

SUPREME COURT OF NEW JERSEY

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WHIRLPOOL PROPERTIES, INC. and) Docket No. A-25-10
PFIZER, INC.,) A-26-10
)
) On Appeal From:
Plaintiffs-Appellants,) SUPERIOR COURT OF
) NEW JERSEY
v.) APPELLATE DIVISION
) DOCKET NO.: A-1182-08T2
DIRECTOR, DIVISION OF TAXATION,)
) Sat Below:
Defendant-Respondent.) HON. A. A. RODRIGUEZ, P.J.A.D.
) HON. J. L. YANNOTTI, J.A.D.
) HON. A. P. CHAMBERS, J.A.D.
-----)

BRIEF OF AMICUS CURIAE THE COUNCIL ON STATE TAXATION
IN SUPPORT OF THE PLAINTIFFS-APPELLANTS

Counsel
Marc A. Simonetti

On the brief
Marc A. Simonetti
Jeffrey A. Friedman

SUTHERLAND ASBILL & BRENNAN LLP
1114 Avenue of the Americas
New York, New York 10036-7703
(212) 389-5000

Counsel for Amicus
Council on State Taxation

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INTEREST OF AMICUS CURIAE

This brief *amicus curiae* in support of Plaintiffs-Appellants ("Taxpayers") is filed on behalf of the Council On State Taxation ("COST"). COST is a non-profit trade association formed in 1969 to promote equitable and nondiscriminatory state and local taxation of multi-jurisdictional business entities. COST represents nearly 600 of the largest multistate businesses in the United States; companies from every industry doing business in New Jersey and every other state. COST's members are concerned that New Jersey's apportionment formula, which is designed to tax extraterritorial values, subjects taxpayers to unconstitutional taxation.

COST represents multijurisdictional businesses that routinely pay apportioned taxes, and our members are alarmed by the possibility that a state can apply an apportionment formula that is designed to tax income earned in other states. The substantive and procedural issues raised in this case create unconstitutional taxation applicable to most of COST's members, and for that reason, this Court should reverse the lower court decision by holding that the New Jersey apportionment rule is facially unconstitutional.

SUMMARY OF THE CASE

The primary issue in this case is whether New Jersey's so-called "throwout rule" is facially unconstitutional because it is designed to reach income earned outside of New Jersey. Simply stated, the throwout rule increases the New Jersey apportionment percentage by "throwing out" sales attributable to other jurisdictions from the denominator of the sales apportionment factor. This exclusion systematically attributes extraterritorial value to New Jersey.

New Jersey Corporation Business Tax is computed on "entire net income," which is "total net income from all sources, whether within or without the United States. . . ." N.J. Stat. Ann. 54:10A-5(c)(1), -4(k) (2008). Prior to the "throwout rule" being imposed in 2002, the New Jersey apportionment formula apportioned income to New Jersey using a three-factor formula comprised of a sales fraction (in-state sales divided by "the total amount of the taxpayer's receipts"), a property fraction (in-state property divided by "property wherever situated") and a payroll fraction (in-state compensation divided by compensation of employees and officers "within and without the State"). N.J. Stat. Ann. 54:10A-6 (2001). Thus, the portion of a taxpayer's entire net income attributable to New Jersey was determined based on the ratio of the taxpayer's in-state activities to its activities everywhere. The formula, and New Jersey taxable income, is increased if either the numerator is increased or the denominator is decreased. The throwout rule is designed to

decrease the apportionment factor denominator thereby increasing New Jersey taxation.

In 2002, New Jersey enacted the Business Tax Reform Act of 2002. L. 2002, c. 40, §§ 1 to 33 ("2002 Tax Reform"). The 2002 Tax Reform changed the definition of the sales fraction to exclude certain sales from the denominator of the fraction in determining a taxpayer's New Jersey apportionment percentage. L. 2002, c. 40, § 8 (amending N.J. Stat. Ann. 54:10A-6(B)). Specifically, as amended by the 2002 Tax Reform, the denominator of the sales fraction is now:

[T]he total amount of the taxpayer's receipts, similarly computed, arising during such period from all sales of its tangible personal property, services, rentals, royalties and all other business receipts, whether within or without the State; 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.

N.J. Stat. Ann. 54:10A-6(B) (2008) (as amended by the 2002 Tax Reform) *emphasis added*.

The throwout rule always increases but never decreases a taxpayer's New Jersey apportionment factor when it is operative.

ARGUMENT

The Due Process and Commerce Clauses prohibit a taxing jurisdiction from taxing extraterritorial values and from taxing

value that is not rationally related to a taxpayer's activities in the taxing jurisdiction.

