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THE TAX COURT COMMITTEE ON OPINIONS

TAX COURT OF NEW JERSEY
DOCKET NO: 012945-2011

BANK OF AMERICA CONSUMER CARD HOLDINGS,
Plaintiff(s),
vs.

STATE OF NEW JERSEY DIVISION OF TAXATION

Defendants.

Approved for Publication
In the New Jersey
Tax Court Reports

TAX COURT OF NEW JERSEY
DOCKET NO: 012947-2011

FLEET CREDIT CARD HOLDINGS INC.

Plaintiff(s),
vs.

STATE OF NEW JERSEY DIVISION OF TAXATION

Defendants.

TAX COURT OF NEW JERSEY
DOCKET NO: 012942-2011

FIA CARD SERVICES, N.A.

Plaintiff(s),
vs.

STATE OF NEW JERSEY DIVISION OF TAXATION

Defendants.

TAX COURT OF NEW JERSEY
DOCKET NO: 000386-2012

FIA CARD SERVICES, N.A.

Plaintiff(s),
vs.

STATE OF NEW JERSEY DIVISION OF TAXATION
Defendants.

FIA CARD SERVICES, N.A. Plaintiff(s), vs. **STATE OF NEW JERSEY** **DIVISION OF TAXATION** Defendants.	TAX COURT OF NEW JERSEY DOCKET NO: 000387-2012

Decided: October 6, 2016

Richard A. Leavy for plaintiffs
(Sidley Austin, LLP, attorneys).

Michael J. Duffy for defendant
(Christopher S. Porrino, Attorney General of New Jersey, attorney).

CIMINO, J.T.C.

I. INTRODUCTION

Bank of America Consumer Card Holdings and related entities (collectively the "taxpayers") are in the credit card account business. The credit card accounts allow customers otherwise known as cardholders to make purchases at or from merchants which accept the cards for payment. The details of these transactions are discussed later in this opinion. The taxpayers' revenues are broadly derived from interest, interchange and service fees. Taxpayers concede there is sufficient constitutional nexus with the State of New Jersey that may subject the taxpayers to the New

Jersey Corporation Business Tax. However, the taxpayers challenge the amount and extent of the tax due and owing.

From 2002 through 2008, the taxpayers filed returns with the Division of Taxation. Thereafter, the taxpayers filed amended returns covering the same period seeking a refund of approximately $42 million. In particular, the taxpayers allege that none of the income earned or derived from accounts of cardholders located in New Jersey should be allocated to the State of New Jersey. The Director of the Division of Taxation rejected taxpayers' refund requests. As a result, the instant actions ensued.

The issue in this case is how the receipts realized by the taxpayers' through interest on purchases not paid within a grace period, interchange which occurs on all transactions, and service fees should be allocated to the State of New Jersey. Each of the appropriate areas will be addressed in turn.

II. CORPORATION BUSINESS TAX

To fully understand the essence of this dispute, some background knowledge of the New Jersey Corporation Business Tax (CBT) is necessary.

Prior to 1938, the United States Supreme Court espoused a "free trade" view of interstate commerce which thwarted many efforts by states to impose taxation on an activity involved in interstate commerce. Complete Auto Transit, Inc. v. Brady,

Chairman, Mississippi Tax Commission, 430 U.S. 274, 279, 97 S. Ct. 1076, 1079, 51 L.Ed. 2d 326, 331 (1977). This view shifted in 1938 when the United States Supreme Court declared that "it was not the purpose of the commerce clause to relieve those engaged in interstate commerce from their just share of state tax burden even though it increases the cost of doing the business." Western Live Stock v. Bureau of Revenue, 303 U.S. 250, 254, 58 S. Ct. 546, 548, 82 L.Ed. 823, 827 (1938).

Shortly thereafter, in 1945, New Jersey enacted the Corporation Business Tax Act. N.J.S.A. 54:10A-1 to -28. Though amended as described in further detail below, the essential framework of the Act has not changed. The act was adopted because of dissatisfaction with prior law under which intangible property was taxable ad valorem at rates applicable to realty and tangible personalty in the municipality where the corporation was located. United States Steel Corp. v. Dir., Div. of Taxation, 38 N.J. 533, 539 (1962). Depending on the municipality, some owners of intangibles paid at negotiated rates or escaped taxation completely, while others were suddenly selected for full taxation, a phenomenon known as "tax lightning." Ibid.

The 1945 enactment was described as a franchise tax for the privilege of having or exercising a corporate privilege in the state or for the privilege of doing business, employing or owning capital in the state or maintaining an office in the state. L.

1945, c. 162, § 2. The tax is in lieu of all other taxes based upon or measured by personal property, thus curing the "tax lightning" issue. Ibid.

As enacted, only a corporation's "net worth" allocated to New Jersey was taxed. L. 1945, c. 162, § 5(a). "Net worth" was defined to include the aggregate value of issued and outstanding capital stock, paid-in or capital surplus, earned surplus and undivided profits, and certain surplus reserves. L. 1945, c. 162, § 4(d).

To determine the allocation for a corporation which maintained a regular place of business outside the state, an allocation factor or formula was delineated by the act. The formula consisted of three fractions or ratios addressing property, payroll and receipts both within and without the state. L. 1945, c. 162, § 6. The numerator of each fraction was the respective amount of property, payroll or receipts within the state and the denominator was the respective amount of property, payroll or receipts both inside and outside the state. Once calculated, the three fractions or ratios were added together and then divided by three to arrive at an allocation factor. This allocation factor was then multiplied by the net worth of the corporation regardless of where the "worth" was located to arrive at a net worth which would be attributable to New Jersey for taxation purposes. This type of allocation factor has been

recognized as constitutionally valid by the United States Supreme Court since at least 1897.[1] Butler Bros. v. McColgan, 315 U.S. 501, 508, 62 S. Ct. 701, 705, 86 L.Ed. 991, 997 (1942) (citing Adams Express Co. v. Ohio State Auditor, 165 U.S. 194, 17 S. Ct. 305, 308, 41 L.Ed. 683, 694 (1897)).

In 1958, the act was amended to also tax net income allocable to New Jersey. L. 1958, c. 63. "Net income" included net income from all sources whether within or without the state. L. 1958, c. 63, § 4(k). Net income for a corporation which maintains a regular place of business outside the state was allocated using the same formula utilized for determining the allocation for net worth. Id. § 5. Both net worth and net income were taxed until the mid-1980's when the net worth portion of the tax was phased out. Id. § 5(a).

By the early 1970's, it was thought that the constitutional reach of the franchise tax, even when measured by net income, was generally more limited. Report of the New Jersey Tax Policy Committee, Non-Property Taxes in a Fair and Equitable Tax System, Part V at 20 (Feb. 23, 1972) (Cahill Commission). In a retrenchment from its 1938 decision in Western Live Stock, the United States Supreme Court restricted the power of states to levy

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[1] In 1989, the Supreme Court held that New Jersey's version of the three factor formula to be constitutional. Armada Hess Corp. v. Dir., Div. of Taxation, 490 U.S. 66, 109 S. Ct. 1617, 104 L.Ed. 2d 58 (1989).

franchise taxes on the privilege of doing an exclusively interstate business in a state. See e.g., Spector Motor Service v. O'Connor, 340 U.S. 602, 71 S. Ct. 508, 95 L.Ed. 573 (1951), overruled by Complete Auto Transit, Inc., supra, 430 U.S. at 288-89, 97 S. Ct. at 1083-84, 51 L.Ed. 2d at 336-37. The basis for these decisions was the principle that the states could not debar foreign corporations from carrying on interstate commerce in a state, and as such, taxes on the privilege of doing business were an undue burden on interstate commerce. Id. However, the Supreme Court did allow a tax on net income provided it was not discriminatory and was properly apportioned to local activities within the state. Northwestern States Portland Cement Co. v. Minnesota, 358 U.S. 450, 464, 79 S. Ct. 357, 365, 3 L.Ed. 2d 421, 431 (1959). A number of states met the perceived constitutional limitation to the reach of a franchise tax by implementing a net income tax levied not on the privilege, or the doing, of business in a state, but on the income derived from sources within the state. Ibid.

Thus, in 1973, New Jersey adopted the Corporation Income Tax Act. L. 1973, c. 170. The Corporation Income Tax Act was essentially identical to the Corporation Business Tax Act. There was one pertinent difference between the two acts. To address perceived constitutional concerns, the Corporation Income Tax (CIT) applied to income derived from sources within New Jersey.

N.J.S.A. 54:10E-2 (repealed 2002). This differed from the franchise tax imposed by the Corporation Business Tax for the privilege of doing business in the state. N.J.S.A. 54:10A-2 (amended 2002). The Corporation Income Tax was considered a second-tier tax in that it applied to corporations that escaped taxation under the Corporation Business Tax.

The Corporation Income Tax utilized the same allocation factor based upon property, payroll and receipts utilized for the Corporation Business Tax. Compare N.J.S.A. 54:10A-6, 54:10E-6 (repealed 2002). In particular, when it comes to the receipts fraction or ratio, both statutory provisions set forth a listing of the types of receipts constituting sales. Two of the receipt types listed are especially relevant to this case and are essentially identical in each act. These two types are "services performed within the state" and "all other business receipts . . . earned within the state." Compare, N.J.S.A. 54:10A-6(B)(4), (6). N.J.S.A. 54:10E-6(B)(4), (6) (repealed 2002).

The Corporation Income Tax Act was effective for taxpayers with the year ending in 1974. N.J.S.A. 54:10E-2 (repealed 2002). The Cahill Commission report indicated that the tax would bring $2 to $4 million into the State's coffers. Cahill Commission, supra, at 22. However, the reality was much different. Over the period in which revenues from the act were separately reported (1974-1995), the State's collections did not exceed $250,000 until

1985. State of New Jersey, Annual Report of the Division of Taxation at 4 (1976), at 6 (1978), at 6 (1980), at 6 (1982), at 4 (1985), at 4 (1988), at 4 (1991), at 21 (1996). This is in stark contrast to the Corporation Business Tax with revenues ranging from hundreds of millions to over a billion dollars per year. Ibid. The reasons for collections failing projections, especially for the earlier years, is unclear. However, in 1977, the United States Supreme Court handed down its decision in Complete Auto, supra, 430 U.S. 274, 97 S. Ct. 1076, 51 L.Ed. 2d 326. With this decision, a franchise tax such as the Corporation Business Tax was constitutionally permitted to have a much broader reach. The Court made a point of emphasizing that "the Spector [Motor Service v. O'Connor, 340 U.S. at 602, 71 S. Ct. at 508, 95 L.Ed. at 573] rule, as it had come to be known, ha[d] no relationship to economic realities. Rather it st[ood] only as a trap for the unwary draftsman" and "as a triumph of formalism over substance." Complete Auto, supra, 430 U.S. at 279, 281, 97 S. Ct. at 1080, 51 L.Ed. 2d at 332.

