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COURT OF APPEALS

STATE OF NEW YORK

WALT DISNEY COMPANY,

Appellant,

-against-

NO. 34

TAX APPEALS TRIBUNAL OF NEW YORK
STATE,

Respondent.

INTERNATIONAL BUSINESS MACHINES
CORP.,

Appellant,

-against-

NO. 35

TAX APPEALS TRIBUNAL OF NEW YORK
STATE,

Respondent.

20 Eagle Street
Albany, New York
March 13, 2024

Before:

CHIEF JUDGE ROWAN D. WILSON
ASSOCIATE JUDGE JENNY RIVERA
ASSOCIATE JUDGE MICHAEL J. GARCIA
ASSOCIATE JUDGE MADELINE SINGAS
ASSOCIATE JUDGE ANTHONY CANNATARO
ASSOCIATE JUDGE SHIRLEY TROUTMAN
ASSOCIATE JUDGE CAITLIN J. HALLIGAN

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Cynthia R. Piett
Official Court Transcriber

1 CHIEF JUDGE WILSON: First case on the calendar
2 is - - - we have two; Disney v. Tax Appeals Tribunal and
3 IBM v. Tax Appeals Tribunal.

4 Counsel.

5 MR. SIMONETTI: Good afternoon, Chief Judge
6 Wilson, and members of the court. It is my pleasure to be
7 here with you all today. May it please the court. I'd
8 like to reserve three minutes of rebuttal time.

9 CHIEF JUDGE WILSON: Yes, sir.

10 MR. SIMONETTI: And my co-counsel, Mr. Friedman,
11 would like to reserve three minutes from his time, as well.

12 CHIEF JUDGE WILSON: Absolutely.

13 MR. SIMONETTI: My name is Mark Simonetti, and I
14 represent the appellant, the Walt Disney Company, and
15 subsidiaries. This appeal arises out of an Article 78
16 proceeding challenging the Tax Appeals Tribunal
17 determination. The profoundly important question before
18 this court is whether New York State can discriminate
19 against a business that engages in international commerce.

20 JUDGE SINGAS: Mr. Simonetti - - -

21 MR. SIMONETTI: Yes.

22 JUDGE SINGAS: - - - can I ask you what the
23 relief is that you're seeking here?

24 MR. SIMONETTI: Your Honor, we're seeking that
25 the court allow Disney the royalty income exclusion, which



1 we believe the statute requires and the Constitution
2 requires.

3 JUDGE SINGAS: And you weren't required to add
4 that back, were you?

5 MR. SIMONETTI: Your Honor, we were not required
6 to add that back because the entity was not a New York
7 taxpayer.

8 JUDGE SINGAS: So if the scheme is found to be -
9 - - you know, if we decide that it shouldn't have been
10 applied, does that affect you in any way - - -

11 MR. SIMONETTI: Your Honor, it - - -

12 JUDGE SINGAS: - - - directly?

13 MR. SIMONETTI: Your Honor, no, it does not. And
14 while the fact is critically important to the analysis, if
15 this were an evenhanded statute that actually applied to
16 everyone consistently because it is not pertinent, because
17 this is a statute that discriminates against their economic
18 interests, and as a result, the fact that there is
19 discrimination here is the issue.

20 JUDGE TROUTMAN: What is the specific
21 discrimination that you are claiming?

22 MR. SIMONETTI: So the discrimination, Your
23 Honor, is perfectly clear, based upon the U.S. Supreme
24 Court precedent, both in Kraft v. Iowa as well as in Oregon
25 Waste. And the first step to determine whether a law - - -

1 tax law is unconstitutional is to determine - - -

2 JUDGE CANNATARO: Is this a - - -

3 MR. SIMONETTI: - - - discriminatory - - -

4 JUDGE CANNATARO: I'm sorry. I didn't mean to
5 interrupt, but before you continue, is this a facial
6 challenge to this statute?

7 MR. SIMONETTI: Your Honor, it is a facial
8 challenge, yes. And the - - - the issue is that because
9 this statute does not regulate evenhandedly, because it
10 actually discriminates against interstate commerce, it is
11 per se invalid.

12 JUDGE CANNATARO: Okay.

13 MR. SIMONETTI: And while a per se invalid
14 statute can be justified, it is not and has not been
15 justified in this case. And I can get to justification.

16 JUDGE TROUTMAN: What is the specific
17 discrimination though?

18 MR. SIMONETTI: The specific discrimination is
19 that the - - - you look at two points, Your Honor. And
20 this is laid out in Oregon Waste. The statutory
21 determinant as to whether you receive the royalty income
22 exclusion or not is based upon a geographic distinction,
23 whether you are - - - whether you are receiving royalties
24 from a subsidiary that is a New York taxpayer or is not.
25 That geographic determinant, Your Honor, actually creates

1 the discrimination that causes the statute to be per se
2 unconstitutional.

3 JUDGE CANNATARO: I don't see a geographic
4 determinant in the statute. Where is that?

5 MR. SIMONETTI: Your Honor, you're right. It is
6 not in the statute. And that is really important point
7 because of the plain meaning of the statute, Your Honor, if
8 I can be clear, does not actually discriminate against
9 interstate or international commerce. The department's
10 interpretation of the statute that has been applied by the
11 Appellate Division does. And it's clear, Your Honor, that
12 the statute, the - - - as written, does not have such a
13 requirement, but that the department and the Appellate
14 Division has blessed them - - - dis - - - disregarding or
15 disallowing the royalty - -

16 JUDGE TROUTMAN: How - - -

17 MR. SIMONETTI: - - - income exclusion based on
18 the fact that - - -

19 JUDGE TROUTMAN: How does that - - -

20 MR. SIMONETTI: - - - that Disney's royalties - -
21 -

22 JUDGE TROUTMAN: Counsel, how does that then
23 affect your facial challenge if it's the application?

24 MR. SIMONETTI: Well, because, Your Honor, it's
25 actually a function of the law itself. They are - - - the

1 - - - the department has taken the position that the law as
2 written - - - their construction of the law is that they do
3 not give Disney the royalty income exclusion because of
4 this geographic determinant.

5 JUDGE TROUTMAN: So it doesn't have to be in the
6 statute, you're saying, and it's not, but it is
7 discriminatory because of how they are applying it?

8 MR. SIMONETTI: Your Honor, we would say the
9 plain meaning of the statute does not have it, but the
10 Appellate Division and the Department of Taxation and
11 Finance has said it is in the statute. They are arguing
12 the statute requires this treatment and denies this - - -
13 this royalty income exclusion - - -

14 JUDGE TROUTMAN: Just to be - -

15 MR. SIMONETTI: - - - based upon that.

16 JUDGE TROUTMAN: Just to be clear - - -

17 MR. SIMONETTI: Yes.

18 JUDGE TROUTMAN: - - - - so are you saying their
19 interpretation is creating the facial - - - the facial
20 challenge?

21 MR. SIMONETTI: Yes, I would say their
22 construction, Your Honor. They are saying that there - - -
23 there are - - - Your Honor, there are three elements to the
24 - - - the exclusion itself. First and foremost, the - - -
25 the statutory requirements for the royalty income exclusion

1 - - -

2 JUDGE HALLIGAN: Do you - - - do you disagree
3 that the add back and the exemption work in tandem, as the
4 ALJ found?

5 MR. SIMONETTI: We do disagree that they actually
6 were - - -

7 JUDGE HALLIGAN: Exactly how - - - how is it that
8 they might not work in tandem?

9 MR. SIMONETTI: They don't work in tandem because
10 there is not a specific requirement that says that it was,
11 in fact, added back under that statute. It says it would
12 be - - -

13 JUDGE HALLIGAN: Can you point to - - - could - -
14 -

15 MR. SIMONETTI: - - - added back.

16 JUDGE HALLIGAN: Well, that's a matter, I think,
17 of statutory construction. I'm - - - I'm asking as a - - -

18 MR. SIMONETTI: Yes.

19 JUDGE HALLIGAN: - - - as a practical matter, are
20 you arguing that they do not, in fact, work in tandem?

21 MR. SIMONETTI: I think that's right, Your Honor,
22 because the royalty income exclusion says that you receive
23 a royalty income exclusion to the extent that the royalty
24 you received would be required to be added back. And that
25 requires you look at that.

1 JUDGE HALLIGAN: Are you aware of any - - - of
2 any examples, or can you point me to one in the record
3 where one is applied but not the other?

4 MR. SIMONETTI: Sure. Well, this instance in
5 particular, Your Honor. Right. We have foreign affiliates
6 who paid royalties to Disney, part of their regular
7 business operations of licensing content.

8 JUDGE CANNATARO: No, but it was - - it was
9 disallowed in this instance because there was no add back.

10 JUDGE HALLIGAN: Yes.

11 MR. SIMONETTI: That is true, Your Honor, they
12 have disallowed it, which is exactly the - - -

13 JUDGE CANNATARO: Well, that wouldn't be a good
14 example - - -

15 MR. SIMONETTI: - - unconstitution - - -

16 JUDGE CANNATARO: - - - of - - - of what Judge
17 Halligan is asking for.

18 MR. SIMONETTI: I apologize.

19 JUDGE CANNATARO: Can you - - - can you cite an
20 instance where the deduction was allowed, but it was
21 somehow disjoined from the add back?

