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GENERAL FOODS CREDIT INVESTORS #3 CORPORATION, Plaintiff, v. DIRECTOR, DIVISION OF TAXATION, Defendant.	TAX COURT OF NEW JERSEY DOCKET NO. 011330-2015 Approved for Publication In the New Jersey Tax Court Reports

Decided: February 22, 2017

Charles P. Hurley, a member of the bar of the District of Columbia, admitted pro hac vice, for plaintiff (Norton Rose Fulbright US, LLP, attorneys, Andrea L. D'Ambra, Esq., local counsel, on the briefs).

Michael J. Duffy for defendant (Christopher S. Porrino, Attorney General of New Jersey, attorney, Paul V. Buonaguro, Deputy Attorney General, on the briefs).

DeALMEIDA, P.J.T.C.

This is the court's opinion with respect to plaintiff's motion for partial summary judgment. At issue is whether assets subject to a sale-leaseback transaction between plaintiff and New Jersey Transit Corporation ("NJ Transit"), and imputed rental income from those assets, should be included in plaintiff's business allocation fractions for purposes of calculating its New Jersey corporation business tax ("CBT") liabilities for tax years 2002 through 2009. The assets are buses sold by NJ Transit to plaintiff, which, in turn, leased the buses back to NJ Transit for use as public transportation in New Jersey. The purpose of the transaction was to transfer the federal tax benefits of owning the buses – depreciation and amortization deductions – to plaintiff, while allowing NJ

Transit to have operational control over the assets. NJ Transit, a public entity, has no use for the federal tax benefits associated with the assets because it does not pay federal income tax.

For the reasons explained more fully below, the court concludes that the motion record contains sufficient undisputed material facts upon which to conclude that plaintiff did not obtain a sufficient ownership interest in the NJ Transit sale-leaseback assets for those assets to be included in the property fractions of plaintiff's business allocation formula for CBT purposes. In light of this conclusion, the court also concludes that imputed rental income from the assets should not be included in the receipts fractions of plaintiff's business allocation formula for the relevant tax years. Plaintiff's motion for partial summary judgment is, therefore, granted.

I. Findings of Fact

Plaintiff General Foods Credit Investors #3 Corporation, a wholly-owned, indirect subsidiary of Altria Group, Inc. ("Altria"), is organized under the laws of Delaware and has its headquarters and principal place of business in Connecticut. During the relevant tax years, plaintiff engaged in sale-leaseback transactions that involved assets both within and outside of New Jersey.

One such transaction took place on September 30, 2002. On that date, plaintiff entered in a leveraged sale-leaseback transaction with NJ Transit, the State-owned corporation that operates New Jersey's public transportation system. The transaction involved 843 buses that NJ Transit used in its daily operations (the "Subject Assets"). Through the transaction, it was plaintiff's intent to purchase single-purpose assets from a tax-indifferent entity, using a primary or head lease that extended beyond the assets' useful life. Plaintiff then subleased the Subject Assets back to NJ Transit through a net sublease for a shorter sublease term. During the term of the sublease, NJ Transit continued to operate the Subject Assets as part of its business operations and had full

operational control over them. NJ Transit was required to pay all insurance, maintenance, improvement, repair, and regulatory costs associated with the Subject Assets.

Plaintiff purchased the Subject Assets through non-recourse loans for up to 80% of the $318 million payment price. NJ Transit then deposited the majority of plaintiff's upfront payments in a bank account from which periodic payments under the subleases were automatically made when those payments became due. The periodic payments were not paid to plaintiff, but were automatically applied to service the non-recourse debt plaintiff obtained to acquire its interest in the Subject Assets. The payments were imputed to plaintiff as rental payments, as plaintiff did not actually receive the receipts under the sublease. NJ Transit was provided a purchase option to acquire plaintiff's residual interest in the Subject Assets at the end of the sublease term.

The Subject Assets had a useful life of 25 years. The transaction was effectuated through a head lease with a 37-year term in which NJ Transit leased the Subject Assets to plaintiff. Plaintiff then leased the Subject Assets back to NJ Transit though a sublease with a 12.25-year term. According to the Participation Agreement between the parties, which was executed simultaneously with the other transaction documents, the head lease was to be treated as a "conditional sale" of the Subject Assets from NJ Transit to plaintiff. The subsequently executed sublease of the Subject Assets back to NJ Transit was to be treated as a "true lease" with NJ Transit treated as the lessee of the Subject Assets.

Section 15(a) of the Participation Agreement provides that NJ Transit assumed responsibility for "any and all liabilities, obligations, losses, damages, penalties, settlements, claims, actions, suits, proceedings or judgments of any kind and nature" in connection with the Subject Assets. In addition, the sublease of the Subject Assets to NJ Transit provides that that entity agreed "at its sole cost and expense" to cause the Subject Assets "to be serviced, repaired,

maintained, overhauled and tested" according to industry standards. The sublease also provides that plaintiff "shall have no obligation, liability or responsibility to" NJ Transit or any other person "with respect to operation, maintenance, repairs, alterations, modifications, improvements, correction of faults or defects . . . or insurance with respect to" the Subject Assets, all of which shall be "the sole responsibility of" NJ Transit.

