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New Jersey enacted its ''throw-out rule'' in 2002 with the intention of closing ''loopholes'' and capturing ''nowhere'' sales. In this article, the authors maintain that robust ''fair apportionment'' analysis requires inquiries into both quantitative and qualitative irrationality, an inquiry into external inconsistency that evaluates a legislature's economic justifications, and an inquiry into internal inconsistency that focuses on interference with free trade. Pursuing this line of analysis, the authors argue that throwout is an egregious overreach of authority that fails all constitutional tests.

# Irrationality, Inconsistency, and Discrimination: Why New Jersey's Throw-Out Rule Is Unconstitutional

BY DONALD M. GRISWOLD AND LEAH SAMIT*

## INTRODUCTION

*Complete Auto Transit's* nexus and discrimination prongs see all the action.[1] For far too long, courts have given broad deference to the states, and taxpayers have ceded or lost the ''fair apportionment'' battles so long as their state's apportionment schemes appear to be aimed generally at achieving rough justice. In our view, that deference has gone too far.[2]

According to some observers, the constitutional standards for judging apportionment regimes have tiny teeth:

- The Due Process Clause ''rational relationship'' test, they say, validates virtually any apportionment scheme, so long as the result is not ''out of all appropriate proportion'' to the taxpayer's presence in the state. Taxpayers cite *Hans Rees*[3] with a resigned sigh and walk away from the settlement table with heads bowed.
- The Commerce Clause ''external consistency'' test, they say, is nothing more than a warmed-over serving of *Hans Rees* rational relationship gruel.[4]
- The Commerce Clause ''internal consistency'' test, they say, is no bar, so long as the nationwide tax base would not exceed 100 percent of a taxpayer's net income in a hypothetical world where all states imposed

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[1] Distilling decades of jurisprudence applying the dormant Commerce Clause in challenges to state taxes, the U.S. Supreme Court held in *Complete Auto Transit Inc. v. Brady*, 430 U.S. 274, 287 (1977), that a tax will withstand constitutional challenge only if it ''is applied to an activity with a 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.''

[2] We will leave for another day a bid for the resuscitation of *Complete Auto Transit*'s fourth prong, regarding ''fairly related to services provided by the State.''

[3] *Hans Rees' Sons v. North Carolina*, 283 U.S. 123 (1931).

[4] Walter Hellerstein, *State Taxation*, §4.15[2] (2007).

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the same type of net income tax with identical apportionment rules.[5] (Those who subscribe to this position appear to have bought into the ''nowhere sales''/''full apportionment'' sloganeering of the Multistate Tax Commission.)[6]

■ The Commerce Clause ''discrimination'' test rarely even enters the picture when the constitutional validity of an apportionment scheme is challenged.

These watered-down versions of the applicable constitutional rules fail to do justice to the robust principles of constitutional law that govern the validity of state apportionment structures and that serve as important safeguards to the national free-trade zone which the U.S. Constitution is designed to protect and foster.[7] It is time for taxpayers to dig in their heels and start winning challenges to the unconstitutional excesses being perpetrated by some states in the name of ''fair apportionment.''

## A New Look at Old Tests

In this article, we will make an unabashed argument for a renaissance of robust ''fair apportionment'' analysis. We will argue that the due process ''rational relationship'' inquiry is both quantitative (are a particular taxpayer's results reasonable?) and qualitative (is the method for dividing income reasonable?) Even if an apportionment scheme survives Due Process Clause scrutiny, it may still be invalidated as unconstitutional if it fails to satisfy either the external or internal consistency requirements of Commerce Clause fair apportionment analysis. We will argue that the internal consistency inquiry extends beyond mere double taxation to the scheme's impact on the free movement of commerce and that the external consistency inquiry includes an evaluation of the legitimacy of the state legislature's economic justifications for its apportionment rules. Finally, we will argue that an otherwise acceptable apportionment statute will nevertheless be invalid if it discriminates against interstate commerce.

Our argument in this article will focus on a challenge to a law that is, perhaps, one of the most egregious modern examples of state usurpation of authority in the field of state taxation: New Jersey's ''throw-out rule.''

## NEW JERSEY'S THROW-OUT RULE

No state can impose tax on all the taxable business income of a company that conducts business in several states. Each state may impose tax only on its fair share of that tax base. ''Apportionment'' is the term generally used for the process by which a state's fair share is determined. New Jersey's method of apportioning a company's tax base was typical of many states' approaches until 2002, when the New Jersey Legislature dramatically altered its apportionment formula by introducing a radical concept: ''throwout.''

Like most other states, New Jersey imposes tax on corporations doing business in the state.[8] As the U.S. Constitution requires, the New Jersey corporation business tax (CBT) may be applied only to the portion of a corporation's entire net income[9] that is attributable to New Jersey, determined by application of an apportionment formula.[10] New Jersey tax is then computed by multiplying that portion by a statutory tax rate.[11] The apportionment formula directly affects the amount of tax a corporation must pay in New Jersey: the higher the apportionment percentage, the larger the portion of a corporation's entire net income subject to tax and, thus, the higher the tax.

**In this article, we will make an unabashed argument for a renaissance of robust ''fair apportionment'' analysis.**

The New Jersey apportionment formula is the average of three fractions, or factors: a property factor, which is the corporation's in-state property divided by its total property; a payroll factor, which is its in-state payroll divided by its total payroll; and a double-weighted sales factor.[12] It is this final factor, the sales factor, that is the subject of inquiry in this article.

## Shrinking the Denominator

The New Jersey sales factor numerator consists of receipts from sales of tangible personal property shipped to destinations within New Jersey, receipts from services performed within New Jersey, receipts from rental property and royalties used within New Jersey, and ''all other business receipts . . . earned within the State.''[13]

Computation of the sales factor denominator differs from computation of the property and payroll denominators; it is not simply ''total sales.'' New Jersey does begin the calculation of the sales factor denominator by determining the total of all the corporation's receipts

[5] *See* Margaret C. Wilson, ''Apportionment Apoplexy: Throwback, Throwout, or Just Throw Up Your Hands,'' *The Tax Executive* 3 (July/August 2005).