In 1995, the Corporation Business Tax was amended to "double weight" the sales fraction of the allocation formula delineated by the act. As stated, the formula consists of three fractions or ratios addressing property, payroll and receipts both within and without the state. L. 1945, c. 162, § 6. The numerator of each fraction was the respective amount of property, payroll or

receipts within the state and the denominator was the respective amount of property, payroll or receipts both inside and outside the state. Once each fraction was calculated, the fractions were added together with the receipts fraction being added in twice (double weighting) and then divided by four to arrive at an allocation factor. This allocation factor was then multiplied by all net income of the corporation whether within or without the state. Parenthetically, an allocation formula which relies more on receipts (through double weighting or some other method) rather than property or payroll is more likely to be found constitutionally permissible. See, e.g., Hans Rees' Sons, Inc. v. North Carolina, 283 U.S. 123, 134, 51 S. Ct. 385, 389, 75 L.Ed. 879, 906 (1931).[2]

In 2002, the Legislature enacted the most sweeping changes to the Corporation Business Tax since 1945. At the same time, the Legislature repealed the Corporation Income Tax, at least as a separate or second tier tax. Previously, the Corporation Business Tax was for the privilege of doing business in the state, whereas the Corporation Income Tax applied to "income derived from sources with in New Jersey." L. 1945, c. 162, § 2. With the 2002 revisions, the Corporation Business Tax was amended to apply to

[2] The allocation formula changed again due to legislative action in 2011. Beginning in 2014, the formula converted to a single receipts fraction formula following a three-year phase-in that began in 2012. L. 2012, c. 59, § 1.

not only to the privilege of doing business in the state, but also to the "privilege of deriving receipts from sources within this State. . ." Thus, a tax on income derived was no longer a second tier tax, but instead was made part and parcel of the Corporation Business Tax. In addition, the Corporation Business Tax was amended further to explicitly state that the tax applies "if the taxpayer's business activity in this State is sufficient to give this State jurisdiction to impose the tax under the Constitution and statutes of the United States." As explained by the Legislature, the purpose of this clause "is to extend the reach of the CBT to the full extent permitted under the United States Constitution and federal statute." Assembly Budget Committee Statement to A-2501, p. 4 (June 27, 2002). As a practical matter, with Spector being overruled by Complete Auto, the CIT was no longer needed.

The 2002 enactment also established a "throwout rule." Under the throwout rule, the denominator of the sales fraction could not include receipts attributable to other states that were not taxed. This provision was later repealed in 2010 and has been narrowed on constitutional grounds by the New Jersey Supreme Court in Whirlpool Properties, Inc. v. Div. of Taxation, 208 N.J. 141 (2011).

III. INTEREST

Taxpayers do not contest that New Jersey has sufficient constitutional nexus to impose a tax. Moreover, the taxpayers do not contest that the three factor allocation utilizing a double-weighted receipts factor applies. Reply Brief of Plaintiff at 47. However, the taxpayers do object to the receipts fraction computation by the Director. Ibid. The taxpayers also argue that the customer-based sourcing of interest is inappropriate. Id. at 63.

The taxpayers earn interest on customer accounts when customers using the credit card accounts to make purchases do not pay the amount advanced by the taxpayers to make the purchases within a designated grace period. Since a number of taxpayers' customers are located in New Jersey, the issue is the allocation of interest income to New Jersey.

The taxpayers do not clearly set forth what sort of sourcing would be appropriate. However, it is assumed that the taxpayers are arguing for the interest payment to be sourced to where the taxpayers conduct their operations.

The taxpayers' argument seems to be that the body of caselaw dealing with the allocation of interest under the former Corporation Income Tax is somehow inapplicable to the present incarnation of the Corporation Business Tax. The taxpayers' arguments fail on a number of points.

It is entirely appropriate to look to how the New Jersey Supreme Court dealt with the interest issue under the Corporation Income Tax. As set forth in the legislative history above, the Corporation Income Tax was enacted as a second tier tax to reach receipts which were not, or possibly could not, be taxed under the Corporation Business Tax. N.J.S.A. 54:10E-2 (since repealed). Both acts were essentially identical in a number of material respects. Both implemented a three-factor formula of property, payroll and receipts to determine the allocation ratio for the taxation due. Compare N.J.S.A. 54:10A-6, 54:10E-6 (repealed 2002). The definition of what constitutes the receipts fraction is essentially identical. Ibid. Under both acts, receipts include "services performed within the State" and "all other business receipts earned within the State."[3]

Moreover, both the CIT and the CBT defined entire net income to be:

> [the] total net income from all sources, whether within or without the United States, and shall include the gain derived from the employment of capital or labor, or from both combined, as well as profit gained through a sale or conversion of capital assets.
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> [N.J.S.A. 54:10A-4, 54:10E-4 (repealed 2002).]

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[3] In 1995, a double weighted formula was introduced for the CBT, but not the CIT. As discussed, supra, the CIT was in decline. In any event, the definition of what was to be included in the receipts allocation formula did not change.

And, the tax calculated under both the CIT and the CBT was determined as the rate of tax multiplied by the entire net income multiplied by the allocation factor. N.J.S.A. 54:10A-5.

The pertinent difference between the two acts is that the former CBT only reached corporations doing business in the state or exercising a corporate franchise in the state. N.J.S.A. 54:10A-2. Conversely, the CIT reached corporations which derived income from sources within New Jersey. N.J.S.A. 54:10E-2 (repealed 2002). To avoid taxation under both the CBT and the CIT, the CIT did not apply to corporations subject to the CBT. N.J.S.A. 54:10E-3 (repealed 2002). Hence, the CIT was a second-tier tax. As already noted, this second tier tax was implemented to deal with the perceived constitutional limitations arising from semantic distinctions in the drafting of a "franchise" tax such as the CBT. Such semantic distinctions were later abandoned by the United States Supreme Court. See Complete Auto, supra, 430 U.S. at 274, 97 S. Ct. at 1076, 51 L.Ed. 2d at 326.

In 2002, the CBT underwent significant amendment. Concurrently, the CIT was repealed. However, the CBT was expanded to include not only corporations doing business or exercising a franchise in the state, but also corporations deriving income in the state. As a practical matter, while the CIT as a standalone second tier tax was repealed, the vitality of its goal to reach corporations which derived income in this state continued. The

purpose of the CIT when enacted was to reach corporations which derived financial benefit from the state, yet were not taxed. Cahill Commission, supra, at 21-22. If there was any doubt that this was still the goal of the New Jersey's corporation taxation scheme, that is dispelled by the concurrent amendment of the CBT to explicitly indicate that the reach of the tax is pushed to the boundaries allowed under the Constitution and statutes of the United States. N.J.S.A. 54:10A-2. The statement accompanying the bill which lead to the amendments indicates the act extends broadly to any income derived in the state. Assembly Budget Committee Statement to A-2501 (June 27, 2002).

Since the current CBT, as amended in 2002, is essentially a continuation of the taxation scheme of the now repealed CIT, the decisions of the former CIT dealing with the allocation of interest have continued vitality in interpreting the CBT.

The Legislature is presumed to be aware of the decisional law of the State. Farmers Mut. Fire Ins. Co. of Salem v New Jersey Property-Liability Ins. Guar. Ass'n, 215 N.J. 522, 543 (2013). As a principle of statutory construction, the legislative branch is presumed to be aware of judicial constructions of statutory provisions. State v. Singleton, 211 N.J. 157, 180 (2012). When the Legislature uses words in a statute that previously have been the subject of judicial construction, the Legislature will be deemed to have used those words in the sense

that has been ascribed to them. State v. Thomas, 166 N.J. 560, 567-68 (2001).

The reach of the CIT to "derived income" was inserted into the CBT which implements an essentially identical taxation scheme. Thus, judicial interpretations of the CIT would continue to have vitality in many respects in determining the reach of taxation under the CBT.

The CIT became effective in 1974. By 1982, three appeals by taxpayers in the consumer lending business made their way to the tax court. The appeals covered tax assessments for 1974 through 1977. All three matters were before Judge Crabtree of this court.[4]

All three decisions primarily focus upon whether the respective taxpayer had sufficient constitutional nexus to be subject to taxation. The constitutional issue is not at stake

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[4] The first of the three cases, Avco Fin. Servs. Consumer Disc. One, Inc. v. Director, Div. of Taxation, 4 N.J. Tax 349 (Tax 1982), was decided on May 5, 1982. Avco was a consumer finance business based in Pennsylvania and deriving its revenues solely from interest income. Id. at 352. Assessments for the Corporation Income Tax for 1974 and 1975 were at issue. Id. at 351.

The second matter, Tuition Plan v. Director, Div. of Taxation, 4 N.J. Tax 470 (Tax 1982), was decided on July 28, 1982. The taxpayer's sole activity was making unsecured tuition loans. Id. at 474. Assessments for the Corporation Income Tax for 1974 through 1977 were under review. Id. at 474.

The final matter, CIT Fin. Servs. Consumer Disc. Co. v. Director, Div. of Taxation, 4 N.J. Tax 568 (Tax 1982), was decided on September 17, 1982. This taxpayer also made consumer loans to New Jersey residents. Id. at 571. Assessments made under the Corporation Income Tax for 1976 and 1977 were being challenged. Id. at 571.

here since the instant taxpayer has conceded nexus. However, related to the nexus argument is the purely statutory issue of whether the statute reaches income "derived" from New Jersey. Avco Fin. Servs. Consumer Disc. Co. One v. Director, Div. of Taxation, 100 N.J. 27, 36 (1985); Tuition Plan, supra, 4 N.J. Tax at 481; CIT Fin. Servs., supra, 4 N.J. Tax at 577. While on the one hand, the instant taxpayers have conceded constitutional nexus; on the other hand, the taxpayers vigorously argue the present statute at issue, the Corporation Business Tax, does not reach taxpayers' income since it was not "earned" in New Jersey.[5]

In the latter two decisions, Tuition Plan and CIT, Judge Crabtree determined there was sufficient nexus and that the statute did apply to the interest income. In the first decision, Avco, Judge Crabtree found a lack of nexus and ruled in favor of the taxpayer. The Avco matter eventually found its way to the New Jersey Supreme Court in 1985 to address the taxability of interest under the Corporation Income Tax.

The taxpayer in Avco raised one of the same arguments raised by the instant taxpayer, that is, the taxable situs of an intangible is the domicile of the creditor and therefore the

[5] All three earlier decisions also dealt with the constitutional issue of whether the tax was fairly apportioned, an issue also raised by the taxpayers here.

taxpayer earned no income in New Jersey. In other words, the statute does reach the interest income at issue.

The underpinning of the arguments both here and in Avco rests on the maxim mobilia sequuntur personam (movables follow the person). The New Jersey Supreme Court dispelled this maxim, as like other maxims, as stating a rule without disclosing the reasons for it. The Court "put[] aside traditional concepts relating to intangibles" and aptly declared that the "real source of [the taxpayer's] income is not a piece of paper, but the New Jersey borrowers." Avco, supra, 100 N.J. at 36. The Legislature's intent was not to restrict the taxation of intangibles to the place of commercial domicile. Ibid. "In the absence of legislative intent that the mobilia maxim be construed as part of the [act], interest income received from New Jersey borrowers is derived from sources in New Jersey under the act, and thus is subject to the constitutional reach of the State." Avco, supra, 100 N.J. at 37.

While the Avco matter was pending before the New Jersey Supreme Court, the Director issued a regulation concerning the taxability of interest under the Corporation Business Tax.[6] This regulation is still in effect.

