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CORRECTED 4/10/2017 - add appearance for plaintiff

XYLEM DEWATERING SOLUTIONS, INC., JOHN M. PAZ, AND XYLEM DEWATERING SOLUTIONS, INC., JOHN M. PAZ, JOHN M. PAZ 2010 GRANTOR RETAINED ANNUITY TRUST FBO JEFFREY PAX, JOHN M. PAZ 2010 GRANTOR RETAINED ANNUITY TRUST FBO JUDITH PAZ AND JOHN M. PAZ 2010 GRANTOR RETAINED ANNUITY TRUST FBO SHARON TREECE Plaintiff, v. DIRECTOR, DIVISION OF TAXATION, Defendant.	TAX COURT OF NEW JERSEY DOCKET NO. 011704-2015 DOCKET NO. 000056-2016 DOCKET NO. 000057-2016

Approved for Publication
In the New Jersey
Tax Court Reports

Decided: April 7, 2017

David J. Shipley and Aliza Sherman for plaintiff
(McCarter & English, LLP, attorneys).

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

FIAMINGO, J.T.C.

This is the court's opinion with respect to the parties' cross-motions for summary judgment. The primary issue presented is whether the gain from the deemed sale of assets of a New Jersey S corporation under Internal Revenue Code §338(h)(10) is sourced to New Jersey on the non-resident shareholders' New Jersey Non-Resident Gross Income Tax returns.

Plaintiffs' motion for summary judgment as to the sourcing of the income on the deemed sale of assets is denied and defendant's cross-motion on that issue is granted. The court finds that the correct method of sourcing the income on the deemed sale of assets is with reference to the

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Corporation Business Tax statutes. In this regard, the holding of McKesson Water Prods. Co. v Director, Div. of Taxation, 408 N.J. Super. 213 (App. Div.), certif. denied, 200 N.J. 506 (2009), controls to allocate the income to New Jersey as the corporate plaintiff's domiciliary state. Defendant's assessment of gross income tax on the non-resident shareholders is affirmed.

The court grants plaintiffs' motion to void the assessment for additional tax on the corporate plaintiff based on the income attributable to the Trust shareholders and denies defendant's cross-motion on this issue. The court finds that the retroactive election filed by the Trust shareholders cured the prior failure to elect to be consenting shareholders.

Finally, the court grants plaintiffs' motion to abate underpayment penalties, finding their position reasonable in light of the lack of certainty in the regulations and lack of judicial guidance. In light of the court's rulings, the court denies plaintiffs' demand for litigation costs.

I. Facts

Xylem Dewatering Solutions, Inc. (formerly known as Godwin Pumps of America, Inc.) (the "Corporation"), is a New Jersey corporation that, in 1997 elected to be taxed as an S corporation for both Federal and New Jersey tax purposes. Until February 2010, John Paz, a non-resident of New Jersey, was its sole shareholder ("Paz"). On or about February 1, 2010, Paz transferred 49 of the 350 issued and outstanding shares of the Corporation to three Grantor Retained Annuity Trusts (the "GRATs") established by him as grantor. Paz and the GRATs will be collectively referred to herein as the "Shareholders."[1]

On or about August 3, 2010, the Shareholders sold all of the shares of the Corporation. The parties elected to apply Internal Revenue Code ("I.R.C.") §338(h)(10) to the transaction. Because of the election, for federal income tax purposes the sale of stock by the Shareholders of

[1] The Corporation, Paz and the GRATS will collectively be referred to as plaintiffs.

the Corporation was disregarded and the transaction was treated as a sale of all of the assets of the Corporation followed immediately by the liquidation of the Corporation. See I.R.C. §338.

The Corporation filed a short year U.S. Income Tax Return for an S Corporation, Form 1120S, for the period ending August 3, 2010, reporting income from operations for that period, as well as the gain from the deemed sale of its assets. The gain from the sale of assets aggregated $357,290,215. Of this amount, $48,842,984 was attributed to the sale of tangible assets and $308,447,231 was attributed to the sale of goodwill.

The Corporation also filed a New Jersey S Corporation Business Tax ("CBT") return for the period ending August 3, 2010. On that return, the Corporation reported a total of $113,385,758 to its shareholders as "S income/loss allocated to New Jersey" on the Schedule K-1 (Shareholder's Share of Income/Loss) to the return while reporting total income of $370,356,782. Paz's New Jersey non-resident GIT return for calendar year 2010 reflected S corporation income in the amount of $113,417,512 from New Jersey sources.[2]

The New Jersey Division of Taxation ("Division") audited the Corporation's CBT returns for the years 2009 through 2011. As a result of that audit, proposed adjustment workpapers were issued to Paz on September 8, 2014, and to the Corporation on November 6, 2014. With respect to the Corporation, the workpapers proposed: 1) that net long term gain in the amount of $308,447,231 was assignable to New Jersey, thus increasing the amount of income from the Corporation sourced to New Jersey;[3] and 2) an assessment against the Corporation of $3,580,461 in GIT on the income allocable to the GRATs as non-consenting S corporation shareholders.[4] The

[2] John Paz's individual share was $99,549,991 and the GRATs' shares was an aggregate of $13,835,767.

[3] Plaintiff maintains that only the deemed gain on goodwill was allocated to New Jersey. Defendant ("Director") maintains that the entirety of the deemed gain on sale was allocated to New Jersey. The workpapers clearly allocate $308,447,231 to New Jersey as "Nonoperational gains - Section 338(h)(10)" and do not appear to differentiate between fixed assets and goodwill.

[4] Additional adjustments were made which are not pertinent to this motion.

adjustment to the amount of income from the Corporation sourced to New Jersey increased the New Jersey sourced income on Paz's non-resident GIT return. The proposed workpapers issued to Paz proposed additional GIT of $19,162,818, plus interest and penalties of more than $5,800,000.