[6] The ''nowhere sales'' concept is addressed in the Uniform Division of Income for Tax Purposes Act (UDITPA), §16(b). Full apportionment, an MTC concept, is discussed at Hellerstein, *State Taxation,* §§9.09 n 269; 9.18; *see also*, William Dexter, ''Taxation of Intangibles of Multistate-Multinational Corporations,'' 29 *Vand. L. Rev.* 401, 407 (1976).

[7] *American Trucking Associations Inc. v. Scheiner*, 483 U.S. 266, 284 (1987).

[8] N.J. Rev. Stat. §54:10A-2.

[9] ''Entire net income'' is defined to mean the ''total net income from all sources, whether within or without the United States, and shall include the gain derived from the employment of capital or labor, or from both combined, as well as profit gained through a sale or conversion of capital assets.'' N.J. Rev. Stat. §54:10A-4(k).

[10] ''Apportionment'' and ''allocation'' are different terms with different meanings. In most states, unitary business income is ''apportioned'' among the states, while nonbusiness income is ''allocated'' to specific jurisdictions. New Jersey statutes and regulations, however, use the terms interchangeably. For purposes of this article, we will use the term ''apportionment'' in its commonly understood meaning, except in direct quotations from New Jersey authorities.

[11] N.J. Rev. Stat. §54:10A-5(c).

[12] N.J. Rev. Stat. §54:10A-6(A)-(C).

[13] N.J. Rev. Stat. §54:10A-6(B)(1)-(6).

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everywhere—attributable to both New Jersey and other destinations or sources—in the manner followed by most other states. Unique among the states, however, New Jersey then applies a second step in the calculation of the sales factor denominator by requiring the following exclusion:

> [I]f 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.[14]

This throw-out rule shrinks the denominator of the sales factor by the amount of any receipts assigned to a jurisdiction where the corporation ''is not subject to a tax.''[15] Under the throw-out rule, a company that has sales into states where it is not taxed will have its sales factor denominator reduced. This reduction increases the size of the taxpayer's sales factor percentage, which in turn increases the size of its apportionment percentage and, consequently, increases its New Jersey tax liability. Consequently, under the throw-out rule, the unfortunate location of a company's non-New Jersey customers can dramatically increase the company's New Jersey tax liability.

To illustrate the operation of the throw-out rule, consider the cases of Happy-Co and Sad-Co. Each company has $100 million in total sales receipts, $30 million of which is attributable to New Jersey sources; all of Happy-Co's sales are made to states where Happy-Co is subject to tax, but half of Sad-Co's sales ($50 million) are made to Wyoming. Despite their equivalent financial pictures, Happy-Co's New Jersey sales factor is 30 percent (30 ÷ 100), but Sad-Co's New Jersey sales factor is 60 percent (30 ÷ [100-50]). Sad-Co's sales factor is double that of Happy-Co simply because Sad-Co sells its goods to a state that is disfavored by New Jersey law.

## CONSTITUTIONAL LIMITATIONS ON APPORTIONMENT

The throw-out rule makes little logical sense: Why should the location of a company's non-New Jersey customers have any impact on New Jersey's ''fair share'' of that company's tax base? The New Jersey statute's pairing of these two unrelated items is nonsensical on its face. The question for consideration here, however, is this: Is the nonsensical nature of throwout sufficient grounds for its invalidation? The validity or invalidity of a state tax apportionment statute depends on whether it complies with the requirements of the Due Process Clause and the Commerce Clause, and it is to these constitutional principles that we now turn.

### Testing for 'Irrationality' Under the Due Process Clause

The Due Process Clause provides that ''No State shall . . . deprive any person of life, liberty, or property, without due process of law.''[16] Thus, the Due Process Clause attempts to assure that ''traditional notions of fair play and substantial justice'' are maintained,[17] while recognizing ''the difficulty of identifying the geographic source of the income earned by a multistate enterprise.''[18] Under the Due Process Clause, a state taxing scheme is acceptable only if there is ''a *rational relationship* between the income attributed to the State and the intrastate values of the enterprise.''[19]

**The aim and expectation of formulary apportionment is rough justice.**

The near-universal response of the states to this ''rational relationship'' requirement has been to adopt formulary apportionment statutes. Mathematical precision cannot be expected in today's complex marketplace, however, and the Due Process Clause does not require it. Rather, the aim and expectation of formulary apportionment is rough justice. In order to divide income ''between the taxing jurisdiction and the rest of the world on the basis of a formula taking into account objective measures of the corporation's activities within and without the jurisdiction,''[20] many states use a three-factor apportionment formula based on the average of a taxpayer's in-state payroll over its total payroll, its in-state property over its total property, and its in-state receipts over its total receipts.

The widespread historical adoption of this three-factor apportionment formula has survived constitutional challenge. ''Indeed, not only has the three-factor formula met [with the U.S. Supreme Court's] approval, but it has become . . . something of a benchmark against which other apportionment formulas are judged.''[21] The three-factor formula has achieved benchmark status because ''payroll, property, and sales

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[14] N.J. Rev. Stat. §54:10A-6(B)(6) (emphasis added).

[15] The throw-out statute does not explain what it means to be ''subject to a tax,'' but the New Jersey Division of Taxation has provided its interpretation in regulations and in informal administrative guidance. The regulations, for example, provide that receipts assigned to states in which a taxpayer is protected from taxation by federal Pub. L. No. 86-272 are to be excluded as not ''subject to a tax.'' N.J. Admin. Code §18:7-8.7(d)(example). The department has also applied the term ''not subject to a tax'' to include those states that generally do not impose a net income tax on corporations: Nevada, South Dakota, and Wyoming. ''New Jersey Throw Out,'' *New Jersey State Tax News* (N.J. Div. Taxn., Trenton, N.J.) Fall 2004, at 2. Furthermore, while there is some guidance concerning what types of taxes are considered ''measured by profits or income, or business presence or business activity,'' this guidance is not definitive. A complete discussion of the proper definition of ''subject to a tax'' is, however, beyond the scope of this article.

[16] U.S. Const. amend. XIV, §1.