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[6] Why there were not concurrent regulations under the Corporation Income Tax is unclear. However, in Tamko Asphalt Prods. v. Glaser, 5 N.J. Tax 446 (1983), the court, relying upon the increased breadth allowed under Complete Auto, determined that the

The regulation proposed on December 17, 1984 and effective February 19, 1985 provided as follows:

> Intangible income not apportioned by other provisions of these rules is included in the numerator of the receipts fraction where the taxable situs of the intangible is in this State. The taxable situs of an intangible is the commercial domicile of the owner or creditor unless the intangible has been integrated with a business carried on in another state. Notwithstanding that the commercial domicile is outside this State, the taxable situs is in New Jersey to the extent that the intangible has been integrated with a business carried on in this State.
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> [N.J.A.C. 18:7-8.12(e).]

The regulation included a comment which is directly on point here:

> Taxpayer has its domicile outside this State. It is in the business of lending money, some of which is loaned to New Jersey residents. Interest income recognized from such loans is income derived from sources within this State and, as such, is earned in New Jersey. That interest income is includable in the numerator of the receipts fraction.
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> [N.J.A.C. 18:7-8.12(e).]

Comments annexed to an enactment may be considered in determining intent. Murray v. Nicol, 224 N.J. Super. 303, 309

Corporation Business Tax, not the Corporation Income Tax, applied to a business which lacked a physical presence through a franchise in the state. Tamko, supra, 5 N.J. Tax at 456. The Corporation Income Tax only applied if the Corporation Business Tax did not. With the increased breadth of the CBT, the importance of the CIT diminished.

(App. Div. 1988). What we have here is more than a mere comment, it is an example embedded in the regulation itself which defines the mechanics of how the regulation is to be implemented. Regulations are adopted in order to further expand and interpret a statutory enactment. Prestia Realty Inc. v. Hartz Mountain Indus., Inc., 303 N.J. Super. 140, 144 (App. Div. 1997). Certainly, an example provided contemporaneously within the regulation itself is a reliable indicator of how the implementation is to occur. Examples provide practical solutions to the interpretation of a regulation. As such, examples are a reliable indicator of the Director's intent. Such contemporaneous examples also resolve ambiguities that may arise from the regulation itself.

Here, the example is plain and unambiguous. The example deals with "interest income" from the business of "lending money" to "New Jersey residents." The regulation determines that such interest income is "derived from sources with this State." N.J.A.C. 18:7-12(e).

When the New Jersey Supreme Court rendered a decision in Avco, supra, a few months later, the Court ruled that interest income received from New Jersey borrowers is "derived from sources within New Jersey." Id., 100 N.J. at 37. Thus, the regulation of the Director under the Corporation Business Tax and the ruling of the Court under the Corporation Income Tax are identical in that

both determine that interest income received from New Jersey borrowers would be allocated to the numerator of the receipts fraction of the allocation formula.

Thus, the interest earned from taxpayers' New Jersey credit card account holders will be allocated to the numerator of the receipts fraction of the allocation formula.

IV. INTERCHANGE

The taxpayer in this case faces an issue as to how the interchange resulting from credit card transactions of New Jersey customers is allocated. The first step is to define what is interchange. Taxpayers are in the business of issuing credit cards accounts which allow consumers access to an unsecured line of credit. The typical credit card is made of plastic with the consumer's name and account numbers embossed thereon. The consumer can physically present the card for payment of goods and services. However, physical presentation is not mandatory, such as for a purchase over the telephone or internet. Moreover, presentment of the physical plastic card for in-person purchases is no longer necessary. Various providers allow the storage of the credit account information on a cellular telephone and the use of the cellular telephone in lieu of the plastic card itself.

The typical flow of a credit card purchase is as follows. Capital One Fin. Corp. v. Comm'r, 133 T.C. 136, 145-51 (2009),

acq., I.R.S. Chief Counsel Notice CC-2010-018 (Sept. 27, 2010). A consumer makes a purchase from a merchant who has a merchant account with his or her financial institution, the merchant bank. Id. at 144-45. This merchant account allows the merchant to accept credit cards for payment. Ibid. Upon the provision of the account information by the consumer (by swiping, cellphone, or otherwise) to the merchant through terminal equipment provided by the merchant bank, the account information and amount of sale is electronically transmitted to the merchant bank. Id. at 146. From there, the information is transmitted to the card network (i.e. Visa, Mastercard) and then routed to the financial institution which issued the card, the issuing bank. Ibid. The issuing bank then verifies whether the consumer's account is in good standing with enough credit to advance the monies. Ibid. If everything checks out, an authorization is sent back through the network to the merchant bank and then to the merchant authorizing the sale. This all occurs in a matter of seconds. Ibid. Later, the issuing bank bills the consumer for the transaction. Id. at 148-49.

Now, if the customer buys a product from a merchant for $100, that does not mean the issuing bank pays out $100. For this type of transaction, interchange can be approximately two percent. Id. at 133. Thus, the issuing bank through the card network would forward $98 to the merchant bank. Id. at 149. The merchant usually also takes a cut of one half percent of the total or in this case

fifty cents. Ibid. The merchant bank would then forward $97.50 to the merchant which is $100 less the $2 interchange and the $0.50 paid to the merchant bank.[7] Ibid.

Even though the issuing bank only paid out $98 in our example, that certainly does not mean the merchant only bills the customer that amount. Rather, the issuing bank bills the customer the full $100. Id. at 150.

With their initial filings, the taxpayer allocated interchange to New Jersey. With the filing of the amended returns, the taxpayers allocated interchange earned on New Jersey cardholder accounts to the home states of the taxpayers. As part of their motions, the taxpayers argue in the alternative that the interchange should be allocated between New Jersey and the home states where taxpayers process the interchange. However, the taxpayers allege the allocation formula promulgated by the Director for credit card fees in N.J.A.C. 18:7-8.10(c) is flawed. The issue the Court has to resolve is whether the interchange is properly allocable to New Jersey, and if so, for how much.

To resolve the above issue, it has to be determined whether interchange constitutes a fee for a service, and if so what service, or is it economically equivalent to interest. The issue

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[7] There is also a small fixed fee charged by the respective network (i.e. Visa, Mastercard). Id. at 141.

of whether credit card interchange constitutes a fee for service or is instead interest has been previously addressed in the comprehensive United States Tax Court decision of Capital One Financial Corp.[8]

Here, the taxpayers prefer that the interchange be deemed a fee rather than interest. In Capital One, a different taxpayer argued that the interchange constituted interest because it would result in the ability to spread out the income over a number of years, instead of over one year, resulting in tax savings. Notably, the taxpayers here consider interchange to be interest when paying federal taxes.

As explained above, net income for a corporation subject to the CBT is allocated per an allocation formula that reflects the amount of business activity which a corporation engages in this state. One part of the allocation formula is the receipts

[8] In Capital One, a taxpayer was successful in arguing that the interchange constituted interest, but was unsuccessful in regards to its argument as to how the interest would be accrued for federal tax purposes over time. The taxpayer appealed the allocation issue but did not appeal the interchange determination issue. The Commissioner did not file an appeal. The Fourth Circuit Court of Appeals affirmed the Tax Court, but did not address specifically the propriety of whether the interchange constituted interest. Capital One Fin. Corp. v. Comm'r., 659 F.3d 316 (4th Cir. 2011). Generally, an Appellate Court will not consider an argument that is based upon a false premise. Schulz v. State Board, 132 N.J.L. 345, 349 (E.&A. 1945); Tibbs v. Boemi, 109 N.J. Super. 200, 204 (App. Div.), aff'd o.b., 55 N.J. 531 (1970). Therefore, it is safe to say that the Fourth Circuit accepted the interchange interest ruling as a sound decision.

fraction. The numerator of the receipts fraction constitutes receipts within New Jersey. The denominator of the receipts fraction constitutes receipts from everywhere, including New Jersey. The receipts fraction is then combined with a property and payroll fraction to determine an allocation factor which is multiplied by the net income of the corporation everywhere (including New Jersey) to come up with the net income allocable to New Jersey for purposes of computing the CBT due.

The controlling statute which has been in place since 1945 provides that the numerator of the receipts fraction of the allocation formula is "computed on the cash or accrual basis calculated according to the method of accounting used in the computation of net income for federal income tax purposes. . ." N.J.S.A. 54:10A-6(B).[9] Likewise the denominator of the receipts factor is "similarly computed." Ibid.

This statutory provision serves two purposes. First, the taxpayer is to compute the receipts for the numerator and denominator the same way. For example, if the cash basis is used for the numerator, the cash basis must be used for the denominator. Second, the taxpayer is to utilize the same overall method of accounting that is utilized for the computation of net income.

[9] Generally speaking, the cash basis recognizes income when it is earned. The accrual basis recognizes income when the right to receive the income comes about or is accrued.

It would not make sense for an allocation factor computation on cash basis receipts to be multiplied by net income computed on the accrual basis.

However, the method of accounting for federal tax purposes is not limited to the two traditional or pure methods, that is, the cash or accrual basis. "Method of accounting" is addressed by I.R.C. § 446. "Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping books." I.R.C. § 446(a). Likewise, under state law, the allocation formula is to be computed utilizing the same method of accounting used to compute federal taxes. N.J.S.A. 54:10A-6(B). Just like the federal law dealing with method of accounting, the goal of the state allocation statute is to get an accurate picture of a taxpayer's income. To argue that only a pure cash or accrual basis can be utilized contravenes the following direction provided by the New Jersey Supreme Court:

> Courts thus do not slavishly limit themselves to the dry words of legislation nor rely on mere abstract logic to determine what interpretation of a statute would fulfill the Legislature's purpose. More is called for than a merely mechanical analysis. Machines can perform mechanical tasks, but judgment is necessary to reach a result informed by intelligence.
>
> [State v. Friedman, 209 N.J. 102, 118 (2012).]

As set forth below, the history and purpose of the CBT reveals that the calculation is not limited to a pure cash or accrual basis. The current Internal Revenue Code provision dealing with methods of accounting indicates permissible methods as including not only the cash and accrual bases, but also any other method permitted by the Code or a hybrid. This provision first appeared with the 1954 edition of the Internal Revenue Code. When the CBT was adopted in 1945, federal taxation was based upon the Internal Revenue Code of 1939. The 1939 Code provision dealing with methods of accounting did not set forth the permissible methods. 26 U.S.C. § 41 (repealed). However, both the 1939 and 1954 provisions indicate that the goal is not so much adherence to a particular method of accounting, but rather ensuring a method that provides a "clear" reflection of income. 26 U.S.C. § 446(b), 41 (repealed).

The federal regulations explaining the current code describe "method of accounting" as

> not only the overall method of accounting of the taxpayer but also the accounting treatment of any item. Examples of such overall methods are the cash receipts and disbursements method, an accrual method, combinations of such methods, and combinations of the foregoing with various methods provided for the accounting treatment of special items. These methods of accounting for special items include the accounting treatment prescribed for research and experimental expenditures, soil and water conservation expenditures, depreciation, net operating losses, etc.
>
> [26 C.F.R. § 1.446-1(a)(1).]

There is a regulation dealing with interest in general. 26 C.F.R. § 1.446-2(a). Moreover, the IRS code has a specific provision dealing with accrual of Original Issue Discount (OID) which applies in lieu of the general rules regarding interest. 26 U.S.C. § 1272. See 26 C.F.R. § 1.446-2(a)(1).

Generally speaking, federal concepts of taxation are not incorporated into New Jersey's tax laws. See Centex Homes of New Jersey, Inc. v. Director, Div. of Taxation, 10 N.J.Tax 473, 492 (Tax 1989). New Jersey courts may apply federal standards only in those instances where the Legislature has specifically referred to federal principles. See Tischler v. Director, Div. of Taxation, 17 N.J. Tax 283, 290 (Tax 1998), Smith v. Director, Div. of Taxation, 108 N.J. 19, 33 (1987). These specific instances usually include instances in which the federal tax in explicitly mentioned. Ibid.

