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THE TAX COURT COMMITTEE ON OPINIONS

TAX COURT OF NEW JERSEY

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Re: Elan Pharmaceuticals, Inc. v. Director, Division of Taxation
Dkt No. 010589-2010

Dear Counsel:

This opinion addresses plaintiff's motion, and defendant's cross-motion, for summary judgment on the issue of the correctness of defendant's application of the "Throw Out" Rule to the denominator of plaintiff's 2002 sales factor. For the reasons stated below, the court grants plaintiff's summary judgment motion.

FACTS

Plaintiff ("Elan") is a Delaware company headquartered in California. It does business in New Jersey, in addition to several other States. For tax year 2002, Elan filed corporate income tax returns in six States: California, Colorado, Delaware, Michigan, New Jersey, and Tennessee. The California return was filed as a combined return by Elan's parent, Athena Neurosciences, Inc.,

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which included information of all of the parent's subsidiaries. The return reported $399 million of capital gains, which included $338 million from the sale of intellectual and employee rights in connection with ABELCET, an anti-fungal medication. The sales allocation factor on the combined return was 25.3% of the group's everywhere gross receipts of $1,041,887,447 on Schedule R-1 (Apportionment Formula). This comprised of $50,225,001 of receipts from sales to California buyers which were "shipped from outside California," and Zero for "sales shipped from California" to either the federal government or to "purchasers in a state where taxpayer is not taxable." The parent's combined return also checked "Yes" to the following questions on the Schedule:

> 4. "Does the California Sales figure on Schedule R-1 . . . include all sales shipped from California to states in which the taxpayer is not subject to tax?"
> 7. "Does the California Sales figure on Schedule R-1 . . . include all sales shipped to California destinations?"
> 8. "Does the California Sales figure on Schedule R-1 . . . include all sales delivered to customers outside California which have an ultimate destination in California?"

Elan's sales receipts to California buyers (from out-of-state deliveries) was a net total of $47,326,604 and Zero for sales from "within California," or to the federal government, or to "states where taxpayer not taxable." With receipts from "other" sources, the total receipts was $225,434,756.[1] The receipts did not include gain income of $390 million primarily from the sale of its U.S. and Canadian markets for ABELCET. Per Elan, California regulations permitted exclusion of non-recurring income (such as from liquidation) to avoid income distortion.

On its 2002 New Jersey Corporation Business Tax ("CBT") return, Elan reported 6.676% of its total income as apportionable to New Jersey. It reported Zero as "Nonsourced receipts."

[1] On the explanatory attachment to Schedule R-1 for a breakdown of the three-factor apportionment per subsidiary, Elan's total California apportioned receipts was $223,297,256.

As part of its audit of Elan's CBT returns, Defendant ("Taxation") increased the allocation factor for tax year 2002 to 9.716%. This was due to the reduction of the denominator of the receipts fraction pursuant to the Throw Out Rule. Since Elan filed tax returns in six States, Taxation included only those amounts (totaling $364,924,528) in the denominator of the sales factor. Thus, it reduced the everywhere income (denominator) from $1,404,501,844 to $364,924,528, and threw out the balance $1,039,577,316 as non-sourced receipts. The thrown out receipts comprised of receipts from drug sales ($952,710,500); net dividends ($0); interest ($3,419,731); rents ($81,377); royalties ($12,436,832); capital gains ($394,001,815); and other income ($41,851,589). Since all of the sourced receipts ($364,924,528) represented receipts from drug sales, the net receipts from this category deemed non-sourced was $587,785,972 ($952,710,500 less $364,924,528).

Elan's inventory was located in seven States: California, Colorado, Delaware, Illinois, New Jersey, Ohio, and Tennessee. In 2002, the inventory average total was $77,751,775. Of this, an average of $46,301,575 was in Tennessee, $25,556,559 in New Jersey and $5,903,541 in the other five States. Since the average inventory in New Jersey in 2002 was 32.87% of the total ($25,556,559 ÷ $77,751,775), the $587,785,972 of deemed non-sourced receipts represented $193,201,851 of goods shipped from New Jersey and $394,584,121 of goods shipped from inventory located in the other six States.