22 MR. SIMONETTI: Yes, Your Honor. So to the
23 extent that the add back - - - the - - - the state has
24 taken the position that to the extent you even file a tax
25 return, that that is sufficient. You don't have to pay any

1 tax. You could have had losses. It does not actually
2 match up with whether you get to - - -

3 JUDGE HALLIGAN: Maybe your - - - your adversary
4 will want to address this as well. I'm just trying to
5 understand how it works in practice and - - - and I'm not
6 sure I see, but correct me if I'm wrong, circumstances
7 where you are hit with one without the benefit of the
8 other.

9 MR. SIMONETTI: Well, Your Honor, that - - -
10 that's exactly what the construction that we believe is
11 appropriate would require. Because otherwise it violates
12 the Constitution of the United States of America and the
13 Commerce Clause in particular. But even more importantly,
14 Your Honor, it violates the statute. The statute says that
15 it would be required to back - - - added back unless these
16 exceptions from subparagraph 2 apply. There are three
17 statutory exceptions from subparagraph 2. That's it.

18 And if I could, those statutory exceptions are if
19 you're included in a combined report, if you paid directly
20 or indirectly to an unrelated party, or if you paid it to
21 an entity that is in a foreign treaty jurisdiction. Those
22 are the three exceptions that are specifically referenced
23 in the law. They are specifically referenced as
24 subparagraph 2 exceptions. And if those exceptions don't
25 apply, the requirement would be required to be added back.

1 That royalty income or that royalty expense would be
2 required to be added back - - -

3 CHIEF JUDGE WILSON: So let me ask - - -

4 MR. SIMONETTI: - - - which then - - -

5 CHIEF JUDGE WILSON: - - - you - - -

6 MR. SIMONETTI: - - - triggers - - -

7 CHIEF JUDGE WILSON: Let me ask you a more
8 abstract question, sort of about your view of tax policy.
9 So if I understand your interpretation of the statute
10 correctly, imagine that Disney is receiving royalties from
11 an affiliate that's foreign and from a completely
12 unaffiliated company that is foreign. I think if I
13 understand it correctly, the way you read - - - that you
14 think the statute should be read is that you would not need
15 to include the affiliate's royalty payment to you in your
16 income, but you would need to read the unaffiliated - - -
17 to include the unaffiliated company's royalty payments to
18 you in your income. Is that how you read the statute?

19 MR. SIMONETTI: That - - - that is correct, Your
20 Honor.

21 CHIEF JUDGE WILSON: Okay. So then what - - -
22 what is the - - - the - - - your understanding of why New
23 York might want to have that distinction in its tax law?

24 MR. SIMONETTI: Yeah. Your Honor, that
25 distinction is specifically designed to avoid an

1 unconstitutional result. The - - - New York is well aware
2 of the fact that it has produced unconstitutional statutes
3 over the course of years; Boston Stock Exchange, the
4 Westinghouse decision as well as - - -

5 CHIEF JUDGE WILSON: Well, let me - - - let me
6 ask it a little differently - - -

7 MR. SIMONETTI: Yeah.

8 CHIEF JUDGE WILSON: - - - because I'm not sure I
9 understand that.

10 MR. SIMONETTI: Right.

11 CHIEF JUDGE WILSON: Suppose instead, the statute
12 said that whether the payment is coming from an affiliate
13 or foreign or domestic and whether it's coming from an
14 unaffiliated company, it's still going to be taxed. Would
15 that have a constitutional problem?

16 MR. SIMONETTI: That - - - that would not, Your
17 Honor, because that would be - - -

18 CHIEF JUDGE WILSON: So then that - - - then that
19 - - -

20 MR. SIMONETTI: - - - an even-handed statute.
21 That wouldn't - - -

22 CHIEF JUDGE WILSON: Okay. Then your answer
23 doesn't - - -

24 MR. SIMONETTI: Okay.

25 CHIEF JUDGE WILSON: - - - get at what I'm trying

1 to get at, which is why would - - - why would New York
2 State want to make a difference in terms of what gets
3 included in your taxable income, depending on whether the
4 payment came from an affiliate or an unaffiliated company,
5 foreign?

6 MR. SIMONETTI: And Your Honor, that's because
7 they put this remedial provision in place. This add back
8 provision requires you to add back income or add back an
9 expense that was otherwise deductible for federal tax
10 purposes. They - - - it's a remedial provision to try to
11 accomplish some goal related to tax planning. There is no
12 tax planning here, but the department doesn't like the way
13 it applies in this - - - in this context.

14 And I would submit, Your Honor, that the
15 legislature understood that there was this constitutional
16 limitation on state taxation because of those cases, and
17 that they could not restrict the benefit of the royalty
18 income exclusion only to the folks that actually had been
19 New York taxpayers.

20 CHIEF JUDGE WILSON: So put it - - - to put it
21 more simply, if I understand your answer, they were trying
22 to do something to help businesses like yours but screwed
23 it up?

24 MR. SIMONETTI: I would say at the opposite, Your
25 Honor. They were trying to increase tax revenue, and

1 because of the way in which they did it, it led to this
2 result that they don't like. They ultimately changed the
3 statute, Your Honor, in 2013. They looked at it and the
4 department went to the legislature and said, we don't like
5 the way this is working.

6 CHIEF JUDGE WILSON: Well, they decided to follow
7 the model tax code, something like that, right?

8 MR. SIMONETTI: Yes, Your Honor. They followed
9 what every other state had done. New York had done it
10 differently. And we all understood that at the time that
11 there was this problem with what New York had done. And
12 the state got to it later and realized that after all this
13 controversy started and realized that they needed to change
14 the law because of the unconstitutional result that happens
15 when they apply their construction of the law.

16 JUDGE GARCIA: May I ask a question?

17 CHIEF JUDGE WILSON: Of course.

18 JUDGE GARCIA: Counsel.

19 MR. SIMONETTI: Yes.

20 JUDGE GARCIA: Assume for the moment that the
21 interpretation of the statute is correct. And I know you
22 dispute that, but assuming there seems to be very different
23 views of what the effect the application of that
24 interpretation would have. Specifically, you have a chart
25 at page, I think 22, and responding to the AG's chart at 22

1 of their brief with wildly different numbers.

2 And I have to admit, I'm struggling to understand
3 just how you arrive at yours. And I will ask them how they
4 arrive at theirs, but could you give me some idea of why
5 you think this application of the interpretation results in
6 this disparity?

7 MR. SIMONETTI: Your Honor, the disparity is - -
8 - well, first of all, they're just using different numbers,
9 Your Honor, so I can't deal with the calculation itself.
10 But what I would say, Your Honor, is that what we were
11 trying to show in our calculation, Your Honor, is that
12 their unconstitutional application would impact even folks
13 from interstate, multi-state companies, or multinational
14 companies. If you had a New Jersey company that was paying
15 royalties to a New York company and they had the same
16 structure, then they would be subjected to tax.

17 Mr. Friedman is going to speak more to that on
18 the internal consistency analysis, but it illustrates the
19 fact that there would be multiple taxation on interstate
20 commerce and international commerce as a result of their
21 application of the - - - of the law, I should say, their
22 construction of the law, Your Honor.

23 JUDGE CANNATARO: Chief, can I just follow up on
24 that, please?

25 CHIEF JUDGE WILSON: Of course.



1 JUDGE CANNATARO: This chart, to me, sometimes
2 when I look at it, I get the impression that it doesn't
3 account for the collective reporting scheme that - - -
4 that's in place. What assurances can you give me that your
5 - - - that this properly reflects what's really going on in
6 the taxing structure that currently - - - or that existed
7 at this time?

8 MR. SIMONETTI: Yeah. And if I could - - - if
9 you're speaking of my chart, Your Honor, I can assure you -
10 -

11 JUDGE CANNATARO: I'm looking at your chart - - -

12 MR. SIMONETTI: - - - it does.

13 JUDGE CANNATARO: - - right now.

14 MR. SIMONETTI: Yeah. Okay. I can assure you
15 that it does, because, Your Honor, at that time, New York
16 State was a separate company filing state. Okay. They did
17 have combined reporting in certain circumstances. These
18 entities were not combined. So any discussion of combined
19 reporting being the panacea or the silver bullet that fixes
20 all this is completely incorrect. It just doesn't because
21 just like in Kraft in footnote 23, they talk about combined
22 reporting, but that's a misnomer in this instance because
23 just like in Kraft, the entity that's paying the - - - the
24 royalty here and was paying the dividend there is outside
25 the group. So since it's outside the group, it is not

1 eliminated as a result of a combined filing.

2 JUDGE CANNATARO: And that was the case for the -
3 - - in - - - in your case - - -

4 MR. SIMONETTI: Yes, Your Honor.

5 JUDGE CANNATARO: - - - the entity who paid the
6 royalty was not part of the group?

7 MR. SIMONETTI: That is correct, Your Honor.
8 It's outside the group because it was a foreign entity.
9 Yes, Your Honor.