[17] *Quill v. North Dakota*, 504 U.S. 298, 307 (1992) (quoting *International Shoe Co. v. Washington*, 326 U.S. 310, 316 (1945)).

[18] *Trinova Corp. v. Michigan Dept. of Treas.*, 498 U.S. 358, 373 (1991).

[19] *Exxon Corp. v. Wisconsin Dept. of Rev.*, 447 U.S. 207, 219-20 (1989) (quoting *Mobil Oil Corp.*, 445 U.S. 425, 437 (1980)).

[20] *Container Corp. of America v. California Franch. Tax Bd.*, 463 U.S. 159, 165 (1983), *reh'g denied*, 464 U.S. 909 (1983).

[21] *Id.* at 170.

appear in combination to reflect a very large share of the activities by which value is generated.''[22] Thus, a comparison of in-state activities to activities everywhere ''reach[es], and [is] meant to reach, only the profits earned within the State'' and thereby satisfies the due process requirement for fair apportionment.[23] Apportionment formulae that compare these in-state activities have been repeatedly approved by, or at least unsuccessfully challenged in front of, the U.S. Supreme Court.[24] Thus, for purposes of this article, we will assume that the result derived from traditional three-factor apportionment is ''fair'' and that this traditional formula is indeed a benchmark against which alternative formulas should be judged.[25]

## Quantitative and Qualitative Irrationality

The test for due process fair apportionment—a rational relationship must exist between the income subjected to tax and the in-state values of the corporation[26]—has been applied rather superficially, without much intellectual rigor, by some courts that are quick to defer to legislatures in complex state tax matters. Taxes are often upheld without any detailed analysis concerning what the ''rational relationship'' test really requires. We believe that most analyses fail to fully address both sides of the fair apportionment coin: heads—a tax must demonstrate a *quantitatively* rational relationship between the income—and tails—a tax must demonstrate a *qualitatively* rational relationship between the income and the in-state values.

*Quantitative irrationality* analysis examines the relationship between two numbers. If the apportionment percentage that is derived from application of the statutory formula is wildly different from the percentage derived from some other approach that is viewed as a more reliable indicator of a particular taxpayer's in-state values, then a court may conclude that the statutorily apportioned income fails the due process ''rational relationship'' test. The best-known example of quantitative irrationality analysis is the U.S. Supreme Court decision in *Hans Rees' Sons*.[27] An apportionment formula that caused 85 percent of a corporation's income to be apportioned to a state when only 17 percent of the company's activities occurred in the state was held to be ''out of all proportion to the business transacted in the state'' and thereby to lack a rational relationship to the taxpayer's in-state values. This quantitative irrationality analysis, focused as it is on specific numbers, is taxpayer-specific in most cases and, thus, likely will invalidate a tax only in an ''as applied'' challenge because the same taxing structure may yield a rational result for one taxpayer and an irrational result for another. Most, if not all, U.S. Supreme Court due process fair apportionment taxpayer victories have hinged on this quantitative analysis. Indeed, according to one noted commentator, the supreme court ''has never held an apportionment formula unconstitutional on its face.''[28]

**The throw-out rule is grounded on an irrational proposition: the only out-of-state sales that contribute to a company's production of income are those sales made to customers in states that impose tax.**

*Qualitative irrationality* analysis, by contrast, involves an examination into the relationship between the elements of the apportionment formula and the in-state values that formula purports to estimate. An apportionment formula that measures some factor wholly unrelated to in-state activities lacks a rational relationship to in-state values. We believe that this qualitative irrationality analysis is inherent in the *Mobil Oil* ''rational relationship'' test. This analysis is not taxpayer-specific and, therefore, is appropriate in facial challenges to the

[22] *Id.* at 183.

[23] *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 274 (1978).

[24] *See generally Trinova Corp.*, 498 U.S. 358; *Container Corp.*, 463 U.S. 159; *Exxon Corp.*, 447 U.S. 207; *Moorman Mfg.*, 437 U.S. 267 (failure of proof); *Hans Rees'*, 283 U.S. 123 (unconstitutional as applied, but the single-factor formula measuring activities over everywhere activities was valid on its face); *Underwood Typewriter Co. v. Chamberlain*, 254 U.S. 113 (1920).

[25] This raises yet another issue that we must leave for another day. (See footnotes 2 and 55 of this article.) Does economic theory provide a sound foundation for including the sales factor in apportionment formulae, along with property and payroll? The time may not be right for a renewed challenge to the propriety of including the sales factor in state apportionment formulae, particularly given the ever-accelerating trend of state adoption of a ''single sales factor'' apportionment formula. Nevertheless, it is worth noting our concern that there may be little foundation in economic theory for the practice.

Economists have historically viewed income as created by the deployment of one's capital (property) and labor. Adam Smith, the father of modern economics, wrote repeatedly of ''the annual produce of the land and labour of the country'' as ''the real wealth and revenue of its inhabitants.'' Adam Smith, *The Wealth of Nations*, book II., ch.5, ¶ II.5.12. Despite the contrary suggestion of the *Container* court, the U.S. Supreme Court has also recognized this principle. ''Income may be defined as the gain derived from capital, from labor, or from both combined . . . .'' *Eisner v. Macomber*, 252 U.S. 189, 297 (1920). Even the New Jersey Legislature was apparently aware of this basic economic principle, for its statutory definition of the tax base expressly acknowledges that ''gain [is] derived from the employment of capital or labor, or from both combined.'' N.J. Rev. Stat. §54:10A-4(k). The property factor, of course, serves as an approximation of a company's deployment of ''capital'' in a state, while the payroll factor approximates its deployment of the other economic source of income–labor. The sales factor does not appear to have a similar foundation in economic theory, and one might speculate that this addition to the standard UDITPA apportionment formula may not have been based on economic theory at all, or on an honest attempt to produce a formula that fairly approximated a company's ''intrastate values.'' One noted commentator has suggested that the sales factor ''is justified as much by political as by economic considerations.'' Hellerstein, *State Taxation* §8.06[2].

[26] *Mobil Oil*, 445 U.S. at 437.