On January 8, 2015 the Corporation filed a "Retroactive S Election Application" Form CBT-2553-R, on which the GRATs evidenced their consent to New Jersey's jurisdiction to tax and collect tax. That form was returned to the Corporation by the Division on or about March 30, 2015, with a hand written note which provided, "This corporation has been an S-corp since 1997.? Please call 609 [XXX XXXX] S Corp Unit." Thereafter, on May 7, 2015, the Division issued a notice rejecting the Retroactive S Election Application, stating that "[t]he [Corporation] submitted a timely CBT-2553 (New Jersey S Corporation election) starting in 1997 and has maintained such status" and "[t]here is no provision in the law or regulations allowing a shareholder to retroactively consent to taxation in this State."

In or about April 2015, the Corporation filed an amended CBT return on which it 1) "sourced" the gain on the deemed sale of fixed assets based on the location of the assets; and 2) "sourced" the gain on the deemed sale of goodwill using the three-year average of its allocation factors for the 2007, 2008, and 2009 tax years. Although the return was filed by the Corporation, the amended return states "[t]he gain from the [Corporation's] deemed asset sale is sourced to New Jersey under the gross income tax rules applicable to 'net gains or income from the disposition of property.'" (emphasis added.) The Corporation issued amended Schedule K-1's to its shareholders allocating $90,018,927 of the entire deemed gain on sale of $357,290,215 to New Jersey.

The change in the sourcing of the corporate income on the deemed sale of assets affected the GIT calculated to be due from Paz on the original New Jersey GIT non-resident return filed by him, and in April 2015, he filed an amended return requesting a refund of $1,741,684.[5]

On December 16, 2015, the Division issued a Notice of Assessment against the Corporation demanding $5,116,396.39, representing the tax due from the GRATs as "non-consenting" S corporation shareholders in the amount of $3,580,810, plus penalties and interest of $1,535,586. On December 24, 2015, the Division issued a Notice of Tax Due to Paz of $26,792,003.92, consisting of GIT of $19,166,036.18, penalties of $958,301.81, and interest of $6,667,665.84. The additional tax was assessed primarily as a result of the characterization of the $308,447,231 gain on the I.R.C. §338(h)(1) deemed asset sale as non-operational income of the Corporation allocable to New Jersey under the CBT Act, and includable in the Shareholders' non-resident GIT calculations as New Jersey source income.

The Corporation and the GRATs filed a complaint in the Tax Court on August 5, 2015, contesting the Director's denial of the Corporation's Retroactive S Election Application. On January 6, 2016, Paz filed a complaint in Tax Court appealing the Director's December 24, 2015 Notice of Tax Due and the Corporation filed a complaint contesting the Director's December 16, 2015 Notice of Assessment against it.[6]

The Corporation, Paz, and the GRATs jointly filed a motion for summary judgment in these matters. The Director filed a cross-motion for summary judgment. Both motions were argued before this court on December 16, 2016.

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[5] All income allocated to the GRATs was included on both of the GIT returns filed by Paz since the GRATs constituted grantor trusts of which he was grantor.

[6] A fourth complaint was filed by the Corporation in March, 2016 contesting a Notice of Assessment issued to the Corporation, but that complaint is not the subject of the current motion for summary judgment.

II. Legal Issues and Analysis

A. Summary Judgment

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

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

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

The parties contend and the court concludes that there is no genuine dispute with respect to any of the material facts in this matter. Resolution of these matters by summary judgment is appropriate.

B. Standard of Review

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

of Taxation, 12 N.J. 130, 146 (1953). "New Jersey Courts generally defer to the interpretation that an agency gives to a statute [when] that agency is charged with enforc[ement.]" Koch v. Director, Div. of Taxation, 157 N.J. 1, 8 (1999) (citing Smith v. Director, Div. of Taxation 108 N.J. 19, 25 (1987)). Determinations by the Director are afforded a presumption of correctness because "[c]ourts have recognized the Director's expertise in the highly specialized and technical area of taxation." Aetna Burglar & Fire Alarm Co. v. Director, Div. of Taxation, 16 N.J. Tax 584, 589 (Tax 1997) (citing Metromedia, Inc. v. Director, Div. of Taxation, 97 N.J. 313, 327 (1984)). The Supreme Court has directed courts to accord "great respect" to the Director's application of tax statutes, "so long as it is not plainly unreasonable." Metromedia, supra, 97 N.J. at 327. However, where the interpretation of an administrative agency is plainly at odds with a statute, that interpretation will not be upheld. See Oberhand v. Director, Div. of Taxation, 193 N.J. 558, 568 (2008) (citing GE Solid State v. Director, Div. of Taxation, 132 N.J. 298, 306 (1993)).

C. Discussion

1. General Principles of the CBT Act

The CBT Act requires that all non-exempt domestic and foreign corporations pay an annual franchise tax for the privilege of having or exercising its corporate franchise in New Jersey, or for the privilege of deriving receipts from sources within the State, or for the privilege of engaging in contacts within the state, or for the privilege of doing business, employing capital or owning capital or property, or maintaining an office in New Jersey. N.J.S.A. 54:10A-2. In general, corporations which are subject to tax in New Jersey are taxed on that proportion of their "entire net income" allocable to New Jersey. N.J.S.A. 54:10A-5(c)(1).

Corporations electing S corporation status are subjected to a different tax scheme under both federal and New Jersey tax laws. Under federal tax law, an S corporation's income, losses, deductions, and credits pass through to its shareholders, based on their individual percentage ownership in the corporation. See I.R.C. §1366. The shareholders, in turn, report their pro rata share of the income and losses on their personal income tax returns in accordance with federal tax laws, and are assessed taxes at their individual tax rates. Id.