The audit report noted that Taxation was provided a copy of Indiana's tax return, which included Elan's "PL 86-272 statement." The report listed 29 States, of which six had sourced receipts, six were blank for tax year 2002 but had receipts for tax years 2003-2006, and the remaining 17 States had a notation "PL86-272."[2] The report also noted that Elan had property (inventory and/or machinery/equipment) in 39 States and payroll in 48 States.

In its answers to Taxation's interrogatories, one of which asked Elan to "enumerate all states in which [Elan] 'was not taxable' on its sales in 2002" with supporting documentation, Elan responded that it was "subject to" income tax in six States (see n.2 supra) and "was not taxable in other states." It further stated that its "business activities in the states in which it made sales, but was not taxable, were protected from state income taxation by federal law, P.L. 86-272, which prohibits a state from imposing income taxes on a corporation that limits its business activities to solicitation of sales orders, which are accepted and filled from inventory located outside the state."

ANALYSIS

1. The Throw Out Rule

The Throw Out Rule was enacted in 2002. It modified the calculation of the denominator of the sales factor (i.e., an entity's worldwide or everywhere receipts) to exclude any receipts which "would be assigned to a state . . . or to any foreign country," wherein the entity "is not subject to tax on or measured by profits or income, or business presence or business activity." N.J.S.A. 54:10A-6(B)(6)(now repealed). In Whirlpool Prop. Inc. v. Director, Div. of Taxation, 208 N.J. 141, 151 (2011), the Court explained the purpose of the Throw Out Rule thus:

> Without application of the Throw-Out Rule, the sales fraction is calculated by dividing the taxpayer's New Jersey receipts by total receipts of the corporate taxpayer. N.J.S.A. 54:10A-6(B). The Throw-Out Rule modifies the sales fraction, transforming the fraction into one that divides New Jersey receipts only by taxed receipts. The effect is consistent: By throwing out receipts from the denominator,

[2] The six States with sourced receipts were California, Colorado, Delaware, Michigan, New Jersey, and Tennessee. The six States with no notation (i.e., no receipts or P.L. 76-272 notation) were Arizona, Florida, Kansas, Massachusetts, Maryland, and New Mexico. The 17 states with the P.L. 86-272 notation were Connecticut, Georgia, Illinois, Indiana, Kentucky, Mississippi, North Carolina, New Hampshire, New York, Ohio, Pennsylvania, Rhode Island, South Carolina, Texas, Virginia, Vermont, and West Virginia.

> the sales fraction always increases, causing the apportionment formula and the taxpayer's resultant CBT liability to New Jersey to increase.

In analyzing the external consistency aspect of the "fair apportionment" prong of the Commerce Clause, the Court explained as "problematic," a situation where "all untaxed receipts are thrown out, regardless of the reason for the other state's action." Id. at 169. This is because "although a lack of jurisdiction is rationally related to how much business a taxpayer does in a state, a state's legislative tax system is not. Whether another state chooses to tax a receipt has no bearing on how much income is attributable to New Jersey." Ibid. The Court held that the Throw Out Rule is constitutional, as applied, when the excluded receipts are "limited" to those "not taxed by another state because the taxpayer does not have the requisite constitutional contacts with the state or because of congressional action such as P.L. 86-272."[3] Id. at 172. However, the Throw Out Rule operates unconstitutionally where the excluded "receipts . . . are not taxed by another state because the state chooses not to impose an income tax." Id. at 173.[4]

2. Application of the Throw Out Rule to the Denominator of Elan's Sales Receipts Fraction

Elan concedes that $149,364,361 was properly thrown out because these represented receipts from shipments from New Jersey inventory to customers located in States in which Elan was not taxable.[5] As to the remainder, it argues that Taxation's exclusion was not only arbitrary but also improper. This is because it covered receipts (1) allocable to other States where Elan was taxable pursuant to the Throwback Rule, or (2) allocable to States where Elan stored its inventory

[3] P.L. 86-272 bars a State from taxing a company "whose only activity in the state is selling or soliciting orders for tangible personal property shipped from out of state to the taxing state." Whirlpool, supra, 208 N.J. at 169, n.10.