10 JUDGE GARCIA: Is there any provision in the New
11 York law for payment of foreign taxes that can be offset?

12 MR. SIMONETTI: There is not, Your Honor. That's
13 exactly why the foreign - - - the Commerce Clause and the
14 foreign Commerce Clause in particular gets implicated so
15 often in state tax because unlike federal taxation, which
16 taxes all your income and then gives you credit for taxes
17 paid to other jurisdictions, the states do not provide a
18 credit system. And so there is no credit for taxes paid to
19 foreign jurisdictions, which is why foreign commerce in
20 particular has been so - - - viewed so - - - with such
21 strict scrutiny because of that.

22 JUDGE GARCIA: So would that be different than
23 your New Jersey example? Because it's a foreign country -
24 - a foreign entity?

25 MR. SIMONETTI: It - - well, it's actually



1 identical, Your Honor, but it's just the New Jersey example
2 obviously brings it a little bit more home in terms of
3 actually understanding.

4 JUDGE GARCIA: But you would not get credit for
5 taxes paid in New Jersey?

6 MR. SIMONETTI: You do not, Your Honor.
7 Absolutely not. Because that - - - that is the
8 apportionment scheme that applies. But to the extent that
9 New York taxed that royalty and New Jersey also taxed that
10 royalty, you're looking at 200 percent taxation.

11 JUDGE GARCIA: But what if New Jersey taxed a
12 portion of that royalty that was attributable to income in
13 New Jersey, and New York taxed that portion attributable to
14 income in New York? Why would that be double tax?

15 MR. SIMONETTI: Because the apportionment does
16 not correct for the addition to taxable income. It does
17 provide an apportionment regime, but it does not correct
18 for the impact of taxable income because of the fact that
19 in an instance, if that taxpayer was a hundred percent in
20 New Jersey, not in New York at all, but was paying
21 royalties to New York, that would be a hundred percent of
22 their taxation would be in New York.

23 CHIEF JUDGE WILSON: Am I right to - - -

24 MR. SIMONETTI: So it's not complemented by the
25 New York apportionment.

1 CHIEF JUDGE WILSON: Am I right that New York
2 treats the situs of the income for intellectual property at
3 the point - - - at the place where it's used?

4 MR. SIMONETTI: Your Honor, that certainly is a
5 bit of - - - a little bit controversial. But it also has
6 changed as - - - after 2015, and there are some differences
7 there as to how it gets sourced.

8 CHIEF JUDGE WILSON: How about - - - how about
9 for the time period we're talking about?

10 MR. SIMONETTI: For the time period we're talking
11 about, Your Honor, it would be - - - theoretically, it
12 would be sourced to where the location is of the
13 performance.

14 CHIEF JUDGE WILSON: Of the use. Okay.

15 MR. SIMONETTI: Yeah.

16 CHIEF JUDGE WILSON: Thank you.

17 MR. SIMONETTI: Thank you, Your Honor.

18 MR. FRIEDMAN: Good afternoon. Jeff Friedman on
19 behalf of IBM. This tax interpretation by the state of New
20 York is the quintessential violation of the internal
21 consistency test. It is an example of a scheme that was
22 designed for perhaps good reason but is an either/or tax.
23 New York made a decision when it put this regime in place
24 in 2003, to impose either a tax on the receipt of a
25 royalty, or on the payment of a royalty. Any time you have

1 an either/or tax it violates the internal consistency.

2 JUDGE HALLIGAN: Why is that?

3 MR. FRIEDMAN: Yeah. So if you do the
4 replication that internal consistency requires of the tax
5 regime - - -

6 JUDGE HALLIGAN: So break that down. What - -
7 what exactly do you mean by the replication? You mean if
8 every jurisdiction were to adopt the same rule?

9 MR. FRIEDMAN: Yes, Your Honor. I'd like to walk
10 through that. Assuming every state in the United States
11 has the identical regime as New York has, as interpreted by
12 the state, of course, we believe they're interpreting it
13 incorrectly - - -

14 JUDGE HALLIGAN: I understand.

15 MR. FRIEDMAN: - - - but I'm applying their
16 interpretation. Every state would have the identical
17 regime. It's a hypothetical. The court has acknowledged
18 that. In fact, in the Wynne case in 2015, the court
19 described it as the identical replication of the regime.
20 Those taxpayers - - - those - - - those companies, let's
21 call them, that are paying royalties to taxpayers in New
22 York, would have that royalty subject to tax twice. For
23 instance, in New - - - let's - - - I'm from New Jersey - -
24 -

25 JUDGE HALLIGAN: Why wouldn't they benefit from

1 both the exclusion and the add back?

2 MR. FRIEDMAN: The - - - according to the New
3 York position - - - interpretation, the only way to get
4 that only once and - - - you know that once and only once -
5 - -

6 JUDGE HALLIGAN: Yeah.

7 MR. FRIEDMAN: - - - mantra would be to have both
8 the payer and payee both taxable in New York. And that is
9 exactly the discrimination that Mr. Simonetti was
10 describing. It forces both companies into the system. If
11 only one is in the system, then yes, New York - - -

12 JUDGE HALLIGAN: When you say in the system, what
13 do you mean by that?

14 MR. FRIEDMAN: Taxable in New York. I'm sorry.

15 JUDGE HALLIGAN: Uh-huh.

16 MR. FRIEDMAN: If only one of them is taxable in
17 New York, then New York would impose its tax on the
18 royalty. But according to the hypothetical replication of
19 the identical structure - - -

20 JUDGE HALLIGAN: Yeah.

21 MR. FRIEDMAN: - - - the out-of-state company
22 would be taxable in its home state, let's say new Jersey.
23 That hypothetical replication shows that the structure of
24 the tax as - - - as - - - has a overreach - - - an inherent
25 overreach that causes the - - -

1 JUDGE HALLIGAN: But wouldn't - - - wouldn't the
2 inverse be true? In other words, is the test measured
3 simply from the perspective of a single company, or do you
4 look at the regime in its entirety?

5 MR. FRIEDMAN: Yeah.

6 JUDGE HALLIGAN: And if it's the latter, which I
7 thought is what it was - - -

8 MR. FRIEDMAN: It is.

9 JUDGE HALLIGAN: - - - then - - - then won't the
10 converse be true for the company in New Jersey and the
11 consequences in New York? I don't understand why across
12 jurisdictions, when you look at it in toto, you have the
13 kind of disequilibrium you're identifying.

14 MR. FRIEDMAN: Yeah. And those are the examples
15 that are in all the briefings in this case is intending to
16 demonstrate via math. But I think we could talk about it
17 conceptually as well, moving away from the charts and the -
18 - -

19 JUDGE HALLIGAN: Yeah.

20 MR. FRIEDMAN: - - - and the briefing. And that
21 is that the payor - - - let's talk about it in the context
22 of a royalty payor and a royalty payee. A royalty payor
23 would be subject to tax, in my example, in New Jersey, and
24 a royalty payee would be subject to tax in New York because
25 in either of those two states, they wouldn't qualify for

1 the royalty income exclusion that is intended to turn it
2 off in both states.

3 JUDGE HALLIGAN: But wouldn't the converse be
4 true if the companies were in the opposite jurisdictions?
5 And - - - and so how do you see inconsistency as across the
6 regime as a whole?

7 MR. FRIEDMAN: The converse would be true. And -
8 - - and if you reversed it, you would have tax on both the
9 payor and payee if you reverse their positions.

10 JUDGE HALLIGAN: Right.

11 MR. FRIEDMAN: Which is why New York was the only
12 state in the country. Thirteen to fifteen states put in
13 place a regime to deal with this problem. New York was the
14 only one to do it this way.

15 JUDGE HALLIGAN: But - - - but - - - correct me
16 if I'm wrong, but I thought that the test looked at whether
17 if you - - - if you have a specific tax regime in state A,
18 whatever state it is - - -

19 MR. FRIEDMAN: Yeah.

20 JUDGE HALLIGAN: - - - and you replicated that as
21 across the country, not whether in fact it is replicated
22 across the country.

23 MR. FRIEDMAN: That's correct, Your Honor. That
24 is exactly what we're doing. We're taking New York's
25 regime - - -

1 JUDGE HALLIGAN: Yeah.

2 MR. FRIEDMAN: - - - New York was the only one to
3 do it, but we're imagining that every state did it. So - -
4 -

5 JUDGE HALLIGAN: And if every state - - - I'll
6 give it one last try and then I'll let it go.

7 MR. FRIEDMAN: Sorry.

8 JUDGE HALLIGAN: But if every state does it, then
9 won't companies be subject to the same consequences in each
10 state? Whether that means that they're taxed once, twice,
11 or not at all?

12 MR. FRIEDMAN: I'm not sure I understand your
13 question in terms of the same consequences. Maybe that's
14 where we're disconnecting on this. The royalty itself - -
15 - there's only one - - - in my hypothetical, it's one
16 royalty being paid. It would be taxed in both states. It
17 would be subject to double taxation.