The wording of the statute itself indicates that the receipts fraction is to be computed according to the same method of accounting "used" in the computation of "its" (the taxpayer's) net income for federal tax purposes. N.J.S.A. 54:10A-6(B). Thus, the Legislature is instructing the taxpayer to compute the receipts fraction using the same method.

Further demonstrating that the Legislature intended the income allocated to New Jersey to track the income reported on

the federal return is the requirement that the CBT return must be amended whenever an amendment to the corresponding federal returns occurs. See N.J.S.A. 54:10A-13. Moreover, the Legislature has indicated a desire for a close alignment of the income determinations when it amended the CBT in the past. See L. 1993, c. 172 (purpose to bring CBT into closer alignment with federal provisions).

Regulations adopted by the Director provide that "the receipts of the taxpayer are to be computed on the cash, accrual or other method of accounting used in computation of its net income for Federal income tax purposes." N.J.A.C. 18:7-8.7. This regulation also recognizes that the method a taxpayer utilizes for federal tax reporting may be other methods in addition to the traditional pure cash or accrual methods of accounting. Certainly, the regulation makes sense since the purpose of the regulation is to have the taxpayer use the same method of accounting for its CBT computations as had been used for the federal computation.

The real goal of both the New Jersey statutory and regulatory provisions is an accurate reflection of both the net income and the gross receipts allocation factor. As such, "the numerator and denominator of the receipts fraction must, in any event, relate to the entire net income recognized during the period covered by the return." N.J.A.C. 18:7-8.7(b). As correctly

promulgated by the Director, the Legislature could not have intended to have differing methods apply to the allocation and net income calculations.

As a practical matter, the State could not direct a taxpayer as to the method to use to compute net income for federal tax purposes in order to have it match a mandated method for the gross receipts allocation factor. To apply one method to net income and another to the allocation factor may also run afoul of Constitutional requirements that the tax be fairly apportioned. See supra. Rather, the Legislature wisely determined that the method selected for federal tax purposes is controlling.

In defining other or hybrid methods of accounting which are generally derivations of the accrual method, the Director has provided two examples. See N.J.A.C. 18:7-8.7(b). One example is a contractor which recognizes income on the completed contract method of accounting in which the entire net income on a construction contract is only recognized in the year of completion. The second example is a taxpayer who recognizes income on a sale on the installment method. Installment sales include things such as a 12-month club membership which has months in two different years, but is paid in full in the first year. The income attributable to the months in the subsequent year is recognized in the subsequent year. For both examples, the income accrues on a date which differs from when the income would be

recognized on a cash basis or a pure accrual basis. What is key though is that the regulation emphasizes that the same method of accounting must be used so that the allocation formula relates to and is proportionate to the net income reported.

Simply stated, under the CBT, net income is generally computed the same way which the taxpayer computes net income for the purpose of computing federal income tax. N.J.S.A. 54:10A-4(k). This net income computation section of the CBT makes no reference to a cash or accrual basis. However, this net income provision clearly requires the net income to correlate with that reported for federal income tax purposes. Ibid. And the allocation factor calculation must utilize the same method of accounting used in the taxpayers' net income calculation. N.J.S.A. 54:10A-6(B). In accordance with the intent that a method of accounting should clearly reflect income and that the allocation formula should reflect the income allocable to New Jersey, it would not make sense to allow a taxpayer who utilized, for example, the installment method to utilize a cash or pure accrual basis to compute the allocation formula. This would result in the net income allocable to New Jersey not being related to or proportionate to the taxpayer's net income. Thus, the overarching goal is an accurate reflection of revenues and income arrived at by utilizing consistent methods of accounting.

In the case at hand, the taxpayer computes net income from interchange pursuant to the original issue discount rules promulgated by I.R.C. § 1272. Prior to a decision of the United States Tax Court in Capital One and the subsequent acquiescence by the IRS, it was an open issue as to whether the credit card interchange constitutes OID. Capital One, supra. The United States Tax Court considered a number of factors which are discussed below and determined that interchange is OID which is economically equivalent to interest.

For federal tax purposes, the taxpayers here are treating interchange as OID which is essentially interest. As part of that method of accounting, the interchange is not fully realized as income in the year in which a particular purchase is made, but is instead spread out over the probable number of years which the cardholder takes to pay off the portion of the balance attributed to the purchase. This calculation of what portion of interchange is included in any given year is fairly complex and was part of a secondary challenge raised in Capital One. See generally, Id. at 173-193. The IRS wanted to treat interchange as a fee so that the income from the interchange was realized in the year of the credit card transaction.

The bottom line is that for federal income tax purposes, the taxpayers are not recognizing interchange on a pure accrual basis, but are utilizing the method set forth in I.R.C. § 1272. The CBT

requires that net income be reported as it is for federal income tax purposes. N.J.S.A. 54:10A-4(k). A proper allocation would not occur if a traditional pure accrual method is utilized for the receipts fraction since it would not relate to, or be proportionate to, the net income computed by the deferred accrual method used for OID.

Likewise, it would not make sense that the taxpayer is asserting the interchange as OID/interest for federal income tax purposes, and deriving the benefits therefrom, but now wants to treat the interchange as a fee for CBT purposes. The significance of this difference is that interest is fully allocable to New Jersey, whereas a fee is potentially only partially allocable to New Jersey based upon the Director's regulation which allocates 25% to the origination of the service, 50% to where the service is processed and 25% to the termination of the service.[10] N.J.A.C. 18:7-8.1; See infra Part V. If taxpayers now want to argue that the interchange is a fee, and not OID/interest, that runs counter to the assertions necessary for taxpayers to enjoy the tax treatment received under federal law. In other words, it is assumed that taxpayer is correctly filing its federal returns in accordance with the facts of the transactions for which it

[10] Taxpayers also argue that the 25-50-25 methodology is flawed and that more exacting percentages must be used. In any event, taxpayer does not want 100% apportioned to New Jersey.

engages. The interchange is either a service fee or OID/ interest, but not both. Taxpayer has staked its position already that interchange is OID/interest. To now claim otherwise would certainly undercut taxpayers' treatment of interchange as OID/interest under federal taxation. Taxpayer cannot have it both ways as to what is essentially a factual determination that interchange is OID/interest.

Notwithstanding how the taxpayer treats OID/interest for federal tax purposes, this Court separately determines that interchange constitutes interest. To determine whether interchange is the economic and functional equivalent of interest, requires two inquiries. The first step is whether interchange constitutes an OID. The second step is whether an OID is essentially a form of interest.

OID typically arises when debt is purchased for cash for less than the face amount of the obligation. Comm'r v. Nat'l Alfalfa Dehydrating & Milling Co., 417 U.S. 134, 143, 94 S. Ct. 2129, 2134, 40 L.Ed. 2d 717, 724 (1974). Thus, in our example, the issuing bank has only paid $98 for a $100 loan. This discount of $2 was part of the original issue of the loan. In other words, the interchange is the original issue discount on the credit card transaction. Capital One, supra, 133 T.C. at 158-59. In a June 16, 2010 ruling request letter to the Director, the taxpayers, in their own words, "thoroughly described" their business. Moving

Brief of Plaintiffs at 18. The business is described as one in which the taxpayers are "effectively a purchaser of an account receivable on which the Borrower is the obligor and the Vendee Payee was the original creditor (the "Receivable")." Letter from Richard Leavy, Esq. to the Regulatory Services Branch, New Jersey Division of Taxation at 1 (June 11, 2010). On a later page of the letter under the heading "Buying the Receivables at a Discount" the taxpayers recognize that "when the revolving line of credit is used by the Borrower for a specific purchase of goods or services, and Loan proceeds are disbursed by the [taxpayers] directly to a Vendor Payee, the [taxpayers are] effectively [] purchaser[s] of a receivable." Id. at 5. And, the taxpayers "may acquire the Receivable at less than its face value." Ibid. In this description of a credit card transaction, the taxpayers undisputedly describe the transaction as a discount on the original issue. To now try to recast the transaction as merely a fee is simply disingenuous.

The taxpayer is undeterred and also claims that the interchange is OID for tax purposes, yet a fee for accounting purposes under generally accepted accounting principles (GAAP). Even if this were true, as discussed above, the CBT mandates that the accounting method track the method used for tax purposes rather than accounting purposes. Nevertheless, per Financial Accounting Standards No. 91 promulgated by the Financial

Accounting Standards Board, "the initial investment frequently differs from the related loan's principal amount at the date of purchase". Financial Accounting Standards Board, Statement of Financial Accounting Standards No. 91, ¶ 15 at 8 (Dec. 1986).[11] In other words, an original issue discount. The difference in the principal amount and the investment amount is "recognized as an adjustment of yield over the life of the loan". Ibid. Stated differently, the discount is a form of interest which adjusts the yield over the life of the loan. Thus, even under GAAP, an original issue discount is treated as interest adjusting the yield of the loan.

Income received by a lender is not a fee just because a lender says it is so. The test to determine if income is a fee is whether the charge compensates the lender for specifically stated services provided to and for the benefit of the borrower beyond the lending of money. Capital One, supra, 133 T.C. at 159. The interchange does not compensate the cardholder for specifically stated services. The only "service" provided by interchange is the lending of money, whether it be a short day or two or some other period. Designation by contract does not render

[11] Parenthetically, the Financial Accounting Standards Board codified its standard into the Accounting Standards Codification. The codification is effective for interim and annual periods ending after September 15, 2009 which is subsequent to the tax years at issue here. Financial Accounting Standards Board, About the Codification 4 (v. 4.9 Jan. 2014).

a charge a fee unless it is shown that the charge was actually used for such purposes and the charge is justifiably a charge to the borrower separate from interest. Western Credit Co. v. Commissioner, 38 T.C. 979, 987-88 (1962). "In short, interchange compensates banks for the costs of lending money." Capital One, supra, 133 T.C. at 161-62. See also Flagstar Bank v. Director, Div. of Taxation, 29 N.J. Tax 130, 156 (Tax 2016) (mortgage origination "fee" more akin to a change for interest than a fee for services); Noteman v. Welch, 108 F.2d 206, 213 (1st Cir. 1939) (3-percent fee charged to all borrowers was interest because the only consideration the borrower received was the use of the money lent). As such, interchange is OID.

The question which follows is whether original issue discount constitutes interest. "[O]riginal issue discount serves the same function as stated interest, it is simply compensation for the use or forbearance of money." United States v. Midland-Ross Corp., 381 U.S. 54, 57, 85 S. Ct. 1308, 1310, 14 L.Ed. 2d 214, 217 (1965). It is economically equivalent to interest. Id., 381 U.S. at 56, 85 S. Ct. at 1309, 14 L.Ed. 2d at 216. It is essentially unanimous that OID is interest. Mark A. Hershey, Face Value Exchanges, Original Issue Discount, and Elimination of the "LTV Rise": In Re Chateaugay Paints a Legal Landscape, 38 Vill. L. Rev. 801, 803 n.11. To complete the loop, interest is

compensation for the use or forbearance of money. John Hancock Life Ins. Co. v. Comm'r, 141 T.C. 1, 146 (2013).