NJ Transit is also solely responsible to replace worn out or damaged components of the Subject Assets. In addition, NJ Transit must, at its sole expense, make alterations and modifications to the Subject Assets that may be required by law. In the event of a loss of the Subject Assets, NJ Transit shall pay either to obtain a substitute for any lost asset or pay plaintiff a stipulated loss value, plus all other amounts due and owing under the sublease. The sublease requires that each bus be marked with a nameplate indicating that the asset is leased to NJ Transit from the statutory trust that carried out the transaction on plaintiff's behalf.[1]

At the conclusion of the sublease, NJ Transit has the option to purchase all, and not less than all, of the Subject Assets at an agreed upon purchase price that exceeds true market value or to return the Subject Assets to plaintiff. If NJ Transit elects to return the Subject Assets to plaintiff, plaintiff has the option to require NJ Transit to procure another entity to operate and service the Subject Assets on plaintiff's behalf. Plaintiff is entitled, at its sole discretion, to reject any qualified entity identified by NJ Transit to operate and service the Subject Assets. If unable to secure or obtain approval of an entity, NJ Transit is obligated to continue to operate the Subject Assets.

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[1] Plaintiff participated in the sale-leaseback transaction with NJ Transit through a Grantor Trust established for the specific purpose of entering into the sale-leaseback transaction. The Grantor Trust was the party that actually executed the transaction agreements. However, since plaintiff was the beneficiary of the Grantor Trust and the tax consequences of the activities of the Grantor Trust flowed to plaintiff, for ease of reference, plaintiff is treated in this opinion as the party that entered into the sale-leaseback transaction.

During the term of the lease, plaintiff listed the Subject Assets in its records as its property with a book value of $0. In addition, NJ Transit reported the Subject Assets on its financial statements under the line item "Capital Leases," indicating that the benefits and burdens of ownership of the Subject Assets stayed with NJ Transit, even though this contradicted the intention of the parties when entering into the sale-leaseback transaction.

The Subject Assets were never used in plaintiff's business operations or in the business operations of any of Altria's subsidiaries or partnerships. Plaintiff, however, claimed depreciation and amortization deductions associated with the Subject Assets on its federal income tax returns for the tax years in question. This was consistent with the purpose of the NJ Transit sale-leaseback transaction, as the depreciation and amortization deductions constitute the tax benefits plaintiff sought to obtain from NJ Transit with respect to the Subject Assets.

On its CBT returns for tax years 2002 through 2009, plaintiff included income, losses, and deductions relating to the Subject Assets in the computation of its entire net income subject to tax. This is so because for CBT purposes, taxable entire net income is calculated based on federal taxable income. Further, in computing its business allocation fractions for each tax year, plaintiff included the value of the Subject Assets in its property fractions, and imputed rental income receipts from the Subject Assets in its sales fractions. Because plaintiff did not have employees, either within New Jersey or outside the State in connection with the NJ Transit sale-leaseback transaction the transaction and Subject Assets had no impact on the payroll fractions of the plaintiff's business allocation formula.

The Internal Revenue Service ("IRS") audited Altria's federal consolidated income tax returns for tax years in which Altria claimed tax benefits associated with various sale-leaseback and lease-leaseback transactions maintained by Altria and its subsidiaries and partnerships,

including the NJ Transit sale-leaseback. The IRS determined that plaintiff had "failed to acquire and retain significant and genuine attributes of a traditional owner, including the benefits and burdens of ownership" of the Subject Assets. As a result, the IRS concluded that "[i]n substance the transaction[s] were merely a transfer of tax benefits to the taxpayer, coupled with its investment of the Equity Collateral for a predetermined after-tax rate of return." Accordingly, the IRS re-characterized the NJ Transit sale-leaseback transaction as a loan and disallowed interest, depreciation, and amortization expenses that plaintiff claimed on federal income tax returns in connection with the transaction.

The IRS also concluded that "since [plaintiff] acquired no present interest in the [Subject Assets] that could be leased to [NJ Transit, plaintiff] did not accrue taxable rental income" from the sale-leaseback transaction. Instead, the IRS determined that plaintiff earned "original issue discount income" ("OID") resulting from the deemed loan to NJ Transit.

The IRS re-characterized and made similar findings with respect to the tax treatment of comparable sale-leaseback and lease-leaseback transactions that several other Altria subsidiaries and partnerships had entered into. On October 16, 2006, Altria challenged the disallowances associated with certain sales-leaseback and lease-leaseback transactions, not including the NJ Transit transaction, in the United States District Court for the Southern District of New York for years that preceded the year in which plaintiff had entered into the NJ Transit transaction. Four sale-leaseback and lease-leaseback transactions were selected to be the subjects of the test case. Following an eleven-day jury trial, a verdict was entered in favor of the United States.

Altria appealed the adverse jury verdict in the United States Court of Appeals for the Second Circuit. That court affirmed the verdict on September 27, 2011. Altria Group Inc. v. United States, 658 F.3d 276 (2d Cir. 2011). The Second Circuit held that Altria "did not obtain a

genuine ownership or leasehold interest in the four facilities [that were the subject of the test-case leases] or incur genuine debt, and therefore Altria was not entitled to a tax refund for any of its claimed deductions." Id. at 291.

