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New Jersey Attempts an End Run Around P.L. 86-272 While Throwout and *Lanco* Are Challenged

March 2007

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New Jersey continues to take aggressive stances against foreign corporations. It asserts that physical presence is not necessary to subject a foreign corporation to income taxation in New Jersey. *See Lanco, Inc. v. Director, Division of Taxation,* 188 N.J. 380 (2006) (petition for certiorari pending) (holding that Quill's physical presence test does not apply to income taxes under the Commerce Clause). It applies the alternative minimum assessment ("AMA") to foreign corporations that are protected from net income based taxes by federal law P.L. 86‑272 only if those corporations do not consent to jurisdiction under New Jersey's regular Corporation Business Tax ("CBT"). It removes receipts from the denominator of the receipts fraction based on whether another state has jurisdiction to tax the corporation or whether another state has decided to exercise its right to tax the corporation, under what has become known as the "throwout" rule. Further, when New Jersey throws receipts out of the denominator, it contradicts its subjectivity position (its Lanco economic nexus position) because it applies economic nexus standards for subjectivity in New Jersey yet refuses to apply those same economic nexus standards for subjectivity in other states.

There is hope that New Jersey will be turned back. We are filing a petition for certiorari in the United States Supreme Court in *Lanco*. The New Jersey Supreme Court favored the State's fisc and misapplied Commerce Clause case law under the United States Constitution. As Justice Benjamin's dissent stated in MBNA, economic nexus positions, like those asserted by the states in MBNA and in Lanco, rely

> not on bedrock constitutional principles or on established legal precedent, but rather on legal commentaries with thinly veiled state-favoring taxing agendas, a strained and inaccurate reading of the United States Supreme Court's decision in *Quill Corp. v. North Dakota*, 504 U.S. 298, 112 S. Ct. 1904, 111 L. Ed. 2d 91 (2002), and a unilateral restatement of the important policy considerations which led to the inclusion of the Commerce Clause within the United States Constitution . . . .

Tax Commissioner of W. Va. v. MBNA Am. Bank, N.A., Docket No. 33049 (W. Va. Nov. 21, 2006) (Benjamin, J., dissenting, slip op. at 1 (Jan. 2, 2007)). We hope that the United States Supreme Court will soon confirm that the physical presence standard exists for all taxes.

We are challenging the throwout rule on constitutional and statutory grounds in the Tax Court of New Jersey. Throwout violates *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977), because, as a result of throwout, the CBT is not fairly apportioned and discriminates against interstate commerce. Moreover, it violates New Jersey law.

Additionally, the application of the AMA to corporations that have P.L. 86-272 protection is, at best, questionable and should be struck down.

New Jersey is out on a limb on nexus, throwout, and the AMA. By these corporation tax policies, New Jersey is also contradicting its governor's expressly stated policy of becoming business-friendly.

New Jersey's Business Environment

Recently, New Jersey Governor Corzine "pledged to erase the perception that New Jersey was, in his words, 'adversarial' to business." David W. Chen, *Corzine Offers Proposals to Bolster Business Climate,* N.Y. Times, Sept. 8, 2006, at B1. Also, Dean Hughes and Professor Seneca, two prominent New Jersey economists at Rutgers University's Bloustein School of Planning & Public Policy, noted "a dramatic shift in the nation's high technology geography away from New Jersey." James W. Hughes & Joseph J. Seneca, *High-Tech Industry Leaving New Jersey,* Bergen Record, Sept. 17, 2006. Those economists note that the United States as a whole and California, Georgia, North Carolina, Texas, and Virginia, in particular, have gained high-tech jobs.

As part of Governor Corzine's pledge, he announced his strategy to "build an environment conducive to economic growth, innovation, and prosperity" in New Jersey and to remove the "negative perceptions of the state's business climate." Jon S. Corzine, *Economic Growth Strategy for the State of New Jersey 2007*, at 2, 5. The Governor's strategy assures that it will not require the State to raise new revenue. The Governor promised: "all resources for executing this strategy are redirected from other sources." *Id.* at 3. As discussed below, one of those other sources is multistate corporations.