18 CHIEF JUDGE WILSON: I can try - - - I think I
19 can try Judge Halligan's question in a different way.

20 JUDGE HALLIGAN: Yes.

21 MR. FRIEDMAN: I'm sorry.

22 CHIEF JUDGE WILSON: Imagine that every company
23 in this hypothetical world is both a payor and a payee.

24 MR. FRIEDMAN: Okay. So let's say there's ten
25 companies in the IBM group and they're all payors and

1 payees.

2 CHIEF JUDGE WILSON: Oh, no no, no, not just the
3 IBM group. We only need to have one payor and payee in the
4 IBM group. But assume that there are ten companies in this
5 hypothetical world - - -

6 MR. FRIEDMAN: Are you - - -

7 CHIEF JUDGE WILSON: - - - ten parents and ten
8 subs in the hypothetical world. And each one is both, as
9 regards intellectual property, let's - - - to make it
10 simpler, a payor and a payee, but in different - - - in
11 different directions in between New Jersey and New York.

12 MR. FRIEDMAN: Yeah. Yeah. It's interesting
13 when the U.S. Supreme Court provided us, created, honestly,
14 the internal consistency test in 1983, in the Container
15 case, actually, it came out of a combined reporting regime,
16 it was California's. And you looked at the - - - the - - -
17 the direction the court gave us in Container and then
18 applied subsequently the next year in 1984 in Armco and
19 then subsequently that in Tyler Pipe, the court is - - - is
20 replicating the law and using the taxpayers' facts.

21 So I could design a fact pattern. And the state
22 has designed a fact pattern where there is no double
23 taxation. What the state did is they created a bunch of
24 zeros. We can get into that if you'd like. And you know,
25 anything times a zero is going to be zero. So it looks

1 like there's no harm being done. There's no double tax.
2 Or you can create other offsets, et cetera to ensure that
3 there's no double taxation.

4 In the application of the internal consistency
5 test to IBM, and I believe Disney as well, you replicate
6 the law, but you don't change the facts. And the facts are
7 what they are, which is that IBM received royalties. They
8 were here in Armonk, New York, and these royalties are all
9 domestically, which aren't in question here, but all
10 throughout the world.

11 And if you replicate this structure so that every
12 other state imposed the same regime as New York's without
13 changing the facts, Your Honor, we have clear double
14 taxation, which creates this quintessential internal
15 consistency violation.

16 JUDGE CANNATARO: Counsel, is it your argument
17 that under the internal consistency test, as articulated by
18 the Supreme Court, I - - - I heard what you said. You use
19 the law to make the rubric and then you plug in the facts -
20 - -

21 MR. FRIEDMAN: Thank you, Your Honor.

22 JUDGE CANNATARO: - - - of the litigant that's in
23 front of you. Is that - - - is - - - is it required that
24 it just be specifically tailored to the particular litigant
25 in the case, or should we look at a range of potential



1 taxpayers? And say sometimes they get more tax in New
2 York, but less in New Jersey. And sometimes it's the other
3 way around. And it all sort of comes out in the wash. And
4 we have a rough approximation of a fair taxing scheme.

5 MR. FRIEDMAN: Well, I like the rough
6 approximation. No, you don't, Your Honor. Thank you. You
7 don't. You can find instances where there won't be a
8 problem at all because the different numbers, et cetera.
9 You only do - - - in the litigation, you apply it to the
10 taxpayer's facts. You don't have to come up - - - you
11 don't have to do the hard work that you were describing to
12 see if there are other scenarios - - -

13 JUDGE CANNATARO: It's too late. I already did
14 it.

15 MR. FRIEDMAN: Well, I'd love to hear about it,
16 Your Honor. But if you were thinking that you would have
17 to go through that process of coming up with other
18 applications where maybe it would work here, but it
19 wouldn't work there, you don't have to do that. All you do
20 is look at the taxpayers' facts that are - - - that is
21 challenging the regime as applying or creating an internal
22 inconsistent tax to it.

23 JUDGE CANNATARO: So inversely if I were to go
24 back and run the numbers just for IBM, and I find that in
25 some situations their New York tax liability is increased,

1 but that's offset by a reduction in another jurisdiction or
2 something like that, has New York's regime then passed the
3 internal consistency test?

4 MR. FRIEDMAN: If there was some taxpayer that
5 didn't have facts like IBM's, perhaps. Fortunately, I
6 don't have to deal with that. And by the way, it's not
7 just me that feels this. The - - - the foremost authority
8 in this area is Professor Hellerstein. I know his treatise
9 has been cited by both parties in the briefing. And I
10 believe it's section or chapter 9, maybe subsection 20, he
11 goes through a very elaborate description of internal
12 consistency.

13 And frankly, he was very hostile, Professor
14 Hellerstein was, to internal consistency prior to the Wynne
15 decision, where the U.S. Supreme Court said, in case
16 there's any doubt, internal consistency is still a test
17 under the dormant Commerce Clause. And he talks about this
18 very - - - bringing it back to your question, he talks
19 about this very specific question about what do you
20 replicate and what do you not replicate when you apply
21 internal consistency. You replicate the regime that you're
22 challenging, the tax.

23 In fact, in Container in 1983, it was specific to
24 a formula. And the court talked about it in terms of a
25 formula. In the subsequent cases they put brackets,

1 removed the word formula, the U.S. Supreme Court did and
2 put in the word tax, meaning the entire tax structure, as
3 you are saying, and you replicate the tax structure, and
4 you apply it to the taxpayer's facts that is challenging
5 the tax structure.

6 JUDGE CANNATARO: And you win when you do it that
7 way?

8 MR. FRIEDMAN: We absolutely win. This is a
9 quintessential internally inconsistent tax. Whenever you
10 have an either/or tax system, and I can go through them in
11 the cases with you, I'd love to, you win. Those are the
12 cases that win. Whenever it's an all or nothing, you don't
13 win. So in Goldberg v. Sweet, Illinois had a tax on
14 telephone calls. It was challenged in part under the
15 internal consistency test. But that telephone call under
16 the Illinois tax regime that was being challenged, the U.S.
17 Supreme Court replicated it, as we've been talking about.

18 And as it turned out, only one state, Illinois,
19 let's say, could tax that telephone call. It was a very
20 controversial decision at the time. In Jefferson Lines,
21 subsequent to that, only one state - - - only Oklahoma can
22 tax that bus ticket, because under the way that tax was
23 structured, those incidences could only be occurring in a
24 single state when you did the hypothetical replication.

25 JUDGE SINGAS: But - - - but don't you get a

1 benefit when a company moves abroad that's using the IP,
2 the intellectual property, and then they have those
3 receipts go with them, and then IBM gets to decrease their
4 taxable income in New York through their business
5 allocation percentage, right?

6 MR. FRIEDMAN: So I'd love to talk about two, I
7 think, embedded points in your question. One is, I think
8 what you're referring to is this allegation of a windfall.
9 And then second of - - - secondly, what is the role of the
10 business allocation percentage in this discussion as it
11 relates to the windfall?

12 JUDGE SINGAS: Right. I'd like to start with the
13 latter.

14 MR. FRIEDMAN: Okay.

15 JUDGE SINGAS: Because if there's some other
16 claim or if there's some other reason - - -

17 MR. FRIEDMAN: Yeah.

18 JUDGE SINGAS: - - - why there's a discrepancy,
19 then it's not the scheme that's at fault, correct?

20 MR. FRIEDMAN: Yeah, we - - - we - - -
21 unfortunately, we only had so much briefing, but we - - -
22 we - - - we attempted to go after this in the briefing
23 first for two reasons. The business allocation percentage
24 does not save this inherently discriminatory - - - this
25 inherently internally inconsistent tax. The first reason

1 is the simple math. If the state were right that don't
2 worry about this because those royalties they're being
3 included in the business allocation percentage.

4 Imagine this. You're multiplying a number that
5 has the royalties in it, and you're putting that royal - -
6 - that same royalty amount in the sales factor denominator,
7 the bottom part of the fraction, they do not offset each
8 other. The income to be taxed is increasing and the
9 denominator is increasing. But the - - - the decrease of
10 the factor does not offset the tax. We spell that out in
11 our briefing. It's hard for me to do it in the short
12 amount of time I have here. And I can see I'm out of - - -

13 JUDGE CANNATARO: Does the Supreme Court of the
14 United States require - - - over here - - -

15 MR. FRIEDMAN: Yes.

16 JUDGE CANNATARO: - - - perfect identity? I - -
17 - I understand what you said, and I realize I think you
18 acknowledge that the BAP goes down if you increase the
19 denominator, but it's not - - - you - - - your argument is
20 that it's not sufficient. It's - - - it's - - -

21 MR. FRIEDMAN: You wouldn't have a - -

22 JUDGE CANNATARO: - - - not a - - -

23 MR. FRIEDMAN: - - - a tax assessment today if
24 that were the case. Yeah.

25 JUDGE CANNATARO: But does - - - does Supreme

1 Court require dollar to dollar identity, or is it enough to
2 say, well your BAP has now proportionally reduced and
3 that's constitutionally tolerable?

