WINSTON & STRAWN LLP

CLIENT ALERT

Economic Nexus as a State Income Tax Planning Opportunity

MARCH 29, 2017

A recent taxpayer victory in New Jersey Tax Court, litigated by Winston & Strawn LLP's state and local tax team, highlights an opportunity for multistate corporate taxpayers to minimize apportionment of income to states in which they conduct business. In *Elan Pharmaceuticals v. New Jersey Division of Taxation*,[1] New Jersey's aggressive extension of its corporate income tax to out-of-state corporations was ultimately used to minimize that portion of the taxpayer's income taxable by New Jersey.

Elan Pharmaceuticals Decision

The taxpayer, Elan Pharmaceuticals, was headquartered in California and filed corporate income tax returns in New Jersey, Tennessee, and a handful of other states. New Jersey determined the taxable portion of a multistate corporation's income by applying an apportionment formula to the taxpayer's total income. New Jersey adopted a three-factor (payroll, property, and double weighted sales) apportionment formula that compared the amounts of payroll, property, and sales in New Jersey to the taxpayer's total payroll, property, and sales everywhere. Sales of tangible personal property generally were sourced to the state in which the goods are delivered, but to avoid so-called "nowhere" sales, New Jersey from 2002-2010 adopted a throwout rule which excluded entirely from the sales factor the sales of goods shipped, or receipts otherwise sourced, to states in which the taxpayer was not "taxable." This throwout rule increased a taxpayer's New Jersey sales factor percentage, by decreasing the denominator of the sales factor by the sales "thrown out" of the sales factor. In contrast to New Jersey's throwout rule, approximately 25 states have adopted a "throw back" rule which throws back and includes in the numerator of a taxpayer's sales factor sales of goods shipped from the state to a state in which a taxpayer is not "taxable."

The New Jersey Division of Taxation in its audit of Elan Pharmaceuticals Inc.'s 2002-2004 New Jersey corporate income tax returns applied its throwout rule to exclude over *$1 billion* of receipts from the denominator of Elan's sales factor, increasing by approximately 50% Elan's income sourced to New Jersey. The Division argued for the broadest possible application of the throwout rule, and excluded all receipts from Elan's sales factor other than those sales of goods shipped to the handful of states in which Elan filed income tax returns.

The New Jersey Tax Court rejected this audit adjustment, finding that the rule must be narrowly limited in its application to sales shipped from inventory stored in New Jersey to states in which Elan was not "subject to" tax.

The court agreed with the taxpayer and ruled that receipts from transactions that could have been taxed by any other state, even where such states had not asserted taxing jurisdiction, could not be thrown out. Thus, the court refused to exclude those receipts from goods shipped from inventory in other states because those states could have taxed these sales by adopting a throwback rule. Similarly, the court found that Elan's investment income was not excludible under the throwout rule because California, where Elan was headquartered, had jurisdiction to tax this income, even though it did not do so.

Tax Planning Implications of *Elan* Decision

The *Elan* decision has tax planning implications in the over 25 states adopting throwout or throwback rules. To better understand this tax planning strategy, some background information is first necessary regarding the extension in recent years of state taxing jurisdiction via "economic nexus."

Economic Nexus – Adding Out-of-State Corporations to the Tax Rolls

For sales tax purposes, the United States Supreme Court has long held that a corporation must have substantial physical presence in a state to be subject to its taxing jurisdiction. The same is not true for income taxes, where the Supreme Court has not spoken and states consequently have taken inconsistent positions. A number of states including California, New York, and Ohio, have adopted an economic nexus standard and have amended their taxing statutes to assert taxing jurisdiction based exclusively on a taxpayer's annual sales exceeding a minimum (typically $500,000 or $1,000,000) threshold. In addition, courts in Illinois, New Jersey, and other states have ruled, even in the absence of such amendment, that a state can constitutionally assert taxing jurisdiction over an out-of-state corporation taxpayer that derives substantial receipts from licensing intellectual property or lending to consumers in the state. In either instance, adoption of economic nexus expands a state's tax base by adding to its tax rolls out-of-state corporations that had previously escaped taxation due to their lack of physical presence in the state.

Besides New Jersey, whose throwout rule was in effect 2002–2010, West Virginia and Louisiana have adopted a throwout rule. Other states, such as Illinois, have adopted a throwout rule specifically for sales of services. Additionally, approximately 25 states have adopted a sales throwback rule for sales of goods, including Alabama, California, Colorado, Illinois, Kansas, and Massachusetts.

Economic Nexus – An Opportunity to Decrease Taxation of In-State Corporations

A consequence of economic nexus has been an increase in the states' jurisdiction to tax economic activity. At the same time, courts have ruled that states adopting economic nexus likewise must apply this same standard in determining the portion of such in-state corporation income they may tax versus that portion that is nontaxable because subject to taxing jurisdiction of other states. Thus, those states adopting an "economic nexus" standard to assert taxing jurisdiction against out-of-state corporations, also must apply this same standard for sales throwback and throwout purposes. As highlighted by the *Elan Pharmaceuticals* decision, this is true regardless of whether other states actually assert such taxing jurisdiction over the income.

For example, in *Lorillard Licensing Co. LLC v. Director Div. of Taxation*, 28 N.J. Tax 590 (Tax 2014), the New Jersey Appellate Division ruled that the New Jersey Division of Taxation could not throw out of a licensing company's New Jersey sales factor, receipts earned from any of the 50 states in which it licensed its products, even though only a handful of those states actually asserted taxing jurisdiction over the receipts. This was because New Jersey courts had ruled that out-of-state corporations without physical presence in New Jersey were taxable by New Jersey even if their contacts with New Jersey were limited to merely licensing their products to New Jersey consumers.

Similarly, in *Technical Advice Memorandum Franchise Tax Board* No. 2012-01 (Nov. 29, 2012) the California Franchise Tax Board ruled that sales of tangible personal property shipped by retailers from California to other states were not subject to the California sales throwback rule when shipped to states in which the seller had economic nexus under California's statutory definition of this term. *See alsoIn Matter of Craigslist*, Ca. SBE Cal. St. Tax Rep. (CCH) ¶¶ 406-504 (Mar. 29, 2016) (California Board of Equalization ruled that Craigslist's receipts could not be thrown out of its sales factor (under an alternative apportionment scheme approved by the Franchise Tax Board) where those receipts were sourceable to states in which Craigslist had economic nexus).

Tax Planning Takeaway

- Economic nexus is a two-edged sword. While state adoption of this nexus standard can increase state income tax jurisdiction over out-of-state corporations, this standard can decrease income taxes in states like California or Illinois, which have adopted both an economic nexus standard in asserting taxing jurisdiction over out-of-state corporations and a sales throwout or throwback rule.
- By asserting that the economic nexus standard applies equally in limiting application of the state's sales throwout or throwback rule, corporations can minimize or eliminate application of this rule to their sales, and reduce the income otherwise apportioned to that state.

---

1 *Elan Pharmaceuticals v. New Jersey Division of Taxation*,No. 010589-2010 (Feb. 6, 2017).

5 Min Read

Related Locations

Chicago

New York

Related Capabilities

Tax

Related Regions

North America