Governor Corzine set forth a six-point plan for growing business and jobs in New Jersey. *Id.* at 3.[1] He said that "stabilizing [New Jersey's] business taxes is critical to attracting capital investment." *Id.* at 5. He credits his administration's progress in reducing business taxes by "the elimination of the alternative minimum assessments." *Id.* at 5. Dean Hughes and Professor Seneca highlight the Governor's progress but note that: "Continual examination of the state's business climate with additional changes [to the tax code] is warranted." Hughes & Seneca, supra. Additional examination is certainly warranted.

The subtext of the Governor's tax strategy (exporting the tax burden) is revealed upon closer scrutiny. The alternative minimum assessments are not eliminated for non-New Jersey corporations that are protected by P.L. 86−272. Thus, the only corporations that are subject to the AMA are those that are protected by federal law from the imposition of the net income component of the CBT (such corporations are still subject to the minimum tax under the CBT).

New Jersey's Contradictory Positions

Aside from inviting retaliation from other states to enact similar taxes, New Jersey has taken contradictory positions of interpretation. New Jersey argues on the one hand that its own laws should not be interpreted strictly but on the other hand argues that federal law should be interpreted strictly.

New Jersey is a separate-entity state, which means that each corporation that has sufficient contacts with New Jersey must file its own CBT return.[2] New Jersey interprets its separate-entity laws loosely by refusing to respect arm's-length transactions among affiliated corporations, notwithstanding that those corporations are separate corporations, and the rights of corporations that are not present in New Jersey to not be subject to New Jersey income tax. One example of a loose interpretation of New Jersey law is that New Jersey asserts nexus over companies whose only connection to New Jersey is the receipt of royalties from licensees that are located in New Jersey.[3] An example of New Jersey's strict interpretation of federal law is its interpretation of P.L. 86-272 and its assertion that the AMA and throwout laws do not violate P.L. 86-272.

One of the hottest issues in state and local taxation for the past half century is nexus, *i.e.*, does a corporation have sufficient contacts with a taxing state to allow that state to subject the corporation to tax. A corporation that solicits and delivers goods into a state with which it has no other contacts has constitutional nexus but is protected from the imposition of a net income tax upon it by federal law (i.e., P.L. 86−272). P.L. 86−272 prohibits a taxing state from imposing a net income-based tax on a corporation's net income if that corporation's only activity with the taxing state is the solicitation and delivery of goods. Services are not protected by that federal law.

Corporations have segregated manufacturing, finance, sales, intellectual property, and other businesses into separate corporations for various business reasons, including risk management, attraction of capital, and isolation of costs for comparison with other sourcing alternatives. By that segregation, businesses have been split into separately functioning corporations.

Separate-entity states, such as New Jersey, have cried foul over the establishment of these separate corporations and assert that the result of these separate corporations is an "end run" around their separate-entity tax-return filing laws. Separate-entity states have made the choice to be separate-entity states rather than unitary states. In *Lanco, Inc. v. Director, Division of Taxation,*188 N.J. 380 (2006), and in other similar cases, New Jersey has asserted that corporations have executed an "end run" for nexus purposes. However, it is New Jersey itself that is attempting to execute an "end run" around P.L. 86–272.

New Jersey enacted two laws that attempt an "end run" around P.L. 86–272. The AMA applies directly to corporations that are protected by P.L. 86–272 in New Jersey. The throwout law applies to corporations that have P.L. 86-272 protection in other states.

The Alternative Minimum Assessment

When the New Jersey Legislature enacted the Business Tax Reform Act of 2002 ("BTRA"), it created a special tax applicable to companies that are protected by P.L. 86-272 and that do not consent to jurisdiction under New Jersey's regular Corporation Business Tax. A company that is protected by P.L. 86-272 and does not consent to jurisdiction is subject to the AMA. N.J. Stat. Ann. 54:10A–5a(e). [4]

New Jersey interprets P.L. 86-272 strictly. However, it also argues that separate corporations should not interpret the separate-entity tax laws of New Jersey strictly. New Jersey plays both ends to its advantage. Contrary to Governor Corzine's strategy and remarks, it is not business-friendly. It is, in his words, "'adversarial' to business." Chen, *supra*.