Technically, under New Jersey tax law, the entire net income of an electing S corporation is subject to CBT. N.J.S.A. 54:10A-5(c)(2). For tax years ending on or after July 1, 2007, however, "no rate of tax" is imposed on an S corporation's entire net income.[7] N.J.S.A. 54:10A-5(c)(2)(ii). Further, an electing S corporation is not subject to the GIT. N.J.S.A. 54A:5-9. The income, dividends, and gains of an S corporation, however, are allocated to its shareholders and subjected to GIT on the shareholders' personal income tax return whether or not actually distributed. Id. Thus, although an S corporation's entire net income is not subject to the CBT or the GIT directly, all of its income is taxed at the shareholder level.

2. S Corporation Election

The CBT Act defines an "S corporation" as "a corporation included in the definition of an 'S corporation' pursuant to [I.R.C.§1361]." N.J.S.A. 54:10A-4(o). A "New Jersey S corporation" is a "corporation that is an S corporation; which has made a valid election pursuant to [N.J.S.A. 54:10A-5.22]; and which has been an S corporation continuously since the effective date of the valid election made pursuant to [N.J.S.A. 54:10A-5.22]." N.J.S.A. 54:10A-4(p).

In order for a corporation to elect to be a New Jersey S corporation, the corporation and its shareholders on the date of the election (the "initial shareholders") must consent to the election and the jurisdictional requirements of becoming a New Jersey S corporation. N.J.S.A. 54:10A-

[7] All S Corporations are however subject to the CBT minimum tax obligation, N.J.S.A. 54:10A-5(e), and New Jersey S corporations are also subject to the regular CBT on its New Jersey entire net income that is subject to federal income taxation. N.J.S.A. 54:10A-5(c)(3).

5.22. Specifically, the initial shareholders must consent to: the State's right to tax and collect the tax on the shareholder's income; the right of the State to tax and collect the tax, regardless of a change of the initial shareholder's residency; and the State's right to collect the tax directly from the corporation should a shareholder other than an initial shareholders fail to consent to the State's jurisdiction to tax and collect the tax. N.J.S.A. 54:10A-5.22(b).

With respect to a shareholder who is not an initial shareholder, an S corporation must either deliver the consent of such shareholder to the State's jurisdictional requirements, or make payments to the Director of the amount of tax on the subsequent shareholder's pro rata share of the S corporation's income calculated at the highest rate of tax under the GIT. N.J.S.A. 54:10A-5.23(a)-(c). The Director may require that the tax estimated to be due be withheld from any distribution made to a nonconsenting shareholder. N.J.S.A. 54:10A-5.23(c). Where a shareholder who is not an initial shareholder fails to deliver a consent and objects to the jurisdiction of the State to withhold payments of the tax due, the State has the right to collect the tax from the corporation. N.J.S.A. 54:10A-5.23(d).

Procedurally, "[a] Federal S corporation must file a New Jersey Subchapter S Election form (CBT-2553) to elect treatment as a New Jersey Subchapter S corporation . . . or to report a change in shareholders." N.J.A.C. 18:7-20.1(c). Here, the Corporation filed its election for 1997 and has been treated as a New Jersey S corporation since. The Director does not contest the status of the Corporation as a New Jersey S corporation. The Director maintains that the GRATs are not initial shareholders and their consent to be taxed was required to be filed once they became shareholders. See N.J.A.C. 18:7-20.1(c)(1)(vii)(1) (if an initial shareholder transfers stock to a "grantor trust of which the shareholder is the grantor, a new CBT-2553 shall be signed and filed by the Trustee in that capacity."). Because the consents were not timely filed, the Director maintains that the State has "the right and jurisdiction to collect a tax . . . directly from the corporation equal to the pro rata share of the S corporation income allocated to this State, . . . of the nonconsenting shareholder times the maximum tax bracket rate provided under [the GIT]." N.J.S.A. 54:10A-5.23(d).

Plaintiffs argue that the GRATs are "grantor trusts" and all of the income otherwise allocable to such trusts is includable on Paz's personal return and was so included for the year in question. See I.R.C. §671. Thus, according to plaintiffs, it was unnecessary for the GRATs to consent to be taxed because Paz remained the sole shareholder of the Corporation even after the transfer of shares. Plaintiffs maintain that N.J.A.C. 18:7-20.1(c)(1)(vii)(1), requiring that a new CBT-2553 be signed and filed by the Trustee of a grantor trust that becomes a shareholder, is invalid because it is contrary to the technical "income tax definition" of the word "shareholder" and because it is inconsistent with the GIT treatment of a grantor trust as a disregarded entity.

Plaintiffs rely heavily on the treatment of S corporations under the Internal Revenue Code in making their argument. The court finds no contradiction between the definition of an S corporation in I.R.C. §1361(a)(1) and the requirement in the regulations that the trustee of a grantor trust file a Form 2553 upon becoming a shareholder. In fact I.R.C. §1361 supports the Director's position that a grantor trust is an eligible "shareholder" under the federal statutes. See I.R.C. §1361(c)(2)(A)(1) (allowing as an eligible shareholder "[a] trust all of which is treated [under I.R.C. §671] as owned by an individual who is a citizen or resident of the United States.")

"That the Legislature may delegate to an administrative agency the authority to promulgate rules and regulations interpreting and implementing a statute is beyond peradventure." T.H. v. Div. of Developmental Disabilities, 189 N.J. 478, 490 (2007). "Agency regulations are promulgated to aid in the practical application of a statute to achieve the legislative purpose." Regent Corp. of Union, Inc. v. Director, Div. of Taxation, 27 N.J. Tax 577, 598 (Tax 2014).

> New Jersey courts generally defer to the interpretation that an agency gives to a statute that agency is charged with enforcing. Smith v. Director, Div. of Taxation, 108 N.J. 19, 25, 527 A. 2d 843 (1987). We have recognized the Director's expertise, particularly in specialized and complex areas of the Act. Metromedia, Inc. v. Director, Div. of Taxation, 97 N.J. 313, 327, 478 A. 2d 742 (1984) (stating that Director's interpretation will prevail "as long as it is not plainly unreasonable"). However, this deference is "not total, as the courts remain the 'final authorities' on issues of statutory construction and are not obliged to 'stamp' their approval of the administrative interpretation." New Jersey Guild of Hearing Aid Dispensers v. Long, 75 N.J. 544, 575, 384 A.2d 795 (1978).
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> [Koch , supra 157 N.J. at 8.]

