AN ALERT FROM THE BDO STATE AND LOCAL TAX PRACTICE

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SUBJECT

THE NEW JERSEY TAX COURT ISSUED A LETTER OPINION TO AMPLIFY ITS BENCH OPINION IN *LORILLARD LICENSING* CONCERNING THE THROW-OUT RULE "SUBJECT TO TAX" STANDARD

SUMMARY

On January 14, 2014, the New Jersey Tax Court issued a letter opinion to augment its August 9, 2013, bench opinion in *Lorillard Licensing Co., LLC v. Director, Division of Taxation*, Docket No. A-2033-13T1. From the bench, Presiding New Jersey Tax Court Judge Patrick DeAlmeida ruled that the New Jersey Division of Taxation must apply the nexus standard under the United States Constitution for purposes of determining whether the taxpayer – a company that licensed trademarks and trade names to an affiliate that used them in all fifty states – is "subject to tax" in such other states when applying the Corporation Business Tax ("CBT") throw-out rule. While the holding in the letter opinion does not deviate from the bench opinion ruling, the letter opinion does provide important insight.

DETAILS

BACKGROUND

For taxable years beginning on or after January 1, 2002, and before July 1, 2010, a taxpayer was required to exclude receipts from the CBT apportionment factor denominator when assigned to a state where the taxpayer was not "subject to tax" (*i.e.*, the throw-out rule).[1] It had been the Division's position that the "subject to tax" standard under the throw-out rule requires a taxpayer to actually file a return in the state where the receipts are assigned and the return must include the subject receipts.[2]

NEW JERSEY TAX COURT HOLDING AND RATIONALE

In *Lorillard*, the New Jersey Tax Court held that, because Lorillard's licensing activities when directed toward New Jersey are sufficient to cause it to be subject to New Jersey tax under the United States Constitution, then such activity when

[1] N.J.S.A. § 54:10A-6(B) (2010).
[2] *See e.g.*, Instructions, 2010 New Jersey Form CBT-100, p. 7.

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directed toward another state must be sufficient to cause it to be subject to tax in the other state for purposes of avoiding throw-out. This conclusion applies without regard to whether such other state actually imposed a tax on Lorillard or whether Lorillard actually filed a return in such other state. The New Jersey Tax Court concluded that the same nexus standard applies for both purposes because there is only one United States Constitution. The New Jersey Tax Court found it irrelevant whether Lorillard filed a return or whether the state actually exercised its jurisdiction to tax because, as the New Jersey Tax Court stated, "New Jersey has no legitimate interest in considering the tax policy and practices of other States when determining whether to apply the [t]hrow-[o]ut [r]ule."

The New Jersey Tax Court based its holding in *Lorillard* on the New Jersey Supreme Court's holdings in *Whirlpool Properties, Inc. v. Director Division of Taxation*, 208 N.J. 141 (2011), and *Lanco, Inc. v. Director, Division of Taxation*, 188 N.J. 380 (2006). In *Whirlpool*, the New Jersey Supreme Court held that, under the United States Constitution's Commerce Clause fair apportionment requirement, the throw-out rule may survive a facial constitutionality challenge if applied only to untaxed receipts assigned to those states that lacked jurisdiction to tax the corporation – either because of insufficient connection under the United States Constitution or because of congressional action. In other words, based on *Whirlpool*, the fair apportionment requirement of the United States Constitution's Commerce Clause is violated if New Jersey increases its apportionment through the throw-out rule when another state could have imposed tax on such receipts. In *Lanco*, the New Jersey Supreme Court held that an out-of-state trademark holding company that licensed its intangibles to an affiliate that used the trademarks in New Jersey had nexus with the state under the United States Constitution. Thus, the New Jersey Tax Court in *Lorillard* determined that when, *Lanco* and *Whirlpool* are read together, the Division is precluded from applying throw-out to those receipts assigned to a state to which Lorillard directs its licensing activities.

According to the New Jersey Tax Court's Letter Opinion in *Lorillard*, the Division has appealed the case to the New Jersey Superior Court, Appellate Division.

BDO INSIGHTS

POTENTIAL REFUND CLAIM

A taxpayer that followed the Division's throw-out rule policy of excluding sales assigned to a state where the taxpayer did not file a return may have overstated its New Jersey receipts factor and, thus, its CBT. Therefore, if the taxable year is still open, a taxpayer may be able to submit a refund claim if, for example, the taxpayer licensed intangibles for use in another state, but didn't file a return in such other state, and on its CBT return threw out sales sourced to such other state.

OPEN QUESTION

Under New Jersey's throw-out statute, throw-out was not permitted if the taxpayer was subject to a tax on or measured by profits or income, or business presence or business activity. In a 2003 question–and-answer publication, the Division was asked, for purposes of the throw-out rule, what type of taxes the Division would consider as "business presence" or "business activity" taxes. The Division responded that "[t]hese taxes would include: net worth taxes, gross receipts taxes, single business tax, but not property taxes, excise taxes (like the cigarette tax), payroll tax, or sales tax." However, the New Jersey Supreme Court in *Whirlpool* stated that throw-out would be appropriate in a case where the other state could not impose a tax due to federal law, *e.g.*, P.L. 86-272. An open question might be whether the New Jersey Supreme Court would continue with that holding if an argument were made that the other state could impose a gross receipts tax or a net worth tax.

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