New Jersey's application of the AMA to out–of–state protected corporations is unconstitutional discrimination and indirect apportionment where direct apportionment would not be permitted. *Fulton Corp. v. Faulkner,* 516 U.S. 325 (1996), prohibits a state from favoring domestic corporations over foreign corporations and discouraging interstate commerce. Corporations that are residents in New Jersey are subject to the net income computation of the CBT. Therefore, they are allowed to take their ordinary business expenses as deductions. Non–resident corporations that do not consent to New Jersey's imposition of the net income computation of the CBT (because they have the protection of P.L. 86–272) are subject to the AMA. Therefore, non-resident corporations are allowed no such deductions.

*Hunt–Wesson, Inc. v. Franchise Tax Board of Californi*a, 528 U.S. 458 (2000), prohibits a state from doing indirectly what it cannot do directly. New Jersey is prohibited by P.L. 86–272 from subjecting protected corporations to a net income-based tax. New Jersey's application of the AMA to P.L. 86–272 is an indirect shot at taxing the protected activity and is an indirect "end run."

Throwout

Further in the BTRA, New Jersey created a special apportionment formula for corporations that are protected by P.L. 86-272 in other states. Ordinarily, the income of a corporation is apportioned (or as New Jersey describes it, "allocated") by a factor derived by the average of the sum of a property fraction, a payroll fraction, and a doubled sales fraction. A corporation that has income that is not taxed in a state, such as for reasons of P.L. 86–272 protection, apportions its income using the same four–factor formula; however, the sales that are assigned to any state's sales to which the protections of P.L. 86-272 apply are thrown out of the denominator of the sales fraction. N.J. Stat. Ann. 54:10A–6(B)(6). The throwout, in many situations, results in the apportionment to New Jersey of income that is out of all appropriate proportion to the corporation's activities in New Jersey and to the services provided by New Jersey. *Container Corp. of Am. v. Franchise Tax Bd*., 463 U.S. 159 (1983); *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977). It is also wrong-headed for business.

If a corporation is organized under the laws of Ohio, has its home office in Ohio, has a repackaging and customer service facility in New Jersey, and has 5% of its property and payroll in New Jersey, 5% of its sales of goods to locations in New Jersey, 5% of its sales of goods to locations in Ohio, and 90% of its sales of goods to locations in Pennsylvania and New York, and its only connections to

Pennsylvania and New York are solicitation and delivery that are protected by P.L. 86-272, New Jersey will throw out the Pennsylvania and New York sales and compute a sales fraction of 5/10, rather than 5/100. With property and payroll fractions of 5/100 and a sales fraction of 5/10, 27.50% of that corporation's income will be attributed to New Jersey, notwithstanding that it only derived 5% of its income from New Jersey.[5] That increased attribution, *i.e.*, a factor that is more than five times higher than the activity in New Jersey as measured by property, payroll, and sales, is out of all appropriate proportion to the activity of the corporation in New Jersey. It is unconstitutional.

It is wrong for business and wrong for New Jersey. If that same corporation has, for instance, limited production capacity of 1 million widgets per year and sells 900,000 widgets in New York and Pennsylvania, and 50,000 widgets in Ohio, it would make sense for the corporation to move its New Jersey facility and sell the remaining 50,000 widgets in a state other than New Jersey, a state that will not treat it so harshly. Assuming the corporation has a market for its remaining widgets outside New Jersey, the corporation would not lose – it would still sell all of its widgets. The citizens of New Jersey would lose. They would lose the jobs at the New Jersey repackaging and customer service facility and would lose the benefits of competition. The lost competition would reduce choice in New Jersey, would decrease competition, and would allow competitors to charge more money for the competitive version of the widget sold in New Jersey. Furthermore, purchasers of those widgets would have unnecessary burdens which could have additional implications.

For example, if the widgets are copper pipes (substitute testing equipment for copper pipes in the example, and a low-technology problem becomes a high-technology problem). The cost of pipes may rise to the extent that small plumbing businesses could no longer afford to carry sufficient amounts of pipes on their trucks. The additional time spent and gasoline consumed to travel to a supply house to purchase needed pipes added to the cost of pipes could force some small businesses to close, thereby reducing prosperity and employment. Further, if the supply of copper pipes were to be reduced in New Jersey, smaller plumbing businesses without the ability to leave the state to purchase pipes or without sufficient volume to demand that the pipes be shipped to New Jersey may be forced to turn down jobs from paying customers. These examples may be at the margin and a bit simplistic. However, they are illustrative.