The Director's construction of the operative law, "which is not plainly unreasonable and with which the Legislature has not interfered, is entitled to prevail". Aetna Burglar & Fire Alarm, supra, 16 N.J. Tax at 589 (citing Metromedia, supra, 87 N.J. at 327). The party challenging the regulation has the burden of proving the regulation is invalid. New Jersey State League of Municipalities v. Department of Cmty. Affairs, 158 N.J. 211, 222 (1999). Here, the Director's regulation providing that a grantor trust be treated as a shareholder which is not an initial shareholder, and requiring that a form 2553 signed by the Trustee be filed, is consistent with the plain language and probable intent of N.J.S.A. 54:10A-5.22(b). The regulation is upheld.

The regulations, however, allow for the filing of a Retroactive S Election form where an S corporation authorized to do business in New Jersey, which is registered with the Division , and which has filed CBT returns, has failed to file a timely New Jersey S corporation election. See N.J.A.C. 18:7-20.3(a). The Statement accompanying the proposal to N.J.A.C. 18:7-20.3 provides, in part:

> Since there are occasions when taxpayers may fail to make [a New Jersey S election] due to inadvertence, the procedure is designed to assist honest taxpayers with a procedure that is less draconian in its consequences than requiring the corporate taxpayer to pay tax, penalty and interest on the difference between the S corporation rates and the C corporation rates, requiring the difference between the S corporation rates and the C corporation rates, requiring the shareholders to file

> amended NJ-1040 returns to get refunds, and deal with the potential disparity in the statute of limitations between corporation business tax and gross income tax.
>
> [39 N.J.R. 3730(a) (Sept. 4, 2007).]

The Director argues that the purpose of the retroactive election is to benefit only corporations which have filed S corporation returns (NJ-CBT-100S) but have failed to timely file New Jersey S corporation election. A strictly literal reading of N.J.A.C. 18:7-20.3 might support the Director's position. There is nothing in the regulation which specifically permits the retroactive filing of consents for non-initial shareholders. The instructions to the Retroactive S Election Application, Form CBT-2553-R, belie a literal interpretation. Those instructions anticipate the filing of a retroactive election by a corporation which has already applied for S corporation status and received approval. Specifically, Instruction 1 to Form CBT-2553-R states:

> This form is to be used by a currently authorized corporation electing New Jersey S corporation status effective retroactively to a prior return period. Submit a copy of the original CBT-2553 if previously approved. If the taxpayer does not currently have New Jersey C Corporation status, an original CBT-2553 must also be submitted.
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> [Id. (emphasis added).]

Furthermore, Part IV of Form CBT 2553-R indicates that the consenting shareholders consent to New Jersey's "retroactive right and jurisdiction to tax and collect the tax on each shareholder's S corporation income . . . ." Thus, it appears to be clearly anticipated that corporations which have received prior approval of the New Jersey S Election be permitted to file retroactive elections and to permit shareholders to retroactively consent to be taxed.

The Director further argues that, if the court finds that the retroactive election applies to permit an untimely consent by the GRATs, relief should not be granted, because

> [a]ll shareholders have not filed appropriate tax returns and paid tax in full when due as if the New Jersey S corporation election request had been previously

> approved, and the taxpayers have not reported the appropriate S corporation income on those returns.
>
> [N.J.A.C. 18:7-20.3(c)(4).]

The Director maintains that since the shareholders did not source the income in the manner determined by the Division and thus "have not reported the appropriate S corporation income" on their returns, relief cannot be granted. This argument cannot be sustained. The Corporation allocated all of what it reported as its income to its various shareholders, including the GRATs. The income allocated to the GRATs by the Corporation was included in the return of Paz, as the grantor of the GRATs. The Division reviewed the Corporation's return and made a determination that the Corporation and its shareholders have protested. To adopt the Director's interpretation would mean that any time a taxpayer contests the action of the Director without first paying the tax alleged to be due, that taxpayer cannot be afforded the remedy of a retroactive election. The court finds such an interpretation to have a chilling effect on the ability of a corporation and its shareholders to legitimately contest an assessment. See United Parcel Service General Servs Co. v. Director, Div. of Taxation, 220 N.J. 90, 94 (2014)(taxpayer which timely files tax returns, pays all reported tax liabilities and is found to be liable for additional tax following an audit, has not failed to pay tax).

Finally, the Director argues that the assessment against the Corporation for the taxes due on the GRATs' share of the income was proper, because as of the 2010 tax year the GRATs had not filed a consent. Therefore, the Corporation was required to

> [m]ake payments to the Director of the Division of Taxation on behalf of each nonconsenting shareholder in an amount equal to the shareholder's pro rata share of S corporation income allocated to this State, as defined pursuant to . . . [N.J.S.A.].54A:5-10 [], reflected on the corporation's return for the accounting or privilege period, multiplied by the maximum tax bracket rate provided under N.J.S.[A.] 54A:2-1 in effect at the end of the accounting or privilege period. The payments shall be made no later than the time for filing of the return for the

accounting or privilege period.

[N.J.S.A. 54:10A-5.23(c).]

Thus, the Director argues, since the Corporation neither had the executed consents from the GRATs at the appropriate time nor did it pay over the tax as required, it cannot be granted relief.

Once again, the Director argues against the retroactivity permitted by his own regulations. What is the sense of permitting retroactive relief if the taxpayer must first be required to act and be assessed as if the retroactive election were not permitted, only to have the retroactivity thereafter apply? Furthermore by filing the Form CBT-2553-R, the GRATs have consented to the retroactive taxation of the income allocable to them, and the tax due on the amounts allocable to them as reported on the corporate return was in fact paid, albeit by Paz.

