Published on *The National Law Review* https://natlawreview.com

New Jersey Tax Court Issues Important Order on the State's Throw Out Rule

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The Tax Court of New Jersey recently issued an important order that may have eviscerated the impact of the Throw Out Rule on intangibles holding companies. On its face the order does not appear to address the application of the Throw Out Rule to traditional operating businesses, however the "bottom line" of the order should be applicable to all businesses.

The Tax Court of New Jersey recently issued an important order that has received surprisingly little attention from the tax media. This newsletter discusses the *Lorillard Licensing Co., LLC v. Director, Division of Taxation* order that may have eviscerated the impact of the Throw Out Rule on intangibles holding companies. While on its face the order does not appear to address the application of the Throw Out Rule to traditional operating businesses, the "bottom line" of the order should be applicable to all businesses.

Challenges to New Jersey's Throw Out Rule fall into three categories: (1) "facial" challenges, asserting that the Rule is unconstitutional in all scenarios; (2) "as-applied" challenges, asserting that the impact of the Rule on the particular taxpayer is unconstitutional; and (3) statutory challenges, asserting that the Rule should not have been applied at all or is being applied incorrectly (regardless of its constitutionality).

Facial challenges, to a large extent, are not likely to gain much traction at the New Jersey Tax Court or Superior Court, Appellate Division, as those courts are bound by the New Jersey Supreme Court's holding in *Whirlpool Properties, Inc. v. Director, Division of Taxation*, 208 N.J. 141 (2011). There, the New Jersey Supreme Court held that the Throw Out Rule is facially constitutional except when it causes the throwing out of receipts based solely on other states' legislatures' tax policy decisions (for example, the decision not to impose an income tax at all, as in Nevada, South Dakota and Wyoming).

As-applied challenges are working their way through the New Jersey courts and should result in decisions over the next few months and years. Taxpayers mounting as-applied challenges are making a number of arguments asserting that the Rule—as applied to their facts—results in apportionment that violates requirements of the Due Process Clause, the Commerce Clause (in terms of fair apportionment and discrimination), the Equal Protection Clause, the Supremacy Clause and possibly New Jersey's state constitution.

Statutory challenges asserting that, for one reason or another, the Rule is being applied incorrectly (including that it should not have applied to the specific taxpayer and, thus, no receipts should have been thrown out) are also working their way through the courts. A number of practitioners—including the authors of this article—have long asserted that the Rule should not cause receipts from states to be thrown out if the taxpayer's contacts with the state would be sufficient for taxation under New Jersey's own nexus standards. In other words, when determining if there are any states from which a taxpayer derives receipts one must use the same nexus standard the Division of Taxation asserts for determining taxability and not some higher standard.

This type of statutory challenge is precisely what the Tax Court recently faced in *Lorillard Licensing Co., LLC v. Director*, Dkt. 008772-2006 (partial summary judgment order issued Aug. 9, 2013).

Lorillard Facts

Lorillard is an intangibles holding company formed under the laws of North Carolina. The only state in which it has a physical presence is North Carolina; it has no employees or property in New Jersey nor in any states other than North Carolina. It owned a number of trademarks and trade names that it licensed to a related company for use in several states, including New Jersey, and it received royalties from such use. The Division of Taxation determined that Lorillard was subject to tax in New Jersey based on the holding in*Lanco, Inc. v. Director, Division of Taxation*, 188 N.J. 380 (2006), cert. denied 551 U.S. 1131 (2007). In *Lanco*, the New Jersey Supreme Court determined that a company could be subject to New Jersey taxation if it licensed intellectual property for use in New Jersey and derived receipts from such licensing.

While the Division of Taxation determined that deriving receipts from the use of its intellectual property in New Jersey was sufficient to subject Lorillard to New Jersey taxation, the Division used a different standard to determine whether Lorillard was "subject to a tax" in other states for purposes of applying the Throw Out Rule. There, the Division of Taxation interpreted "subject to a tax" to include only those jurisdictions where Lorillard actually filed a tax return. In other words, while a version of "economic nexus" was New Jersey's standard for New Jersey taxation, the Division of Taxation invoked a higher standard—actually filing tax returns in a state—for Throw Out Rule purposes.

Only One Nexus Standard Allowed

Without much fanfare—in fact, without even a written opinion—Presiding Tax Court Judge DeAlmeida determined that New Jersey could have only one nexus standard and that that standard is the one upheld by the courts in *Lanco*. With only one nexus standard, Lorillard's proof that it derived receipts from licensing its marks into all 50 states and elsewhere was sufficient to demonstrate that it was "subject to a tax" in those others states and, thus, none of its receipts were subject to the Throw Out Rule; the Tax Court granted partial summary judgment in Lorillard's favor. Although not articulated by the Tax Court in a written decision, it seemed clear that the Division of Taxation's view of taxable nexus violated not only the U.S. Constitution's external consistency requirement, but the internal consistency requirement as well.

Impact on Other Taxpayers

Because the order granted only *partial* summary judgment, the Division of Taxation does not have an immediate right to appeal. It can wait for all remaining issues to be addressed, then appeal a final decision, or it can file a motion asking the Appellate Division to hear this matter on an interlocutory basis, which the Appellate Division may or may not agree to do. Other cases raising the same argument are pending in front of other Tax Court judges who are not bound by this decision, so it is possible that a different result could be reached in other cases.

Taxpayers that were forced to throw out receipts from sales into jurisdictions that—under New Jersey's *Lanco* nexus standard—could have imposed tax on them but did not should consider filing similar motions in the Tax Court or making similar arguments before the Division of Taxation's Conference and Appeals Branch. Taxpayers that settled Throw Out Rule issues should review their settlement closing agreements to determine whether they now have an opportunity to seek a refund based on this argument.

Taxpayers that were forced to throw out receipts for other reasons—such as another state not imposing tax because the company is an S-corporation or because the company has P.L. 86-272 protection—may not find direct relief in the order, but should find some hope. The New Jersey Supreme Court's *Whirlpool* decision dictates that the Throw Out Rule cannot apply to receipts from sales into states that have jurisdiction to tax a company but that legislatively elect not to do so. Nevada, South Dakota and Wyoming were specifically identified as states that have made the legislative decision not to impose an income tax on any corporations.

National Law Review, Volume III, Number 253

Source URL:https://natlawreview.com/article/new-jersey-tax-court-issues-important-order-state-s-throw-out-rule