The New Jersey Supreme Court’s July 28 decision in Whirlpool Properties Inc. v. Director, Division of Taxation that New Jersey’s “throw-out rule” was constitutional in response to a challenge under the dormant commerce clause of the U.S. Constitution. The court reached this conclusion by interpreting the throw-out rule to apply only when the other state could not constitutionally tax the taxpayer. This article explores the background of New Jersey’s rule and the
details of the case itself. It also analyzes the broader implications of the *Whirlpool* decision for taxpayers outside of the context of apportionment.

2. The Throw-Out Rule

A. New Jersey’s Business Tax Reform Act

In 2002, New Jersey enacted the Business Tax Reform Act (BTRA), which provided comprehensive reforms to the state’s corporate business tax. The New Jersey Assembly’s primary goal in passing the BTRA was to curb “the ‘runaway erosion of the CBT . . . revenue base’ caused by the ‘proliferating loopholes’ that allow corporations to avoid paying tax to the state.”

One such loophole was described as simply the “ability of multistate corporate taxpayers to ‘export’ their profits” out of New Jersey. At the time of the BTRA’s passage, the state was facing a multi-billion-dollar budget deficit. Thus, like many tax reform movements, New Jersey’s impetus to change was a financial crisis.

Among other reforms, the BTRA amended the state’s statutory CBT apportionment provisions by creating the throw-out rule. Generally, New Jersey requires multistate taxpayers to determine their CBT liability using a three-factor apportionment formula, which consists of a double-weighted sales factor, a property factor, and a payroll factor. Prior to the enactment of the throw-out rule, New Jersey’s sales factor was typical: the numerator consisted of a taxpayer’s receipts sourced to New Jersey, while the denominator consisted of a taxpayer’s total receipts from all states.

The throw-out rule modified the calculation of the sales factor to provide 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.” The rule therefore operated to increase the sales factor of a multistate taxpayer to which it applied and, in turn, the amount of CBT owed by that taxpayer to New Jersey. No explanation was provided in the statute regarding when receipts would be considered to be “subject to tax” in another state.

In 2008, the New Jersey Assembly repealed the throw-out rule effective July 1, 2010. As was the case for its adoption, the genesis of the repeal was a combination of a “plummeting tax revenue and a $5 billion budget shortfall.” In contrast to the 2002 financial crisis, however, the 2008 crisis inspired the state to engage in business development tactics rather than tax increases in an effort to boost its flagging economy.

B. Other State Iterations of the Throw-Out Rule

New Jersey was not the first (or last) state to adopt or attempt to apply a throw-out rule. A brief overview of other states that have been associated with such a rule follows.

**Kentucky.** In the 1970s, the Kentucky Revenue Cabinet assessed additional corporate income tax against a taxpayer based on an alternative-apportionment formula, which involved the application of a throw-out rule. On appeal, the Board of Tax Appeals concluded that the proposed alternative apportionment was not proper and that the standard three-factor formula fairly represented the extent of the taxpayer’s activities in the state. Shortly thereafter, the Board of Tax Appeals again rejected the Revenue Cabinet’s contention that a throw-out rule could be applied to alter the standard apportionment formula.

**Illinois.** More recently, Illinois amended its income tax apportionment statute to adopt a throw-out rule relating to receipts from services. Specifically, Illinois provides that if a taxpayer “is not taxable in the state in which the services are received, the sale must be excluded from both the numerator and the denominator of the sales factor.”

**Maine.** Maine also recently amended its statutory apportionment formula to provide for a throw-out rule. As a result, to compute the apportionment percentage (Maine is a single-factor state) for tax years beginning on or after Jan. 1, 2010, Maine requires that a taxpayer “exclude from both the numerator and the denominator sales of tangible personal property delivered or shipped by the taxpayer . . . to a purchaser within a state in which the taxpayer is not taxable . . . unless any member of an affiliated group with which the taxpayer conducts a unitary business is taxable in that state in the same manner as a taxpayer is taxable.”

The statute further explains that “taxable in another state” means that the taxpayer is “subject to a net income tax, a franchise tax measured by net income, a franchise tax for the privilege of doing business, or a corporate stock tax.” Notably, Maine also defines the phrase to mean “that [the] state has jurisdiction to subject the taxpayer to a net income tax regardless of whether in fact, the state does or does not.”

---


3 *Id.*


7 A. 2722, 213th Leg. (N.J. 2008).


13 Me. Rev. Stat. Ann. §5211(2). Thus, unlike New Jersey, Maine’s throw-out rule explicitly does not exclude receipts from states that do not impose an income tax. Maine’s throw-out rule is therefore externally consistent and facially constitutional, at least under the logic of the New Jersey Supreme Court in *Whirlpool*.