[27] *Hans Rees'*, 283 U.S. at 123 (State's apportionment formula was unconstitutional, as applied to this taxpayer, when it resulted in between 83 percent and 85 percent apportionment to state even though separate accounting demonstrated that only 17 percent of taxpayer's activities occurred within the state).

[28] Hellerstein, *State Taxation* §8-12[1].

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constitutionality of a taxing provision, rather than to "as applied" challenges.

To illustrate the critical importance of qualitative irrationality analysis, imagine a state apportionment formula based on the ratio of blue-eyed employees compared to all employees. Quantitatively, this formula might result in an apportionment factor that underestimates one company's in-state activities, overestimates another company's in-state activities, and is exactly on target for a third company based on the number of blue-eyed workers the company happens to employ. The quantitative inquiry looks to the results; thus, for some taxpayers, blue-eye apportionment may yield a quantitatively rational result and for others it may yield a quantitatively irrational result, "out of all proportion" to in-state values. Qualitatively, however, it is facially apparent that employee eye color is an arbitrary measure that bears no relationship whatsoever to a company's in-state activities.

Consequently, in order to satisfy the strictures of fair apportionment under the Due Process Clause, we believe an apportionment formula must survive both quantitative and qualitative irrationality analysis. After all, sharing an evenly divided apple is not "fair" if one half includes a worm.

## Quantitative Irrationality And the Throw-Out Rule

This two-step analysis can be applied to the throw-out rule. Quantitatively, the throw-out rule will fail to produce a rationally related apportionment percentage for many taxpayers (though it is possible that the rule may produce a rational relationship in the rare case). An example may help illuminate the quantitative irrationality of the throw-out rule. Consider Wyoming-Co, a Cheyenne-based manufacturer and distributor of goods that has identical operations (property, payroll, and sales) in 2002 (the year before New Jersey's enactment of the throw-out rule) and in 2003 (when throwout applies). In both years, $10,000 of Wyoming-Co's $100,000 payroll is in New Jersey; $30,000 of its $100,000 in real and tangible property is in New Jersey; and $2 million of its sales are attributable to New Jersey sources, while the remaining $8 million of sales are all attributable to Wyoming, which does not impose a net income tax.

In 2002, using the "benchmark" formula for apportionment (with double-weighted sales), Wyoming-Co has a 20 percent apportionment factor in New Jersey, calculated as follows:

$$20\% = \frac{10/100 + 30/100 + 2 \text{ x } (2/10)}{4}$$

This type of calculation has been approved by the U.S. Supreme Court as satisfying the "rational relationship" requirement for fair apportionment under the Due Process Clause.[29] In this example, 20 percent of the company's activities occurred in New Jersey, so it makes sense that New Jersey should be able to tax 20 percent of the company's net income.

The result changes dramatically for Wyoming-Co in 2003, with identical facts but this time with the throw-out rule in effect. Because all of the company's non-New Jersey sales were made into a state without a net income tax, Wyoming-Co's New Jersey apportionment factor increases threefold to 60 percent, even though the "benchmark" formula demonstrates that 20 percent is the fair result. Wyoming-Co's New Jersey apportionment is calculated under the throw-out rule as follows:

$$60\% = \frac{10/100 + 30/100 + 2 \text{ x } (2/[10 - 8])}{4}$$

This tripling of Wyoming-Co's New Jersey apportionment factor, driven by nothing other than a legislative perversion of the benchmark sales factor calculation, demonstrates the quantitative irrationality of the throw-out rule as applied to these hypothetical facts. Wyoming-Co, fairness dictates, should win an "as applied" due process challenge to the throw-out rule.

## Qualitative Irrationality And the Throw-Out Rule

Qualitatively, the throw-out rule's methodology is unfair to *all* taxpayers because the source of any taxpayer's non-New Jersey sales receipts bears no rational relationship to its New Jersey values or activities. New Jersey's formula follows traditional three-factor apportionment standards for identifying the factors (payroll, property, and sales) and for calculating the numerators of those factors (in-state payroll, in-state property, and in-state sales). To this extent, the New Jersey Legislature seems to agree with the principle that in-state activities contribute to a company's production of income. However, the throw-out rule completely abandons this benchmark principle for purposes of calculating the sales factor denominator. Flying in the face of logic, the throw-out rule is grounded on an irrational proposition: the only out-of-state sales that contribute to a company's production of income are those sales made to customers in states that impose tax. Under this revised formula, the decision by another state to tax a corporation causes an increase in that corporation's New Jersey activities. This makes no logical sense. Instead of comparing in-state apples to "everywhere" apples, the throw-out rule compares in-state apples to less-than-everywhere oranges.

**Imagine a state apportionment formula based on the ratio of blue-eyed employees to all employees. Qualitatively, employee eye color is an arbitrary measure that bears no relationship whatsoever to a company's in-state activities.**

Such an irrational comparison is incapable of producing a result that accurately reflects how New Jersey income is generated because the inputs driving the formula (the focus of our qualitative inquiry) are unrelated to the activities that build any corporation's value. Qualitative irrationality was introduced earlier in this article with a consideration of "blue-eye apportionment." Consider now another illustration: "Blue State throwout." Assume that the North Carolina Legislature, not to be outdone by its sister state New Jersey, decides to adopt its own version of the throw-out rule. Assume that North Carolina (deemed a "Red State" by political

[29] *See generally Container Corp.,* 463 U.S. 159; *Exxon Corp.,* 447 U.S. 207.

pundits because it voted Republican in the last presidential election) requires that a corporation's sales into "Blue States" (those that voted Democratic in the last presidential election) be thrown out of the sales-factor denominator, for purposes of calculating the corporation's North Carolina apportionment factor. Qualitative irrationality analysis reveals that Blue State throwout must be unconstitutional under the Due Process Clause, because the political climate of another state bears no rational relation to any company's income generation in North Carolina. This hypothetical North Carolina "Blue-State throwout," like New Jersey's actual no-tax-state throwout, must be unconstitutional.[30]

Under the New Jersey throw-out rule, a corporation is required to increase its sales factor by eliminating receipts from its denominator when sales are assigned to a state that:

- does not impose a net income tax;
- imposes a net income tax, but the corporation does not have nexus-producing presence in the state; or
- imposes a net income tax, but the state is barred by Pub. L. No. 86-272 from taxing the corporation.[31]

As interpreted by the New Jersey Division of Taxation, the throw-out rule increases a corporation's New Jersey apportionment of entire net income (and New Jersey tax) when any of these three scenarios is present. Not one of these scenarios, however, is relevant to the constitutional question that a "fair" apportionment statute must address: How much of the corporation's net income is attributable to its in-state activities?

