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## New Jersey Supreme Court Holds Throwout Rule Is Facially Constitutional, But Unconstitutionally Applied

On July 28, 2011, the New Jersey Supreme Court denied a taxpayer's claim that New Jersey's Throwout Rule (which excludes certain sales from the denominator of the sales apportionment factor) is facially unconstitutional. *Whirlpool Props., Inc. v. Div. of Tax'n*, Case No. 066595 (N.J. July 28, 2011). However, the court held that the application of the Throwout Rule to sales sourced to a state that has jurisdiction to tax the sales (but chooses not to) leads to an unconstitutional result. In addition, the court held that, while facially constitutional based on the narrow interpretation, the Throwout Rule remains subject to an as-applied constitutional challenge when there is distortion.

### What is the Throwout Rule?

New Jersey's Corporate Business Tax (CBT) provides that every corporation with a regular place of business outside of New Jersey is subject to tax on its entire New Jersey net worth and income. A taxpayer determines its entire New Jersey net worth and income by using an apportionment formula composed of a property factor, a payroll factor and a double receipts factor.<sup>1</sup> For tax years 2002 through 2010, taxpayers were required to compute the receipts factor by applying a Throwout Rule.<sup>2</sup> Without the Throwout Rule, the receipts factor is calculated by dividing the taxpayer's New Jersey receipts by total receipts. The Throwout Rule modifies the receipts factor by excluding from the denominator receipts assigned to jurisdictions in which the taxpayer is not "subject to tax."<sup>3</sup> The Throwout Rule transformed the receipts factor from a ratio of New Jersey receipts to *total* receipts, to a ratio of New Jersey receipts to *total taxed* receipts.

### Whirlpool Background

The New Jersey Division of Taxation (the "Division") issued the taxpayer, Whirlpool, an assessment for the 2002 and 2003 tax years based on the taxpayer not applying the Throwout Rule in computing its New Jersey receipts factor.<sup>4</sup> Whirlpool brought an action challenging the constitutionality of the Throwout Rule on its face. The New Jersey Tax Court denied the taxpayer's facial constitutional challenge because it found that the Throwout Rule could operate constitutionally in some circumstances. The New Jersey Superior Court Appellate Division sustained the Tax Court's holding that the Throwout Rule was not facially unconstitutional because (i) the apportionment formula did not attribute income to New Jersey out of all appropriate proportion to the business transacted in the state, (ii) the Throwout Rule did not expose any income to multiple taxation, and (iii) the Throwout Rule did not tax in-state and out-of-state sales in a discriminatory manner. Whirlpool appealed the decision to the New Jersey Supreme Court.

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<sup>1</sup> N.J.S.A. § 54:10A-6.

<sup>2</sup> N.J.S.A. § 50:10A-6(B).

<sup>3</sup> The Business Tax Reform Act of 2002 amended the CBT to include the Throwout Rule to N.J.S.A. § 54:10A-6(B).

<sup>4</sup> Using the Throwout Rule, the Division allocated to New Jersey approximately 29% and 41% of Whirlpool's 2002 and 2003 income, respectively. By comparison, before the Throwout Rule came into application, the portion of Whirlpool's income that was allocated to New Jersey for tax years 1996 through 2001 ranged between .9% and 1.3%.

## New Jersey Supreme Court Decision

The court focused on the fair apportionment and discrimination prongs of the *Complete Auto Commerce Clause* analysis in deciding whether the Throwout Rule was constitutional on its face.<sup>5</sup> For purposes of the fair apportionment prong, the court was troubled by the application of the Throwout Rule to all receipts from sales to states where the taxpayer is not subject to tax. The court made a distinction between two particular types of receipts: (i) receipts that are not taxed because the taxpayer does not have the requisite constitutional contacts with a state or because of P.L. 86-272,<sup>6</sup> and (ii) receipts that are not taxed because a state chooses not to impose an income tax.