The Due Process Clause requires that there be "some minimum connection" (*Miller Bros. v. Maryland*, 347 U.S. 340, 344 (1954)) between the taxing jurisdiction and the property or activities it seeks to tax and, more importantly for present purposes, a rational relationship between the values that the jurisdiction seeks to tax and taxpayer's intrastate property or activities. *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425, 436-37 (1980); *Moorman Mfg. Co. v. Bair*, 437 U.S. 267 (1978). The U.S. Supreme Court has found that the minimum connection requirement is met when a taxpayer avails itself of the privilege of conducting business in the state. *Mobil Oil*, 445 U.S. at 437. The more exacting requirement of the Due Process Clause emanates from the mandate that the tax have a rational relationship to the taxpayer's presence in the state.

The Commerce Clause of the United States Constitution expressly authorizes Congress to "regulate Commerce . . . among the several States." U.S. Const., Art. 1, § 8, cl. 3. The Commerce Clause has been interpreted by the United States Supreme Court to be both an affirmative grant of power to Congress to regulate commerce between the states and an implied prohibition on the states and local governments to do the same. *Gibbons v. Ogden*, 22 U.S. (9 Wheat). 1, (1824). For decades there was significant confusion as to what regulations—including taxes—a state or local government could impose on businesses operating in

interstate commerce without running afoul of the Commerce Clause. In 1977, the Supreme Court adopted a four-part test for determining whether a state or local tax on an interstate business is valid under the dormant Commerce Clause. *Complete Auto Transit Inc. v. Brady*, 430 U.S. 274 (1977). The Supreme Court will uphold a tax under the dormant Commerce Clause only when the tax is "applied to an activity with substantial nexus with the taxing state; is fairly apportioned, does not discriminate against interstate commerce; and is fairly related to the services provided by the state." *Id.* at 279. This case brings into question the fair apportionment and fairly related parts of *Complete Auto*.

I. THE NEW JERSEY THROWOUT RULE IS A FACIAL VIOLATION OF THE U.S. CONSTITUTION BECAUSE IT IS DESIGNED TO TAX EXTRATERRITORIAL INCOME

The United States Supreme Court has made it clear that "[a]ny [apportionment] formula used must bear a rational relationship, both on its face and in its application, to property values connected with the taxing State." *Norfolk & W.R.Co. v. Missouri State Tax Comm'n*, 390 U.S. 317, 325 (1968) (citing *Fargo v. Hart*, 193 U.S. 490, 499-500 (1904)); see also *Moorman Mfg. Co.*, 437 U.S. at 273 ("the income attributed to the State for tax purposes must be rationally related to 'values connected with the taxing State,'" (quoting *Norfolk & W.*, 390 U.S. at 325)). Two terms ago, the United States Supreme Court took the opportunity to reiterate its long-standing principle that "[t]he Due Process and Commerce Clauses forbid the States to

tax 'extraterritorial values.'" *Mead-Westvaco Corp. v. Illinois Dept. of Revenue*, 538 U.S. 16, 19 (2008). Indeed, the Court has acknowledged that the taxation of interstate commerce "provide[s] the opportunity for a State to export tax burdens and import tax revenues." *Trinova Corp. v. Mich. Dep't Treas.*, 498 U.S. 358, 374 (1991).

The New Jersey throwout rule is designed to tax income from outside of New Jersey. The taxation of extraterritorial income is not rationally related to the taxpayer's New Jersey activity because it increases the taxpayer's New Jersey apportionment factor based on its activity outside of New Jersey. In fact, the throwout rule systematically creates a mismatch between the portion of the tax base assigned to New Jersey and the activity actually conducted there. The throwout rule reassigns to New Jersey a portion of the tax base that exists outside of New Jersey.

When a formula, such as the one at issue here, fails to align the scope of the in-state factors used to apportion the tax base with the in-state activities, there ceases to be a rational relationship between the apportioned income being taxed and the activities that generated that income. New Jersey's throwout rule bears no relation to the taxpayer's in-state presence, its use of in-state services and resources, or the value it generally derives from the state. Whether or not a taxpayer is taxed in another jurisdiction bears no relation to the value it creates within the taxing state. A state does not gain greater power to

tax a nonresident taxpayer merely because the taxpayer's out-of-state activities may not bear any tax in that other state.