The first scenario—a state does not impose a net income tax—turns on another state legislature's tax policy decisions. This fact has nothing whatsoever to do with a corporation's business activity in either the non-taxing state or in New Jersey. It has no more relevance to the determination of the extent to which a corporation's income is derived from New Jersey than, for example, the Nevada Legislature's decision to legalize prostitution or the California electorate's decision to vote Democratic. In an apples-and-oranges-type analogy, this scenario is a hamburger.

The second and third scenarios—a state imposes a net income tax, but the corporation does not have nexus-producing presence in the state or is protected from taxation by Pub. L. No. 86-272—turn on the nature of a corporation's activities in another state and not on the relative value of the corporation's activities in New Jersey. The *nature* of activities is totally unrelated to determining proper apportionment. Whether, for example, a corporation's sales force is present in a state for a sufficient number of days to create taxable nexus (an inquiry of the second scenario) or whether a corporation's in-state activities are limited to solicitation of sales (an inquiry of the third scenario) has nothing to do with the extent to which its income is derived from New Jersey activities.

A meaningful measurement of a corporation's activities for income apportionment purposes must be based, not on the nature, but on the *amount* of the corporation's activities in each state, which generally is taken into account in the "everywhere" denominators of the traditional three-factor apportionment formula. Apportioning income based on the amount of activities in the taxing state compared to that activity everywhere, and not on the nature of these activities (or unrelated activities), satisfies the requirement for "a rational relationship between the income attributed to the State and the intrastate values of the enterprise."[32] Apportioning income based on comparing the amount of the corporation's activities in the taxing state to the amount of its activities only in a limited number of other states (depending upon the nature of activities in each state) does not satisfy this requirement.

When a company's New Jersey apportionment percentage increases, *based solely on the lack of taxation by other states,* and not based on any increase in activities within New Jersey, the company's New Jersey income tax will increase. As such, the throw-out rule "reaches beyond that portion of value that is fairly attributable to economic activity within the taxing State."[33]

**The throw-out rule should fail most taxpayer challenges under quantitative analysis, and it should fail any challenge under qualitative analysis.**

Another perspective on the problem sheds further light on the irrationality of the throw-out rule. No one would seriously suggest that a state would be constitutionally permitted to include in its sales factor numerator a company's sales of tangible goods that are shipped from and delivered to out-of-state locations. In the Wyoming-Co example above, where goods manufactured in Wyoming ship directly from Wyoming to the destination states of Wyoming and New Jersey, New Jersey is indisputably prohibited from including the company's receipts from Wyoming-destined sales in the numerator of its New Jersey sales fraction.[34] Inclusion of sales in the numerator, however, has an effect that is similar (if not mathematically identical) to the exclusion of sales from the denominator: the sales fraction increases and, consequently, so do the apportionment percentage, the amount of taxable income, and, ultimately, the amount of tax.

While the amounts of increase may not be identical, the effect is the same—more income is apportioned to New Jersey based on an out-of-state factor. It is, therefore, just as impermissible to exclude non-New Jersey receipts from the denominator as it is to include non-New Jersey receipts in the numerator. What a state con-

[30] Consequently, if the courts disregard this qualitative analysis and uphold the throw-out rule as constitutional, the door will be opened wide for state legislatures to use their taxing structures to influence the political decisions of other states.

[31] 15 U.S.C. §381.

[32] *Mobil Oil Corp.*, 445 U.S. at 437.

[33] *Oklahoma Tax Comn. v. Jefferson Lines Inc.*, 514 U.S. 175, 185 (1995).

[34] *See Exxon Corp.*, 447 U.S. at 219 (*quoting Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450, 460 (1959)) (fair apportionment allows for "formulas utilizing in-state aspects of interstate affairs"); *Mobil Oil Corp.*, 445 U.S. at 436 (same).

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stitutionally cannot achieve by increasing a company's numerator cannot legitimately be achievable by decreasing its denominator. As it has been said, ''a tax on sleeping measured by the number of pairs of shoes you have in your closet is a tax on shoes.''[35]

In sum, an apportionment formula will pass muster under the Due Process Clause only if the resulting apportioned tax base is rationally related to the corporation's in-state values. The rationality or irrationality of this relationship must be tested from the standpoint of both quantitative and qualitative analysis. If the apportionment scheme is both quantitatively rational and qualitatively rational, the tax is constitutionally sound. If either element is answered in the negative, the tax should fail. The throw-out rule should fail most taxpayer challenges under quantitative analysis, and it should fail *any* challenge under qualitative analysis.

## TESTING FOR INCONSISTENCY UNDER THE COMMERCE CLAUSE

The U.S. Commerce Clause, which prohibits any state action that unduly burdens or interferes with interstate commerce,[36] also requires that income be fairly apportioned among the states.[37] While the inquiry under the Due Process Clause is irrationality, the inquiry under the Commerce Clause is inconsistency. Specifically, in order to withstand a challenge based on the Commerce Clause, a tax must be both internally and externally consistent.[38]

### External Inconsistency

To a limited extent, the Commerce Clause ''external consistency'' test overlaps with the Due Process Clause requirement for fair apportionment.[39] Indeed, the test has been criticized, incorrectly, for ''adding nothing'' to the constitutional inquiries of due process fair apportionment.[40] The external consistency test, however, does indeed add a very important additional perspective: While the due process test looks at the relationship between the income being taxed and a taxpayer's in-state activities, the external consistency test ''looks . . . to the *economic justification* for the State's claim upon the value taxed'' to evaluate whether the relationship is fair.[41] This is a pragmatic test that looks to external factors.[42]

Therefore, the New Jersey Legislature's justification for imposing the throw-out rule sheds important light on whether the state has a legitimate claim upon the value taxed. The New Jersey State Assembly and Senate each voiced the same four purposes for enactment of the throw-out rule:

- to raise revenue,
- to close ''loopholes,''
- to ensure that taxpayers pay tax on 100 percent of their income, and
- to capture ''nowhere'' sales.[43]

None of these purposes, however, provides sufficient economic justification for the state's far-too-deep reach into taxpayer pockets.