Typical credit card users fall into two categories, transactors and revolvers. Id. at 153-154. Transactors pay their bill in full every month. On the other hand, revolvers carry a balance on their card and therefore pay monthly finance charges. Thus, for the hypothetical transaction noted above, once the merchant has been paid, the issuing bank seeks payment from the cardholder and the cardholder has the option of either paying the amount in full within a grace period or paying it over time with additional interest assessed.

For transactors who pay their bill every month in full, interchange would be the only revenue which a credit card issuer would receive on the transaction. The length of a credit card issuer's loan to a transactor may be as little as a day or two (if the cardholder pays the monthly bill immediately upon making a charge) or as long as sixty days (if the cardholder makes a charge on the first day of the billing cycle and pays the statement balance on the last day of the grace period). Whether for one day or for sixty, the credit card issuer has foregone the use of those funds and interchange represents payment for such use. Id. at 162.

Like interest, interchange also compensates a credit card issuer for costs associated with lending money to credit card

holders. These costs include risk costs, which are comprised of credit and fraud risks, financial carrying costs and processing costs. Id. at 163.

As with interest, interchange is expressed as a percentage of the amount lent. Thus, as the amount of the loan increases, the amount of interchange increases just as the amount of interest would increase. "Crucial in establishing whether a particular payment constitutes interest is whether the payment bears some relationship to the amount borrowed." Capital One, supra, 133 T.C. at 165. It is not necessary that the interchange cover all the costs of lending. Whether interchange covers all of a credit card issuer's costs or just a small fraction for certain types of credit card transactions is not dispositive of the determination of whether the interchange is a fee for service or economically equivalent to interest. Id. 165-66. This court agrees with the United States Tax Court and concludes that interchange is not a fee for any service other than lending money to cardholders, income from which is generally treated as interest.

Before credit cards, merchants had two options for payment, cash on delivery or house credit account. With a house credit account, the merchant undertook the credit risk. If payment was not made, the merchant could attempt to collect on its own or could sell the receivable to a factorer. The factorer would purchase the obligation at a discount and try to collect the full

amount without the discount. With credit cards, the merchant takes a small discount (the interchange) on each credit transaction in exchange for what is essentially instant payment and elimination of the credit risk, the processing costs of maintaining house accounts and the cost of carrying accounts (time value of money). Without credit, either house account or credit card, the merchant would lose sales. Credit card sales allow the extension of credit with the merchant accepting a discounted payment in exchange for sure payment.

The issue about who really bears the cost of interchange is largely academic. Id. at 166. Whether merchants, acquiring banks or cardholders ultimately pay interchange is not determinative of the tax treatment of interchange. Id. at 166-67. Even accepting the argument that the issuing bank pays interchange, it would still be concluded that interchange is properly treated as creating or increasing OID on the pool of loans to which it relates. Id. at 167. Interchange is part of the lending transaction. Ibid. The primary purpose of interchange is to encourage issuing banks to lend money to cardholders so cardholders can make purchases.

Since interchange is indeed interest, the rationale which is set forth in the proceeding section as to the CBT treatment of interest is incorporated herein. But for taxpayers having

cardholders in New Jersey, they would not derive any interchange interest. Thus, interchange is properly allocable to New Jersey.

V. **FEES**

In addition to interest and interchange, the taxpayers here earn fees through the issuance of credit cards to New Jersey residents. These fees include late fees, return check fees, over the limit fees, non-sufficient funds fees and annual fees. These fees are paid directly by the cardholders to the taxpayers.

The question arises as to the allocation of the fees to New Jersey under the CBT. As explained above, the CBT is calculated by determining the portion of net income from everywhere (including New Jersey) which is attributable to New Jersey. This is accomplished through an allocation formula consisting of a property, payroll and receipts fraction. As to service fees, the receipts fraction is pertinent. The numerator of the receipts fraction consists of receipts within the state and the denominator of the receipts fraction consists of receipts both inside and outside the state. For the period in question, the receipts fraction was double weighted which means it was doubled and then added to the single weighted property and payroll fractions which are calculated in a manner similar to the calculation of the receipts fraction. The sum of the property, payroll and doubled

receipts fractions were divided by four. The resulting fraction was then multiplied by the net income of the corporation both inside and outside the state to arrive at the apportionment of net income attributable to New Jersey. The resulting amount was then utilized to calculate the tax.

As a starting point, N.J.S.A. 54:10A-6 provides that the receipts fraction for calculating the corporation business tax includes sales for both "services performed within the State" and "all other business receipts . . . earned within the State." N.J.S.A. 54:10A-6(B)(4), (6).

To implement the receipts allocation formula, the Director has adopted regulations specifically allocating service fees. These regulations provide in pertinent part:

> (c) Certain service fees from transactions having contact with this State are allocable to New Jersey based upon the following:
>
> 1. Twenty-five percent of such fees are allocated to the state of origination.
>
> 2. Fifty percent of such fees are allocated to the state in which the service is performed.
>
> 3. Twenty-five percent of such fees are allocable to the state in which the transaction terminates.
>
> Example 1: A taxpayer issues credit cards to its customers allowing funds to be obtained through the use of authorized machines located within New Jersey. A

customer originates a transaction at a New Jersey location, and the taxpayer's computer, located outside this State, performs a credit check. Funds (or a bank draft) are received by the customer at the point of origin in New Jersey, where the transaction terminates. Taxpayer must allocate 50 percent of the service fee income earned from this transaction to New Jersey based upon the points of origination and termination. For purposes of this example the issuer of credit cards has nexus with New Jersey through physical presence in New Jersey.

Example 2: Taxpayer earns income by providing on-line internet access to customers located within New Jersey and outside New Jersey. Taxpayer's physical equipment allowing such access is located outside New Jersey. Taxpayer must allocate 50 percent of its revenue from internet access charges to New Jersey based upon the origination and termination of such access from points within New Jersey. Absent specific identification of points of origination and termination, the customer's billing address will serve to locate these activities. For purposes of this example, the internet service provider has physical presence through a home office located in New Jersey.

[N.J.A.C. 18:7-8.10(e).]

The taxpayers argue that the service fees should be excluded from the numerator of the allocation fraction in toto. The taxpayers rely upon a narrow reading of the receipts allocation statute. In particular, subsection 4 of the receipts allocation statute includes "services performed within the state". The taxpayers argue that the fees in question were for services not performed within New Jersey, but rather at the home offices of

taxpayers in Delaware and North Carolina and therefore cannot be part of the allocation formula.

However, this ignores subsection 6 that includes "all other business receipts ... earned within the state." Taxpayers argue that subsection 6 would not be applicable because services such as the service fees in question are already addressed in subsection 4. In other words, the taxpayer's position is that once the service fees are excluded as a "service" performed in this state under subsection 4, the same service fees cannot be included as being earned in this state under subsection 6.

In the alternative, the taxpayers argue that the allocation formula set forth in the regulations which allocates twenty-five percent to the origination state, twenty-five percent to the destination state and fifty percent to where the service is performed must be calculated with exactitude, thus rendering the 25-50-25 percent allocation formula ultra vires.

The New Jersey Supreme Court dealt with the interplay between the catch-all provision in subsection 6 and specific provisions in the other subsections of the receipts allocation formula in Stryker Corp. v. Dir., Division of Taxation, 168 N.J. 138 (2001). Stryker was the manufacturer of orthopedic hips and knees located in New Jersey. The products were sold at retail by Osteonics, also located in New Jersey. Osteonics would market and sell Stryker's products and transmit orders to Stryker's computers.

Stryker would then pack and ship the products directly to Osteonic's customers, many of whom were located out of state. The process of a product being shipped directly from the manufacturer is referred to as drop-shipping. This is in lieu of the manufacturer shipping the product to the retailer who then ships the product to the customer.

Subsection 1 of the receipts allocation formula provides that the receipts fraction includes sales of tangible personal property located within the State to other locations within the state. In other words, if the product is shipped out of state, it is not included in the receipts allocation formula. Stryker argued that the sales to Osteonics were not within subsection 1 since Stryker made no shipment of products to Osteonics. Instead, the drop-shipped products which went directly to the customers out of state fell outside of subsection 1.

Applying the doctrine of ejusdem generis, Stryker then argued that since its activities of shipping the product out of state are specifically addressed by subsection 1, the catch-all provision of subsection 6 does not apply. Ejusdem generis provides that "when general words follow specific words in a statutory enumeration, the general words are construed to embrace only the objects similar in nature to those objects enumerated by the preceding specific words." Id. at 155-156. In rejecting the application of ejusdem generis to the CBT provision, the Court

cited its earlier decision in Edwards v. Mayor, Council of Moonachie, 3 N.J. 17, 23 (1947) in which the Court stated:

> The rule of ejusdem generis is in aid of construction where the expression is of doubtful meaning; and it has no application where the legislative design is expressed in plain and unambiguous terms. The doctrine is a specific application of the maxim "noscitur a sociis;" and it would be a perversion of the essential purpose if it were allowed to render general words meaningless. It is not an absolute formula that overrides all other canons of interpretation; and it is never applied to defeat the legislative purpose revealed by the provision in its entirety, giving to all the terms their normal sense and significance. . . . As with all other canons of construction, the doctrine yields to the intention revealed by the context, viewing the language in its ordinary acceptation.
>
> [Stryker, supra, 168 N.J. at 156.]

And the court continued:

> Such a rule must be subordinated to the paramount purpose of construing a statute to ascertain the legislative intent. Although the Legislature enumerates specific objects or conditions which have come to their attention, this enumeration is not intended to limit the operation of the statute to the specific objects set forth. Thus, many modern commentators have been critical of the ejusdem generis rule because it creates a manifest bias toward the strict construction of statutes.
>
> [Id. at 157 (citation omitted).]

In the end, the Court did not squarely address whether the drop-shipments were included or not under subsection 1. Rather,

the Court recognized that the subsection 6 "loophole" closing provision would require that the disputed receipts be included in the allocation fraction. Id. at 159.

Stryker is not the first time the New Jersey Supreme Court rejected the use of so-called statutory maxims in interpreting the CBT. In Avco, the taxpayer argued that the mobilia maxim applied to the sourcing of interest receipts. The Court rejected this proposition on the basis that the Legislature never indicated that this maxim would be determinative of how the statute is interpreted. Avco, supra, 100 N.J. at 37. Thus, in interpreting in the CBT, the ancient maxims of construction are not applied unless specifically indicated by the Legislature.

The Legislature has clearly departed from the limiting maxims represented by ejusdem generis and mobilia sequuntur personam when enacting the CBT. Obviously recognizing this departure when deciding Stryker in 2001, the New Jersey Supreme Court held that "the catch-all provision under (B)(6) should be interpreted to allow the Division to plug loopholes in the CBTA." Id. at 159. Subsequently, in 2002, the CBT was amended. The Assembly Committee Statement for the bill amending the CBT indicated that the purpose of the bill was to "close[] numerous loopholes that allows many profitable companies to reduce their taxable New Jersey income." Assembly Budget Comm., Statement to A., No. 2501, at 1 (June 27, 2002). Moreover, the bill contained a number of

"loophole closers." One of these loophole closers was extending the CBT to constitutional limits to reach all income corporations derive in New Jersey. Budget Committee Statement to A., No. 2501, supra, at 4. While the bill did not specifically deal with the catch-all provision under (B)(6), it demonstrates the continuing commitment of the Legislature to close loopholes in the CBT.

