

## State and Local Tax ADVISORY

August 2, 2011

### In *Whirlpool*, New Jersey Supreme Court Finds the Throw-Out Rule Facially Constitutional Based on a Limited-Scope Application of that Rule

On July 28, 2011, the New Jersey Supreme Court held in *Whirlpool Properties, Inc. v. Director, Division of Taxation* that the state's "Throw-Out Rule" is facially constitutional under the Due Process Clause and the fair apportionment prong of the Dormant Commerce Clause of the U.S. Constitution. The court based its holding on a limited interpretation of the Throw-Out Rule, restricting its scope to apply only to certain categories of receipts.

New Jersey uses a three-factor apportionment formula to calculate a multi-state corporation's New Jersey Corporate Business Tax. For purposes of computing the sales factor, the Throw-Out Rule—which was adopted by New Jersey in 2002 and repealed effective for tax years beginning on or after July 1, 2010—excluded from the denominator certain out-of-state sales when such sales were assigned to jurisdictions in which the taxpayer was not subject to tax. N.J.S.A. 54:10A-6(B) (2002). Accordingly, the Throw-Out Rule operated to increase a corporation's sales fraction, and thus, the corporation's resulting New Jersey tax liability.

Whirlpool Properties, Inc. challenged the facial constitutionality of the Throw-Out Rule after the New Jersey Division of Taxation applied it to dramatically increase Whirlpool's income apportioned to the state for the tax years in question. In finding the Throw-Out Rule constitutional, the New Jersey Supreme Court drew a distinction between two categories of receipts that the state could potentially exclude from the sales factor denominator: (i) "receipts that are not taxed because the taxpayer does not have the requisite constitutional contacts with a state or because of congressional action setting some other, lower threshold of what Congress considers a business's activity in a state sufficient for a state to tax the business"; and (ii) "receipts that are not taxed because a state chooses not to impose an income tax."

#### Fair Apportionment Analysis

The court held that "the Throw-Out Rule may operate constitutionally, under a fair apportionment analysis, when applied to untaxed receipts from those states that lack jurisdiction to tax the corporate taxpayer due to the insufficient business activity in that state, but not when applied to receipts that are untaxed due to a state's determination not to have an income or similar business activity tax." In other words, the Throw-Out Rule could apply to exclude only the first category of receipts. According

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to the court, excluding receipts because another state does not impose an income tax—i.e., because such state elects not to tax the receipts in question—does not yield an externally consistent outcome under the fair apportionment test “because a state’s decision to have an income tax is independent of a taxpayer’s business activity.” On the other hand, when receipts are excluded because a state does not have jurisdiction to tax, “the Throw-Out Rule is arguably externally consistent,” as New Jersey “may have contributed more to the production of a sale than the sales factor, without the Throw-Out Rule, would suggest.”

### Legislative History Revisited

However, the court acknowledged that the Throw-Out Rule’s plain language did not distinguish between these two categories of receipts and thus could operate unconstitutionally in some circumstances. Nonetheless, in an unexpected twist, the court adopted a limiting interpretation of the Throw-Out Rule in order to overcome Whirlpool’s facial challenge, finding that the “more prudent” course of action was to “interpret the statute narrowly so that it generally operates constitutionally.” The court held that the Throw-Out Rule could operate only to exclude the first category of receipts based on its review of the rule’s legislative history. According to the court, since this operation of the rule was clearly facially constitutional, the rule itself was facially constitutional. The court thus concluded that based on its limiting interpretation, “the statutory Rule suffers no facial constitutional infirmity.”

### Ramifications of the Decision

Hence, subject to the U.S. Supreme Court’s eventual review of this specific question on appeal, it appears that the New Jersey Supreme Court has hung Whirlpool’s facial challenge to the Throw-Out Rule out to dry, and similarly situated taxpayers whose receipts were “properly” thrown out (i.e., because they were sourced to states without jurisdiction to tax such receipts) will need to focus their efforts on as-applied challenges to the Throw-Out Rule. However, by the same token, taxpayers whose excluded receipts were sourced to states that chose not to impose an income tax, now have the opportunity to file refund claims with respect to open tax years.

Finally, the reasoning in this decision may have implications for the constitutionality of state add-back statutes. Those statutes typically require the payor of royalties and/or interest to add-back to federal taxable income the amount of the federal deduction associated with those payments when the state in which the payee is located chooses not to tax the payee.

***For additional insight into this opinion and other New Jersey tax matters, please contact Alston & Bird’s state and local tax attorneys.***

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