14 *Id.*
Pennsylvania. Pennsylvania had adopted a throw-out rule by regulation based on its alternative apportionment statute, and the Supreme Court of Pennsylvania had approved it. However, in 1984, the court changed its mind and withdrew its approval. The revenue department subsequently amended its regulation to eliminate the rule.

West Virginia. West Virginia has adopted a throw-out rule by administrative regulation, which provides that “[a]ll other sales of tangible personal property delivered or shipped to a purchaser within a state in which the taxpayer is not taxed are excluded from the denominator of the sales factor.” The regulation defines “not taxed in another state” to mean “in that state the taxpayer is not subject to a net income tax, a franchise tax measured by net income, a franchise tax for the privilege of doing business, or a corporation stock tax or that a state has no jurisdiction to subject the taxpayer to a net income tax.”

3. Background of Whirlpool

Although the New Jersey throw-out rule has been repealed, it remains a viable issue for disputes with the Division of Taxation involving tax years for which the rule was in effect, 2002 through 2010. Whirlpool represents one such dispute.

The taxpayer in Whirlpool was Whirlpool Properties Inc. (Whirlpool), a Michigan corporation that conducted all of its activities outside of New Jersey. Whirlpool’s business operations consisted of owning various trademarks and brand names and licensing them to several parties, including its corporate parent, Whirlpool Corp. Unlike Whirlpool Properties, Whirlpool Corp. (and other licensees) did conduct activities in New Jersey and paid CBT to the state accordingly. Whirlpool, however, neither paid CBT nor filed New Jersey returns from 1996 to 2003. As a result, Whirlpool was assessed by the Division of Taxation for each of those years based on information “gleaned from Whirlpool’s related entities.”

For 1996 through 2001, the New Jersey standard apportionment formula resulted in at most only 1.3337 percent of Whirlpool’s income being apportioned to the state. However, for 2002 and 2003, the formula resulted in apportionment percentages of 29.2572 and 41.8647, respectively, due to the applicability of the throw-out rule for those years. Needless to say, the impact of the throw-out rule on Whirlpool was dramatic.

Whirlpool brought suit in the New Jersey Tax Court, appealing its assessment and challenging the constitutionality of the throw-out rule. Several other taxpayers also sued the division based on allegations that the throw-out rule was unconstitutional. The Tax Court consolidated the lawsuits, and it ultimately concluded in the consolidated action that the throw-out rule was constitutional.

Whirlpool sought an interlocutory appeal with the Superior Court of New Jersey, Appellate Division, which was denied. However, the New Jersey Supreme Court granted Whirlpool’s appeal and remanded the suit back to the Appellate Division. Agreeing with the Tax Court, the Appellate Division rejected Whirlpool’s facial challenges to the throw-out rule on both commerce clause and supremacy clause grounds. The court held that the rule “does not expose any income to multiple taxation” and “does not tax in-state and out-of-state sales in a discriminatory manner.” Further, the court held that there were “circumstances in which the rule could operate consistently with federal law.”

Consequently, Whirlpool appealed the Appellate Division’s decision, and the N.J. Supreme Court granted review on Oct. 21, 2010. The primary issue on appeal was the same issue addressed by the Tax Court and the Appellate Division: whether New Jersey’s throw-out rule was constitutional. Additionally, Whirlpool challenged the proper standard to use in the evaluation of a tax statute’s constitutionality.

4. The Court’s Decision

A. Facial Constitutionality of the Rule

The court’s substantive analysis regarding the facial constitutionality of the throw-out rule focused exclusively on the dormant commerce clause. Specifically, the court analyzed the rule under the four-pronged test established by the U.S. Supreme Court in Complete Auto:

- whether the tax is “applied to an activity with a substantial nexus with the taxing State,”
- whether the tax “is fairly apportioned,”
- whether the tax “does not discriminate against interstate commerce,” and
- whether the tax “is fairly related to the services provided by the state.”

The court summarily dismissed the first and fourth prongs. The court held that the “substantial nexus prong is not pertinent because it goes to whether it is fair for a state to tax a taxpayer.” The constitutionality of the throw-out rule did not, according to the court, implicate whether Whirlpool lacked nexus with New Jersey. Similarly, the court held that the fair relation prong also has no impact on the rule’s constitutionality, as it “requires only that a taxpayer has been accorded the general benefits of civilized society.” Accordingly, the court centered its analysis on whether the throw-out rule resulted in a tax that was fairly apportioned, and

19 W. Va. Regs. §110-24-7.7.g.2.
20 W. Va. Regs. §110-24-7.7.g.2.A.
24 Id. at 536.
27 Id. at 30.
whether the tax discriminated against interstate commerce.