In the case at hand, taxpayers argue that the services were performed in Delaware and North Carolina since subsection 4 only applies to services performed in New Jersey, such services have no impact upon the numerator of the sales fraction. However, this ignores the catchall provision of subsection 6 which was designed to plug loopholes. Subsection 6 sweeps in all business receipts earned within the state.

The sole question now becomes whether the service fee receipts from taxpayers' New Jersey customers are earned in New Jersey. Stryker, supra, 168 N.J. at 158; Flagstar, supra, 29 N.J. Tax at 153. The receipts for service fees here are not discrete services but are part and parcel with a New Jersey customer having one of the taxpayers' credit cards. Without the underlying credit card relationship, the service fees in question would not arise. It is plain to see that the desire of New Jersey customers to have taxpayers' credit card accounts is the basis for the receipts earned by taxpayer. If there was not any demand for taxpayers' credit card accounts in New Jersey, the taxpayers would not have

any service fee receipts earned in New Jersey, and thus no allocation based upon the statutory receipts fraction.

Unlike getting a haircut or a carwash, the situs of the service provided here is amorphous. With a haircut or carwash, one can clearly define where the service is performed. In such cases, the benefit of the service provided is the same as where the service is performed. For example, if one gets a haircut performed in North Carolina, the benefit of that haircut also occurs in North Carolina.

When the statute was first enacted in 1945, a service, which by definition is intangible, was likely to be performed upon a tangible object. Examples include the intangible service of cutting which is performed upon the tangible object of hair. With modern financial transactions, the intangible service of a late fee, is performed upon another intangible, the credit card account. Thus, there is not a tangible object like a head of hair existing at a particular situs. Rather, an intangible credit card account exists everywhere one has access to telecommunications equipment to access the account (i.e., internet, cellphone).

With an annual fee, late fee or some other fee, there is not any dispute that the fee is imposed upon the New Jersey customer regardless of whether the customer ever goes to the corporate headquarters of taxpayers in Delaware or North Carolina. Taxpayers argue that the benefit of the service fee is being

performed in part in Delaware or North Carolina since that is where the service fee is processed. However, no benefit is being provided to the customer in Delaware or North Carolina. Rather, the benefit of the service fee which is part and parcel of having the credit card account is being derived (and paid for) by the New Jersey customer of taxpayer. Simply stated, the benefit of the service is being provided in New Jersey and is earned in New Jersey.

The taxpayers can choose to locate their businesses wherever they want. However, without the New Jersey customers, there would not be any earnings in New Jersey regardless of the home state of the taxpayers. The economic reality is that the taxpayers have their money invested here in New Jersey through unsecured credit card loans which are being repaid by New Jersey customers. Where the taxpayers choose to process the loans, including service fees, is of no consequence. The revenue being derived here is not from the service provided by any late fee or other fee, but by the service of lending money to the customer.

The courts have recognized that the three-factor formula at issue was initially developed for a manufacturing economy. In the manufacturing context such as in Stryker, the receipts fraction subsections look to where the benefit is derived, not where the manufacture of the product is performed. Thus, a product whose manufacture was performed in New Jersey is not allocable to

New Jersey unless it is sold in New Jersey. N.J.S.A. 54:10A-6(B)(1). Likewise, a product whose manufacture was performed outside the state is not allocable to New Jersey unless a New Jersey consumer has the benefit of having the product shipped to him or her. N.J.S.A. 54:10A-6(B)(2).

When it comes to services in a service-based economy, the application of the three-factor formula becomes awkward at times. That is because a service is intangible, whereas a manufactured product is tangible. One can easily see where a manufactured product is, one cannot readily see where a service is. However, that does not provide the basis for a service provider to escape their fair proportion of taxation, while a manufacturer does not. Id. at 156. Just like the manufacturer, the service provider allocation should be based upon where the benefit of the service is derived or earned, not necessarily where the service is technically performed.

When the CBT was adopted in 1945, New Jersey and the United States had a manufacturing-based economy. That has shifted over time to a more service-based economy. In fact, in New Jersey in 1943, there were two goods producing manufacturing jobs for every service job. For 2013, the ratio is eight service jobs to every goods producing job. James W. Hughes & Joseph J. Seneca, New Jersey's Postsuburban Economy 2 (Rutgers University Press eds., 2015). Moreover, with the advent of advanced telecommunications

technologies such as the internet, the decentralization of many service based activities has increased. For example, taxpayers argue that the services are performed in Delaware or North Carolina and thus allocable to those states. However, what if the taxpayer's computers are located in Delaware, but the employees operating or entering the data to process the service fees are located in another state such as California, or even New Jersey? In the reverse, what if the employees located in Delaware are operating a computer in California, or New Jersey, which processes the fees? This slicing and dicing of where the service is processed ignores the economic realities of where the income from the transaction derives as well as the legislative purpose of fairly apportioning a corporation's net income to where the benefit of the service is performed.

In addition, with the increasing telecommunications infrastructure such as the internet and cellular telephones, services are no longer being processed locally. There was a time when one went to a local bank for a loan. Things have changed since 1945. Telecommunications in 1945 was a world without area codes in which any call outside one's local area had to be patched through by multiple operators.[12] Now, the New Jersey consumer has

[12] Direct dial long distance telephone calls were not commercially inaugurated until 1951. Kenneth Love, Englewood Ready to Dial U.S. Today, N.Y. Times, Nov. 9, 1951, at 19.

the option of easily dealing with a multitude of banks and lenders over the internet. However, the benefit of the service performed for the New Jersey customer still occurs in the same place, New Jersey. And, the income which the corporation derives still comes from the same place, New Jersey.

The Legislature in adopting and amending this legislation over the years has clearly looked to having corporations which derive a benefit (i.e. monetary receipts) from New Jersey contribute their fair share to the support of the government that facilitates an economic environment that fosters economic activity. Through subsection 6, the Legislature is not looking to tax economic activity that does not result in an economic benefit to a taxpayer that is derived from New Jersey.

When adopted in 1945, subsection 4 which only looked to performance, worked well in a local economy in which the location of performance and the location of the benefit were conterminous. However, in a global economy, applying subsection 4 without subsection 6 would result in manufacturers of tangible products that provide beneficial products to New Jersey consumers having to shoulder an unfair burden of taxation as a result of service providers escaping taxation for services that also provide a benefit to New Jersey consumers.

At least one prior decision of this court has recognized that allocating the service to where the customer is located is

appropriate. In Mayer & Schweitzer, Inc. v. Director, Div. of Taxation, 20 N.J. Tax 217 (Tax 2002), the business was located in New Jersey with the customers out of state. The taxpayer in Mayer & Schweitzer was in the wholesale business of selling securities, an intangible product. The Court concluded that the taxpayer correctly allocated its receipts to the location of its customers and not to the location of its traders.

The Mayer & Schweitzer court also noted that the three-factor formula was initially designed for a manufacturing economy. The three-factor formula becomes more difficult to apply to receipts from the sale of services, or receipts from the sale of intangibles. In dealing with intangibles, distinguishing between the destination of securities and money is very ephemeral.

Under the facts of Mayer & Schweitzer, the taxpayer earned its income by selling securities at a higher price than originally purchased, not by charging commissions to the dealers who purchased the securities offered by the taxpayer. Thus, the taxpayer sold intangibles to purchasers in other states and New Jersey. Notably, the activities of the taxpayer’s salespeople in New Jersey were virtually identical to the activities of the salespeople of a company selling tangible goods which are delivered out of state. The court emphasized that the structure of a taxing system designed for a manufacturing economy must adapt itself to the realities of modern business practice and an economy

which raises revenues from sources other than the sale of tangible goods. Id. at 230. Thus, the sale of the intangible securities had been integrated with the business carried on in other states.

Finally, the Mayer & Schweitzer Court indicated that to allocate the bulk of its sales as well as the bulk of its payroll and property in New Jersey would result in an unfair apportionment of income. This case demonstrates that in the case of intangibles, New Jersey law provides that an intangible will be taxed at the location of the customer regardless of whether that determination is advantageous to the State of New Jersey.

The application of a state corporation tax to credit card accounts has been considered by a number of other states, albeit in a different context. In other states, the constitutional requirement of sufficient nexus was being challenged (nexus is discussed later in the opinion). Even though nexus has been conceded by the taxpayers here, the decisions of the other states are still instructive.

The Supreme Court of West Virginia, the Supreme Judicial Court of Massachusetts, and the Indiana Tax Court have recognized that "electronic" commerce now makes it possible for an entity to have a significant economic "presence in a state." Tax Comm'r v. MBNA Am. Bank, N.A., 640 S.E.2d 226, 234 (W. Va. 2006); Capital One Bank v. Comm'r of Revenue, 899 N.E.2d 76, 86 (Mass. 2009), MBNA Am. Bank, N.A. v. Ind. Dep't of State Revenue, 895 N.E.2d

140, 143 (Ind. Tax Ct. 2008). The West Virginia Supreme Court recognized it is no longer necessary for entity to have some sort of warehouse, office or salesperson in a state to generate substantial business in-state. MBNA Am. Bank, N.A., supra, 640 S.E.2d at 171. The court eschewed rigid and mechanical legal formulations which it tempered with healthy doses of fairness and common sense. Ibid. Overall, case law which was written well before electronic commerce or even the word "internet" existed cannot be used to pigeonhole and defeat the reach of a state's corporate tax.

Upon amendment in 2002, the CBT is to apply to the extent which the Constitution allows. The CBT like any other statute must not reach beyond the bounds the Constitution allows. This does not have to be expressed in the statute. However, the legislators explicitly indicate that the CBT must not only stay within constitutional bounds, but that it is to extend to the full boundaries which the Constitution allows. These words are not superfluous. The Legislature is presumed to not use superfluous wording; which means that all words are to be given effect. Flexx Petroleum Corp. v. Dir., Div. of Taxation, 12 N.J. Tax 1, 12 (Tax 1991).

The impact of the Legislature's pronouncement is that the CBT is to be broadly and liberally read in favor of taxation. This clearly abrogates the maxim that tax statutes are to be

narrowly read when it comes to interpreting the CBT. Secondarily, the statutory phrase goes further than just a liberal reading. The CBT is to be read to the bounds allowed under law, the law in this case being the Constitution.

The taxpayers, while conceding nexus, still attempt to limit the reach of the statute by relying upon the statutory language of Section 6 alone. However, the statutory language of the allocation formula alone, without considering the scope of the CBT set forth in another section, is not the test of the reach. The Legislature plainly indicated that the reach extends to constitutional limits. Thus with the 2002 amendment, the Legislature extended or at least confirmed the broad reach of the statute.

Finally, the same arguments which apply to fees are as equally and as forcefully applied to interest and interchange. See, e.g., Flagstar Bank, supra, 29 N.J. Tax at 155-156 (applying CBT to interest and origination "fee"). The fact that interest and interchange also have separate and distinct grounds for allocation to New Jersey (which has already been discussed) does not mean that fees are somehow less worthy of allocation to New Jersey.

Without proceeding any further, for all the reasons stated above, this Court determines that 100% of the fee receipts are attributable to New Jersey. However, that is not the end of the

story. "Allowing the catch-all provision [of subsection 6] to embrace such receipts is consistent with the powers that the Legislature has given the Division to adjust a corporation's allocation factor to effect a fair and proper allocation of the entire net income and the entire net worth reasonably attributable to the state." Stryker Corp., supra, 168 N.J. at 159 (citing N.J.S.A. 54:10A-8(e)). "Hence, the Act gives the Director broad authority to adjust the allocation factor in order to reflect more accurately and fairly the activity, business, receipts, capital, entire net worth, or entire net income of a taxpayer reasonably referable to the state." Metromedia, Inc. v. Director, Division of Taxation, 97 N.J. 313, 323 (1984) (citing N.J.S.A. 54:10A-8).