### Fair Apportionment Challenge

For purposes of the fair apportionment prong of *Complete Auto Transit*, the court was concerned with the broad application of the Throwout Rule under the external consistency test. Specifically, the court was troubled by the application of the Throwout Rule to all receipts from sales to states where the taxpayer is not subject to tax. The court made a distinction between two particular types of receipts: (i) receipts that are not taxed because the taxpayer does not have the requisite constitutional contacts with a state or because of P.L. 86-272,<sup>7</sup> and (ii) receipts that are not taxed because a state chooses not to do so.

The court interpreted New Jersey tax law to apply the Throwout Rule solely to receipts from sales to states that lack the jurisdiction to impose a tax. The Supreme Court construed the “Throwout Rule so as to limit the receipts that may be thrown out to untaxed receipts from those states that lack jurisdiction to tax due to the insufficient business activity by the taxpayer in that state.” The court reasoned that the threshold determination of whether a state has jurisdiction to impose a tax was rationally related to the taxpayer’s presence in the other state, while another state’s tax regime was not. In other words, although the other non-taxing state may have provided some benefits, such as a market, because those benefits were not sufficient to give that state jurisdiction to tax, the benefits would be constitutionally insignificant in terms of apportionment.

The court reasoned that throwing out receipts because another state does not impose a tax would cause an externally inconsistent result. The court’s opinion provides that “whether another state chooses to tax a receipt has no bearing on how much income is attributable to New Jersey.” Further, the court dispelled the notion that full apportionment to a jurisdiction that imposes a tax is necessary. The decision states that “it bears emphasizing there is no requirement that all sales be allocated by an apportionment formula . . . just because one state does not impose a tax on a sale does not mean that New Jersey or any other state can.”

**Sutherland Observation:** The court’s distinction between receipts from jurisdictions that have authority to subject the taxpayer to tax and those jurisdictions that do not seems flawed. In either case, the Throwout Rule systematically reattributes receipts to New Jersey that (under New Jersey’s rules) are properly sourced to other states.

<sup>5</sup> The fair apportionment test provides that a tax must be internally and externally consistent. See *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159 (1983). An apportionment formula is internally consistent when, if applied by every jurisdiction, it would result in no more than all of the unitary business’s income being taxed. External consistency is satisfied if the factors used in the apportionment formula actually reflect a reasonable sense of how income is generated.

<sup>6</sup> 15 U.S.C. § 381-84.

<sup>7</sup> 15 U.S.C. § 381-84.

## Fair Apportionment Challenge – Division’s Application

The court invalidated the Division’s application of the Throwout Rule.<sup>8</sup> The court noted that it was unclear how the Throwout Rule was being applied by the Division, so it is relied on the Division’s regulation. The Division’s initial temporary regulation broadly applied the Throwout Rule by excluding receipts from the denominator unless the taxpayer was subject to another state’s jurisdictional authority and actually paid a tax. Specifically, the Division’s regulation stated that receipts were thrown out of the denominator when the taxpayer was “not subject to a tax and d[id] not pay a tax.” The Division revised the language in the final regulation to eliminate the requirement that the taxpayer actually pay a tax because of pressure from the business community.

While the requirement to actually “pay a tax” was eliminated from the regulation, the Division continued to interpret the Throwout Rule to require that taxpayers apply the Throwout Rule unless the taxpayer filed a separate company state return or a consolidated state return.<sup>9</sup> As a result, the Division’s regulation continued to require taxpayers to throw out of the denominator receipts sourced to any unitary combined reporting states because such returns did not constitute being subject to tax based on the Division’s regulation.<sup>10</sup>

Therefore, the court’s holding invalidates the Division’s regulation as facially unconstitutional because it required taxpayers to throw out of the denominator receipts from sales to states where the taxpayer was subject to the states’ taxing authority.

**Sutherland Observation:** The New Jersey Supreme Court held in *Lanco, Inc. v. Division of Taxation*, that economic presence nexus—having sales sourced to another state—creates nexus.<sup>11</sup> Reconciling the court’s holdings in *Lanco* and *Whirlpool* may suggest that any taxpayer with economic presence nexus in any other state would arguably satisfy the “subject to tax” exception from the Throwout Rule.