4 MR. FRIEDMAN: We are not challenging the
5 application of the apportionment formula, which is where
6 the rough approximation standard comes from. And the rough
7 approximation standard doesn't say this tax because the
8 royalty is being multiple taxed. It doesn't make a
9 difference if it's 1.1, or one to ten, or a hundred to one,
10 as long as that royalty is being taxed more than once
11 applying the internal consistency test, it is a failure.
12 The tax is illegal. It violates the dormant Commerce
13 Clause. And it cannot be saved.

14 And as it relates to the severability point, I
15 just need to mention this very quickly. Our first tax year
16 in this litigation is 2007. There is no way - - - the U.S.
17 Supreme Court has - - - has been very liberal about how to
18 remedy an illegal tax. And in - - - in a case like this,
19 you could either level up or level down. That's how the
20 court has described it. But when you're dealing with years
21 that go back seventeen, there's no way to level up.
22 There's no way to fix retroactively the harm caused by the
23 discriminatory tax because the statute of limitations is
24 closed for all of those that they would level up against.

25 IBM will always be disadvantaged as it relates to

1 others because of that statute of limitations problem. The
2 McKesson case talks about the due process clause and the
3 requirement to either level up or level down, and it can't
4 happen here just because of the passage of time.

5 CHIEF JUDGE WILSON: Do you also think that the
6 department has misread the statute?

7 MR. FRIEDMAN: A hundred percent. We are
8 challenging the interpretation - - - the department - - -
9 the state's interpretation of the statute, Your Honor.

10 CHIEF JUDGE WILSON: Thank you.

11 MR. FRIEDMAN: Thank you.

12 MR. BRODIE: May it please the court. Frederick
13 Brodie for the commissioner. Both judgments should be
14 affirmed. Appellants paid royalties to themselves from one
15 related party to another. New York addressed related
16 member royalties by requiring the paying member to add them
17 back to its income. If the paying member added back the
18 royalties to income, the receiving member got a deduction
19 and could deduct them. No add back meant no deduction.

20 Appellants alien members didn't pay New York
21 taxes, so their royalty payments were not added back. Yet,
22 appellants want the benefit of deductions for the foreign
23 royalties they received without the corresponding burden of
24 an add back. No policy supports such a windfall, and the
25 Constitution doesn't require it.

1 JUDGE CANNATARO: Counsel, in the Rorschach test
2 of reading tax statutes, sometimes when you look at these
3 two provisions, subsection 3 and subsection 2 together, it
4 looks more like a scheme. It - - - it's - - - it's - - -
5 it doesn't - - - sometimes it doesn't look like an - - - an
6 articulation of tax policy, so much as a scheme to shift
7 payment of a tax that New York is assessing.

8 You know, a royalty payment is clearly taxable as
9 income, at least to the payee. And this scheme seems to
10 allow instead of the payee paying the tax to - - - to shift
11 the - - - the responsibility for payment to the payor in a
12 sort of tax neutral way. I'm wondering, is that just an
13 aberration in my mind, or is that a fair description of
14 what these two provisions are doing?

15 MR. BRODIE: No, Your Honor's absolutely right.
16 At the corporate group level, the total tax burden for
17 companies with alien members and those with just New York
18 members is the same, was the same. The royalties were
19 taxed, but only once. Start with the international group.
20 Because the alien members weren't New York taxpayers, they
21 weren't required to add back anything.

22 When the parent received those royalties in New
23 York, no add back meant no deduction, so the parent had to
24 include them in income. The result was the royalties were
25 taxed once at the parent level. Now, compare a group

1 that's wholly in New York. The paying members had to add
2 back the royalties, but the receiving member got a
3 corresponding deduction. Again, the royalties were taxed
4 once, this time to the - - - to the paying member.

5 JUDGE HALLIGAN: So why is the relevant reference
6 point the parent group as opposed to the royalty payor or
7 payee?

8 MR. BRODIE: Well, I'm just using parent as - - -
9 as - - - as a shorthand because they were paid from one
10 related member to another.

11 JUDGE HALLIGAN: I understand that, but - - - but
12 why is - - - is that the relevant reference point as
13 opposed to what is one related member as opposed to another
14 related member paying, if that makes sense?

15 MR. BRODIE: Well, I - - - I think what Your
16 Honor is asking is why is the whole corporate group the
17 relevant - - -

18 JUDGE HALLIGAN: That is what I'm asking.

19 MR. BRODIE: Yes. And the answer to that is that
20 the internal consistency test precedence and the other
21 Supreme Court precedence on discrimination look to economic
22 interests. And - - - and I agree with one of my opposing
23 counsel who said that. So all of the subs, all of the
24 subsidiaries, or all the - - - and the parent corporation,
25 each corporate group share the same economic interest. So

1 that's why it's appropriate to look at - - - at the
2 corporate group as a whole.

3 JUDGE HALLIGAN: Do you want to res - - -

4 JUDGE CANNATARO: No, go ahead.

5 JUDGE HALLIGAN: I was just gonna say do you want
6 to respond to your - - - your adversary's discussion of the
7 internal inconsistency test? Why are they not correct that
8 that means that there's a dormant Commerce Clause problem
9 here?

10 MR. BRODIE: Well, I want to - - - I want to do
11 two things on internal consistency. I want to explain why
12 we passed the internal consistency. But I also want to be
13 brave and address IBM's chart. And - - - and I think I'll
14 do the chart first. It's on page 22 of IBM's brief.
15 Because when we - - - when we look at that, the flaws in
16 that chart, and there are two key flaws, you'll see how we
17 pass internal consistency, and the chart doesn't prove what
18 IBM says it does.

19 First problem with the chart, and this is
20 critical, IBM's chart doesn't reflect the deduction the
21 recipient would get from the payor's state. Now if state X
22 payor, and I'm looking at the bottom rung - - - bottom deck
23 of the chart, inter-state enterprise. If a state X payor
24 pays royalties to a New York recipient, the New York
25 recipient now has income from a state X source. So that

1 means the New York recipient needs to file a return not
2 just in New York, but also in state X.

3 Now, when the New York recipient files in state
4 X, it gets a deduction from state X. Why? Because under
5 the internal consistency test, we assume that state X has
6 the same tax law as New York. So add back, deduction, no
7 add back, no deduction. Here, state X is making them add
8 back.

9 JUDGE RIVERA: Yes.

10 MR. BRODIE: So state X gives them a deduction.

11 JUDGE RIVERA: So - - - so if I'm understanding
12 this small part of the chart as you're describing it, if we
13 assume the two states we're talking about, all states have
14 the exact same statutory regime, in one state you have the
15 payor. They're getting taxed because you don't also have
16 the payee in that state. I'm correct so far?

17 MR. BRODIE: I think so. That's right.

18 JUDGE RIVERA: They don't get the deduction from
19 the payee. And in the other state where the payee is
20 located because the payor is not in that state, the payee
21 gets hit with the tax.

22 MR. BRODIE: Right. And - - -

23 JUDGE RIVERA: And that's where you say you have
24 the balance.

25 MR. BRODIE: That - - - that's - - -



1 JUDGE RIVERA: That there's only one tax one time

2 - - -

3 MR. BRODIE: Right.

4 JUDGE RIVERA: - - - on each end?

5 MR. BRODIE: Right.

6 JUDGE GARCIA: But are you saying a New York
7 entity has to file a Jersey, let's say, tax return, also or
8 no?

9 MR. BRODIE: Absolutely. Because - - -

10 JUDGE GARCIA: Yes.

11 MR. BRODIE: - - - and - - - and that's New York
12 tax law.

13 JUDGE GARCIA: Right.

14 MR. BRODIE: If you've got New Jersey source
15 income then you've got to file in - - - in both New York
16 and in where - - - where you're living and in New Jersey.

17 JUDGE GARCIA: The Jersey entity and the New York
18 entity get the deduction in Jersey? That's - -

19 MR. BRODIE: That's right. And if you look at
20 the bottom right of IBM's chart, it has the royalty payor
21 in state X giving a return, but not the New York payee.
22 The New York payee's return is missing. And now our chart,
23 in contrast, includes that New York payee's return for
24 money that it had got from state X, and it includes the
25 deduction that state X gives you. And that's what evens it

1 out. So you do get a deduction - -

2 CHIEF JUDGE WILSON: Your chart - - your chart
3 shows that nobody would pay any tax anywhere. But I assume
4 that's just an artifact of making the total income the same
5 as the royalty income?

6 MR. BRODIE: Well - - - well, no.

7 CHIEF JUDGE WILSON: It's all zeros, right - - -

8 MR. BRODIE: Right.

9 CHIEF JUDGE WILSON: - - in your chart?

10 MR. BRODIE: Well - - - well, I'm - - - I'm not
11 manipulating the chart with zeros as - - - as - - - as
12 counsel accused. What we do - - -

13 CHIEF JUDGE WILSON: No.

14 MR. BRODIE: - - - is we - - - it's a virtue.
15 It's not a flaw. We isolate the payment of a \$50 royalty
16 in our IBM chart.