**The Commerce Clause 'external consistency' test ... has been criticized, incorrectly, for 'adding nothing' to the constitutional inquires of due process fair apportionment.**

First, the need to raise revenue simply cannot justify a tax that reaches beyond the amount of income rationally related to in-state activities. If it did, any and all taxes would satisfy the Commerce Clause test for external consistency. Moreover, there are many alternatives for increasing state revenue without overreaching. For example, a state could increase its income tax rate or expand its taxable base, both of which New Jersey has done in the past.

[35] *Trinova Corp.*, 498 U.S. at 374 (*quoting* Jenkins, ''State Taxation of Interstate Commerce,'' 27 Tenn. L. Rev. 239, 242 (1960).

[36] *Quill Corp.*, 504 U.S. at 309.

[37] *Complete Auto Transit*, 430 U.S. at 279.

[38] *Container Corp.*, 463 U.S. at 169.

[39] *See Container Corp.*, 463 U.S. at 169; *Trinova Corp.*, 498 U.S. at 373.

[40] Hellerstein, *State Taxation* §4.15[2].

[41] *Jefferson Lines*, 514 U.S. at 185 (emphasis added).

[42] *See Goldberg v. Sweet*, 488 U.S. 252, 264 (1989).

[43] In both the Assembly Budget Committee's statement in support of the Business Tax Reform Act, Bill No. A. 2051, P.L. 2002, ch. 40 (the BTRA), which contains the throw-out rule, and the Senate Budget and Appropriations Committee's statement in support of the BTRA, each committee described its view of the operation of the throw-out rule as follows:

> [Without the throw-out rule] [t]he more goods that are shipped out of New Jersey, the lower [the sales] factor is. Some of those sales are made in states where the corporation is not subject to tax because the corporation has no operations in those states. These are typically referred to as ''nowhere sales'' because they result in income being assigned so that it is taxed nowhere. The [BTRA] closes this loophole by ''throwing out'' the ''nowhere sales'' from the denominator of the sales fraction, which causes more of the income of the corporation to be assigned to states where the corporation actually has operations.

Assembly Budget Committee Statement to Assembly, A.B. 2501, at 3 (New Jersey 2002; Senate Budget Committee Statement to Senate, S.B. 1556, at 3 (New Jersey 2002). The committees' description of the throw-out rule, however, reflects three basic misunderstandings of how the rule actually operates. First, while the quoted language states that excluding ''nowhere sales'' causes more of the income to be assigned ''to states where the corporation actually has operations,'' the throw-out rule effectively allows New Jersey to take the entire benefit of sales not taxed elsewhere, by eliminating them from the sales denominator and increasing the New Jersey sales factor, without regard to other states where the company has operations. Second, while the committees seem to be voicing approval of a rule that eliminates ''nowhere sales'' that ship from New Jersey, the actual rule eliminates ''such sales'' regardless of the shipping point. Finally, the quoted language implies that receipts are excluded only when they would otherwise be assigned to states where a corporation does not have operations. However, the location of operations is utterly irrelevant to the rule's application. A corporation can have operations in Nevada, South Dakota, Wyoming, or in a state where it is protected from taxation by Pub. L. No. 86-272, or in a foreign country that does not impose an income tax on the corporation—and yet sales into those jurisdictions are subject to the throw-out rule.

The Legislature's second economic justification for its throw-out rule was that this would close tax "loopholes." The New Jersey Legislature is mistaken; the throw-out rule does not close any New Jersey tax loopholes because it does not even address them. Prior to enactment of the throw-out rule, a taxpayer that conducted 15 percent of its business in New Jersey, as determined under the benchmark three-factor apportionment formula (albeit double-weighted), would have been subject to tax on 15 percent of its income. New Jersey would not have been prevented from taxing any of the taxpayer's income that is properly attributable to the state. It may be that some percentage of the taxpayer's income is attributable to states that do not impose tax, but that non-New Jersey income cannot be constitutionally reached by New Jersey in any event. There is no New Jersey tax loophole. If a "loophole" exists, it is in the nationwide system. That leads us to consideration of the Legislature's third economic justification.

**Like some other marketing slogans, the 'nowhere sales' catch-phrase does not stand up to scrutiny.**

The third stated goal of the throw-out rule was to capture "nowhere sales" and redirect them to New Jersey by increasing the sales factor based on those sales.[44] Kudos are due the Multistate Tax Commission for clever marketing, for the phrase is rather catchy. Like some other marketing slogans, however, the "nowhere sales" catch-phrase does not stand up to scrutiny. There is simply no such thing as a "nowhere sale." Sales shipped into South Dakota are actually shipped into South Dakota, not to "nowhere"; services performed in Wyoming are actually performed in Wyoming, not in "nowhere." If Wyoming or South Dakota want to subject companies to a tax measured on business activities, they are free to do so. That South Dakota and Wyoming elect not to have net income taxes has no bearing on the extent to which a company's income is attributable to activities in New Jersey.

Further, states that are prohibited from taxing a company because of the protections of Pub. L. No. 86-272 likely would include these sales in their sales fraction numerators if they were able to tax the companies. Neither another state's decision to forgo taxation, nor federal restrictions on its tax jurisdiction, have any bearing on the extent to which a corporation's income is generated by its New Jersey activities. Indeed, the throw-out rule's statutory language itself acknowledges that it eliminates receipts that "would be assigned" to some state *other than New Jersey*.[45] Thus, taxing "nowhere sales" is yet another flimsy excuse that does not provide a reasonable economic justification for extraterritorial taxation.