For example, a taxpayer that derives ten dollars of New Jersey receipts and one hundred dollars of total receipts has a 10% New Jersey sales factor. However, if the same taxpayer makes twenty dollars of sales to Nevada customers (and Nevada does not impose a corporate income tax), then the taxpayer's New Jersey sales factor denominator is decreased to eighty dollars (by virtue of the throwout rule), and its New Jersey apportionment factor increases by 25% to 12.5%. The 25% increase in the New Jersey sales factor results from New Jersey re-directing Nevada sales to New Jersey. This misappropriation of sales creates extraterritorial taxation - taxation of income without a connection to New Jersey. The throwout rule redirects income from other states every time it is operative, and in doing so facially violates the fair apportionment prong of *Complete Auto Transit*.

While the Supreme Court has given leeway to the states to craft apportionment formulas and has recognized that independent decisions by states on how to apportion income might "occasionally" result in the taxation of extraterritorial values, see *Moorman Mfg. Co.*, 437 U.S. at 273, the Supreme Court has not allowed states to use an apportionment formula that is specifically designed to tax income earned in other states. This type of systematic extraterritorial taxation goes far beyond the minor flaws that are overlooked in a "rough approximation"

analysis. See *Trinova Corp. v. Michigan Dept. of Treasury*, 498 U.S. 358, 382 (1991). Rather, like a tax that discriminates against interstate commerce, a tax attributable to an unfair apportionment formula that, on its face, can be seen as inevitably producing deliberate and systematic extraterritorial taxation should not be allowed to survive, irrespective of the amount of extraterritorial taxation that may be involved. See *Associated Indus. of Missouri v. Lohman*, 511 U.S. 641, 650 (1994).

II. THE NEW JERSEY THROWOUT RULE IS UNCONSTITUTIONAL ON ITS FACE BECAUSE IT OPERATES TO CREATE AN ARBITRARY APPORTIONMENT FACTOR

Apportionment formulas used to determine state taxable income need not be precise. In fact, the U.S. Supreme Court has described the role of an apportionment factor as providing a "rough approximation" of a taxpayer's presence. *Trinova Corp. v. Michigan Dept. of Treasury*, 498 U.S. 358, 382 (1991). And, the Court has acknowledged that the role of apportionment formula is a difficult one: "Allocating income among various taxing jurisdictions bears some resemblance . . . to slicing a shadow." *Container Corp. of America v. Franchise Tax Bd.*, 463 U.S. 159, 192 (1983). Despite the challenges of designing and applying an apportionment formula, states must design apportionment formulas that are rationally related to the income to be apportioned. There must be some "minimal connection" or "nexus" between the interstate activities and the taxing State, and a "rational relationship between the income attributed to the State and the

intrastate values of the enterprise." *Id.* At 165-166 (quoting *Exxon Corp.*, 447 U.S. at 219-220, in turn quoting *Mobil Oil Corp.*, 445 U.S. at 436, 437).

New Jersey's throwout rule is arbitrary and is not designed to measure a taxpayer's income and activities and the connection with the taxing state. Rather, the throwout rule is designed to tax income that other states leave untaxed. As the U.S. Supreme Court has noted, "a tax on sleeping measured by the number of pairs of shoes you have in your closet is a tax on shoes." *Trinova Corp. v. Michigan Dep't of Treasury*, 498 U.S. 358, 374 (1991) (quoting *Jenkins, State Taxation of Interstate Commerce*, 27 Tenn. L. Rev. 239, 242 (1960)). Similarly, New Jersey's throwout rule is not a tax on in-state income, but rather a tax on income earned in other states.

In *Hunt-Wesson v. Franchise Tax Bd.*, the Court held that California's interest offset provision "is not a reasonable allocation of expense deductions to the income that the expense generates" and "constitutes impermissible taxation of income outside its jurisdictional reach." *Hunt-Wesson v. Franchise Tax Bd.*, 458 U.S. 458, 468 (2000). The provision was determined to violate the Due Process and Commerce Clauses. The New Jersey throwout rule also fails to reasonably approximate income earned in New Jersey. The New Jersey throwout rule is specifically designed to increase New Jersey tax due to activities taking place in other states. Thus, the inherently arbitrary throwout rule violates the Due Process and Commerce Clauses on their face.

III. THE NEW JERSEY THROWOUT RULE UNCONSTITUTIONALLY EXPORTS NEW JERSEY'S TAX BURDEN

The New Jersey throwout rule exports New Jersey's tax burden by inextricably linking the amount of New Jersey tax to the economic activity a taxpayer undertakes in other jurisdictions. Increasing New Jersey tax liability simply because another jurisdiction cannot or chooses not to tax activity is an unconstitutional enactment of an extraterritorial law. The throwout rule necessarily increases the amount of New Jersey tax depending entirely on a taxpayer's non-New Jersey activities. It is simply not within New Jersey's jurisdiction to assess tax outside of its borders.