Following the Second Circuit's decision, on May 22, 2012, Altria entered into a binding Closing Agreement with the IRS to, among other things, settle the tax treatment of the sale-leaseback and lease-leaseback transactions, including the NJ Transit sale-leaseback transaction, that were not directly at issue in the Second Circuit's opinion. Under the terms of the Closing Agreement, Altria agreed to forego more than 80 percent of the claimed deductions associated with its portfolio of sale-leaseback and lease-leaseback transactions, including the NJ Transit transaction, and to pay tax based on imputed OID income arising from those transactions. Those adjustments substantially increased Altria's federal taxable income.

On August 17, 2012, as required by N.J.S.A. 54:10A-13, plaintiff timely notified the Director, Division of Taxation, of the IRS adjustments to plaintiff's federal taxable income for tax years 2002 through 2009 resulting from the Second Circuit's decision and the IRS Closing Agreement (the "Federal Changes"). Plaintiff included schedules detailing the Federal Changes and computing the appropriate adjustments to its CBT liabilities. The adjustments changed plaintiff's taxable federal income, and therefore its entire net income subject to CBT, by reducing plaintiff's previously reported depreciation and amortization deductions, removing plaintiff's previously reported imputed rental income, and adding the imputed OID income. This had the net effect of substantially increasing the amount of plaintiff's entire net income subject to CBT. The

schedules reflected an increase in CBT liabilities of $1,465,710, which plaintiff paid with a check accompanying its notification letter.[2]

For tax years 2002-2006, plaintiff applied the increase to its federal taxable income against its New Jersey business allocation fractions as computed on its original returns, which were calculated based on property fractions including the value of the Subject Assets, and receipts fractions including imputed rental income from the NJ Transit sale-leaseback transaction.

Plaintiff's notification letter also informed the Director that plaintiff intended to adjust its business allocation fractions for tax years 2007 through 2009 to reflect the Federal Changes. At the time that the August 17, 2012 notification letter was filed, the four-year statute of limitations for refund claims was open for tax years 2007 through 2009. N.J.S.A. 54:49-14(a). On or about February 20, 2013, plaintiff filed amended CBT returns for tax years 2007 through 2009. On those returns, plaintiff applied the increase in its federal taxable income as a result of the Federal Changes against modified New Jersey business allocation fractions that: (a) removed the value of the Subject Assets from its property fractions; (b) removed imputed rental receipts from the NJ Transit sale-leaseback transaction from its receipts fractions; and (c) added imputed OID income imputed by the IRS to plaintiff's receipts fractions denominator.

In its August notice, plaintiff explained the reasons it intended to file amended CBT returns: "[i]t has been determined that certain of the leveraged leases entered into by [plaintiff],

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[2] During the tax years at issue, plaintiff entered into both the NJ Transit sale-leaseback transaction and a second sale-leaseback transaction. Plaintiff's reported CBT liabilities relate to both transactions, each of which is addressed in the Director's final determination at issue here and in plaintiff's Complaint. To simplify the motion record, plaintiff filed separate motions for partial summary judgment addressing each of the transactions. This opinion addresses only the motion for partial summary judgment relating to the NJ Transit transaction. Other similar transactions are the subject of a separate Complaint filed by entity related to plaintiff under Docket No. 011703-2015. This opinion does not address the allegations in the separate Complaint.

including the leases involving property in New Jersey, are financing agreements and, as such, that [plaintiff] is not considered the true owner of the property for income tax purposes. Additionally, the related assets are not treated as being owned for book purposes. Accordingly, [plaintiff] is amending its CBT returns for [2007 through 2009] to properly reflect certain financial transactions in the computation of the sales and property allocation fractions. N.J.S.A. 54:10A-6."

The changes in plaintiff's business allocation fractions in its amended CBT returns reduced plaintiff's CBT liabilities for tax years 2007 through 2009.

On April 8, 2013, the Director sent a letter acknowledging plaintiff's August 17, 2012 notification letter. Although the Director accepted the increase in plaintiff's entire net income resulting from the Federal Changes, he rejected plaintiff's proposed adjustments to its business allocation fractions, asserting that "[t]he original allocation fraction is proper in accordance with New Jersey Regulations." The Director cited N.J.A.C. 18:7-8.5(d) for the proposition that the property allocation fraction includes "real and tangible personal property owned, leased, rented or used in this state." The Director then asserted that:

> Since the leased property is owned by the taxpayer and [the taxpayer] receives rental income that is included in entire net income, the taxpayer properly included the leased property in the Property Allocation Fraction on the original CBT Return . . . .

As to the receipts allocation fractions, the Director asserted in his letter that:

> The taxpayer received rental income from the financing arrangement of the property that is leased to third parties and should be included in the numerator and denominator of the Receipts Allocation Fraction.

The Director did not address the apparent contradiction between his acceptance of the increase in plaintiff's entire net income, which was based on the premise that plaintiff had not obtained a sufficient ownership interest in the Subject Assets for those assets to be considered

plaintiff's property (and that those assets did not, therefore, generate imputed rental income), and his conclusion that the Subject Assets are properly considered plaintiff's property for purposes of the property and receipts business allocation fractions.