A fair and proper allocation can be implemented by the Director two ways. The first procedure allows a determination on a case by case quasi-adjudicatory basis if the issue is specific to a taxpayer. The second procedure is quasi-legislative and consists of the adoption of an administrative rule of general applicability and continuing effect. Id. at 332-33. For either procedure, "language of the statute [N.J.S.A. 54:10A-8(e)] vests broad authority in the Director to determine what income producing activity of the taxpayer is reasonably referable to its business in New Jersey, so that this income can appropriately be used in the measure of the franchise tax. This statutory scheme recognizes that this is a highly specialized decision that entails

considerable discretion." Id. at 324. The Legislature has empowered the Director to adopt regulations to implement the broad language of N.J.S.A. 54:10A-8(e) and fill in the interstices of the CBT Act. Id. at 336. See also N.J.S.A. 54:10A-27.

In this case, the Director adopted a regulation in 1997 that provides that certain service fees from transactions having contact with the state are allocable to New Jersey as follows: (1) 25% of such fees are allocated to the state of origination; (2) 50% of such fees are allocated to the state in which the service is performed; and (3) 25% of such fees are allocable to the state in which the transaction terminates. N.J.A.C. 18:7-18.10(c).

Moreover there are three general principles that must be applied in interpreting what the Director has done in this case. First is that the Director's determinations are entitled to a presumption of validity. Atlantic City Trans. Co. v. Director, Div. of Taxation, 12 N.J. 130, 146 (1953). The presumption in favor of the taxing authority can be rebutted only be cogent evidence that is definite, positive and certain in quality and quantity to overcome the presumption. Pantasote v. City Passaic, 100 N.J. 408, 413 (1985). See also Yilmaz v. Director, 390 N.J. Super. 435, 23 N.J. Tax 361, 366 (App. Div.), certif. denied, 192 N.J. 69 (2007).

The second general legal principal is that the Director's regulations are presumptively valid and should receive deference from the Court unless they are inconsistent with the provisions of the statute they interpret. Koch v. Dir., Division of Taxation, 157 N.J. 1, 8 (1999). The regulation at issue here addressing the allocation factor is not inconsistent with the statute. If anything, the regulation provides an advantage to the taxpayer by reducing the allocation for the service fees from 100% down to 50%.[13]

The third general legal principal is that taxpayers are bound by the tax consequences of their business decisions. General Trading Co. v. Director, Div. of Taxation, 83 N.J. 122, 136 (1980). The taxpayer is free to organize its business affairs as it chooses but nevertheless once having done so must accept the tax consequences of its choice whether contemplated or not. The taxpayers made the decision to conduct business in New Jersey and as a result have to accept the tax consequences of that choice, namely the payment of corporation business tax to the State.

Considering the broad discretion of the director generally to establish regulations, and the specific discretion to make adjustments to CBT allocations under Section 8, this Court is

[13] As already stated, supra, this court could readily find that upon striking down the regulation a 100% allocation of the service fee would be appropriate and within the boundaries of the law.

hesitant to invalidate the regulation as it now stands. Invalidating the regulation would be an advantage to the Director who adopted the regulation in the first instance. The Director is free to rescind the regulation in the future if he deems necessary. However, for purposes here, the Director is bound to his own regulation resulting in only 50% of the service fee income allocable to New Jersey.

In the alternative, the taxpayers suggest that if allocation between the performing state and the benefit state (where the transaction originates and terminates) is appropriate, the 25-50-25 allocation is incorrect.

The taxpayers here have failed to demonstrate that the percentage allocated to New Jersey is somehow flawed and unconstitutionally impermissible. The New Jersey Supreme Court and the United States Supreme Court do not require mathematical certainty or exactitude in an apportionment. Container Corp. of America v. Franchise Tax Board, 463 U.S. 159, 169, 103 S. Ct. 2933, 2942, 77 L.Ed. 2d 545, 555 (1983); Whirlpool Props. Inc., supra, 208 N.J. at 150. Rather, all that is sought is rough approximation of fairness. Ibid. A requirement of exactitude is not only administratively impractical but would be subject to the shifting sands of legislative enactments over fifty states and other jurisdictions regarding taxation. Ibid. A slight change in any one state could throw the whole balance off invalidating the

tax statutes of 49 others. Ibid. The constitutional mandate of a fair approximation should not be equated with exactness, but permitting invalidation only upon a showing of clear and cogent evidence to not be rationally related to the benefits conferred. Id. at 170. This is a heavy burden for a taxpayer and a heavy burden which the taxpayers in this case do not sustain.

To summarize, the court has four possible outcomes when dealing with the service fees issue. The first possible outcome would be that the catch-all provision of subsection 6 does not reach business receipts earned in this state, by claiming the service is not performed in this state. This outcome, which is the taxpayers' primary position, is rejected for the reasons set forth above.

The second possible outcome is that the regulation is simply inapplicable or beyond the rulemaking authority of the Director and therefore full taxation would apply to the transaction. While the court has determined above that 100% of the fees can be allocated to New Jersey, such a ruling would improperly undercut the discretion vested in the Director to make such an adjustment based upon his expertise. It is not this court's job to second-guess the Director's expertise and determine whether the same decision would have been reached in adopting the regulation. Newark v. Natural Res. Council in Dept. of Envtl. Prot., 82 N.J. 530, 539 (1980). Rather, this Court must examine the regulation

to determine whether it is arbitrary or capricious. Ibid. The Director’s interpretation is more favorable to the taxpayers than what this court would have done if no regulation existed. The court is thus inclined to defer to the Director’s interpretation.

This leads to the third possible outcome which is the 25-50-25 allocation set forth by the Director. For the reasons set forth, this third option is the ruling of this court.

The fourth possible outcome would be that the percentages in the regulation do not properly allocate the receipts between New Jersey and the other states. However, the “statutory three-ply formula can only approximate the taxpayer’s true net worth and income generated by its New Jersey activities.” Metromedia Inc., supra, 97 N.J. at 323. Likewise, the Director’s regulation does not need to be exact, but only needs to provide a fair approximation of the amount due. Ibid. These issues of a fair approximation are further discussed under the issues concerning the constitutionality of the provision. See infra.

VI. CONSTITUTIONAL ISSUES

Prior to 1938, the United States Supreme Court construed the Commerce Clause as affording a sort of free trade immunity from state taxation. See Complete Auto Transit, Inc., supra, 430 U.S. at 278-79, 97 S. Ct. at 1079, 51 L.Ed. 2d at 330-331. Then in 1938, the Supreme Court proclaimed that “[i]t was not the purpose

of the commerce clause to relieve those engaged in interstate commerce from their just share of state tax burden even though it increases the cost of doing the business." Western Live Stock, supra, 303 U.S. at 254, 58 S. Ct. at 548, 82 L.Ed. at 827.

New Jersey adopted the CBT in 1945 and shortly thereafter the United States Supreme Court issued a number of decisions considered a retrenchment from its earlier 1938 decision. See, e.g., Freeman v. Hewit, 329 U.S. 249, 67 S. Ct. 274, 275, 91 L.Ed. 265, 270 (1946); Spector, supra, 340 U.S. 602, 71 S. Ct. 508, 95 L.Ed. 573. Continuing from the late 1940's through the late 1970's, there were a number of decisions that found unconstitutional franchise taxes for the privilege of engaging in activity that is part of interstate commerce, while at the same time approving taxes on income so long as same are fairly apportioned, nondiscriminatory and there is sufficient nexus.[14]

By the end of the 1970's, "the Spector rule, as it has come to be known, ha[d] no relationship to economic realities. Rather it st[ood] only as trap for the unwary draftsman." Complete Auto, supra, 430 U.S. at 279, 97 S. Ct. at 1079, 51 L.Ed. 2d at 331. The rule was regarded "as a triumph of formalism over substance." Id. at 281. It "had come to operate only as a rule of

[14] States reacted to this by adopting second tier taxes such as the Corporation Income Tax in an effort to work around the limitations imposed by the Court. See Avco, supra, 4 N.J. Tax at 32.

draftsmanship, and served only to distract the courts and parties from their inquiry into whether the challenged tax produced results forbidden by the Commerce Clause." Id. at 285.

In 1977, the Supreme Court refocused the inquiry upon the practical effects of the tax when it overruled the Spector rule. Id. at 289. The Complete Auto court focused upon four factors, while cited by the Court previously, were not fully synthesized in prior decisions of the Court. Id. at 279. The four factors require that there be 1) substantial nexus, 2) fair apportionment both internally and externally, 3) non-discrimination as to interstate commerce, and 4) a fair relation to presence and activities of the taxpayer within the state. Complete Auto, supra, 430 U.S. at 277-78, 97 S. Ct. at 1078-79, 51 L.Ed. 2d at 330.

The taxpayers in this case have conceded nexus. However the three other factors remain.[15] [16]

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[15] Nexus is required under both the Due Process and the Commerce Clause. Due Process nexus merely requires purposeful direction of activities to the state. Commerce Clause nexus requires more of a connection in which at least some of the business is conducted in the state. Whirlpool Props., supra, 208 N.J. at 164.

[16] One reason taxpayers may have conceded nexus is a result of a Voluntary Disclosure Agreement entered between the Director and the taxpayers. Said agreement waives taxpayers' right to seek a refund on the basis of nexus. However, contrary to the Director's argument, the agreement does not bar a challenge on other grounds. If the Director wanted a broader agreement, the Director could have bargained for same.

The thrust of the taxpayers' argument seems to focus on the second prong, that is, whether the tax is fairly apportioned. The taxpayer has the burden of establishing by clear and cogent evidence that the income attributed to the State is in fact out of all appropriate proportions to the business transacted. Container Corp., supra, 463 U.S. at 180-181, 103 S. Ct. at 2948, 77 L.Ed. 2d at 563. However, the Constitution does not automatically invalidate an apportionment formula whenever it may result in taxation of some income that did not have its source in the taxing state. Id. at 180.

The issue of fair apportionment is broken down into two separate considerations, external consistency and internal consistency. Internal consistency analyzes the hypothetical function of a tax formula, not its real world effects on a taxpayer. This component looks to the structure of the tax at issue to see whether its identical application by every state in the union would place interstate commerce at a disadvantage as compared to the intrastate commerce. Based upon the taxpayers' argument, the focus here does not seem to be upon internal consistency. As applied, the CBT only reaches income generated by New Jersey cardholders. If New Jersey's CBT were in effect in every state, each state would only reach income generated by cardholders of each respective state. Since this would not result

in double taxation when applied in each state, there is internal consistency.