**Fair Apportionment.** The court first addressed whether the throw-out rule ran afoul of the fair apportionment prong of the *Complete Auto* test. The court correctly noted that fair apportionment involves two separate requirements: the tax in question must be both internally consistent and externally consistent. A tax is internally consistent when “if applied by every jurisdiction, it would result in no more than all of the unitary business’ income being taxed.”28 Unlike the external consistency requirement, internal consistency is concerned with the “hypothetical functioning of a tax formula, not its real world effects on a taxpayer.”29

“[T]he question is whether the state's tax law reasonably reflects the activity within its jurisdiction.”

**NEW JERSEY SUPREME COURT**

On the other hand, the court found, external consistency is a “more difficult requirement,” one that looks “to the economic justification for the State’s claim upon the value taxed, to discover whether a State’s tax reaches beyond that portion of value that is fairly attributable to economic activity within the taxing state.”30 In other words, under the external consistency analysis, “the question is whether the state’s tax law reasonably reflects the activity within its jurisdiction.”31 In contrast to internal consistency, analyzing external consistency “requires a ‘practical inquiry’ into the inter-state activity taxed in relation to the activity in the taxing jurisdiction.”32

With these principles in mind, the court asserted that the throw-out rule’s validity under the fair apportionment prong of the *Complete Auto* test depended on the type of receipts being excluded from the sales factor denominator by operation of the rule. In the court’s view, such receipts could be separated into two distinct categories:

1. [R]eceipts 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, such as P.L. 86-272, the taxpayer’s sales factor denominator by operation of the rule. In the court’s view, such receipts could be separated into two distinct categories:
   1. 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, such as P.L. 86-272, . . . and
   2. Receipts that are not taxed because a state chooses not to impose an income tax.33

The court held that the external consistency test is not met—and thus the throw-out rule is not constitutional—when the rule operates to exclude category-two receipts. When such receipts are thrown out of the denominator of a taxpayer’s apportionment formula, there will be no externally consistent outcome, “because a state's decision to have an income tax is independent of a taxpayer’s business activity.”34 The court explained:

Whether another state chooses to tax a receipt has no bearing on how much income is attributable to New Jersey. A state’s choice not to impose a tax is equivalent to taxing at a rate of 0 [percent]. New Jersey’s share should not increase because another state sets its tax rate at 0 [percent] any more than if that state’s rate was .01 [percent] or 10 [percent]. Such an increase would interfere with the taxing authority of the other state over the receipts generated in that state.35

In contrast, when receipts are excluded because a state does not have jurisdiction to tax (i.e., the receipts fall into the first category), the court held that 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.”36

The court said the “more prudent” course of action was to “interpret the statute narrowly so that it generally operates constitutionally.”

The court presented an example in which a taxpayer was a Nevada company with 90 percent of its sales in Nevada and 10 percent in New Jersey. If the taxpayer relocates to New Jersey, causing Nevada to lose jurisdiction to tax it under P.L. 86-272, the taxpayer’s sales factor would be 10 percent without the throw-out rule but 100 percent with the throw-out rule. In such circumstances, the court opined that “allocating 100 [percent] to Nevada may be reasonable. Nevada contributed relatively little compared to New Jersey and application of the Throw-Out Rule may more closely reflect the economic reality of New Jersey’s contributions to the [taxpayer’s] Nevada sales.”37 Thus, although application of the rule to category-one receipts may not “lead to a fair outcome in every case,” its “minor distortion would likely fall within the zone of permissible inaccuracy when using an apportionment formula.”38

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—when category-two receipts were excluded from the denominator of a taxpayer’s apportionment formula. Nevertheless, the court adopted a limiting interpretation of the 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 oper-

---

28 Id. at 24 (quoting *Container Corp. of Am. v. Franch. Tax Bd.*, 463 U.S. 159, 166 (1983)).
29 Id.
30 Id. at 25 (quoting *Container Corp.*, 463 U.S. at 169; *Okla. Tax Comm. v. Jefferson Lines*, 514 U.S. 175, 185 (U.S. 1995)).
31 Id. at 25-26.
32 Id. at 26.
33 Id. at 31.
34 Id. at 33.
35 Id. at 31-32.
36 Id.
37 Id. at 33.
38 Id. at 34.
ates constitutionally." The court’s limiting interpretation was that the throw-out rule provision could only be applied to exclude category-one receipts—"receipts that are not taxed because the other state lacks jurisdiction to tax." \[40\]