On May 10, 2013, the Director sent plaintiff a Notice of Assessment Related to Final Audit Determination. Pursuant to the Notice, the Director computed plaintiff's entire net income subject to CBT for all of the years at issue by including the adjustments to plaintiff's federal taxable income resulting from the Federal Changes and the resulting recharacterization of plaintiff's interest in the Subject Assets. Accordingly, the Director increased plaintiff's taxable entire net income by the amount of depreciation and amortization deductions claimed on plaintiff's original federal returns related to the transaction. However, the Director applied to this increased entire net income the business allocation fractions used in plaintiff's original CBT returns, which were based on the proposition that plaintiff owned the Subject Assets and earned imputed rental income from those assets. As a result, the Director determined that plaintiff was liable for an additional $3,801,342 in CBT, plus interest. This represents the difference between the tax liability calculated by the Director and the amount plaintiff paid when it reported the adjustments to its federal taxable income because of the Federal Changes.[3]

On or about June 19, 2013, plaintiff filed a timely protest of the Notice of Assessment and requested a hearing.

On May 1, 2015, the Director issued a final determination stating that "[i]t has been determined that the taxpayer's original method of reporting the taxpayer's property and receipts

[3] This includes CBT liability for the NJ Transit sale-leaseback and for the sale-leaseback transaction that is the subject of a separate motion for partial summary judgment.

fractions for apportionment purposes was and is the appropriate method of measuring the taxpayer's business presence in New Jersey for" tax years 2002 through 2009.

On July 30, 2015, plaintiff filed a Complaint in this court challenging the Director's May 1, 2015 final determination. Plaintiff alleges that the controlling statutes, regulations, and legal precedents support the conclusion that the Subject Assets are not plaintiff's property for CBT business allocation purposes. In addition, plaintiff argues that even if the Subject Assets are plaintiff's property for CBT business allocation purposes, the value of the Subject Assets is $0 because that is the value attributed to the Subject Assets in plaintiff's books.

In addition, plaintiff alleges that any imputed income from the Subject Assets must be removed from the CBT business allocation receipts fractions because, according to the Second Circuit's decision and plaintiff's Closing Agreement with the IRS, plaintiff never received income from the Subject Assets. Instead, plaintiff alleges, the imputed OID income recognized by the Closing Agreement must be included in plaintiff's entire net income subject to CBT and in the denominator of plaintiff's receipts allocation fractions. Finally, plaintiff alleges that if it is unsuccessful on its allegations regarding the property and receipts fractions it is entitled to relief pursuant to N.J.S.A. 54:10A-8 because the Director's proposed allocation formula does not properly reflect plaintiff's business income reasonably attributable to New Jersey for the tax years in question.

Plaintiff thereafter moved for partial summary judgment, arguing that the motion record contains sufficient undisputed material facts upon which the court may conclude that plaintiff did not obtain a sufficient ownership interest in the Subject Assets for those assets to be plaintiff's property for purposes of the property allocation fractions for the tax years at issue. In addition, plaintiff argues that given its lack of a sufficient ownership interest in the Subject Assets as

established by the motion record, the court may conclude that imputed rental income from those assets should not be included in plaintiff's receipts allocation fractions.

The Director opposes the motion, arguing that there are genuine issues of material fact relating to the NJ Transit transaction that must be resolved at a trial. In particular, the Director argues that the motion record does not contain evidence of NJ Transit's understanding of the transaction or the circumstances surrounding the execution of the agreements memorializing the transaction.

The court heard oral argument from counsel.

III. Conclusions of Law

Summary judgment should be granted where "the pleadings, depositions, answers to interrogatories and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact challenged and that the moving party is entitled to a judgment or order as a matter of law." R. 4:46-2 (c). In Brill v. Guardian Life Ins. Co., 142 N.J. 520, 523 (1995), our Supreme Court established the standard for summary judgment as follows:

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

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

A. Whether Disputed Material Facts
Preclude Partial Summary Judgment.

When evaluating a summary judgment motion record, the court views the facts in a light most favorable to the non-moving party, "keeping in mind '[a]n issue of fact is genuine only if, considering the burden of persuasion at trial, the evidence submitted by the parties on the motion . . . would require submission of the issue to the trier of fact.'" Schiavo v. Marina District Dev. Co., LLC, 442 N.J. Super. 346, 366 (App. Div. 2015)(quoting R. 4:46-2(c)), certif. denied, 224 N.J. 124 (2016). Mere assertions, without factual support, will not defeat a motion for summary judgment. Miller v. Bank of Am. Home Loan Servicing, L.P., 439 N.J. Super. 540, 551 (App. Div.), certif. denied, 221 N.J. 567 (2015); Ridge at Back Brook v. Klenert, 437 N.J. Super. 90, 97-98 (App. Div. 2014)(citations omitted). "Competent opposition requires 'competent evidential material' beyond mere 'speculation' and 'fanciful arguments.'" Hoffman v. Asseenontv.Com, Inc., 404 N.J. Super. 415, 426 (App. Div. 2009)(citations omitted). When a party has presented competent evidential material in opposition to a summary judgment motion, "[t]he slightest doubt as to an issue of material fact must be reserved for the factfinder, and precludes a grant of judgment as a matter of law." Akhtar v. JDN Props. at Florham Park, LLC, 439 N.J. Super. 391, 399 (App. Div.), certif. denied, 221 N.J. 566 (2015)(citations omitted).

