plaintiff's income to this State and allowed a credit for taxes paid to other jurisdictions where plaintiff filed a separate return.

For the years 2004 through 2009, the Director also added back all interest deducted on loans paid by the plaintiff to related parties.[4] The Director also assessed late payment penalties and the amnesty penalty. A Notice of Assessment was issued on December 20, 2013, assessing additional taxes, interest and penalties in the aggregate in the amount of $21,218,020.38. Plaintiff chose not to file a protest and request a hearing and instead filed a direct appeal in the Tax Court on March 4, 2014 contesting the assessment.

Thereafter, plaintiff filed the within motion for summary judgment. The Director opposed the motion and filed a cross motion for summary judgment which the plaintiff opposed.

II. Legal Issues and Analysis

A. Summary Judgment

Summary judgment should be granted where "the pleadings, depositions, answers to interrogatories and admissions on file, together with the affidavits, if any, show there is no genuine issue as to any material fact challenged and the moving party is entitled to a judgment or order as

[4] The deduction for interest paid to related parties for tax year 2010 was not disallowed and is not at issue.

a matter of law." R. 4:46-2(c). In Brill v. Guardian Life Ins. Co., 142 N.J. 520, 523 (1995), our Supreme Court established the standard for summary judgment as follows:

> [W]hen deciding a motion for summary judgment under Rule 4:46-2, the determination whether there exists a genuine issue with respect to a material fact challenged requires the motion judge to consider whether the competent evidential materials presented, when viewed in the light most favorable to the non-moving party in consideration of the applicable evidentiary standard, are sufficient to permit a rational factfinder to resolve the alleged disputed issue in favor of the non-moving party.

"The express import of the Brill decision was to 'encourage trial courts not to refrain from granting summary judgment when the proper circumstances present themselves.'" Township of Howell v. Monmouth Cty. Bd. of Taxation, 18 N.J. Tax 149, 153 (Tax 1999) (quoting Brill, supra, 142 N.J. at 541).

"[T]he determination [of] whether there exists a genuine issue with respect to a material fact challenged requires the motion judge to consider whether the competent evidential materials presented, when viewed in the light most favorable to the non-moving party in consideration of the applicable evidentiary standard, are sufficient to permit a rational factfinder to resolve the alleged disputed issue in favor of the non-moving party." Ibid. at 523.

There are no genuine issues of material fact in dispute. Thus, the matter is ripe for summary judgment.

B. Standard of Review

The review of this matter begins with the presumption that determinations made by the Director are valid. See Campo Jersey, Inc. v. Director, Div. of Taxation, 390 N.J. Super. 366, 383 (App. Div.), certif. denied, 190 N.J. 395 (2007); L&L Oil Service, Inc. v. Director, Div. of Taxation, 340 N.J. Super. 173, 183 (App. Div. 2001); Atlantic City Transp. Co. v. Director, Div. of Taxation, 12 N.J. 130, 146 (1953). "New Jersey Courts generally defer to the interpretation that

an agency gives to a statute [when] that agency is charged with enforc[ement.]" Koch v. Director, Div. of Taxation, 157 N.J. 1, 15 (1999). Determinations by the Director are afforded a presumption of correctness because "[c]ourts have recognized the Director's expertise in the highly specialized and technical area of taxation." Aetna Burglar & Fire Alarm Co. v. Director, Div. of Taxation, 16 N.J. Tax 584, 589 (Tax 1997) (citing Metromedia, Inc. v. Director, Div. of Taxation, 97 N.J. 313, 327 (1984)). The Supreme Court has directed courts to accord "great respect" to the Director's application of tax statutes, "so long as it is not plainly unreasonable." Id. at 327. See also GE Solid State, Inc. v. Director, Div. of Taxation, 132 N.J. 298, 306 (1993) ("Generally, courts accord substantial deference to the interpretation an agency gives to a statute that the agency is charged with enforcing.")

However, judicial deference is not absolute. An administrative agency's interpretation that is plainly at odds with a statute will not be withheld. See Oberhand v. Director, Div. of Taxation, 193 N.J. 558, 568 (2008) (citing GE Sold State, supra, 132 N.J. at 306); Advo, Inc. v. Director, Div. of Taxation, 25 N.J. Tax 504, 511 (Tax 2010).

C. New Jersey Corporation Business Tax Act

1. General Principles of the Act. The New Jersey CBT requires all domestic and non-exempt foreign corporations to pay an annual franchise tax for the privilege of having or exercising its corporate franchise in New Jersey, or for the privilege of deriving receipts from sources within the State or for the privilege of engaging in contacts within the State or for the privilege of doing business, employing capital or owning capital or property, or maintaining an office in New Jersey. N.J.S.A. 54:10A-2.

If a corporation has multistate income, an allocation factor is applied to determine the amount of its overall income subject to tax in the state. For the years under review, when a taxpayer

did not maintain a regular place of business outside this State, the allocation factor was 100%. N.J.S.A. 54:10A-6 ("§6")[5]. If a taxpayer maintained a regular place of business outside the State, New Jersey determined the proportionate share of the income subject to the CBT by applying a three factor allocation formula taking into account the Corporation's in-state sales, payroll and property.[6] Ibid.