Further, the court held that its interpretation of the throw-out rule was in accordance with the rule’s legislative history. \[41\] The court cited an excerpt from a statement by the N.J. Assembly Budget Committee and the Senate Budget and Appropriations Committee issued while the BTRA was under consideration, which indicated that "original views as to the Rule’s reach meant for it to apply only to receipts assigned to states lacking jurisdiction over the taxpayer, not to situations where states have taxing jurisdiction over a corporation’s operations but choose not to impose an income tax." \[42\]

Thus, despite the fact that “the literal text of the Rule seemingly covers any situation where a corporation is not subject to income tax, in view of the shadow of unconstitutionality over such an interpretation,” the court determined that it must adhere to its “obligation to construe statutes in a way that avoids constitutional infirmity” and concluded that the rule was facially constitutional. \[43\]

**Discrimination.** The court briefly addressed but rejected the argument that the throw-out rule was constitutionally discriminatory. Although the court admitted that “in its broadest interpretation” the throw-out rule discriminated because it distinguished between taxing and non-taxing states, it declined to examine “how such a practice would fare based on a dormant Commerce Clause analysis.” \[44\] Such an examination was unnecessary, according to the court, in light of its “limiting interpretation” of the rule under the fair apportionment prong.

**B. Proper Standard for a Facial Challenge**

In addition to the central question of whether the throw-out rule was facially unconstitutional, Whirlpool challenged whether the Tax Court and Appellate Division applied the proper standard in evaluating the rule’s facial constitutionality.

Whirlpool contended that “the correct standard is whether there [were] any circumstances in which the statute would have been unconstitutional.” \[45\] Both the Tax Court and the Appellate Division disagreed, holding instead that the U.S. Supreme Court’s decision in U.S. v. Salerno provided the proper test: “the challenger must establish that no set of circumstances existed under which the Act would be valid.” \[46\] In other words, "[t]he fact that a statute might operate unconstitutionally under some conceivable set of circumstances is insufficient to render it wholly invalid." \[47\]

Although this issue was viewed by the Appellate Division as preliminary and necessary to resolve before tackling the more substantive question of the throw-out rule’s facial constitutionality, the N.J. Supreme Court disagreed. The court found that, based on its limiting interpretation of the rule instead, it was “unnecessary to wade extensively into the depth of the parties’ strident disagreement” over the proper standard of review. \[48\] Still, the court attempted to offer some conclusions regarding the proper standard to apply.

Acknowledging that there was "a measure of uncertainty over the use of Salerno as the de facto standard for facial challenges to the constitutionality of a statute," the court declined to accept Whirlpool’s argument that it should be abandoned in this case. Rather, the court opined: "We see no ready or clear indication that the [U.S.] Supreme Court has signaled its abandonment generally, or specifically in tax statute challenges." \[49\] Because of the court’s limiting interpretation of the throw-out rule—i.e., it could only operate to exclude one category of receipts—it declined to offer a more definitive resolution of the standard of review issue.

5. **Ramifications of Whirlpool 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 state’s throw-out rule out to dry, so to speak, and similarly situated taxpayers whose receipts were “properly” thrown out (because they were sourced to states without jurisdiction to tax such receipts) should focus their efforts on as-applied challenges to the rule.

The court’s reasoning may have implications for the constitutionality of state add-back statutes.

The court did not elaborate on its puzzling editorial comment that such as-applied challenges should be “eliminated” or “shortened” by virtue of this decision. However, it does seem clear that:

- such challenges remain a legitimate option for taxpayers in appropriate circumstances, and
- 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.

Additionally, the court’s reasoning in Whirlpool 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 asso-

---

39 Id. at 36.
40 Id. at 38.
41 Id. at 37.
42 Id. at 37-38.
43 Id. at 38. The court explained that this obligation was rooted in both state and U.S. Supreme Court case law, citing State v. Miller, 170 N.J. 417, 433 (N.J. 2002), which in turn cited In re. Assn. of Machinists v. Street, 367 U.S. 740, 749 (U.S. 1961), for the proposition that “when a statute’s constitutionality is drawn into question or placed in serious doubt, this Court should ascertain whether a construction of the statute is possible that avoids the constitutional problem.” Whirlpool Prop. Inc., N.J., No. A-25-10, at 36.
46 Id. (citing Salerno, 481 U.S. 739, 745 (1987)).
47 Id.
49 Id. at 43.
associated with those payments when the state in which the payee is located chooses not to tax the payee.
A taxpayer can seize on the reasoning in *Whirlpool* and argue that in such situations, there will be no externally consistent outcome, as adding back such amounts would interfere with the taxing authority of the payee state.