External consistency, the second and more difficult requirement of fair apportionment, is satisfied only if "the factor or factors used in the apportionment formula actually reflect in a reasonable sense of how income is generated." Container Corp., supra, 463 U.S. at 169, 103 S. Ct. at 2942, 77 L.Ed. 2d at 556; Whirlpool Props., supra, 208 N.J. at 165. "External consistency looks to the economic justification for the State's claim upon the value taxed, to discover whether a State's tax reaches beyond the portion of the value that is fairly attributable to the economic activity within the taxing state."[17] Oklahoma Tax Comm'n v. Jefferson Lines, 514 U.S. 175, 185, 115 S. Ct. 1331, 1338, 131 L.Ed. 2d 261, 272 (1995). Whirlpool Props., supra, 208 N.J. at 165. "Stated simply, the question is whether the State tax law reasonably reflects the activity within its jurisdiction. The external consistency test requires a practical inquiry into the interstate activity taxed in relation to the activity in the taxing jurisdiction." Whirlpool Props., supra, 208 N.J. at 165.

[17] Due Process similarly requires that "the income attributed to the State for tax purposes must be rationally related to values connected with the taxing State." Moorman Mfg. Co. v. Bair, 437 U.S. 267, 273, 98 S. Ct. 2340, 2344, 57 L.Ed. 2d 197, 204 (1978).

In Container Corp., the Court specifically evaluated California's three-factor formula and determined that it satisfied external consistency. Container Corp., supra 463 U.S. 159, 182-86, 103 S. Ct. 2933, 2949-51, 77 L.Ed. 2d 545, 564-66. The Court also noted that the three-factor formula first approved in Butler Bros. v. McColgan, 315 U.S. at 501, 62 S. Ct. at 701, 86 L.Ed. at 991 has become something of a benchmark against which other apportionment formulas are adjudged. Container Corp., supra, 463 U.S. at 170, 103 S. Ct. at 2942, 77 L.Ed. 2d at 556.

There has not been any showing made by the taxpayers in this matter that by attributing all the income to where the customers are located in applying New Jersey's three-factor formula double-weighted for receipts results in some sort of external inconsistency.

While the taxpayers may be unhappy with the fact that the income is apportioned to its New Jersey customers, mere dissatisfaction does not rise to the level of invalidating the apportionment applied in this case. If anything, a double-weighted receipts factor more closely approximates a taxpayer's activities in a state rather than the standard single-weighted receipts factor considered in Container Corp. or Butler Bros. This does not result in a situation such as the Court faced in Hans Rees' in which an apportionment method based entirely on ownership of tangible property resulted in an attribution rate of between 66%

and 85% of the taxpayers' income, while a separate accounting resulted in an attribution rate of no more than 21.7% to the state. Hans Rees', supra, 283 U.S. at 134, 51 S. Ct. at 389, 75 L.Ed. at 906. The Court struck down such a provision because it "reach[ed] profits which in no just sense [were] attributable to transactions with [the] jurisdiction." Ibid. Thus, a double weighted sales factor is more likely than a single weighted formula to result in an attribution to the taxing state that more closely reflects the net income derived from the state.

Likewise, when a related challenge arose in Amerada Hess v. Dir., Div. of Taxation, 490 U.S. 66, 109 S. Ct. 1617, 104 L.Ed. 2d 58 (1989), the United States Supreme Court specifically upheld New Jersey's three-factor formula consisting of property, payroll and single weighted receipts then utilized by the State of New Jersey. (Double weighted receipts were put in effect 6 years later by legislative enactment.) Certainly, in accord with Hans Rees', the double weighted receipts factor at issue here which places an even greater emphasis on receipts rather than a mere single weighted factor which survived constitutional challenge.

"Geographical accounting and formula apportionment are imperfect proxies for an ideal which is not only difficult to achieve in practice but also difficult to describe in theory." Container Corp., supra, 463 U.S. at 159, 103 S. Ct. at 2949, 77 L.Ed. 2d at 564. Apportionment formulas are generally upheld

except for the occasions when there is such a "distortive effect focusing on only one factor [that is] so outrageous to require a reversal." Id. at 182-183.

"The three factor formula has gained wide approval precisely because payroll, property and sales appear in combination to reflect a very large share of the activities by which value is generated." Id. at 183. Nevertheless, the Court has recognized that even the three-factor formula is necessarily imperfect, and at times can be based upon very rough economic assumptions. Id. at 183, 184 n.20.

To put it all in perspective, "[a]llocating income among various taxing jurisdictions bears some resemblance . . . to slicing a shadow. In the absence of a central coordinating authority, absolute consistency, even among taxing authorities whose basic approach to the tax is quite similar, might just be too much to ask. If [three-factor] formula apportionment inevitably led to double taxation, that might be reason enough to render it suspect. But since it does not it would be perverse, simply for the sake of avoiding double taxation, to require a state to give up one allocation method that sometimes results in double taxation in favor of another method that also sometimes results in double taxation". Id. at 192-93.

While taxpayers here wring their hands and allege that New Jersey's version of the three-factor formula unfairly allocates

taxation, taxpayers do not allege any clear and cogent evidence that the formula as implemented results in such a distortive effect that is so outrageous to require invalidation.

The third prong is described as the discrimination prong which addresses the "basic dormant commerce clause proscription against states using taxes to promote in-state businesses at the expense of out-of-state businesses." Whirlpool Props., supra, 208 N.J. at 165. See also, Complete Auto, supra, 430 U.S. at 281, 97 S. Ct. at 1080, 51 L.Ed. 2d at 332. Such prohibited discrimination includes not only disparate treatment, in which the tax explicitly puts greater burdens on out-of-state business, but also disparate impact in which a facially neutral law disproportionately impacts out-of-state business. Whirlpool Props., supra, 208 N.J. at 166. Here, there is not any indication that the tax treats out-of-state businesses any differently than in-state businesses or has a disparate impact on out-of-state business. Taxpayers generate income by New Jersey consumers having credit card accounts. The tax is focused upon the source of the income, not the location of the recipient of the income. Whether a taxpayer is based in New Jersey, or somewhere else, the rate of taxation is the same.

Moreover, the Director promulgated a regulation as to services which allocates 25% to the where the service originates, 25% to where the service terminates, and 50% to where the service

is processed. N.J.A.C. 18:7-8.1. This regulation reduces the amount an out-of-state taxpayer is allocated for services and is neither disparate treatment, nor a disparate impact upon out of state taxpayers.

The final or fourth prong is that of fair relation which examines whether taxpayers receive benefits from the taxing state. Whirlpool Props. Inc., supra, 208 N.J. at 167. However, this is not to suggest the now discarded benefits theory of taxation is in play. That theory suggests that a taxpayer should only pay a tax in proportion to the benefit received. The modern approach focusses upon the ability to pay for the common good. See generally, Ajay K. Mehrotra, Making the Modern American Fiscal State (Cambridge 2013). As synthesized by the United States Supreme Court:

> A tax is not an assessment of benefits. It is, as we have said, a means of distributing the burden of the cost of government. The only benefit to which the taxpayer is constitutionally entitled is that derived from his enjoyment of the privileges of living in an organized society, established and safeguarded by the devotion of taxes to public purposes. Any other view would preclude the levying of taxes except as they are used to compensate for the burden on those who pay them, and would involve abandonment of the most fundamental principle of government -- that it exists primarily to provide for the common good.
>
> [Commonwealth Edison Co. v. Mont., 453 U.S. 609, 622-623, 101 S. Ct. 2946, 2956, 69 L.Ed. 2d 884, 897-98 (1981).]

Here, there is not any serious doubt that the taxpayers in this case utilized the benefits of or have available to them the benefits of this state including its court system for collection of debt and its infrastructure for payment, marketing and servicing of its accounts held by New Jersey cardholders. Thus, the taxation of taxpayers is a fair relation to their generation of income in this state.

Overall, with the exception of the throwout rule, discussed infra, the taxpayers challenge on constitutional grounds fails.

VII. THROWOUT RULE

In effect from 2002 through 2010, the throwout rule affected the allocation factor used by the Director for purposes of determining what portion of the income of a corporation is subject to taxation under the Corporation Business Tax. L. 2002, c. 40, § 8, codified at N.J.S.A. 54:10A-6(B)(repealed). Without application of the throwout rule, the receipts fraction is calculated by dividing the taxpayers' New Jersey receipts by the total receipts of the corporate taxpayers. Ibid.

The throwout rule modifies the receipts fraction of the CBT allocation formula by transforming the fraction into one that divides New Jersey receipts only by receipts from elsewhere (and New Jersey) which are actually taxed. In other words, if the

receipts occur in a state which does not impose a corporation tax, said out-of-state receipts are "thrown out" and not included in the denominator of the receipts fraction. The practical effect of throwing out receipts from the denominator is the receipts fraction increases, resulting in the CBT liability to New Jersey to increase. Whirlpool Props., supra, 208 N.J. at 151.

The constitutional infirmity of the rule has to do with external consistency. To be constitutional, an allocation formula must not reach beyond the portion of value fairly attributable to the economic activity in the state. Id. at 165. Throwing out receipts from other states because the other states decide not to tax the receipts improperly skews the allocation ratio. Id. at 169.

Where a taxpayer has direct constitutional contact with a state which can authorize taxation under the United States Constitution, receipts attributable to that state cannot be removed from the denominator of the receipts fraction of the throwout rule. Whirlpool Props., supra, 208 N.J. at 168.

In construing the statute so that it would not be found wholly unconstitutional, the Supreme Court ruled that the issue is not whether the other states had indeed imposed a tax, but whether the other states could impose taxation based upon the taxpayer having sufficient nexus with the state. Only in the event that a receipt cannot be reached for taxation purposes by

any jurisdiction, so called no-where sales, can said receipts be thrown out. Id. at 173. See also Lorillard Licensing Co. v. Director, 29 N.J. Tax 275, 283 (App. Div. 2015), certif. denied, 226 N.J. 212 (2016).

When it comes to the throwout rule, the parties seem to switch hats as to the degree of constitutional breadth afforded the Commerce Clause. Now, the taxpayers want a reading which would sweep in every jurisdiction which taxpayer has cardholders because there is economic nexus. On the other hand, the Director wants the throwout rule to apply if a state does not have sufficient economic nexus. See Lorillard Licensing Co. v. Director, 28 N.J. Tax 590, 605 (Tax 2014), aff'd, 29 N.J. Tax 275 (App. Div. 2015), certif. denied, 226 N.J. 212 (2016) (also addressing incongruity of argument). Both parties engage in a double standard. Also allocation is about consistency. While it need not be perfect, there cannot be blatant inconsistently in the application of the in-state versus the out-of-state reach being advocated by either party.

Here, the Director has not pointed to any jurisdiction or any portion of the taxpayers' sales that could not be reached by another taxing jurisdiction. For that reason, all of the taxpayers' receipts will be applied to the denominator of the receipts allocation formula.

VIII. CONCLUSION

The overriding theme of this matter is the proper amount of tax which the taxpayers are responsible for under the CBT. Numerous technical arguments have been raised by both sides. However, we cannot lose sight of the requirement that the reason and spirit of a statute controls in its interpretation. Paradise Park Homeowners Ass'n, Inc. v. Riverdale Mgmt. Associates, 404 N.J. Super. 309, 328 (App. Div. 2008). Moreover, statutes must be read sensibly with the reason and purpose for the legislation controlling. Borough of Closter v. Abram Demaree Homestead, Inc., 365 N.J. Super. 338, 350 (App. Div. 2004). Over the years, the Legislature has taken a number of steps to prevent and to close loop-holes in implementing the CBT. A hypertechnical reading and interpretation of the statute undercuts the legislative intent.

For the reasons set forth herein, taxpayers' receipts of interest and interchange generated from New Jersey cardholder accounts are fully allocable to the state. Moreover, taxpayers' receipt of fees are 50% allocable to the state. An order will follow.