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Subject: New Jersey Throwout Rule Survives Facial Constitutionality Challenge
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To Our Clients and Friends:

The first round of the constitutional challenge to New Jersey's throwout rule is over, and the rule survives for now. In Pfizer Inc., et. al. v. Director, Division of Taxation, New Jersey Tax Court, Docket No. 000055-2006, May 29, 2008, the plaintiffs were denied summary judgment that the throwout rule is facially unconstitutional.

By way of background, in calculating the denominator of the sales fraction of the apportionment formula, the throwout rule provides: "If 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 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."

The plaintiffs argued that the throwout rule, in effect, enables New Jersey to tax income generated in a foreign state, but not taxable there, under circumstances where New Jersey facilities and activities have not contributed to the generation of the income. The Director responded that the court should view the value provided to each plaintiff by New Jersey in a broad sense, and that, when so viewed, New Jersey's contributions are sufficient to satisfy the Due Process Clause and Commerce Clause tests relating to fair apportionment and fair relationship to the services or "value" provided by New Jersey.

In the context of challenges to the facial constitutionality of statutes relating to taxation, the United States Supreme Court has stated that a taxing statute is not facially unconstitutional if it operates constitutionally in some instances. The court concluded that under the Due Process and Commerce Clauses, the throwout rule is constitutional on its face because, in at least some circumstances, it can operate in a manner that satisfies the requirements for constitutionality as set forth by the United States Supreme Court. In such circumstances, the tax imposed by New Jersey, after application of the throwout rule, would be fairly related to services or values provided by New Jersey and fairly apportioned.

The court also addressed the argument that the throwout rule violates the Supremacy Clause because application of the rule results in taxation of income not taxable under Public Law 86-272. The court rejected the argument for two reasons. First, the prohibitions of Public Law 86-272 do not immunize from all taxation income resulting from sales to foreign states in which the taxpayer corporation has a limited presence. Second, the throwout rule affects only the denominator used in the calculation of the amount of receipts apportioned to New Jersey, and,

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therefore, the rule does not, in itself, result in the imposition of a tax on the income of a multistate corporation.

If you have any questions regarding the within, or any other state and local tax matters, please do not hesitate to contact me.

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