[4] The Court noted that the Throw Out Rule was "internally consistent" because it would result in taxation of only "100% of a taxpayer's income." Whirlpool, supra, 208 N.J. at 169, n.11. "The Throw-Out Rule operates to divide the untaxed receipts among the taxing states but does not result in double taxation." Ibid.

[5] This represents total sales from New Jersey inventory ($193,201,851) minus goods shipped to Illinois and Ohio of $43,837,500. Per Elan, Illinois and Ohio had the ability to assert nexus, thus, impose tax, upon Elan due to storage of inventory in those States.

since this activity is a constitutional basis for asserting nexus, and (3) allocable to California (gains from sale of ABELCET) where Elan was headquartered.

Taxation contends that its application of the Throw Out Rule is proper because pursuant to Elan's own concession in its answers to Taxation's interrogatory, the 44 States lack jurisdiction to tax due to P.L. 86-272. Therefore, there is no need for any further analysis such as was undertaken in Lorillard Licensing Co. L.L.C. v. Director, Div. of Taxation, 28 N.J. Tax 590 (Tax 2014), aff'd., 29 N.J. Tax 275 (App. Div. 2015), certif. denied, 226 N.J. 212 (2016). This is especially because, per Taxation, Whirlpool required focus only on the ability of a destination State to tax receipts, no more, no less.

Taxation's arguments overlook the underlying substance of the Whirlpool decision, which afforded a narrow construction of the Throw Out Rule, which in turn was the essence of the ruling in Lorillard. The Lorillard court rejected Taxation's contention that the phrase "subject to tax" under Whirlpool was different than the meaning of that phrase for deciding economic presence. The "lynchpin of the . . . analysis in Whirlpool" is the constitutional ability to tax, i.e., "whether a taxpayer has 'the requisite constitutional contacts with a state.'" 28 N.J. Tax at 604; see also Flagstar Bank v. Director, Div. of Taxation, 29 N.J. Tax 130 (Tax 2016) (rejecting Taxation's attempted distinction since "[i]t matters not that the corporations in Whirlpool, Lanco and Lorillard were intellectual property holding companies" since the inquiry is "not the type of entity or income being reviewed"). Taxation's argument that the Lorillard analysis does not apply because it did not address P.L. 86-272 is therefore unavailing.

Further, the possibility that P.L. 86-272 is implicated does not necessarily foreclose the limitations on the application of the Throw Out Rule. As was held by this court,

> Based on the constitutionality of the throwback rule, New Jersey would have the right to include in the numerator of the sales fraction the receipts generated by a sale of goods from New Jersey to a foreign state precluded from taxing the income from the sale under P.L. 86-272, provided, of course, that the Due Process and Commerce Clause requirements discussed above are satisfied. See Exxon Corp. v. Department of Revenue, 447 U.S. 207, 230 . . . (1980) (stating that income of a unitary business "subject to fair apportionment among all States to which there is a sufficient nexus with the interstate activities of the business"). Consequently, New Jersey may exclude the same receipt from the denominator of the sales fraction. The effect of such exclusion on a taxpayer's obligations to New Jersey would be less significant than inclusion of the receipt in the sales fraction numerator. From a constitutional standpoint, however, the two procedures do not differ significantly.
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> [Pfizer Inc. v. Director, Div. of Taxation, 24 N.J. Tax 116, 134-35 (Tax 2008), aff'd, 25 N.J. Tax 519 (App. Div.), certif. granted, 204 N.J. 34 (2010)].[6]

Further, in rejecting a challenge that the Throw Out Rule violated the Supremacy Clause because it effectively nullified P.L. 86-272, the same court held:

> [T]he prohibitions of P.L. 86-272 do not immunize from all taxation income resulting from sales to foreign states in which the taxpayer corporation has a limited presence. Nothing in the statute bars an origin state (the state from which goods are sold) from taxing the income generated from sales of goods to foreign states that cannot tax the income, provided, of course, that the corporation has nexus with the origin state and the other Due Process and Commerce Clause requirements discussed above are satisfied. Thus, to the extent New Jersey's relationship to and taxation of the income satisfies the requirements of the Due Process and Commerce Clauses, this State's taxation of the income would be constitutional and unaffected by P.L. 86-272.
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> [Pfizer, supra, 24 N.J. Tax at 138-39].