The Director, while arguing that there are disputed issues of material fact precluding partial summary judgment, produced no evidence in support of his position. The Director's opposition is not accompanied by any affidavits, certifications, or exhibits raising a question of material fact. Instead, the Director refers to provisions of the documents memorializing the NJ Transit sale-leaseback and argues that the parties to the transaction intended to transfer ownership of the Subject Assets to plaintiff. Plaintiff, however, does not dispute this point. Plaintiff readily admits that the parties did intend to transfer ownership of the Subject Assets to plaintiff. The IRS,

however, found that they failed to achieve this goal. Faced with the outcome of the Altria litigation, in which the IRS prevailed with respect to plaintiff's failure to obtain ownership of assets in similar sale-leaseback and lease-leaseback transactions, plaintiff entered into a Closing Agreement with federal tax authorities concerning the NJ Transit transaction in which plaintiff forfeited 80% of the deductions it claimed with respect to the Subject Assets.

The question presented by plaintiff's summary judgment motion is not whether the parties to the NJ Transit transaction intended to transfer ownership of the Subject Assets to plaintiff, but whether, under New Jersey law, plaintiff obtained sufficient benefits and burdens of ownership of the Subject Assets for those assets to be included in plaintiff's property and receipts allocation fractions for CBT purposes. Thus, the Director's focus on the intention of the parties when entering the NJ Transit transaction does not defeat summary judgment. For example, the Director cites a provision of the sublease to NJ Transit in which the agency agrees to display a plaque on each bus noting that the asset is leased to NJ Transit from the trust acting on plaintiff's behalf. Plaintiff does not dispute the existence of the provision or the fact that it reflects the intention of the parties to the NJ Transit transaction to vest in plaintiff ownership of the Subject Assets. It is the legal significance for CBT purposes of this provision, along with the other operative provisions of the transactional documents, that must be determined by the court.

The interpretation of contracts presents a purely legal question that is particularly suitable for resolution by summary judgment. See Spaulding Composites Co. v. Liberty Mut., 346 N.J. Super. 167, 173 (App. Div. 2001)(citations omitted), rev'd on other grounds, 176 N.J. 25 (2003), cert. denied, 540 U.S. 1142, 124 S. Ct. 1061, 157 L. Ed. 2d 953 (2004). This is precisely the issue plaintiff brings to the court through its motion for partial summary judgment.

B. Allocation Under the CBT Act.

The CBT Act imposes a tax on each non-exempt domestic corporation and foreign corporation

> for the privilege of having or exercising its corporate franchise in this State, or for the privilege of deriving receipts from sources within this State, or for the privilege of engaging in contacts within this State, or for the privilege of doing business, employing or owning capital or property, or maintaining an office, in this State.
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> [N.J.S.A. 54:10A-2.]

The tax is imposed on a corporation's "entire net income," which is defined as follows:

> "Entire net income" shall mean 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(k).]

This broad definition of entire net income is limited in the following paragraph of the statute:

> For the purpose of this act, the amount of a taxpayer's entire net income shall be deemed prima facie to be equal in amount to the taxable income, before net operating loss deduction and special deductions, which the taxpayer is required to report . . . to the United States Treasury Department for the purpose of computing its federal income tax . . . .
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> [N.J.S.A. 54:10A-4(k).]

This provision of the statute couples entire net income under the CBT Act to line 28 of the federal income tax return which is entitled "Taxable income before net operating loss deduction and special deductions."

After linking entire net income for CBT purposes to line 28 of the federal return, the statute provides that "[e]ntire net income shall be determined without the exclusion, deduction or credit

of" and lists several exceptions to federal tax statutes that define federal taxable income. See N.J.S.A. 54:10A-4(k)(2)(A) through (J). Those exclusions are not relevant here.

New Jersey is constrained by the Constitution to tax only corporate income that has a sufficient nexus to the State and is fairly attributable to the taxpayer's economic activity here. Pursuant to N.J.S.A. 54:10A-6, a foreign entity, such as plaintiff, that maintains a regular place of business outside of the State "is obligated to pay tax only on that portion of its entire net income which is allocable to this State." Stryker Corp. v. Director, Div. of Taxation, 18 N.J. Tax 270, 272-73 (Tax 1999), aff'd, 333 N.J. Super. 413 (App. Div. 2000), aff'd, 168 N.J. 138 (2001); see also Telebright Corp., Inc. v. Director, Div. of Taxation, 25 N.J. Tax 333 (Tax 2010), aff'd, 424 N.J. Super. 384 (App. Div. 2012). The amount of an entity's income subject to CBT is determined by multiplying the entity's entire net income by an allocation fraction. N.J.S.A. 54:10A-4(b). The purpose of the allocation fraction is to limit application of the CBT Act to only that income that has a sufficient nexus to New Jersey to satisfy constitutional constraints on State taxation. Lorillard Licensing Co., LLC v. Director, Div. of Taxation, 28 N.J. Tax 590 (Tax 2014), aff'd, 29 N.J. Tax 275 (App. Div. 2015), certif. denied, 226 N.J. 212 (2016); Central National-Gottesman, Inc. v. Director, Div. of Taxation, 14 N.J. Tax 545, 552 (Tax 1995), aff'd, 291 N.J. Super. 277 (App. Div.), certif. denied, 146 N.J. 569 (1996). Use of formula apportionment to derive taxable income has long been established. See Container Corp. of Am. v. Franchise Tax Bd., 463 U.S. 159, 165, 103 S. Ct. 2933, 2940, 77 L. Ed. 2d 545, 553 (1983).