17 CHIEF JUDGE WILSON: Right. I'm just - -

18 MR. BRODIE: And - - - and - - -

19 CHIEF JUDGE WILSON: - - - I'm really just asking
20 if your assumption in those charts is that the total income
21 of the companies is the royalty - - - is the royalty?

22 MR. BRODIE: Right. Exactly.

23 CHIEF JUDGE WILSON: Yeah.

24 MR. BRODIE: All that's happening - - -

25 JUDGE HALLIGAN: What page is your chart on? I

1 don't mean to interrupt you, but what page?

2 MR. BRODIE: What page - - - our - - - our IBM
3 chart is on page 59 of our IBM brief.

4 JUDGE HALLIGAN: Thank you.

5 MR. BRODIE: So - - - so in the lower right, you
6 see that extra return, New York recipient state X return.
7 So you do get a deduction in the interstate scenario.
8 Appellants just don't include it in their charts. Now,
9 second problem with IBM's chart. IBM's chart wrongly
10 allocates to New York royalties for intellectual property
11 used elsewhere. New York law allocates receipts based on
12 where the property is used.

13 Royalties paid from state X are for property used
14 in state X. The royalties should therefore be allocated a
15 hundred percent to state X and zero to New York. But IBM's
16 chart allocates a hundred percent of the royalty income to
17 both state X and New York. And we can see this if you look
18 bottom deck, interstate enterprise, left side, \$50 royalty
19 income in New York. Now, that's allocated a hundred
20 percent to New York. It's income. It's right there.

21 Now, go over to the right side. \$50 royalty add
22 back. Wait a minute. That's allocated a hundred percent
23 to state X. Now, you can't allocate a hundred percent of
24 this payment to both New York and state X. There's a
25 problem there. And the problem is the IP, the intellectual

1 property, is used in state X. So it should be allocated a
2 hundred percent to state X, not at all to New York.

3 New York's been over allocated. And that's
4 another problem with the chart. Now, how do we pass the
5 internal consistency test? There are - - - there are four
6 independent reasons. First, the add back applied only to
7 the extent a company deducted royalties on its U.S. federal
8 tax. On both the add back in (o) (2) and the deduction in
9 (o) (3) were measured by looking to royalties deductible on
10 federal income tax returns.

11 That's reasonable because federal income tax is,
12 in fact, the starting point for New York franchise tax.
13 Under internal consistency, we assume the foreign country
14 has a tax scheme identical to New York's. And counsel
15 stressed identical. Because the alien members don't pay
16 U.S. federal tax, if their home countries adopted New York
17 law, no add back would be required and that means no
18 additional burden.

19 Second, New York can tax the receipt of royalty
20 income, which is a separate local taxable event. Now, the
21 Supreme Court in Jefferson Lines and this court in Zelinsky
22 and Tamagni recognized that taxation of the same flow of
23 funds by different authorities at different points in the
24 stream of commerce is inevitable in a multi-state system.
25 Payment and receipt of royalties occur in different

1 jurisdictions and involve different entities. Each
2 jurisdiction may include that transaction in taxable income
3 when the stream of commerce touches the state.

4 For example, the Supreme Court upheld a fee on
5 trucks traveling through Michigan - - - in Michigan, even
6 though if all states imposed the same fee under internal
7 consistency rule, an interstate trucker would pay a lot
8 more than a purely intrastate trucker. The reason was by
9 traveling in Michigan, the trucks engaged in - - - in local
10 business, and that's American Trucking Association against
11 Michigan Public Service, 545 US at 438. And I'd submit the
12 same situation here. New York receives, New Jersey or
13 state X company pays, those are two separate taxable
14 events.

15 JUDGE CANNATARO: Counsel, that proposition seems
16 relatively un - - it - - it's - - - it's not terribly
17 disputed in this case that money flowing through can be
18 taxed in different jurisdictions constitutionally. The
19 issue here, though, the argument here, is that the way
20 certain monies are treated in New York are differentiated
21 based on where the income is coming from. And I understand
22 that to be the crux of - - - of the argument that's being
23 made by your adversaries.

24 MR. BRODIE: Well, all right. Well, I - - - if -
25 - - if that's - - - if Your Honor's referring to the

1 geographic determinant argument - - -

2 JUDGE CANNATARO: Well, that's what they call it.

3 MR. BRODIE: - - - that - - - that Disney made.

4 JUDGE CANNATARO: But you know, it's
5 distinguishable from your statement that the same stream of
6 income can be taxed by different authorities. It's - - -
7 they distinguish it by saying, but you're taxing similar
8 streams of income differently.

9 MR. BRODIE: Well - - - well, here's - - - here's
10 why they're wrong. 208(9)(o) did not contain a geographic
11 determinant. The determinant was whether there was an add
12 back, not where the company was located. And being a New
13 York taxpayer is not a geographic determinant.

14 JUDGE CANNATARO: Why is that?

15 MR. BRODIE: A foreign company can still be a New
16 York taxpayer. That's Tax Law 209(1)(a), first section of
17 the franchise tax. It doesn't matter where you are.

18 JUDGE HALLIGAN: Is the geographic determinant
19 the locus of where the tax is assessed or - - - or where
20 the entity is? I take it you're saying it must be the
21 second and not the first?

22 MR. BRODIE: Well, you know, I'm not sure because
23 opposing counsel basically made up the test. You can run
24 the phrase geographic determinant in Westlaw, and you can
25 look for Supreme Court cases, there aren't any cases that

1 say geographic determinant. So - - - but it - - - it's - -
2 - it's not - - -

3 JUDGE HALLIGAN: But I take what - - - what - - -
4 and - - - and I'm sure they'll clarify. But I take it that
5 the - - - that the crux is you are taxed differently if
6 you're in New York as opposed to out of New York. And in
7 that sense, it's a geographic determinant. Isn't that what
8 they're arguing?

9 MR. BRODIE: Well, if that's the argument, then
10 it's - - - then differently but equally. Because remember,
11 you know, the out of state, no add back if you're out of
12 state - - - I mean, out of the country. If you're not a
13 New York taxpayer, you don't add back. You don't add back,
14 the other guys don't get a deduction. If you - - -

15 CHIEF JUDGE WILSON: Well, you could be out - - -

16 MR. BRODIE: - - - bring - - -

17 CHIEF JUDGE WILSON: You could be out of the
18 country and be a New York taxpayer, right? As long as you
19 had business in New York?

20 MR. BRODIE: Yes.

21 CHIEF JUDGE WILSON: Yeah.

22 MR. BRODIE: Absolutely.

23 CHIEF JUDGE WILSON: I mean, this is the same
24 thing you're saying is missing from the charts?

25 MR. BRODIE: Right.

1 JUDGE CANNATARO: And in that scenario that the
 2 Chief Judge just articulated, you're saying you would get
 3 the add back because you're a New York taxpayer - - - a
 4 foreign New York taxpayer, so you would have to do the add
 5 back, and the pay would also concomitantly be entitled to
 6 the exclusion.

7 MR. BRODIE: Correct.

8 JUDGE CANNATARO: Okay.

9 MR. BRODIE: Add back, deduction. No add back,
 10 no deduction. The statute works very, very simply in that
 11 sense. And - - - and I would like to address the counsel
 12 for Disney's argument on what the statute says, because - -
 13 -

14 JUDGE HALLIGAN: As you talk about that, can you
 15 tell us if, you know, if the legislative history or
 16 anything that - - - that the agency's put out explains why
 17 it was amended in 20 - - - I think it was 2013?

18 MR. BRODIE: There - - - there - - - there is a
 19 statement and it's in the legislative history, I believe,
 20 for 2013, that said that the add back and deduction had
 21 been interpreted aggressively by taxpayers and they - - -
 22 they - - - or the deduction had. I don't know if it was
 23 referring to this case, but they said they were getting rid
 24 of the deduction because of - - - because of that. Now - -
 25 -

1 JUDGE CANNATARO: Can - - - can we - - - just
2 going back even further to 2003 when this - - - this
3 particular regime came into existence, why would a state or
4 a taxing authority want to create this system whereby you -
5 - - it would seem to me common sense would dictate to me
6 that the person who should be paying tax on a royalty
7 payment is the person who receives the royalty payment.
8 Why would New York go through the trouble of creating a
9 regime whereby, you know, you - - - you require the add
10 back, and that allows you to exclude it? What benefit is
11 to be gained by doing that?

12 MR. BRODIE: Well, this legislative history and -
13 - - and this is the history of the - - - some technical
14 amendments that were made about six months after the
15 statute was passed, but it's close in time. Same statute.
16 Legislative history says it's to - - - to prevent tax
17 loopholes concerning intra-corporate royalties, related
18 member royalties.

19 JUDGE CANNATARO: Yeah, but my understanding of
20 the way that - - - that unfortunate situation existed prior
21 to 2003, is that the ownership of the IP was transferred
22 completely out to another country where it wasn't very
23 heavily taxed or not taxed at all. And then the - - - the
24 payor would be a New York taxpayer who would then deduct
25 the - - - deduct the royalty payments as a - - - as a

1 business expense, thereby allowing the entire IP licensing
2 transaction to go completely untaxed. Very bad situation.