2. Discretionary Authority of Director. The application of either allocation formula in certain circumstances may not produce a fair approximation of the net income attributable to a corporation's activities in the State. See, F.W. Woolworth Co. v. Director, Div. of Taxation, 45 N.J. 466, 498 (1965); Metromedia, supra 97 N.J. at 323; SMZ Corp. v. Director, Div. of Taxation, 193 N.J. Super 305, 317 (App. Div. 1984). As a result, the Director is granted discretionary authority to adjust the §6 allocation factor if it would not reflect a taxpayer's business activity reasonably attributable to the State. In this regard, N.J.S.A. 54:10A-8 ("§8") provides:

> If it shall appear to the commissioner that an allocation factor determined pursuant to section 6 does not properly reflect the activity, business, receipts, capital, entire net worth or entire net income of a taxpayer reasonably attributable to the State, he may adjust it by:
>
> (a) excluding one or more of the factors therein;
>
> (b) including one or more other factors, such as expenses, purchases, contract values (minus subcontract values);
>
> (c) excluding one or more assets in computing entire net worth; or
>
> (d) excluding one or more assets in computing an allocation percentage; or
>
> (e) applying any other similar or different method calculated to effect a fair and proper allocation of the entire net income and the entire net worth reasonably attributable to the State.

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[5] The statute was amended to delete the 100% allocation factor for a taxpayer not maintaining a regular place of business outside the State for tax years beginning on or after July 1, 2010. See, L. 2008, c. 120, §§2 and3.

[6] The CBT apportionment factor changed as a result of legislative action in 2011. The formula converted to a single sales fraction formula following a three-year phase in which began January, 2012. L. 2011, c. 59, §1.

Our Supreme Court has determined that this statutory direction does not simply provide authorization to, but indeed imposes an obligation upon the Director "to consider requests for adjustment on claims of unfairness which do not attain constitutional dimensions." F.W. Woolworth Co., supra, 45 N.J. at 497. The intention is for the "taxation of multi-state businesses [ ] be administered on a basis which is equitable, and not merely constitutional." Id. at 499. See also, S.M.Z. Corp., supra 193 N.J. Super.; Hess Realty Corp. v. Director, Division of Taxation, 10 N.J. Tax 63 (Tax 1988); New Jersey Natural Gas Co. v. Director, Div. of Taxation, 24 N.J. Tax 59 (Tax 2008) (applying F.W. Woolworth, supra to corporations not having a regular place of business outside the state).

In recognition of the Director's §8 obligations, N.J.A.C. 18:7-8.3 sets forth a rule by which a corporation otherwise subject to the 100% allocation may apply for an adjustment to reduce the CBT. To do so, the taxpayer is to file its return utilizing the statutorily mandated 100% business allocation factor of N.J.S.A. 54:10A-6 and "apply for a reduction in the amount of its tax." N.J.A.C. 18:7-8.3(b)(1)(i). The taxpayer is to attach a rider to its return demonstrating that a part of entire net income is duplicated on a return filed with another state, together with other information from the return filed in the other state. N.J.A.C. 18:7-8.3(b)(2)(i).[7]

Plaintiff maintains that it is entitled to utilize the three-factor formula because it is the "benchmark against which other apportionment formulas are judged." Hess Realty, supra 10 N.J. Tax at 86. However, "plaintiff's idea of what is the fairest method of apportionment is not controlling. The question is not whether one technique as opposed to another should be used, but whether the method selected by the Director produces a degree of unfairness that amounts to

[7] It does not appear that plaintiff complied with the cited regulation, but instead filed its returns as if it was a taxpayer maintaining a regular place of business outside the state and applied the three-factor allocation formula in calculating the CBT due from it during the years in question.

‘substantial inequity’” Id. at 88. The court found that such unfairness resulted where the revised taxes were 250% to 280% of the taxes under the three factor formula of §6, and the Director offered nothing to demonstrate that the three-factor formula did not reflect the extent of the taxpayer’s business activity in the State. Id. at 93.

In New Jersey Natural Gas Co., supra, the increase in tax utilizing the Director’s §8 adjustment (100% allocation with a credit for taxes paid to other jurisdictions) over the three-factor formula ranged from 16% to 4%. 24 N.J. Tax at 84. There Judge Small found that while the Director had misapportioned certain of the taxpayer’s profits to New Jersey, that misapportionment and the method used by the Director did not establish a degree of unfairness or inadequacy sufficient to override the discretion vested in the Director to effect an apportionment that fairly and reasonably reflects the taxpayer’s activities in the State. Id. at 87.

In the matter before this court there is no question that plaintiff did not maintain a regular place of business outside this State and that at least preliminarily the statutory allocation factor under §6 is 100%. During the audit, consideration was given to plaintiff’s request for relief under N.J.S.A. 54:10A-8. Alternative methods were reviewed. Apparently plaintiff’s request for use of the three-factor formula was rejected. Instead, a 100% allocation with a credit for taxes paid to other jurisdictions where the plaintiff paid taxes on a separate entity basis was applied in accordance with N.J.A.C. 18:7-8.3(b)(1)(i).