## Fair Apportionment – As-Applied Challenge

Although the court held that the Throwout Rule was not facially unconstitutional when applied narrowly, the decision recognized that creating minor distortions that would likely fall within the zone of permissible inaccuracy for apportionment may nonetheless create an unconstitutional result in some circumstances *as applied*.<sup>12</sup> Specifically, the decision states that it is “not to assert that this interpretation of the Throwout Rule would lead to a fair outcome in every case, but only that the systematic distortion would not render the rule facially unconstitutional.”

<sup>8</sup> N.J.A.C. § 18:7-8.7(d) (in effect for tax year 2003 from February 2 until August 26).

<sup>9</sup> The Division’s regulation refers to a pre- or post-apportionment combined return. Pre-apportionment combined returns are commonly referred to as a unitary combined return while a post-apportionment combined return is commonly referred to as a consolidated return for state tax purposes.

<sup>10</sup> N.J.A.C. § 18:7-8.7(d) “This principle applies to single entity taxing jurisdictions as well as postapportionment combination states. The rule also permits the throwout of receipts to preapportionment combination states. Receipts from preapportionment combination states are not required to be thrown out of the denominator of the New Jersey receipts fraction if they create a potential tax in a foreign state. For purposes of this subsection, “preapportionment combination states” are those states where the receipts from all states are added together before the apportionment factor is calculated. “Post-apportionment combination states” are those where the various apportionment factors are calculated first then totaled.”

<sup>11</sup> *Lanco, Inc. v. Div. of Tax’n*, 908 A.2d 176 (N.J. 2006).

<sup>12</sup> Whirlpool only asserted that the Throwout Rule was *facially* unconstitutional in this appeal; an as-applied challenge will likely follow.

**Sutherland Observation:** The New Jersey Supreme Court’s reasoning may have an application to the New Jersey related party addback provision, which requires taxpayers to add back certain expenses paid to related parties unless the recipient is subject to tax in another jurisdiction.<sup>13</sup> Interestingly, the related party addback provision statutorily requires the recipient to be subject to, and to pay, a tax in the other jurisdiction within 3% of the taxpayer’s New Jersey effective tax rate.<sup>14</sup> If the “subject to tax” language were to be analyzed under the court’s fair apportionment external consistency reasoning, the exception to the addback requirement might not satisfy the Commerce Clause fair apportionment requirement.

**Discrimination Challenge**

In addition, the court reviewed the constitutionality of the Throwout Rule under *Complete Auto’s* discrimination prong and held that the Throwout Rule is not facially discriminatory.<sup>15</sup> In particular, the court found that the Throwout Rule does not differentiate between in-state and out-of-state businesses because both are equally subject to the Throwout Rule. Moreover, the court stated that when the Rule is applied to thrown-out receipts that are untaxed because of lack of jurisdiction, the effect is the same for all states, and it is irrelevant in which non-New Jersey state a business generates the untaxed receipts. Finally, the court held that by limiting the operation of the Throwout Rule to receipts generated in states that lack jurisdiction to tax, the Throwout Rule may still operate in a facially constitutional manner with respect to the fair apportionment requirement.



*If you have any questions about this Legal Alert, please feel free to contact any of the attorneys listed below or the Sutherland attorney with whom you regularly work.*