In a series of cases related to non-tax matters, the Supreme Court has crafted careful limits on the ability of a state or locality to control activities beyond its borders. These cases support a conclusion that it is not proper for a state to extend its reach beyond its borders. While "Congress has ample authority to enact such . . . polic[ies] for the entire Nation, it is clear that no single State [much less a municipality] could do so, or even impose its own policy choice on neighboring states." See *Bonaparte v. Tax Court*, 104 U.S. 592, 594 (1881) ("No State can legislate except with reference to its own jurisdiction. . . ."). See also *BMW of North America, Inc. v. Gore*, 517 U.S. 559, 571 (1996) (holding that Congress has the sole authority to enact policies for the entire nation and "it is clear that no single State could do so, or even impose its own policy choice on neighboring States"); *State Farm Mut. Auto. Ins.*

Co. v. Campbell, 538 U.S.408, 421-22 (2003) ("Any proper adjudication of conduct that occurred outside of Utah to other persons would require their inclusion, and, to those parties, the Utah courts, in the usual case, would need to apply the laws of their relevant jurisdiction."); *Bigelow v. Va.*, 421 U.S. 809, 824 (1975) ("A State does not acquire power or supervision over the internal affairs of another State merely because the welfare and health of its own citizens may be affected when they travel to that State"); *New York Life Ins. Co. v. Head*, 234 U.S. 149, 161 (1914) ("[I]t would be impossible to permit the statutes of Missouri to operate beyond the jurisdiction of that State . . . without throwing down the constitutional barriers by which all the States are restricted within the orbits of their lawful authority and upon the preservation of which the Government under the Constitution depends. This is so obviously the necessary result of the Constitution that it has rarely been called into question and hence authorities dealing with it do not abound."); *Huntington v. Attrill*, 146 U.S. 657, 669 (1892) ("Laws have no force of themselves beyond the jurisdiction of the State which enacts them, and can have an extra-territorial effect only by the comity of other States."). The "Commerce Clause . . . precludes the application of a state statute to commerce that takes place wholly outside of the State's borders, whether or not the commerce has effects within the State." *Edgar v. MITE Corp.*, 457 U.S. 624, 642-43 (1982).

A taxpayer with consistent and unchanged activities in New Jersey, but with differing activity in other jurisdictions, might expect to see its tax liability in the other jurisdictions change. However, the *Hunt-Wesson v. Franchise Tax Bd.* throwout rule operates to increase New Jersey tax because of its activities outside of New Jersey. In effect, the New Jersey apportionment formula creates situations where a taxpayer's New Jersey tax liability can vary not based upon its New Jersey activities, but based entirely upon whether the taxpayer's activities take place in a "good state" (i.e., a state that imposes an income tax) or a "bad state" (i.e., a state that does not impose an income tax). Such overreaching by New Jersey should not survive constitutional scrutiny.

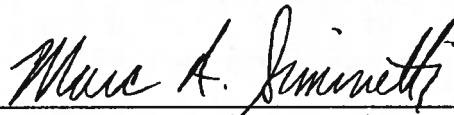
A throwout rule is not designed to measure a taxpayer's in-state value; it is deliberately designed to capture out-of-state income that is not taxed by another state. The New Jersey throwout rule seeks, in part, to punish taxpayers with activities in other states by requiring taxpayers to disregard certain activities. Not only is New Jersey's throwout rule designed to tax income without a New Jersey connection, it does so based on the tax regimes imposed by other states - which is an insidious attempt by New Jersey to extend its tax system to other states (and superimpose its tax policy decisions on other states). New Jersey has no authority to punish, by way of increased New Jersey tax, taxpayer activities in states outside of New Jersey that had no connection with or impact upon New Jersey.

CONCLUSION

The New Jersey throwout rule operates to apportion income to New Jersey that is not fairly related to the taxpayer's New Jersey activities. In addition, the New Jersey throwout rule leads to arbitrary apportionment of income for taxpayers to New Jersey based on their activities outside of New Jersey. The throwout rule violates the Supreme Court's extraterritorial principle by inextricably linking the amount of New Jersey tax to activity in other jurisdictions. Further, increasing a taxpayer's New Jersey tax liability simply because another jurisdiction cannot or chooses not to tax an activity is an unconstitutional enactment of an extraterritorial law to export New Jersey's tax burden on activities taking place outside of New Jersey. The throwout rule produces unconstitutional results each and every time it operates and is facially unconstitutional.

RESPECTFULLY SUBMITTED

Sutherland, Asbill & Brennan LLP



By Marc A. Simonetti
Jeffrey A. Friedman

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