Thus, although the CBT's apportionment formula treats New Jersey as a destination State, New Jersey could if it chose to, be able to capture the sales as the originating State regardless of P.L. 86-272, provided there is other basis for nexus to tax. See also New Jersey Division of Taxation, Technical Bulletin 79(R) (August 13, 2015) (a "corporation's activities . . . protected by [P.L.] 86-

[6] The plaintiffs, including Whirlpool, had conceded that, "New Jersey could, as a constitutional matter, elect to treat such income as taxable by this State." Pfizer, supra, 24 N.J. Tax at 133. The Pfizer matter was settled before oral argument. See Whirlpool, supra, 208 N.J. at 156. The Supremacy Clause argument was abandoned at the Supreme Court level. Id. at 157, n.1.

272," do not immunize it from CBT "if it . . . otherwise has nexus in New Jersey."). This rationale dilutes Taxation's contentions that as long as the destination State cannot tax an entity due to P.L. 86-272, no alternate argument for limiting the Throw Out Rule needs consideration.

The court thus finds more persuasive Elan's argument that the originating State still has the authority to tax Elan's non-New Jersey sourced, everywhere sales, via a Throwback Rule, the counter-part of the Throw Out Rule.[7] It is uncontested that several States where Elan does business (not just the six other States it filed returns in), have Throwback Rules. The fact that Elan had inventory only in seven States does not mean that products shipped into the remaining 43 States constitute "nowhere sales." Under the shipping State's Throwback Rules those sales could be captured (and even by New Jersey, for drugs shipped from this State, as conceded by Elan). Thus, Elan properly contends that New Jersey cannot isolate application of the Throw Out Rule to itself and deny that other originating States can effectuate tax by a similar Throwback Rule. See Whirlpool, supra, 208 N.J. at 170 n.12 (if an entity's "activity in two states is insufficient to support, constitutionally, the imposition of any income tax by those taxing states," and "the remaining forty-eight states," which "all have throw-out rules identical to New Jersey," chose to capture those receipts, it may be unfair because this "could swell the taxpayer's tax liability in every state").

Similarly, the contention that Delaware (one of the States where inventory is located) does not have a Throwback or Throw Out Rule, does not require a conclusion that the sales of goods shipped from Delaware to a State where Elan claims protection under P.L. 86-272 become

[7] "A throwback rule . . . reassign[s] sales receipts to the state that the goods were shipped from when the purchaser's state cannot impose income or franchise taxes on the sale because of constitutional restrictions or Public Law 86-272 . . . . [B]oth rules [Throwback and Throw Out] prevent the creation of nowhere income [and] accomplish the same result as economic nexus . . . ." Alexander Smith, Quill by Affiliation, 66 U. Miami L. Rev. 755, 779, 781 (Spring 2012). In 2002, at least 26 States had Throwback Rules.