During the tax years relevant to this appeal, the allocation fraction was equal to the average of four fractions: a property fraction, a payroll fraction, and a receipts (or sales) fraction (which is considered twice). The fractions had as their numerators, the property, payroll and receipts of the taxpayer fairly attributable to New Jersey, and as their denominators the total property, payroll and

receipts of the taxpayer. Lorillard, supra, 28 N.J. Tax at 599. According to N.J.S.A. 54:10A-6, as it read at the time applicable to the relevant tax years, a foreign corporation's taxable net income is "determined by multiplying such . . . entire net income . . . by an allocation fraction which is the property fraction, plus twice the sales fraction plus the payroll fraction and the denominator of which is four[.]"

The property fraction is determined by dividing the average value of the taxpayer's property in New Jersey by the average value of the taxpayer's property everywhere. N.J.S.A. 54:10A-6(A). "The sales fraction is the receipts of the taxpayer, computed on the cash or accrual basis according to the method of accounting used in the computation of its net income for federal tax purposes, arising during such period from" sales of tangible personal property within and without this State where shipments are made within this State, services performed in this State, rental income from property situated in this State, royalties from the use of patents and copyrights within this State and all other business receipts earned within this State, divided by the taxpayers receipts from all such sources within and without this State. N.J.S.A. 54:10A-6(B)(1) through (6).[4]

The court's review of the Director's application of these statutes is influenced by the familiar principle that the Director's interpretation of tax statutes is entitled to a presumption of validity. "Courts have recognized the Director's expertise in the highly specialized and technical area of taxation." Aetna Burglar & Fire Alarm Co. v. Director, Div. of Taxation, 16 N.J. Tax 584, 589 (Tax 1997)(citing Metromedia, Inc. v. Director, Div. of Taxation, 97 N.J. 313, 327 (1984)). The scope of judicial review of the Director's decision with respect to the imposition of a tax "is

[4] The CBT apportionment formula changed as the result of legislative action in 2011. The formula will become a single sales fraction formula following a three-year phase-in starting in January 2012. L. 2011, c. 59, §1.

limited." Quest Diagnostics, Inc. v. Director, Div. of Taxation, 387 N.J. Super. 104, 109 (App. Div.), certif. denied, 188 N.J. 577 (2006). The Supreme Court has directed the courts to accord "great respect" to the Director's application of tax statutes, "so long as it is not plainly unreasonable." Metromedia, supra, 97 N.J. at 327. See also GE Solid State, Inc. v. Director, Div. of Taxation, 132 N.J. 298, 306 (1993)("Generally, courts accord substantial deference to the interpretation an agency gives to a statute that the agency is charged with enforcing.").

Of course, an administrative agency's interpretation of the law that is plainly at odds with the statute will not be upheld. See Oberhand v. Director, Div. of Taxation, 193 N.J. 558, 568 (2008). Nor may the Director "extend the [corporation business] tax to income not within the fair contemplation of the Legislature as derived from the text of the statute imposing the tax." International Bus. Machines Corp. v. Director, Div. of Taxation, 26 N.J. Tax 102, 116 (Tax 2011). With these authorities in mind, the court turns to an analysis of the validity of the Director's decision that the Subject Assets should be treated as plaintiff's property for purposes of the property allocation fractions and receipts allocation fractions when calculating plaintiff's CBT liability.

C. Whether the Subject Assets are Plaintiff's Property for Purposes of the Property and Receipts Fractions of its CBT Business Allocation Formula.

The Supreme Court's holding in Reuben H. Donnelley Corp. v. Director, Div. of Taxation, 128 N.J. 218 (1992), guides resolution of the taxpayer's motion. In that case, the Court determined whether certain assets purchased through safe-harbor leases should be included in the property fraction of the taxpayer's business allocation formula under the CBT. Congress approved safe-harbor leases in 1981 through enactment of the Economic Recovery Tax Act ("ERTA"), which granted additional depreciation and tax credits for the purchase and leasing of certain machinery

and other equipment. Id. at 220 (citing I.R.C. §168 (f)(8)). As the Court explained, "Congress recognized that some companies that wished to purchase new equipment might not be able to take advantage of the tax benefits. That would be the case if the company had lost money or paid no taxes that year." Id. at 220. The Court continued:

> To achieve the distribution of those tax benefits Congress permitted businesses to enter into safe-harbor leases. Those safe-harbor leases permitted a company needing equipment to buy and then sell the equipment to another company that could use the tax benefits. The second company would then lease the equipment back to the first. The safe-harbor lease was a net lease: the company employing the equipment loaned the funds to the second company for the "purchase," and in lieu of paying rent, reduced this debt on a regular basis. Usually the two companies exchanged no money except for the down payment.
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> The transaction took place solely on paper. The buyer-lessor entered into a safe-harbor lease solely to take advantage of its tax benefits. Prior to ERTA, the Internal Revenue Service (IRS) scrutinized leases to determine the underlying economic substance of the transactions. The IRS considered whether the lessor derived a profit or cash flow from the transaction itself or solely from the tax benefits of ownership, and whether the lessor held the burdens, benefits, and incidents of ownership.
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> In contrast, under ERTA, as long as the parties used the appropriate form for the transaction, that the lease had no economic substance aside from federal tax benefits was irrelevant. ERTA made actual ownership of the property unnecessary for federal tax purposes. The only requirement was that "all of the parties to the agreement characterize such an agreement as a lease and elect to have the provision . . . apply." I.R.C. §168(f)(8)(A). If the parties entered into a safe-harbor lease, "the lessor [would] be treated as the owner of the property." I.R.C. §168(f)(8).
>
> [Id. at 220-21.][5]