3 But this is reversed in the sense that the payee
4 is now in New York. And the payor, in our case, is outside
5 of New York. So I don't know that it even addresses that
6 particular scenario. This is a - - - this allows the payor
7 - - - the payee to exclude the income. And I - - - as I
8 said before, I consistently find myself asking, why would
9 you want to do that? What's - - - what's the purpose of
10 doing that?

11 JUDGE GARCIA: And I think, following on that
12 question and this may not be relevant, but if this transfer
13 hadn't happened, what would New York's ability be to tax
14 this money?

15 MR. BRODIE: And by this transfer - - -

16 JUDGE GARCIA: Into the New York entity from
17 overseas, right?

18 MR. BRODIE: Right. Well, we don't have the
19 ability to tax transactions that are solely overseas to - -
20 - to - -

21 JUDGE GARCIA: So the only way you get to tax
22 this is because they brought it into New York?

23 MR. BRODIE: That's right. And it's the only way
24 New York gets to tax anything is there has to be a - - - a
25 nexus with the state. Now - - - now, to - - - to answer



1 Judge Cannataro, the original situation that - - - that the
2 statute addressed was as you described. So this is - - -
3 is sort of the opposite.

4 JUDGE CANNATARO: It's the inverse.

5 MR. BRODIE: Right.

6 JUDGE CANNATARO: Yeah.

7 MR. BRODIE: But - - - but the fact that it's the
8 inverse shows two things. One, it shows that the statute's
9 neutral as to whether money is flowing into New York,
10 flowing out of New York, or flowing entirely intrastate.
11 So it's not - - - there's no discrimination. And number 2,
12 we still have equity on our side, I think because what you
13 have now is a situation where if Disney and IBM get the
14 benefit of the deduction, they would have been able to
15 create their own deductions by paying royalties to
16 themselves.

17 And really, that's not the purpose of the tax
18 code. But I agree with Your Honor, that what they were
19 originally trying to do was say, wait a minute, you can't
20 play games. If you're going to pay an intra-corporate
21 royalty, you have to add it back. And we're going to deal
22 with the person who originally had the money. But again,
23 that was balanced by the deduction. Now, I want to get to
24 interpretation.

25 JUDGE GARCIA: I'm sorry. Are you taxing - - -

1 again, this may be irrelevant. Are you - - - when this
2 money comes into New York from the foreign sub, you tax one
3 hundred percent of that as New York income?

4 MR. BRODIE: Not correct.

5 JUDGE GARCIA: And so what do you tax?

6 MR. BRODIE: We tax the business allocation
7 percentage of - - - you know, we attribute that income to
8 New York.

9 JUDGE GARCIA: Right.

10 MR. BRODIE: But - -- but - - - but then the New
11 York income - - - the total income is multiplied by the
12 business allocation percentage.

13 JUDGE GARCIA: Based on business done in New
14 York?

15 MR. BRODIE: Right. It's - - - it's receipts in
16 New York over all receipts.

17 JUDGE HALLIGAN: Do you agree - -

18 CHIEF JUDGE WILSON: Okay. So - - - go ahead.

19 JUDGE HALLIGAN: Do you agree with your
20 adversary's comment that the allocation doesn't fully
21 address any concerns because of a difference between
22 whether it's going into the numerator or the denominator?

23 MR. BRODIE: No. We're - - - we were talking
24 about different things when I - - - when I say allocation.

25 JUDGE HALLIGAN: Okay.

1 MR. BRODIE: And - - -

2 JUDGE HALLIGAN: Help me understand the
3 difference.

4 MR. BRODIE: He's talking about the fact that if
5 - - - you know, if you get some New York income - - -

6 JUDGE HALLIGAN: Yeah.

7 MR. BRODIE: - - - you allocate it to the
8 numerators, New York income - - -

9 JUDGE HALLIGAN: Right.

10 MR. BRODIE: - - - and to - - - to the
11 denominator is all receipts that you might have to pay more
12 tax as a result of getting that income. That's a truism.
13 We don't dispute that. What we're saying about allocation
14 is the business allocation percentage. And - - - and this
15 goes back to internal consistency. What would happen if
16 every taxing jurisdiction adopted New York's system?

17 Well, in New York's system, you're only taxed on
18 the proportion of your receipts in New York to global
19 receipts. And if every jurisdiction adopted that, then
20 there would be no problem because everyone would only get
21 their fair allocated percentage.

22 CHIEF JUDGE WILSON: And just to be clear, the -
23 - - the IP licensing here, at least New York, would treat
24 it as out of state income that is not in the numerator of
25 the fraction that gives you the BIP.

1 MR. BRODIE: That's right. We - - - we - - - we
2 put it in the denominator.

3 CHIEF JUDGE WILSON: Yes.

4 MR. BRODIE: But we don't need to do math
5 because, you know, you were told there would be no math.

6 CHIEF JUDGE WILSON: And then we were pointed to
7 tables and there's lots of numbers in them. But okay.

8 MR. BRODIE: Yeah. No.

9 JUDGE RIVERA: Lots of charts.

10 MR. BRODIE: We don't need to do math because you
11 - - - when you use the internal consistency rule, it's a
12 simple question. If every state taxed only their allocated
13 proportion of income, would it be fair? Answer. Yes.

14 JUDGE CANNATARO: The fairness, as I understand
15 it, that you're proposing is a result of a reduced BIP,
16 right? Or is it something other than that?

17 MR. BRODIE: No, no, the fairness that I'm
18 talking about is everyone gets only their allocated
19 percentage. You only get the tax your allocated
20 percentage.

21 JUDGE CANNATARO: Okay. And I mean, the
22 allocated percentage is - - - is the BIP.

23 MR. BRODIE: Yes.

24 JUDGE CANNATARO: And - - and I don't want to do
25 math either. But it's because the numerator isn't

1 changing, and the denominator is growing. And thereby
2 there's a reduction. And there was an answer to a question
3 that I asked from one of your adversaries that that doesn't
4 - - - that doesn't solve the problem, or at least for
5 constitutional purposes. It - - - was that a correct
6 answer?

7 MR. BRODIE: Well, I think his - - - his answer
8 was adding more to the denominator than you add to the
9 numerator doesn't solve the problem for constitutional
10 purposes. And I agree, that's not our constitutional
11 argument. Our constitutional argument is every - - - if
12 every state had a system where you taxed only the
13 proportion of receipts applicable to your state, and
14 everyone had the same system under internal consistency,
15 that would be internally consistent. There would be no
16 double taxation by definition because everyone only gets -
17 - - gets their portion.

18 Now, I - - - I do want to address briefly,
19 statutory interpretation because this is something that Mr.
20 Simonetti, on behalf of Disney, misquoted the statute to
21 the court. Mr. Simonetti said the deduction in (o) (3)
22 referenced the add back exceptions. It doesn't. It
23 references the add back requirement, not the exceptions.
24 It says you get a deduction, quote "unless such royalty
25 payments would not be required to be added back under

1 subparagraph 2", referencing the requirement.

2 The reason why add backs would not have been
3 required under (o) (2) included the three stated exceptions,
4 but those exceptions were not exclusive. Indeed, the
5 enumerated exceptions in (o) (2) (B) to be couldn't be
6 exclusive because in 2007 the legislature added a non-
7 enumerated exception in (o) (2) (A) for combined reporting.
8 But the circumstances where an add back is not required,
9 extend beyond the exceptions, and include instances where
10 the paying member wasn't subject to New York tax in the
11 first place.

12 JUDGE CANNATARO: Just one last question if I
13 may. And regarding that, I agree with you that the statute
14 enumerates the situations in which you would be required to
15 do the add back, and it includes combined reporting as - -
16 - as one of those situations.

17 MR. BRODIE: As an exception.

18 JUDGE CANNATARO: Right. So I believe there was
19 an argument on the other side that that's - - - made - - -
20 made by Mr. Simonetti, that that's what results in the
21 double taxation that he's talking about. Can you address
22 that?

23 MR. BRODIE: That - - - that that - - - I'm
24 sorry. That what results in double taxation?

25 JUDGE CANNATARO: That the exception from the add

1 back requirement.

2 MR. BRODIE: For - - - for combined reporting?

3 JUDGE CANNATARO: Well, I mean, he said there was
4 no combined reporting here.

5 MR. BRODIE: Well, I mean - - - I mean, combined
6 reporting applies to U.S. It doesn't apply to foreign
7 countries. So the combined reporting is an exception. So
8 if you look at IBM's and Disney's charts, they're both
9 interstate commerce charts. They're both one state versus
10 New York. And - - - and if you apply the combined
11 reporting exception to those charts, then the add back in
12 both charts is zero because combined reporting's an express
13 exception to the add back.

14 So therefore no add back, no deduction. And the
15 chart zeros out. So now, we're - - - but this case is
16 about the foreign Commerce Clause. It's not about the
17 domestic Commerce Clause. They're not claiming any of
18 their domestic subsidiaries added back. So we have to
19 analyze what would happen if every nation around the world,
20 if every taxing jurisdiction anywhere, adopted New York's
21 law, and that would be the thought experiment that's
22 compelled by the internal consistency test.