The court finds that the failure of the GRATs to file the necessary consents was cured by the filing of the retroactive S Election. Any potential harm to the State has been obviated. While the amount of the income required to be included in the Shareholders' returns has yet to be finally determined, at the time of the filing of the return, the tax due from all of the Shareholders was paid by Paz.

3. General Principles of the GIT Act

Under the GIT, the net income earned by an S corporation from the operation of its business is passed through to its shareholders and taxed in a single category as the "[n]et pro rata share of S corporation income." N.J.S.A. 54A:5-1(p); Miller v. Director, Div. of Taxation, 352 N.J. Super. 98, 104-105 (App. Div. 2002), rev'g and remanding 19 N.J. Tax 522 (Tax 2001). However, where a corporation sells virtually all of its assets and distributes the proceeds to its shareholders in complete liquidation of the corporation, the gain on the actual sale of corporate assets is not taxed as S corporation income. Instead, the two transactions are treated "as if they were one transaction involving a sale of stock to a third party, with the tax being calculated precisely in accordance with the provisions of N.J.S.A. 54A:5-1(c) specifically governing Subchapter S corporations." Id. at 108. This treatment is required in order to avoid a tax on return of capital. Ibid.

In a corporate liquidation subject to the I.R.C. §338(h)(10) election, there is no actual sale of corporate assets. Instead, the shareholders sell their shares in the corporation to a third party and elect to treat the transaction as if the corporation sold all of its assets and liquidated. For federal tax purposes, the shareholders "take their pro rata share of the deemed sale tax consequences into account under section 1366 and increase or decrease their basis in the selling corporation's stock under section 1367." Treas. Reg. §1.338(h)(1)-1(d)(5)(i).

In Mandelbaum v. Director, Div. of Taxation, 20 N.J. Tax 141 (Tax 2002), the court considered the tax consequences under the GIT of a sale of stock subject to an I.R.C. §338(h)(10) election and held that "the income passing through to [the shareholder] as a result of the deemed sale of [the corporation's] assets is taxable under N.J.S.A. 54A:5-1(c)." Id. at 153. The distinction between the characterization of the income on the deemed sale of assets as being from "disposition of property" and not "S corporation income" for GIT purposes forms the basis for the plaintiffs' challenge to the Director's sourcing of income in this matter.

GIT is imposed on all New Jersey Gross Income earned by any taxpayer. N.J.S.A. 54A:2-1. "New Jersey Gross income" consists of sixteen specified categories of income, including "net gains or income from the disposition of property" and "net pro rata share of S corporation income." N.J.S.A. 54A:5-1(c), 5-1(p). GIT is imposed on non-residents based on a percentage of the GIT imposed on a resident, the numerator of which is the non-resident taxpayer's income from sources within New Jersey and the denominator of which is the non-resident taxpayer's gross income calculated as if the taxpayer was a resident of the state. N.J.S.A. 54A:2-1.1. Thus, the source of a non-resident's income is an integral factor in the determination of the amount of GIT imposed.

Both parties concur that gain from the deemed asset sale under I.R.C. §338(h)(10) is taxable as "net gains or income from disposition of property" and not as "S Corporation income" under the GIT. See N.J.A.C. 18:35-1.5(k)(2)(ii). Mandelbaum, supra, 20 N.J. Tax 141. The crux of the disagreement between the parties is the manner in which the income arising from the deemed sale of the corporation's assets is sourced for the purposes of the GIT imposed on the non-resident shareholders.

4. Sourcing of Income

a. Application of CBT concepts

"S corporation income" allocated to New Jersey constitutes income from sources within the state for a non-resident taxpayer. N.J.S.A. 54A:5-8(a)(6). S corporation income allocated to New Jersey means "that portion of the S corporation income that is allocated to this State by the allocation factor of the corporation for the [taxable year in question] pursuant to [N.J.S.A. 54:10A-6 through 54:10A-10]." N.J.S.A. 54A:5-10. Thus, in computing the amount of "S corporation income" allocable to a non-resident for GIT purposes, the statute specifically references the CBT allocation factors of the S corporation.

"Net gains or income from the disposition of property," however, are sourced to New Jersey "to the extent it is earned, received or acquired from sources within this State" based on rules specifically related to the type of property. N.J.S.A. 54A:5-8(a)(1)-(4). Thus, plaintiffs argue, the allocation factor applicable to S corporation income under the CBT is irrelevant in determining the sourcing of gains arising from an I.R.C. §338(h)(10) deemed sale of assets notwithstanding the fact that those deemed gains were earned at the corporate level.

This dispute has its roots in the decisions of Miller, supra 352 N.J. Super. 98 and Mandelbaum, supra, 20 N.J. Tax 141. In Miller, there was an actual sale of assets by an electing S corporation followed by a complete liquidation of the corporation. The Director treated the transactions as they occurred – a sale of assets by the corporation, resulting in S corporation income to the shareholders, and the complete liquidation of the corporation, resulting in income from the disposition of property.

The court held that while the Director's position was a literal application of the GIT, the characterization of the gain on the sale of the corporate assets as S corporation income unavoidably resulted in an unacceptable tax on the return of capital, a result inconsistent with legislative intent. Miller, supra, 352 N.J. Super. at 105. See also Koch, supra, 157 N.J. at 8-14. "[S]ince the literal statutory words are incompatible with the overall legislative purpose not to tax a return on capital, the only solution that appears to us to make sense, without doing violence to the [GIT] Act, is to treat these transactions as a sale of corporate stock." Miller, supra 352 N.J. Super. at 107.