The taxpayer in Donnelley entered into a number of equipment leases with several manufacturers qualifying as safe-harbor leases under ERTA. The transactions "were entered into

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[5] Congress later amended the Internal Revenue Code to eliminate safe-harbor leases.

solely for federal-tax purposes." Id. at 221. "Other than tax benefits, [the taxpayer] did not receive any incidences of property ownership." Id. at 222. "Although its ownership was for federal-tax purposes only," the taxpayer in Donnelley, like the plaintiff here, "included its [leased] property in the property fraction used to calculate its" CBT liability. Ibid. After an audit, the Director excluded the leased property from the taxpayer's property fraction, on the theory that the taxpayer was not the true owner of the property and, as the nominal owner of the property, could not include it in its property allocation fraction. Ibid. This is precisely the opposite of the argument being advanced by the Director in the present case, although the facts in the two matters are quite similar.

The Director's position in Donnelley was based, in part, on a 1982 amendment to the CBT Act intended to avoid the significant revenue loss to the State that would have resulted from ERTA's allowance of safe-harbor leases and their related accelerated depreciation. The amendment provided that a corporate taxpayer's entire net income subject to CBT would be determined "without the exclusion, deduction or credit of . . . [t]he amount by which depreciation . . . exceeds the amount of depreciation" that would have been permitted by the federal government prior to the enactment of ERTA. Id. at 225 (quoting N.J.S.A. 54:10A-4(k)(2)(F)(i) and (ii)). The statute establishing the property allocation fraction was also amended to provide that "for the purpose of determining average value, the provisions with respect to depreciation as set forth [in N.J.S.A. 54:10A-4(k)(2)(F)(i) and (ii)] shall be taken into account for arriving at such value." Id. at 225 (quoting N.J.S.A. 54:10A-6(A)).

The taxpayer in Donnelley argued that while the Legislature intended to exclude the depreciation deduction aspects of safe-harbor leases under the ERTA from a taxpayer's entire net income, it did not intend to exclude assets obtained through safe-harbor leases from the taxpayer's property allocation fraction. Instead, the Donnelley taxpayer argued, the Legislature intended that

the nominal owner of safe-harbor lease assets would be deemed the owner of those assets for purposes of the property allocation fraction. Id. at 225-26.

The Court rejected this argument. It held that both the intention of the Legislature in excluding depreciation deductions and receipts from ERTA safe-harbor assets and "the fact that the CBT Act permits a corporation to include only its 'real and tangible personal property' in the property fraction" supports the conclusion that assets obtained through a safe-harbor lease should not be included in the taxpayer's property allocation fraction. Id. at 228 (quoting N.J.S.A. 54:10A-6(A)). Noting that "traditional tax jurisprudence emphasizes the economic substance or purpose of the transaction" over its form, ibid. (citing Silent Hoist & Crane Co. v. Director, Div. of Taxation, 100 N.J. 1, 6, cert. denied, 474 U.S. 995, 106 S. Ct. 409, 88 L. Ed. 2d 359 (1985)), the Court concluded that the taxpayer, "as the nominal owner of" safe-harbor lease assets, "may not include that property in the allocation fraction." Ibid. As the Court explained, "[u]nlike ERTA, the CBT Act requires that a corporation must actually own the property in order to include it in the allocation fraction." Ibid.

In reaching its conclusion, the Court relied exclusively on the documents memorializing the transaction. The court observed that with safe-harbor leases, the "incidents, benefits and burdens of ownership rest with the lessee, and all that is actually sold is the tax benefit associated with the property." Ibid. The "form of a lease" is simply "a conduit to transfer the tax benefits." Ibid. The sales-leaseback contract, the court noted, provided that the owner of the equipment desired to sell only that part of its ownership interest "necessary to transfer to the Lessor ownership of the [e]quipment for Federal income tax purposes and only for such purposes . . . ." Id. at 228-29. This concept is repeated in the sublease back to the original property owner. Id. at 229. The Court further noted that "[t]he non-economic nature of the transaction is further illustrated by the

fact that it is the seller-lessee, and not [the purchaser-lessor], that reports the [safe-harbor lease] property on its books." Id. at 229 (citation omitted).

The Court succinctly explained the foundation of its holding:

> The basic rationale for using the property fraction to determine the amount of business a corporation does in a state is that the state provides a site for the wealth-creating aspects of the multi-state business. Brunswick v. Division of Taxation, 11 N.J. Tax 530, 539 (1991). Donnelly does not use its [safe-harbor lease] property in its business. Indeed, only because the corporation does not have an extensive manufacturing plant that needs new equipment is Donnelley a lessor of [safe-harbor lease] property. Because Donnelley does not own [safe-harbor lease] property for the purpose of creating wealth, inclusion of that property in the allocation fraction would undermine the fraction's purpose.
>
> [Id. at 229-30.]