nowhere sales. Delaware's choice of not imposing a corporate tax is not a reason for throwing out sales made from Delaware. Additionally, as Elan correctly points out, the originating State (or even the P.L. 86-272 destination State) can impose a business-presence based corporate tax if it has other basis to assert nexus over Elan, such as storage of inventory, ownership of property, or payroll. See, e.g., Toyota Motor Credit Corp. v. Director, Div. of Taxation, 28 N.J. Tax 96, 127 (Tax 2014) (reversing Taxation's removal of out-of-state receipts from the denominator because the taxpayer "had a significant physical presence in all three jurisdictions — through either property, payroll or both — during each relevant tax year. Those contacts are sufficient to vest in the three States the ability to impose tax"). See also Lorillard, supra, 28 N.J. Tax at 605 ("The relevant inquiry under Whirlpool is . . . whether the other States have authority under the United States Constitution to tax the taxpayer because the taxpayer has contacts with the other States that are sufficient to constitute nexus under the Due Process and Commerce Clauses"); Technical Bulletin 79(R), supra (activity of "[o]wning, leasing, or maintaining in-State facilities such as a warehouse," can "create nexus for [CBT] purposes" and will be considered as "outside the protection" of P.L. 86-272). Here, it is uncontested that Elan has property in 39 States, has sizeable inventory in six States (excluding New Jersey), and had payroll in 48 States. Such a business presence can create nexus for a Sate's ability to constitutionally impose corporate tax on a foreign corporation.

Based on the precedent above, the court agrees with Elan that the Throwback Rules, and the inventory storage in the six States, provide legitimate grounds reversing Taxation's determination that only receipts reported to the six States constitute the denominator of the sales factor, and the remainder become "nowhere sales" for purposes of the Throw Out Rule.[8] As noted

[8] In this connection, the court agrees with Elan that it is not estopped or foreclosed from making legal arguments as to the limited reach of, and application of the Throw Out Rule, regardless of its responses to Taxation's interrogatories.

in Whirlpool, supra, "[f]ormula apportionment recognizes that multiple states may contribute to a transaction even if a taxpayer would attribute the transaction to only one state . . . . But, just because one state does not impose a tax on a sale does not mean that New Jersey or any other state can." 208 N.J. at 171.

In response to Elan's duly certified breakdown of its multi-state income, Taxation points out that it contradicts Elan's filed California combined return (not amended thus far), and further that, Elan must prove such multi-state allocation by proof of filed multi-state tax returns. Taxation is correct that the combined California return does not "throwback" any non-sourced receipts, and sourced only some portion of its receipts to California.[9] However, this does not form an adequate basis for granting Taxation's summary judgment motion that it properly excluded all receipts from the denominator (except for the receipts reported to the six States where Elan filed returns). A similar argument was made in Lorillard, supra, that Taxation should first ascertain whether the taxpayer filed returns and paid tax in other States. 28 N.J. Tax at 606. The court rejected the argument because what "control[s] the inquiry . . . is the ability to tax, not actual taxation." Ibid. Thus, it is irrelevant that a taxpayer "failed to file a return where one was due," or whether a State did not audit that taxpayer for "underreport[ing]." Ibid. New Jersey's "only arguable interest" vis-à-vis the Throw Out Rule is to exclude receipts from the denominator which other States cannot constitutionally tax or are so limited by federal law. Ibid.

This is especially so where some of the income allocated to the other states included intangible income such as royalties, which are clearly subject to tax under the economic nexus test.

[9] Elan explains that there was never any under-reporting of its gains from the sale of ABELCET because California regulations permit exclusion of income due to non-recurring business liquidation, which is how Elan deemed the transaction. It points out that this exclusion proves that California can, but chose not to, tax such income, the precise limitation addressed in Whirlpool. The court agrees. The California regulation implicates issues with the numerator of the sales factor fraction, thus, the quantum of income allocable, and not the issue here, which is a State's ability to tax that allocable income.

In this connection, Taxation's contention that it disputes whether California was Elan's principal place of business or management is also irrelevant. Whether it is California, as averred by Elan (and recognized by Taxation's auditor), or New Jersey as contended by Taxation, it only proves Elan's point: that either or both (on an apportionable basis), has/have the ability to tax the California receipts attributable to the sale of ABELCET ($338 million), or other intangible income (such as interest and dividends). This then prevents those receipts from being thrown out of the denominator of the sales factor pursuant to Whirlpool.

CONCLUSION

For the aforementioned reasons, Elan's motion for partial summary judgment motion on the Throw Out issue is granted. Taxation's cross-motion in this regard is denied. An order reflecting this conclusion will be entered with this opinion.

Very truly yours,

Mala Sundar

Mala Sundar, J.T.C.