In Mandelbaum, Judge Kuskin was confronted with the sale of S corporation stock in a transaction involving an election under I.R.C. §338(h)(10) similar to that before this court. At the time, neither the GIT Act nor the regulations issued thereunder provided for the GIT treatment of the I.R.C. §338(h)(10) deemed sale of assets. Despite that, the Director argued that the deemed sale of assets should be recognized as a taxable event resulting in S corporation income to the shareholder under N.J.S.A. 54A:5-1(p), followed by a complete liquidation of the corporation, resulting in a capital gain or loss to the selling shareholder under N.J.S.A. 54A:5-1(c). Judge Kuskin held that "in the absence of valid regulations under the GIT Act, the Director may not import and apply federal tax principles from I.R.C. §338(h)(10) and assess gross income tax in accordance with those principles." Mandelbaum, supra, 20 N.J. Tax at 152. Agreeing with Judge

Small's analysis in Miller, supra, he found that income not generated in the regular course of business of the corporation should be taxed under N.J.S.A. 54A:5-1(c) and not as regular business income under subsection (p). Ibid.

On September 5, 2006, the Director proposed amendments to GIT regulations applicable to the gain on sale on the disposition of property in connection with the complete liquidation of sole proprietorships and partnerships. See N.J.A.C. 18:35-1.1, 1.3; 38 N.J.R. 3502(a) (Sept. 5, 2006). Simultaneously, new regulations addressing the sale of assets in connection with a liquidation of an S Corporation were proposed. See N.J.A.C. 18:35-1.5; 38 N.J.R. 3502(a), supra.

Specifically, the Director noted:

> The New Jersey Tax Court opinions in Miller v. Director, Division of Taxation, 19 N.J. Tax 522 (2001), reversed 352 N.J.Super. 98, 799 A.2d 660 (App. Div. 2002) and Mandelbaum v. Director, Division of Taxation, 20 N.J. Tax 141 (2002) held that income of a shareholder resulting from the sale of corporate assets is taxable as the net gain from the disposition of property. More specifically, the Courts explained that to the extent that a partnership or subchapter S corporation has income outside of its ordinary trade or business, that income retains its character as gains from the disposition of property when it is passed through to the partners or subchapter S shareholders, and the taxpayer can deduct his or her basis in the stock from the passed-through proceeds from the sale in calculating his or her income tax liability.
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> [38 N.J.R. 3502(a), supra.]

Thus, N.J.A.C. 18:35-1.1(c)(5), relating to sole proprietorships, provides that "[g]ain or loss from the sale or disposition of assets employed in a trade or business as a result of a complete liquidation of the business must be reported as described in N.J.S.A. 54A:5-1.c, net gains or income from the disposition of property." Similarly, N.J.A.C. 18:35-1.3(2)(i), relating to partnerships, provides "[t]he partnership's gain or loss from the sale or disposition of its assets as a result of a complete liquidation are to be separately reported as net gains or income from disposition of property in accordance with N.J.S.A. 54A:5-1.c." Both regulations contain sourcing rules for business activities carried on both inside and outside of New Jersey, providing that (a) the gain or loss from the sale of real and tangible assets located in New Jersey is sourced to New Jersey; (b) the gain or loss from the sale of real and tangible assets located outside New Jersey is sourced to the other jurisdiction; (c) the gain or loss from the sale of motor vehicle equipment is sourced to the state where the vehicle is registered, unless the vehicle was used predominantly in another state; and (d) the gain or loss from the sale of intangibles is allocated using the average of the business allocations for the last three years. N.J.A.C. 18:35-1.1(e)(5), 1.3(d)(5). Notably, the sourcing of the income under the regulations relates to the use of the property by the unincorporated business entity in its business.

Consistent with the amendments applicable to sole proprietorships and partnerships, the new S corporation regulations governing the "Complete Liquidation of an S Corporation" provide, in part, "if the adopted Federal plan of liquidation requires the S corporation, and ultimately the shareholders(s), to recognize a gain or loss from the deemed sale of its assets, the gain or loss from the deemed sale is reported by the shareholder(s) for gross income tax purposes." N.J.A.C. 18:35-1.5(k)(1).

Additionally, the new regulations provide,

> The income or loss from an S corporation's sale or deemed sale, exchange, distribution or other disposition of all of its assets when in conjunction with the sale, exchange or disposition of all of the S corporation's stock must be reported by the shareholder in the category "net gains or income for the disposition of property."
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> [N.J.A.C. 18:35-1.5(k)(2)(ii).]

Unlike the regulations applicable to unincorporated business entities the regulations addressing the complete liquidation of S corporations did not precisely address sourcing rules. The examples under the new regulations demonstrate only the application of the regulations to a New

Jersey S corporation electing I.R.C. §338(h)(10) treatment "which allocates 100 percent to New Jersey." N.J.A.C. 18:35-1.5(o), Example 4. While not specifically referencing any other sourcing rules, the regulation provides that in the case of a non-resident, that portion of the liquidating distribution representing the gain on sale of the corporation's assets is New Jersey Income. Id.

In April 2007, however, the Director proposed an amendment to CBT regulation N.J.A.C. 18:7-8.12, adding subsection (g), as follows:

> Unless the taxpayer can show by clear and convincing evidence that such a methodology does not properly reflect the activity or business of the taxpayer reasonably attributable to the State, receipts from the sale of tangible and intangible assets in a transaction pursuant to I.R.C. 338(h)(10) are allocated and sourced to New Jersey by multiplying the gain by a three-year average of the allocation factors used by target corporation for its three tax return periods immediately prior to the sale.
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> [39 N.J.R. 1243(a) (April 2, 2007).]

The proposal was intended to provide a "more accurate methodology than sourcing such receipts to New Jersey by reference to the sales fraction only that would reflect customer locations." Id. It is thus clear that the Director intended that the sourcing rules set forth in N.J.A.C. 18:7-8.12 be utilized in deemed asset sales under I.R.C. §338(h)(10). The regulation does not distinguish between the treatment of S corporations and C corporations.