Applying the 100% allocation formula with the credit for taxes paid to other jurisdictions results in taxes ranging from 221% to 310% of the taxes payable utilizing a three-factor formula. Plaintiff submits that these results are substantially similar to those in Hess Realty, supra and that they are, therefore, entitled to utilize the three-factor formula. The court agrees that the proposed

allocation does not result in an apportionment that fairly and reasonably reflects the plaintiff's business activities in this state.

The court disagrees however, with plaintiff's conclusion that they are entitled to utilize the three-factor formula. In Hess Judge Andrew found that the Director provided no explanation why the three-factor formula should not be applied and that, had the Director offered something to demonstrate a deficiency in the three-factor formula, the Director's suggestion that the matter be remanded for further consideration of §8 adjustments would have been "appropriate." 10 N.J. Tax at 52.

In the case before this court, the Director has demonstrated the deficiency in the three-factor formula as applied to the plaintiff's business in this matter. Utilizing an unadjusted three-factor formula, the property fraction, wage fraction and receipts fraction for each of the years in question and the three factor allocation factor are as follows:

Year	Property fraction	Wage Fraction	Receipts Fraction[8]	3-Factor Allocation Percentage
2004	0.126714	0.899094	0.102906	0.307905
2005	0.113806	0.906055	0.096538	0.303234
2006	0.106936	0.900120	0.091789	0.298659
2007	0.101655	0.907227	0.085403	0.294822
2008	0.102575	0.895271	0.079966	0.295152
2009	0.105835	0.920213	0.078432	0.295728
2010	0.105148	0.990541	0.078934	0.313389

However, if the leased equipment is separated from the Property fraction, the revised fractions are as follows:

[8] For these purposes only, no receipts have been excluded from the denominator pursuant to the Throw Out Rule.

Year	Property fraction leased equipment	Property fraction Business assets	Wage Fraction	Receipts Fraction
2004	0.106854	0.996628	0.899094	0.102906
2005	0.098031	0.998912	0.906055	0.096538
2006	0.090183	0.997174	0.900120	0.091789
2007	0.085658	0.988445	0.907227	0.085403
2008	0.083483	0.946499	0.895271	0.079966
2009	0.081655	0.953483	0.920213	0.078432
2010	0.084042	0.799604	0.990541	0.078934

All of plaintiff's office functions are located in New Jersey and all of its lending decisions are made in New Jersey. (The wage fraction ranges from 90% to 99%.) With the exception of the leased equipment, substantially all of the assets utilized in its business are in New Jersey. (The Property Fraction ranges from 80% to 100%). Yet, the application of the three-factor formula would result in allocation formulas of approximately 30% in each of the years under review. Furthermore, pursuant to N.J.S.A. 54:10A-6(B)(5) the rental income generated by the leased equipment located out of the State is considered non-New Jersey income. Its inclusion in the denominator of the receipts fraction and the double weighting of the receipts fraction under the Three Factor formula already works to allocate plaintiff's income away from the State.[9]

Thus, the Director persuasively argues that strictly applying the three-factor formula does not fairly allocate plaintiff's business activities in this State.

As noted above, the court finds that the Director's application of the 100% allocation factor with credit for taxes paid to other jurisdictions does not result in a fair apportionment of the plaintiff's net income allocable to this State. However, the court also finds that the Director has presented a basis upon which to demonstrate that the application of the three-factor formula does

[9] The §6 allocation formula consists of the property fraction, the wage fraction and twice the receipts fraction, divided by 4.

not produce a fair and proper result such that a remand for further §8 consideration is justified.[10] This is especially appropriate where, as here, the plaintiff did not follow the Director's regulation in filing its returns and requesting §8 relief and chose to forego filing a protest. Although the court acknowledges that the plaintiff has a statutory right to file a direct complaint with the Tax Court, rather than participate in a protest before the Conference and Appeals section of the Division of Taxation, the court finds that having done so limited the Director's ability to consider §8 alternatives, making a remand all the more appropriate.

III. Conclusion

Plaintiff's motion for summary judgment is denied, as is defendant's cross motion. This matter is remanded to the Director for further proceedings consistent with this opinion, to be undertaken within 90 days of the date hereof.

The court retains jurisdiction of this matter.

Very truly yours,

/s/Kathi F. Fiamingo, J.T.C.

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[10] The court notes that in its opposition brief, the Director submitted a Certification of a Conferee of the Division who posited a five-factor formula as an alternate method of allocation. Counsel for the Director had no authority to adopt this formula as the Director's position for litigation purposes, and stated that the 100% allocation with a credit for taxes paid to other jurisdictions was the official §8 position. The court makes no finding as to the appropriateness of the suggested five-factor formula or as to plaintiff's position that the imposition of such a formula would be contrary to the rule-making requirements of the Administrative Procedure Act (N.J.S.A. 52:14B-1 et seq.) and Metromedia, supra, 97 N.J. at 328-37.