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Bulletins

New Jersey Throwout: Legislature Mulls Throwing It Out!

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Do not give up your “throwout” challenges! Not only is the New Jersey throwout provision being challenged in the courts (as being unconstitutional and violating aspects of New Jersey law too numerous to count), it also may, and should, be eliminated by the Legislature’s own hand.^[1]

Assembly Bill A2722 was recently proposed by New Jersey Assemblyman Joseph Vas to repeal the New Jersey throwout. Yes, read it again – a bill has been proposed in New Jersey to repeal throwout.

The Statement to the bill explains that:

This bill eliminates the so-called “throwout” provision of the corporation business tax.

Under the apportionment formula that is currently used for determining the portion of a corporation’s entire net income that is taxable by New Jersey, the sales fraction is the most heavily weighted factor. Some of those sales are made in states where the corporation is not subject to tax. Currently, a provision of the allocation formula omits these sales from the denominator of the sales fraction. This “throwout” of sales assigned to states where the corporation is not subject to tax increases the sales fraction, which increases the portion of the entire net income of a corporation allocated to New Jersey.

This bill eliminates that throwout provision, and also eliminates a corresponding provision that currently limits the increase in tax liability related to the throwout rule for affiliated groups of corporations.^[2]

The bill was proposed as part of what is ramping up to be the state’s budget package and should be referred to the Assembly Appropriations Committee in connection with the budget package for the state’s fiscal year to begin July 1, 2008.^[3] The Assembly Appropriations Committee is the same group that brought us throwout in the Business Tax Reform Act of 2002 as part of the budget “fixes” for the fiscal year that began July 1, 2002.^[4] Other 2002 budget “fixes” included the add back of interest and royalties paid to related entities and forced filing of Corporation Business Tax (“CBT”) returns on a combined basis.^[5]

The Throwout Provision

Throwout is the short name given to the removal (or throw out) of receipts from the denominator of the sales fraction. Ordinarily, the income of a corporation that is subject to the CBT in New Jersey is apportioned (or, as New Jersey describes it, allocated) by statute via a factor derived from the average of the sum of a payroll fraction, a property fraction and a double-weighted sales fraction.^[6] The throwout starts with the normal sales fraction:

provided however, that if receipts would be assigned to a state, a possession or territory of the United States or the District of Columbia or to any foreign country in which the taxpayer is not subject to a tax on or measured by profits or income, or business presence or business activity, then the receipts shall be excluded from the denominator of the sales fraction.^[7]

The effect of throwout is limited to \$5 million for each affiliated group.^[8]

The Division's Use of the Throwout Provision

The New Jersey Division of Taxation (the "Division") has interpreted the throwout statute to require that receipts be removed from the denominator of the sales fraction when the corporation does not pay a tax based on those sales, i.e., when the sales to be included in the denominator of New Jersey's sales fraction are not included in the numerator of some other state's sales fraction, for example if the sales are protected by P.L. 86-272.^[9] The Division also applies throwout when receipts are included in another state's sales fraction numerator as a result of throwback in that other state.^[10]

When a corporation has nexus with New Jersey, the throwout "enhances" New Jersey's share of the corporation's income. Although the throwout provision was enacted in 2002, the Division has applied throwout for years prior to 2002. There have also been situations where, for corporations that have no physical presence in New Jersey, the Division has asserted that a 100% receipts fraction is applicable under throwout – that is, the Division apportions all of the corporation's receipts to New Jersey, notwithstanding that only a small percentage of those receipts could even arguably be attributable to the company's economic activity in New Jersey.

For example, a corporation owns a substantial amount of intellectual property and aggressively manages and protects that property. It is organized under the laws of Nevada, has tangible personal property in Nevada and payroll in Nevada. The corporation maintains license agreements with entities that permit those entities to use the intellectual property all over the United States, including in New Jersey. The licensees have 2% of their sales in each of the 50 states (50 times 2% equals 100% of sales). The entities that use intellectual property under the license agreements pay CBT in New Jersey. The corporation receives income from the licensees for the licensees' use of the intellectual property in connection with sales that were made to customers in New Jersey by the licensees.

The Division has in similar audits: (1) computed a four factor formula (the sales factor is double-weighted at 100% due to throwout and divided by four) to result in a 50% apportionment factor; or (2) computed a single sales factor (double-weighted sales at 100% divided by two) to result in a 100% apportionment factor. In fairness to the Division, we have seen it grant on its own accord a reduction of that purported 100% factor to 50% under the Division's alternative apportionment provision.^[11] Notwithstanding the Division's grant of that relief on its own, a 50% factor is still quite an enhanced apportionment factor – a factor that is 25 times greater than the 2% of sales of the licensees.

The Future of Throwout

It is impossible to predict what the New Jersey Legislature (or the courts) will do with respect to throwout. The New Jersey Legislature should do the right thing and repeal throwout.

Footnotes:

^[1] Currently, there five cases challenging "throwout" in the New Jersey Tax Court. Four of those cases were argued contemporaneously on March 28, 2008 on the threshold issue of facial constitutionality. We are awaiting a decision in those cases.

^[2] Assembly Bill A2722. The Statement is not law. It is merely a description of what is intended by the bill. It can, however, provide useful legislative history.

^[3] The package also includes a proposal to switch to a single sales factor apportionment for manufacturers. See Assembly Bill A2626 (also introduced by Assemblyman Vas).

^[4] 2002 N.J. Laws 40.

^[5] N.J. Stat. Ann. § 54:10A-4(k)(2)(l) (interest add back); N.J. Stat. Ann. § 54:10A-4.4 (royalty add back); N.J. Stat. Ann. § 54:10A-10(c) (forced combination). The New Jersey Division of Taxation's forced combination authority is notable for many reasons, including that it purports to place the burden on the taxpayer of disproving that combined reporting should apply. Taxpayers should be aware that the Division is conducting 20 pricing study audits per year and has retained an outside consultant to assist with the audits. The Division has confirmed that the outside consultant that it is using to conduct these pricing studies is being paid on a contingent fee basis.

^[6] N.J. Stat. Ann. § 54:10A-6(B)(6).

^[7] N.J. Stat. Ann. § 54:10A-6(B)(6). The bill deletes this entire throwout provision.

[8] N.J. Stat. Ann. § 54:10A-5(i). This \$5 million cap is also removed in the bill inasmuch as the cap will be unnecessary if the throwout provision is repealed.

[9] N.J. Admin. Code § 18:7-8.7(d) (Example). New Jersey's attack on corporations that are protected by P.L. 86-272 is the subject of a previous article. C. Fields and M. Newmark, *Business Friend or Foe - New Jersey Attempts an End Run Around P.L. 86-272*, 43 State Tax Notes 53 (Jan. 8, 2007).

[10] N.J. Admin. Code § 18:7-8.7 (e). Throwback is the addition of sales to the numerator of a state's sales fraction when the sales originate in the state but are not taxed by the destination state.

[11] N.J. Stat. Ann. § 54:10A-8.