Michele Borens	202.383.0936	<a href="mailto:michele.borens@sutherland.com">michele.borens@sutherland.com</a>
Jeffrey A. Friedman	202.383.0718	<a href="mailto:jeff.friedman@sutherland.com">jeff.friedman@sutherland.com</a>
Stephen P. Kranz	202.383.0267	<a href="mailto:steve.kranz@sutherland.com">steve.kranz@sutherland.com</a>
Marc A. Simonetti	212.389.5015	<a href="mailto:marc.simonetti@sutherland.com">marc.simonetti@sutherland.com</a>
Eric S. Tresh	404.853.8579	<a href="mailto:eric.tresh@sutherland.com">eric.tresh@sutherland.com</a>
W. Scott Wright	404.853.8374	<a href="mailto:scott.wright@sutherland.com">scott.wright@sutherland.com</a>
Douglas Mo	202.383.0847	<a href="mailto:douglas.mo@sutherland.com">douglas.mo@sutherland.com</a>
Jonathan A. Feldman	404.853.8189	<a href="mailto:jonathan.feldman@sutherland.com">jonathan.feldman@sutherland.com</a>
Pilar Mata	202.383.0116	<a href="mailto:pilar.mata@sutherland.com">pilar.mata@sutherland.com</a>
Michele L. Pielsticker	916.498.3311	<a href="mailto:michele.pielsticker@sutherland.com">michele.pielsticker@sutherland.com</a>
Diann L. Smith	202.383.0884	<a href="mailto:diann.smith@sutherland.com">diann.smith@sutherland.com</a>
Marlys A. Bergstrom	404.853.8177	<a href="mailto:marlys.bergstrom@sutherland.com">marlys.bergstrom@sutherland.com</a>
Andrew D. Appleby	212.389.5042	<a href="mailto:andrew.appleby@sutherland.com">andrew.appleby@sutherland.com</a>
Zachary T. Atkins	404.853.8312	<a href="mailto:zachary.atkins@sutherland.com">zachary.atkins@sutherland.com</a>
Madison J. Barnett	404.853.8191	<a href="mailto:madison.barnett@sutherland.com">madison.barnett@sutherland.com</a>
Scott A. Booth	202.383.0256	<a href="mailto:scott.booth@sutherland.com">scott.booth@sutherland.com</a>
Michael L. Colavito Jr.	202.383.0870	<a href="mailto:mike.colavito@sutherland.com">mike.colavito@sutherland.com</a>
Miranda K. Davis	404.853.8242	<a href="mailto:miranda.davis@sutherland.com">miranda.davis@sutherland.com</a>
Maria P. Eberle	212.389.5054	<a href="mailto:maria.eberle@sutherland.com">maria.eberle@sutherland.com</a>

<sup>13</sup> N.J.S.A. § 54:10A-4(k)(2)(l).

<sup>14</sup> N.J.A.C. § 18:7-5.2(a)(1)(ix).

<sup>15</sup> Under this test, a state is prohibited from imposing a heavier tax burden on out-of-state businesses that compete in an interstate market than it imposes on its own residents who also engage in commerce among states.

Seth A. Fersko	212.389.5049	<a href="mailto:seth.fersko@sutherland.com">seth.fersko@sutherland.com</a>
Lisbeth A. Freeman	202.383.0251	<a href="mailto:beth.freeman@sutherland.com">beth.freeman@sutherland.com</a>
Charles C. Kearns	202.383.0864	<a href="mailto:charlie.kearns@sutherland.com">charlie.kearns@sutherland.com</a>
Jessica L. Kerner	212.389.5009	<a href="mailto:jessica.kerner@sutherland.com">jessica.kerner@sutherland.com</a>
Fabio Leonardi	202.383.0881	<a href="mailto:fabio.leonardi@sutherland.com">fabio.leonardi@sutherland.com</a>
David A. Pope	212.389.5048	<a href="mailto:david.pope@sutherland.com">david.pope@sutherland.com</a>
Melissa J. Smith	202.383.0840	<a href="mailto:melissa.smith@sutherland.com">melissa.smith@sutherland.com</a>
Maria M. Todorova	404.853.8214	<a href="mailto:maria.todorova@sutherland.com">maria.todorova@sutherland.com</a>
Mark W. Yopp	212.389.5028	<a href="mailto:mark.yopp@sutherland.com">mark.yopp@sutherland.com</a>

For more information about Sutherland's SALT team and for coverage and commentary on state and local tax developments, visit Sutherland SALT Online at [www.stateandlocaltax.com](http://www.stateandlocaltax.com).