23 CHIEF JUDGE WILSON: Thank you.

24 MR. FRIEDMAN: If it's okay, Your Honor, we're
25 going to go a little out of order here.

1 CHIEF JUDGE WILSON: Absolutely.

2 MR. FRIEDMAN: Thank you.

3 CHIEF JUDGE WILSON: As you prefer.

4 MR. FRIEDMAN: Just a few points I was hoping to
5 make very quickly. The first one, if you recall the point
6 I was trying to make earlier regarding if you replicate the
7 identical tax structure, but you don't change the facts,
8 with all due respect, the state's changed the facts. In
9 1947, IBM created World Trade Corporation when they were
10 selling typewriters throughout the world. Those
11 typewriters had IP associated with them. The IP use
12 outside of the United States was paid into the United
13 States and paid into New York, and taxed here in the United
14 States, and taxed here in New York.

15 It was no tax planning, and that would not give
16 them a taxable presence. And paying a royalty into a state
17 does not create a tax presence. And when he - - - when the
18 state was criticizing our report, saying it would suck them
19 into the New York taxing structure via the royalty, he
20 flipped it. The royalty is being paid into New York, not
21 paid out of New York. If it had been paid out of New York,
22 that would give the royalty - - - royalty recipient a tax
23 presence in New York. You can't flip the facts. And
24 that's what he did.

25 So the - - - the unconstitutionality here is



1 coming from the fact that when you replicate the New York
2 tax structure, you have an either/or tax structure. New
3 York is taxing either the payments or the receipts of the
4 royalty, and it's not eliminated because now all of a
5 sudden, the company paying the royalty into New York is now
6 having to file a New York tax return. As he said during
7 his criticism of our chart, that does not happen. That's
8 not New York law. It's never been New York law. It's not
9 law then. It's not law now. That is not - - - he flipped
10 it. So I needed to clear that up.

11 Number 2, the differences between allocation and
12 apportionment, I hate to do this. This is what I spent a
13 lot of time on. Just because a royalty is situs to a
14 jurisdiction does not mean it's either in or out of the tax
15 base. It's in the tax base. It only means whether it's in
16 the sales factor numerator, the top part of the fraction.
17 And the criticism associated - - - look the \$50 is here and
18 it's over there. Of course, it's in the tax base. We're
19 talking about the tax base on the chart, not the
20 calculation of that fraction.

21 Tennessee Gas is a 2001 case from - - - from this
22 court. It is very helpful to our position. In that case,
23 the court looked at the discriminatory - - - or the
24 challenged tax, determined that it actually wasn't
25 discriminatory because it was determined to be a



1 compensatory tax. Then the court went on and applied the
2 internal consistency test, found that there was a failure,
3 struck down the tax.

4 Internal - - - irrespective of whether you find
5 this to be a facial tax or not, it is internally
6 inconsistent. It violates the dormant Commerce Clause.

7 Another point I needed to make regarding combined
8 reporting. New York - - - IBM filed a combined report in
9 New York. It included ten companies in the combined report
10 that it filed in New York. That's on the record, page 168.

11 CHIEF JUDGE WILSON: Those are all domestic
12 companies.

13 MR. FRIEDMAN: Those are all domestic companies.
14 Its total domestic companies, however, Your Honor, were a
15 hundred and - - - I'm sorry, eighty-six total domestic
16 companies. So only ten out of the eighty-six were included
17 in the combined report. Just because there's a royalty
18 payment, and just because they're domestic - - -

19 CHIEF JUDGE WILSON: Right. Is that - - - is
20 that because - - -

21 MR. FRIEDMAN: - - - doesn't mean it's in the
22 combined - - -

23 CHIEF JUDGE WILSON: Is that because the ten had
24 a New York tax situs?

25 MR. FRIEDMAN: That's correct, Your Honor. Thank

1 you. I see that I'm out of time.

2 CHIEF JUDGE WILSON: You had another point you
3 wanted to make. It seemed like.

4 MR. FRIEDMAN: I did, Your Honor. Internal
5 consistency is designed, and I just want to end with my
6 thesis, which is that it is designed to - - - to examine
7 the impact on interstate commerce versus intrastate
8 commerce. It's not designed to determine whether New York
9 or some other state has some particular desired preference.
10 It is aimed and it sussess out whether a tax - - - I'm
11 sorry, a transaction across the state lines is taxed more
12 heavily than a transaction that occurs entirely within New
13 York, which is exactly what the structure as interpreted by
14 New York does.

15 CHIEF JUDGE WILSON: Thank you.

16 MR. FRIEDMAN: Thank you, Your Honor.

17 MR. SIMONETTI: And Your Honor, I - - - I assure
18 you, you can put all of your charts away. I only have a
19 couple more points here in terms of the argument. Opposing
20 counsel talked about the - - - my geographic determinant
21 phrase. And yes, I admit I coined a phrase here, and it
22 comes from the U.S. Supreme Court decision in - - - in
23 Oregon Waste. And they said two things, Your Honor, is
24 that are really important. And these are quotes. That
25 geographic distinction patently discriminates against

1 interstate commerce, and that statutory determinant for
2 which fee applies to the transaction was whether it was
3 generated out of state or in the state.

4 And so yes, I did coin the geographic determinant
5 as the - - - really to capture what the court looked at to
6 see if there was discrimination. If the statute says you
7 get it because you're in the state, but you don't get it
8 because you're out of state, that is the geographic
9 determinant. That makes the law per se invalid under
10 discrimination. It can be justified, but opposing counsel
11 has not in any way attempted to justify it. And we know
12 that there is a nondiscriminatory means to accomplish that,
13 which is one of the two elements to try to justify a per se
14 discriminatory tax.

15 The second thing, Your Honor, opposing counsel
16 actually confesses the very discrimination that we allege.
17 He loves the catch phrase no add back, no deduction. In
18 fact, he said it five or six times today, five or six times
19 at the Appellate Division. And it's catchy, catchy slogan;
20 I got to admit, you know. But what I would say is this,
21 Your Honor, when you hear no add back, no deduction,
22 understand that he is confessing to the very discrimination
23 we allege.

24 When he says no add back he means non-New York
25 taxpayer. And when he says no deduction, he means no tax

1 benefit. And so what he's ultimately accomplishing is
2 saying the taxpayers are denied the tax benefit when the
3 payor is not a New York taxpayer. That is per se
4 discrimination. It causes the statute, under their
5 construction, to be invalid. And from our perspective,
6 Your Honor, it actually violates the plain language of the
7 law itself. This case is easily fixed by reading the law
8 the way the law was intended.

9 JUDGE CANNATARO: Your adversary's concern is, as
10 he says it, making sure that we only tax the transaction
11 once. And that's the purpose of the add back to send it -
12 - - send the value back because we're allowing the
13 deduction on the receiver side. Your argument to me sounds
14 like you - - - you only pay taxes on the transaction zero
15 times because you get a deduction regardless of whether
16 there's an add back or not, or where the payment comes
17 from, or anything else. It's in some ways the - - - the
18 biggest loophole you can create in this regime.

19 MR. SIMONETTI: And Your Honor, we understand the
20 concern about a loophole, a windfall, all kinds of terms
21 like that, that really disparage the fact that the taxpayer
22 followed the law. Fidelity, to the law, is important. It
23 is crucial that we have fidelity to the Constitution of the
24 United States. And - - -

25 JUDGE CANNATARO: So the fact that it works, a



1 financial benefit to you is just a consequence of a
2 constitutional reading of the statute.

3 MR. SIMONETTI: And - - - and I would urge, Your
4 Honor, it's actually not a loophole because the - - - it
5 was actually intended by the legislature.

6 JUDGE CANNATARO: I didn't say it was a loophole.

7 MR. SIMONETTI: Yeah.

8 JUDGE CANNATARO: I said it was a financial
9 benefit.

10 MR. SIMONETTI: No, no, I understand.

11 JUDGE CANNATARO: Okay.

12 MR. SIMONETTI: But before - - - it's been called
13 a loophole before. But a loophole is when it's an
14 unintended consequence. This is, in fact, an intended
15 consequence. The legislature enacted it this way, this
16 specific language, in order to prevent the constitutional
17 discrimination that is actually happening as a result of
18 the way they are construing the law. They - - - we agree
19 on one thing, Your Honor, there are - - - there is not an
20 exception in the statute for the royalty add back if you
21 are not a New York taxpayer.

22 Opposing counsel has created - - - and with the
23 help of the Appellate Division, has created a brand-new
24 exception that applies to deny Disney and IBM the royalty
25 income exclusion that reeks an unconstitutional result



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because of the way it is construed.

CHIEF JUDGE WILSON: Thank you.

MR. SIMONETTI: Thank you, Your Honor.

(Court is adjourned)



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C E R T I F I C A T I O N

I, Cynthia R. Piett, certify that the foregoing transcript of proceedings in the Court of Appeals of Walt Disney Company & International Business Machines Corp. v. Tax Appeals Tribunal of New York State, No. 34, 35 was prepared using the required transcription equipment and is a true and accurate record of the proceedings.

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