Just prior to the proposal this court decided McKesson Water Prods. Co. v Director, Div. of Taxation, 23 N.J. Tax 449 (Tax 2007), aff'd, 408 N.J. Super 213 (App. Div.), certif. denied, 200 N.J. 506 (2009), in which Judge Kuskin held that "the income resulting from [the corporate taxpayer's] deemed sale of assets was nonoperational income under N.J.S.A. 54:10A-6.1(a).[8] As a result, the income . . . must be assigned to . . . the location of [the target's] principal place of business" 23 N.J. Tax at 465. Applying that holding to the facts of this case, the gain on sale of

[8]Judge Kuskin's decision in McKesson was initially issued as a bench decision March 9, 2007 and was amplified by a Formal Opinion issued August 13, 2007 and published at 23 N.J. Tax 449.

the corporation's deemed asset sale would be assigned to New Jersey and would constitute New Jersey income to Paz and the GRATs. The Director argues, persuasively, that McKesson conclusively established that gains from an I.R.C. §338(h)(10) deemed sale are nonoperational income assignable to the domiciliary state of the corporation and effectively invalidated subsection (g) of N.J.A.C. 18:7-8.12.

Plaintiffs contend, however, there is no statutory cross reference to the CBT for determining the portion of net gains or income from the disposition of property under N.J.S.A. 54A:5-1(c) that should be sourced to New Jersey and that the CBT principles apply only to source S corporation income under N.J.S.A. 54A:5-1(p). Thus, according to plaintiff, the principles of McKesson are inapplicable and the methodology of the regulations for sourcing the gain on the sale of assets disposed of in the complete liquidation of the businesses of sole proprietorships and partnerships should instead control.

The income at issue arose from the sale of assets utilized by the Corporation in its business. But for the fact that these assets were sold (or deemed to be sold) in anticipation of the complete liquidation of the Corporation, it is clear that the sourcing rules of the CBT would apply. The Miller court did not reach its decision by way of comparing the transaction with what would occur if the corporation had been an unincorporated business entity. Miller, supra, 352 N.J. Super. 98. The court reached its decision by finding that the legislative intent behind the GIT Act was not to tax capital. Id. In sourcing the gain from the deemed sale of assets to New Jersey the Director's determination does not run afoul of the court's reasoning in Miller not to tax a return of capital. The sourcing of gain was not a factor in Miller.

Furthermore, the court, albeit in dicta, referenced the rules applicable to S corporations in suggesting an alternative interpretation of the GIT and proposed resolution thereunder. Id. at 101.

It would seem, therefore, that the Miller court implicitly recognized the efficacy of applying S corporation concepts under the CBT to the transactions under review in that matter.

Although Judge Kuskin in Mandelbaum, supra, considered the similarity of the principles of taxation applicable to partnerships and S corporations, that comparison related to the characterization of income as being generated in the regular course of business.

> [T]he taxation principals applicable to partnerships and S corporations are not identical, but, for the purposes of determining what constitutes taxable partnership income under category k of N.J.S.A. 54A:5-1 and what constitutes subchapter S corporation income under category p of the same statute, the same principles apply. Under those principles, only income generated in the regular course of business is includable. Other income retains its character and is subject to tax if it fits within one of the other categories of taxable income set forth in N.J.S.A. 54A:5-1.
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> [20 N.J. Tax at 154.]

This court does not find that the seemingly disparate sourcing treatment of sole proprietors and partners is inapposite to the result achieved here. While the pass-through tax treatment of S corporation shareholders is similar to that of sole proprietors and partners in partnerships, that treatment is not identical. See e.g. Sidman v. Director, Div. of Taxation, 18 N.J. Tax 636 (Tax 2000)("Nowhere in the legislation (or any regulation) does it state the subchapter S corporations are to be treated as sole proprietors, unlike the regulations about partnerships and sole proprietorships."), aff'd, 19 N.J. Tax 484 (App. Div.), certif. denied 170 N.J. 387 (2001).

To support their position that the sourcing rules set forth in N.J.A.C. 18:35-1.1 and 1.3 should apply to S corporations, plaintiffs point to the language in 38 N.J.R. 3502(a), supra, that, "[t]he adoption of the new rules and amendments is expected to have a beneficial social impact by clarifying the proper procedures for reporting income received from the sale of business stock in a complete liquidation. This treatment is consistent for sole proprietors, partners, and S corporation shareholders". It is clear that the referenced language refers solely to the application of the rulings in Miller and Mandelbaum, that the net income from the disposition of assets in a complete liquidation of a business entity representing a return of capital not be subject to tax. Nothing within Miller or Mandelbaum, supports plaintiffs' position that the CBT sourcing rules should not be applied.

The court concludes that applying the CBT sourcing rules to the deemed gain on sale of assets under I.R.C. §338(h)(10) is wholly consistent with the taxation of such income as net gains from the disposition of property under the GIT.

b. Operational vs. Non-Operational Income

The court in McKesson, supra, reviewed a transaction substantially similar to that before this court and concluded that the gain on the deemed sale was non-operational income under N.J.S.A. 54:10A-6.1, and was therefore assignable to the taxpayer's principal place of business. In McKesson, the result of the transaction was a cessation of the business operations by the target corporation with a complete liquidation and distribution to the shareholders of the proceeds of sale. 23 N.J. Tax at 465.

McKesson is binding on this court. See Badische (BASF) Corp. v. Township of Kearny, 17 N.J. Tax 594, 599 (App. Div. 1998) ("[a] trial judge has the responsibility to comply with the pronouncements of the Appellate Division."). Therefore, unless this matter is either factually distinguishable or there is subsequent binding new law, this court must follow McKesson. There is no discernible difference between the transaction in McKesson and that before this court, and thus the court concludes that factually McKesson is not distinguishable. As noted above, the court does not find that the decisions in Miller, supra, or Mandelbaum, supra, addressed the issue of the sourcing of gain presented here.

The court concludes that McKesson controls so that the income from the deemed sale of assets by the corporation constitutes non-operational income. The court further concludes that such income, having been deemed to be earned by the corporation, must be sourced with reference to the CBT and is assignable to New Jersey as the principal place of business of the corporation under N.J.S.A. 54:10A-6.1.