The last stated purpose for the throw-out rule was to ensure that corporations pay income tax on 100 percent of their income (and, apparently, to ensure that New Jersey alone benefits from this windfall).[46] This purpose, however, also lacks sufficient economic justification. New Jersey may not like the idea that some of a corporation's income will go untaxed—because it is attributable to a no-tax state—but, if that is a "problem," it is not New Jersey's problem to fix.[47] Corporations are free to sell their goods where the markets take them; states are free to tax or to abstain from taxing the activities occurring within their borders; and Congress (and only Congress) is free to curtail the protections of Pub. L. No. 86-272.

The Legislature's economic justifications underlying the enactment of the throw-out rule do not provide a sufficient basis to increase a company's tax burden based on out-of-state sales. Consequently, the throw-out rule fails the external consistency test of the Commerce Clause requirement for fair apportionment.

## Internal Inconsistency

The second constitutional test of fair apportionment under the Commerce Clause is "internal consistency." This test asks whether a state tax is of a kind that, "if applied by every jurisdiction, there would be no impermissible interference with free trade."[48] This criterion has at times been treated as violated only when the total nationwide tax base—if all states imposed the identical apportionment method—would be no greater than 100 percent. In many cases, however, this "hypothetical world" approach is too far removed from reality to be useful.

An analysis of the throw-out rule as part of a hypothetically uniform nationwide taxing scheme, for example, would first require the fiction that Nevada, South Dakota, and Wyoming—all states that have clearly rejected a net income tax—adopt a net income tax and, second, adopt a throw-out rule. Under that fiction, exactly 100 percent of a company's income would be subject to tax if each of the 50 states adopted a throw-out rule. Admittedly, the throw-out rule would pass this test. But this test requires so many "let's pretend" assumptions that it is virtually meaningless.

**Hypothetical fictions (reasonable or unreasonable) are not, however, the extent of the internal consistency analysis that is required under the Commerce Clause.**

A more realistic approach would require an assumption that a throw-out rule is adopted in all states that already impose net income taxes. Under this more realistic fiction, 47 states would each throw out the same Nevada, South Dakota, and Wyoming sales, and this

[44] Budget Committee Statements at 3.

[45] N.J. Rev. Stat. §54:10A-6(B)(6).

[46] Budget Committee Statements at 1, 3.

[47] *See Central Greyhound Lines Inc. v. Mealey*, 334 U.S. 653, 662 (1948) ("But even if neither [of the other states with the right to tax a portion of the transaction at issue] sought to tax their proportionate share of the revenue from this [transaction], such abstention would not justify the taxing by New York of the entire revenue.")

[48] *American Trucking*, 483 U.S. at 266, 284 (quoting *Armco Inc. v. Hardesty*, 467 U.S. 638, 644 (1984)).

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would most certainly result in greater than 100 percent taxation.

Hypothetical fictions (reasonable or unreasonable) are not, however, the extent of the internal consistency analysis that is required under the Commerce Clause.[49] The inquiry that is most relevant here is *whether there would be an "impermissible interference with free trade*" if every state imposed a throw-out rule.

Assuming that all 50 states imposed an income tax with three-factor apportionment, including a throw-out rule, a taxpayer with sales into all 50 states but which is protected from taxation only in Vermont by virtue of Pub. L. No. 86-272, will be forced to reduce its denominator in each of 49 states by its sales into Vermont. The taxpayer will pay a greater amount of tax in each of 49 states based on its sales into Vermont. This will effectively increase the cost of doing business in Vermont, an increase that would only be eliminated if the corporation ceased selling into that state. Thus, universal imposition of a throw-out rule would deter sales into any nontaxing state. The throw-out rule thus fails the internal consistency requirement because it creates a "financial barrier" around nontaxing states.[50]

## TESTING FOR 'DISCRIMINATION' UNDER THE COMMERCE CLAUSE

The Commerce Clause expressly authorizes Congress to "regulate Commerce . . . among the several States."[51] By negative implication, the Commerce Clause has been interpreted to prohibit any state action that unduly burdens or interferes with interstate commerce.[52] Thus, the most basic function of the Commerce Clause is "to assure that there be free trade among the several States. This free trade purpose is not confined to the freedom of trade with only one State; it is freedom to trade with any State, to engage in commerce across all state boundaries."[53] These principles form the foundation of the third prong of the *Complete Auto Transit* test: a tax affecting interstate commerce is valid only if it does not discriminate against interstate commerce.[54] This is an inquiry that is independent of the fair apportionment prong considered previously in this article.

Before considering why throwout unconstitutionally discriminates against interstate commerce, it should be observed that the benchmark three-factor apportionment formula (without throwout or throwback)[55]—in addition to reaching only that portion of a company's profits that are arguably related to a particular state–actively encourages the growth and free flow of interstate commerce. As a company conducts more business outside of one particular state, its "everywhere" sales factor denominator will increase, lowering its apportionment formula (and therefore its tax) within that state. Thus, traditional formulary apportionment is consistent with the Commerce Clause's goal of protecting and encouraging a frictionless national economy. The throw-out rule, however, operates in precisely the opposite fashion.

The relevant inquiry under the discrimination prong is this: "[D]o the methods by which the [challenged tax] [is] assessed discriminate against some participants in interstate commerce in a way that contradicts the central purpose of the Commerce Clause?"[56] Under the throw-out rule, the answer is "yes."

The Commerce Clause "does not prevent the States from structuring their tax systems to encourage the growth and development of intrastate commerce and industry. Nor [does it] hold that a State may not compete with other States for a share of interstate commerce, such competition lies at the heart of a free trade policy."[57] The case law, however, does mandate "that in the process of competition no State may discriminatorily tax the products manufactured or the business operations performed in any other State."[58]

**Throwout is invalid because it discriminates against interstate commerce, operating effectively as a New Jersey tariff imposed on economic activity conducted in other states.**

The throw-out rule creates a significant disincentive for corporations to make sales into Nevada, South Dakota, Wyoming (nontaxing states) and Pub. L. No. 86-272 protected states. For example, if Sad-Co makes sales into New Jersey and South Dakota, it will bear a greater New Jersey tax burden (and likely a greater overall tax burden[59]) than otherwise identical Happy-Co, which limits its sales into New Jersey and New York. When the throw-out rule operates to increase Sad-Co's New Jersey apportionment, that rule is economically equivalent to a tariff imposed on Sad-Co's sales into nontaxing states.

