New York ALJ: Disney Can’t Exclude Foreign Affiliates' Royalty Payments

Posted on Jun. 7, 2019

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The Walt Disney Co. and its consolidated subsidiaries (Disney) can't exclude royalty payments received from foreign affiliates when computing its corporation franchise tax, a New York administrative law judge held.

In the *Matter of The Walt Disney Co. and Consolidated Subsidiaries*, ALJ Kevin Law of the Division of Tax Appeals ruled May 30 that allowing an exclusion for the royalty payments would frustrate the legislative intent of the statutory provision — to address a common tax avoidance strategy — and allow the payments to escape taxation.

Disney licensed intellectual property to foreign affiliates in return for payments by the affiliates, and it filed combined New York corporation franchise tax for the tax periods ending September 2008, October 2009, and October 2010, the audit periods at issue in this case. The total payments Disney received from its foreign affiliates for the licensing of its intellectual property rights tallied approximately $1.7 billion for the 2008 tax period, $1.6 billion for 2009, and $2.2 billion for 2010.

Disney amended its 2008 combined report to deduct the payments and requested a refund. It also deducted the payments from its entire net income on its original 2009 and 2010 reports.

The New York State Department of Taxation and Finance’s tax division audited the company and asked for the state law supporting the deductions. Disney argued that royalty income from related corporations can be excluded from taxable income if the payer was required to add back the deduction for that royalty income.

Under New York Tax Law section 208.9(o)(3), taxpayers could exclude royalty income received from a related member from their entire net income unless the royalty payments are not required to be added back. The exclusion was eliminated for tax years beginning on or after January 1, 2013.

But the division disallowed the exclusion, saying that its position is that royalty income could be excluded only if the related corporations making the payments are New York filers. It issued a notice of deficiency of almost $4 million in tax and denied Disney's refund request for the 2008 tax period.

Before the ALJ, the division also argued that Disney had not proven that the payments were royalties. Disney, however, contended that the division was required to establish that the payments were not royalties because the issue was never examined at audit.

While Law determined that the division was entitled to assert an alternative basis for the deficiency, he criticized the division, stating that it "seeks to put petitioner at a disadvantage to prove something during the formal hearing process that should have been explored at the audit level."

Law ultimately concluded that the payments were royalties because they "were made in connection with the licensing of intangible assets."

But Law determined that the addback and exclusion provisions in the former law "work in tandem to ensure that royalty transactions between related members are taxed only once, not escape taxation altogether." He noted that the royalty payments would not be required to be added back to the foreign affiliates' federal taxable income because they were not United States taxpayers or New York taxpayers.

Disney also claimed that providing the exclusion only if the payer of the royalty is a New York taxpayer was facially discriminatory and invalid under the dormant commerce clause of the U.S. Constitution. Law rejected that argument, noting that statutes are presumed constitutional at the administrative level.

Law determined that the royalty transactions were subject to tax only once, "regardless of whether the payer is a New York taxpayer." He added that "the royalty payments escape taxation altogether" under Disney's interpretation.

Timothy Noonan of Hodgson Russ LLP told *Tax Notes* June 6 that the statutory language at issue in the case seemed a bit sloppy, adding that "the taxpayer's interpretation of the language was plausible and made sense."

Noonan said the ALJ tried to resolve the confusion that existed in the language by looking more at the legislative intent of the statute than trying to parse the language of the statute itself. But Noonan added that whatever the result, he was happy to see that the ALJ gave no deference to the division's interpretation of the statute, calling it "a move in a positive direction on the general issue concerning judicial deference to taxing jurisdictions."