Thus, the Court concluded that both the 1982 amendments to the CBT Act and the Act's intended purpose of "permitting only property actually owned by a taxpayer to be included in the property fraction" supported the holding that the Director "properly excluded Donnelley's [safe-harbor lease] property from the property fraction." Id. at 230.

These observations are equally applicable here. Although the NJ Transit sale-leaseback transaction is not a safe-harbor lease, it has many of the same characteristics that resulted in the Court's holding in Donnelley. Of primary importance is the fact that the parties to the NJ Transit sale-leaseback transaction were motivated solely by the desire to transfer to plaintiff the tax benefits associated with the Subject Assets. Plaintiff has no use for the 843 buses that are the subject of the transaction, apart from use of the depreciation and amortization deductions associated with those assets. See Caterpillar Fin. Servs. Corp. v. Wells, 278 N.J. Super. 481, 502-03 (Law Div. 1994)(holding that the terms of a sale-leaseback transaction and the circumstances

surrounding the execution of the lease, such as the reason for executing the lease, are significant facts to consider when determining whether the lessor retained true ownership) .

Secondly, the lease from plaintiff to NJ Transit is a net lease, with NJ Transit responsible for all costs, including taxes, associated with operating, insuring, and maintaining the Subject Assets. NJ Transit is responsible for any loss of the Subject Assets and bears the risk of all damages and liabilities arising from the operation of the Subject Assets. NJ Transit also has significant responsibilities at the conclusion of the lease, either to opt to purchase the Subject Assets or to arrange for those assets to be managed by another entity on behalf of plaintiff. In short, plaintiff, like the taxpayer in Donnelley retained none of the "incidents, benefits and burdens of ownership" of the Subject Assets. See Sierra Diesel Injection Serv., Inc. v. Burroughs Corp., 890 F.2d 108, 115 (9th Cir. 1989)("[L]ease was in fact a financing agreement because [lessee] was responsible for maintenance, for all taxes, and for loss due to damage to the" leased asset.); International Trade Admin. v. Rensselaer Polytechnic Inst., 936 F.2d 744, 750 (2d Cir. 1991)("[T]he fact that the lessee assumes and discharges substantially all the risks and obligations ordinarily attributed to outright ownership of the property is more indicative of a financing transaction than of a true lease."). The transaction documents are perfectly clear: plaintiff was the nominal owner of the Subject Assets, enjoying the federal tax benefits of ownership, but burdened by none of the other incidents of property ownership.

The court's conclusion is also supported by the holding in Altria, supra, which concerns similar transactions with the same purpose as the NJ Transit sale-leaseback. Although not binding on this court, the opinion is influential, as is the IRS's treatment of the NJ Transit transaction and other similar sale-leaseback transactions not before the court. See Accuzip, Inc. v. Director, Div. of Taxation, 25 N.J. Tax 158, 172 (Tax 2009)("Although not bound by the Internal Revenue Code

or the treasury regulations, '[m]ethods used by the Internal Revenue Service for tax purposes may serve as useful guidelines' for this court.")(quoting Westfield Ctr. Serv. v. Cities Serv. Oil Co., 86 N.J. 453, 466 (1981)). The court recognizes that the transactions at issue in Altria and the NJ Transit transaction are not identical. The assets involved in the Altria transactions were strategically important facilities for which no secondary market existed, and the leases were fully defeased. Still, the critical elements of the Altria transaction – that the purpose of the sale-leaseback was to transfer tax benefits with no intention of the lessor ever using the assets for its business operations – are the same as those present here. While there may be a secondary market for used buses after the conclusion of the NJ Transit sublease, the terms of the sublease make it unlikely that plaintiff would ultimately have possession and use of the buses at any time during their useful life. There is no doubt in the court's mind that the purpose of the NJ Transit sale-leaseback was to transfer to plaintiff only the tax benefits associated with the Subject Assets.[6]

Plaintiff's motion for partial summary judgment is granted.[7]

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[6] The Director urges the court to consider N.J.S.A. 12A:1-203, a statute enacted in 2013, after the tax years at issue here. That statute sets forth factors to be considered when distinguishing between a lease and a security interest under the Uniform Commercial Code ("UCC") and is substantially identical to a prior statute on the same subject. The court considers the Supreme Court's holding in Donnelley to control the question of whether under the CBT Act a taxpayer owns property that is the subject of a sale-leaseback transaction. It does not, therefore, decide whether the NJ Transit transaction is a lease or security interest under the UCC.

[7] In light of the court's conclusion that the Subject Assets are not plaintiff's property for purposes of the business allocation fractions, the court need not address the question of whether the Director may accept an entire net income that is based on the premise that the Subject Assets are not plaintiff's property while also contending that the business allocation fractions must be calculated based on the premise that the Subject Assets are plaintiff's property. See Donnelley, supra, 128 N.J. at 227-28 ("The tax court correctly observed that if the receipts from safe-harbor leases are considered to have no economic significance, and are thus excluded from income, to 'permit the very property giving rise to the excluded income to be included in the property fraction . . . does not make sense . . . .'")(quoting Reuben H. Donnelley Corp. v. Director, Div. of Taxation, 11 N.J. Tax 241, 252 (Tax 1990)). This opinion also does not address the question of whether the plaintiff's OID income for the tax years in question was properly sourced as out of State income or whether the Director is procedurally precluded from raising this issue, as plaintiff contends.