Plaintiffs next argue that under the plain language of N.J.S.A. 54:10A-6.1, only the taxpayer can classify income as non-operational.[9] The court rejects this argument. Clearly, the initial sentence of N.J.S.A. 54:10A-6.1 by defining "operational income" excludes from that definition such income that is not within the definition. The second sentence provides an opportunity for the taxpayer to demonstrate that income is nonoperational and sets forth the standard of "clear and convincing evidence." Plaintiffs have not made any demonstration which would require this court to conclude that the income could be classified as anything but non-operational income.

Finally, plaintiffs argue that sourcing the entire gain from the deemed asset sale is violative of the fair apportionment requirement of the Due Process Clause and the Commerce Clause of the United States Constitution because sourcing the entire gain to New Jersey is out of all proportion to the business activities conducted in the state by the corporation. Because the McKesson court resolved the issue before them on purely statutory grounds, they did not reach the constitutional

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[9] N.J.S.A. 54:10A-6.1 provides:

> "Operational income" subject to allocation to New Jersey means income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations and includes investment income serving an operational function. Income that a taxpayer demonstrates with clear and convincing evidence is not operational income is classified as nonoperational income, and the nonoperational income of taxpayers is not subject to allocation but shall be specifically assigned; provided, that 100% of the nonoperational income of a taxpayer that has its principal place from which the trade or business of the taxpayer is directed or managed in this State shall be specifically assigned to this State to the extent permitted under the Constitution and statutes of the United States.

issues implicated in the unitary business principle. 408 N.J. Super. at 221.

Plaintiffs' argument is misplaced. As noted by Judge Kuskin, the definitions of operational and nonoperational income in N.J.S.A. 54:10A-6.1(a) have their origin in the UDITPA definitions of business and nonbusiness income. McKesson, supra, 23 N.J. Tax at 456. "Under [the Uniform Division of Income for Tax Purposes Act] and similar statutes, all business income [of a unitary business] is apportioned and all nonbusiness income is allocated." Jerome R. Hellerstein and Walter Hellerstein, State Taxation, §9.05 (3rd ed. 1998).

"The Constitution places limits on a State's power to tax value earned outside of its borders." Allied-Signal, Inc. v. Director, Div. of Taxation, 504 U.S. 768, 784, 112 S. Ct. 2251, 2261, 119 L.Ed. 2d 535, 550 (1992). "Under both the Due Process and the Commerce Clauses the Constitution, a State may not, when imposing an income-based tax, 'tax value earned outside its borders.'" Container Corp. of Am. v. Franchise Tax Bd., 463 U.S. 159, 103 S. Ct. 2993, 77 L.Ed. 2d 545 (1983). Thus, the business income of a unitary business must be apportioned among all the jurisdictions in which it conducts business. See Mead/Westvaco Corp. v. Illinois Dep't of Revenue, 553 U.S. 16, 24-25, 128 S.Ct. 1498, 1505, 170 L.Ed. 2d 404, 412 (2008). "The Commerce Clause forbids the States to levy taxes that discriminate against interstate commerce or that burden it by subjecting activities to multiple or unfairly apportioned taxation." Id. at 24. The gain on the sale of the corporation's assets, however, constituted nonoperational/nonbusiness income and was not "earned" as business income beyond the borders of New Jersey. The Constitution does not require that nonbusiness income be apportioned among the states. See Ala. Dep't of Revenue v. Kimberly-Clark Corp., 95 So. 3d. 820, 826 (Ala. Civ. App. 2012).

The income at issue arose from the deemed sale of assets in connection with a complete liquidation of the corporation. That income is clearly nonoperational income under McKesson, by which precedent this court is bound. There is no constitutional requirement that such income be apportioned and it is appropriately allocated to the domiciliary state, New Jersey.

5. Abatement of Penalties

The Director imposed underpayment penalties to the tax due from both Paz and the corporation on the GRATs' share of the income from the Corporation pursuant to N.J.S.A. 54:49-4. That section provides, in pertinent part, that "[u]nless any part of any underpayment of tax required to be shown on a return or report is shown to be due to reasonable cause, there shall be added to the tax an amount equal to 5% of the underpayment." The Director is authorized to waive the penalty, in whole or in part, "if the failure to pay any tax when due . . . is explained to the satisfaction of the Director." N.J.A.C. 18:2-2.7(a).

As noted above, the tax due from the Corporation for the income tax payable by the GRATs was abated by the retroactive consents filed by the GRATs. Thus, to that extent the underpayment is eliminated and no penalty should be imposed.

The court has found that Paz incorrectly sourced the income taxable to the shareholders on the liquidation of the corporation. Under the facts of this case, the court finds that the failure to pay tax as a result of the incorrect sourcing of income was reasonable. The court reaches this decision in light lack of direct guidance as to the sourcing of income in the N.J.A.C. 18:35-1.5, the Director's regulation at N.J.A.C. 18:7-8.12(g) apportioning the gain on an I.R.C. §338(h)(10) deemed sale, and the seemingly disparate treatment of sole proprietorships and partnerships as set forth in N.J.A.C. 18:35-1.1 and 1.3. The lack of clear direction from the Division and the lack of judicial guidance on the issue lead to the result that the plaintiffs' position regarding the sourcing of gain was reasonable, although ultimately incorrect. Thus, the penalty should be abated. See United Parcel Service, supra 220 N.J. at 93.

6. <u>Litigation Costs</u>

In light of the court's decision, plaintiffs' demand for litigation costs is rejected.

II. <u>Conclusion</u>

For the foregoing reasons, the court affirms the assessment of tax against Paz for the tax on the gain from the deemed sale of assets of the Corporation; rejects the assessment against the Corporation for the GIT imposed on the GRATs; abates the penalty imposed on Paz for the incorrect sourcing of income; and denies plaintiffs' request for litigation costs. In accordance with R. 8:9-3 the parties shall submit computations pursuant to the court's decision hereunder showing the correct amount of the underpayment within 45 days of the date of this opinion.