New Jersey interprets the throwout law, which removes from the denominator of the sales fraction sales that are assigned to a state "in which a taxpayer is not subject to tax on or measured by profits or income, or business presence or business activity," to mean that if a corporation is "not subject to tax in other states due to the protection of P.L. 86−272," then the corporation is subject to throwout of receipts attributable to those states in which the corporation is protected by P.L. 86−272. N.J. Admin. Code 18:7−8.7(d) (Example). The example in the regulation shows the sample allocation factor rising from 55% to 65% on the same business activity. New Jersey has no reservation about demonstrating its entitlement to a larger share of the proverbial pie if other states are prohibited from eating or decline to eat their share of the pie.

New Jersey Is Adversarial to Business

New Jersey has said, in so many words, that it will get P.L. 86-272-protected corporations for protected activities in New Jersey and it will get P.L. 86-272-protected corporations for protected activities in other states. The fundamental basis of its position is that P.L. 86-272 does not say that New Jersey cannot use such a "loophole." The type of "loophole" that New Jersey favors for apportionment is precisely the type of "loophole" that New Jersey claims separate corporations should not be able to use for nexus.

If a corporation that is protected from taxation in New Jersey by P.L. 86-272 is hit with the AMA or if it is subject to throwout of P.L. 86−272-protected sales once in New Jersey, then why should business leaders think that corporations will be treated any better if jobs are added in New Jersey? As Dean Hughes and Professor Seneca noted, corporate leaders have demonstrated that they know how to add jobs in California, Georgia, North Carolina, Texas, and Virginia.

Let us hope that New Jersey can be exposed for its whipsaw of corporations and that once exposed will eliminate the AMA for all corporations and will respect P.L. 86-272 protection afforded in other states. There has to be a better way for New Jersey to grow. New Jersey should do the right thing.

Footnotes:

1 The first priority in the Governor's action plan is to create a "single account management team to provide outreach and support to businesses seeking to expand within or relocate to New Jersey." Jon S. Corzine, *Economic Growth Strategy for the State of New Jersey 2007*, at 12. Before acting on any proposals from the account management team, corporations should ask what the tax impact would be if the account management team's proposal is followed.

2 New Jersey has been a separate-entity state since before the imposition of the CBT in 1945. N.J. Stat. Ann. 54:10A-1 *etseq.* (L. 1945, c. 162). The CBT replaced two taxes. The tax on domestic corporations arose in 1906, N.J. Stat. Ann. 54:13-1 *etseq.*, and the tax on foreign corporations arose in 1937, N.J. Stat. Ann. 54:32A-1 *etseq*.

3 *See*, *e.g.*, *Lanco, Inc. v. Director, Division of Taxation,* 188 N.J. 380 (2006) (certiorari to be requested). However, for apportionment purposes, when New Jersey applies its throwout provisions, *i.e.*, removes from the denominator of the receipts fraction sales that are not "subject to tax" in another state, N.J. Stat. Ann. 54:10A-6(B)(6), it will not assume that its nexus position applies in other states.

4 The AMA is based on gross receipts or gross profits. Initially, the AMA applied to all corporations that are subject to tax in New Jersey. For privilege periods commencing after June 30, 2006, the AMA is reduced to zero for all taxpayers except taxpayers that are protected by P.L. 86-272. However, for privilege periods commencing after December 31, 2006, if a taxpayer that is protected by P.L. 86−272 consents to jurisdiction under the normal CBT (i.e., waives the protections afforded to it under federal law), that corporation's AMA liability will be zero. N.J. Stat. Ann. 54:10A−5a(e).

5 The property and payroll fractions would each be 5/100. The sales fraction would be 5/10. The computation would be (0.0500 + 0.0500 + (2 x 0.5000))/4 or 27.50%. N.J. Admin. Code 18:7-8.1(c).