The throw-out rule thereby creates an environment in which taxpayers with goods and services that can be sold anywhere are deterred from making tax-neutral decisions regarding where to sell their wares; instead,

[49] As the court in *American Trucking* observed by way of example, if each state imposed a tax on entering the state, there would be "no conceivable doubt that commerce among the States would be deterred" and internal consistency violated, even though the "greater than 100% taxation" concept is inapplicable in the flat tax example provided. *American Trucking*, 483 U.S. at 284.

[50] *See American Trucking*, 483 U.S. at 284.

[51] U.S. Const. art. I, §8, cl. 3.

[52] *See Quill Corp.*, 504 U.S. at 309.

[53] *Boston Stock Exchange v. State Tax Comn.*, 429 U.S. 318, 335 (1977).

[54] *Complete Auto Transit*, 430 U.S. at 279.

[55] The unconstitutionality of throw-back rules, which increase the taxpayer's sales factor numerator in the "ship from" state for sales destined for states that do not impose tax, is manifest. An explanation of the reasons for that unconstitutionality, however, is beyond the scope of this article and must be left for another day.

[56] *American Trucking*, 483 U.S. at 282.

[57] *Armco Inc.*, 467 U.S. at 646 (*quoting Boston Stock Exchange*, 429 U.S. at 336-337).

[58] *Id.*

[59] New Jersey imposes one of the highest net income tax rates in the country. Thus, even if 100 percent of a corporation's income is subject to tax, the larger the portion subject to tax in New Jersey, the higher the overall tax burden likely will be. Only a handful of states have rates equal to or higher than that of New Jersey.

the increased New Jersey tax burden stemming from sales destined for certain states will be a business consideration. Whether a discriminatory tax encourages a business to move into a tax-favored state or merely prevents a business from leaving a favored state, ''it is still a discriminatory tax that 'forecloses tax-neutral decisions and . . . creates . . . an advantage' for firms operating in [the tax-favored state] by placing a 'discriminatory burden on commerce to its sister States.' ''[60]

Consider again the case of Happy-Co and Sad-Co, identical companies except for the states into which they sell their goods. If Sad-Co has $100 million of total sales, $10 million of which are made into New Jersey and $90 million into Nevada, then Sad-Co's New Jersey apportionment calculation will include a double-weighted sales factor of 100 percent (10 ÷ [100-90]). If Happy-Co also has $100 million of total sales, $10 million of which are into New Jersey, but has its remaining $90 million of sales into Mississippi rather than Nevada, Happy-Co will have a much better tax posture in New Jersey. Happy-Co's double-weighted New Jersey sales factor would be dramatically lower—just 10 percent (10 ÷ 100). Sad-Co therefore suffers a penalty—a tariff, if you will—in the form of the grossly augmented double-weighted sales factor for continued trade in Nevada.

**The New Jersey Legislature's shameless admission that the goal of throwout is to tax income not captured by other states makes the statute externally inconsistent because this economic justification is impermissible.**

Some New Jersey taxpayers will be able to modify their behavior as a result of the New Jersey throw-out rule. If Happy-Co's goods can be sold anywhere, New Jersey will reward it for increasing its sales in Mississippi and for continuing to stay out of the Nevada marketplace. But consider again Sad-Co, a casino slot machine manufacturer whose goods have a relatively less mobile market. In all likelihood, Sad-Co will continue to make sales into Nevada and will pay a higher New Jersey tax because of it. This is a textbook example of the ''forbidden impact on interstate commerce [that] exerts an inexorable hydraulic pressure on interstate businesses to ply their trade within the [tax favored states] rather than 'among the several States.' ''[61]

Therefore, the throw-out rule is unconstitutional because it discriminates against interstate commerce. This discrimination is evident on the face of the statute, not merely as applied in the case of particular taxpayers, because the barrier to trade applies to all taxpayers regardless of circumstance: All face the prospect of higher New Jersey taxation should they choose to expand their economic activity in Wyoming or other non-tax states. Facially discriminatory taxes are per se invalid,[62] so New Jersey's throw-out rule is unconstitutional and unenforceable.

## CONCLUSION

New Jersey's throw-out rule is unconstitutional under the Due Process Clause because its dependence upon the tax laws of other states causes the relationship between every taxpayer's New Jersey apportionment factor and its in-state values to be *qualitatively irrational.* The analysis is complete at this point. Nothing can rehabilitate the throw-out rule; it must be struck down by any court that considers it.

There are, however, other independent grounds for the statute's invalidity as well. For most taxpayers, throwout fails due process analysis for another reason: it produces apportionment factors that are *quantitatively out of all proportion* to in-state values. Furthermore, from the perspective of another line of constitutional analysis, throwout's mortal inconsistency makes it incapable of withstanding a Commerce Clause challenge. The New Jersey Legislature's shameless admission that the goal of throwout is to tax income not captured by other states makes the statute *externally inconsistent* because this economic justification is impermissible. Another line of Commerce Clause ''fair apportionment'' analysis also demands the demise of throwout: the statute is *internally inconsistent* because it interferes with free trade by penalizing taxpayers for selling into no-tax states instead of into states that subject them to tax. Finally, under yet another line of Commerce Clause analysis, throwout is invalid because it *discriminates* against interstate commerce, operating effectively as a New Jersey tariff imposed on economic activity conducted in certain other states of the Union.

In short, throwout is an unconstitutional abomination, invalid because it is irrational, inconsistent, and discriminatory. One can only hope that the New Jersey Legislature will recognize that it enacted a shamefully unsound statute in 2002 and that it will promptly repeal the throw-out rule, saving itself the embarrassment of having to defend the indefensible in court.

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[60] *Westinghouse Electric,* 466 U.S. at 406 (*quoting Boston Stock Exchange*, 429 U.S. at 331).

[61] *American Trucking*, 483 U.S. at 286–87.

[62] *Camps Newfound/Owatonna v. Town of Harrison*, 520 U.S. 564, 581 (1997).

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