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An Unconstitutional Alternative Tax On Companies In NJ

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Law360, New York (June 7, 2017, 12:16 PM EDT) -- During the spring of 2017, we noticed a significant uptick in the New Jersey Division of Taxation's audit activity for companies with P.L. 86-272 protection. Within just a few weeks, several P.L. 86-272-protected companies received 30-day notices or notices of deficiency asserting that, even though the companies are protected from a net income tax, they must pay the alternative minimum assessment (AMA) component of the Corporation Business Tax (CBT).

The AMA itself is capped at $5 million per year, but in many of the notices we have seen, the proposed liability is $50,000–$100,000 per year (plus penalties!). As described below, New Jersey's assertions transgress congressional protections and, we believe, are unconstitutional.

P.L. 86-272 Background

Congress has the power to regulate commerce, and it did so in record speed nearly 60 years ago, by enacting P.L. 86-272 after the U.S. Supreme Court upheld the imposition of an apportioned state tax on an out-of-state corporation that sold tangible personal property in interstate commerce and maintained a sales office in the state.[1]

The decision was such a significant departure from the business community's expectations, that Congress responded to their complaints and concerns by enacting statutory protections against impositions of "net income taxes" against companies whose activities in a state are limited to the soliciting sales of tangible personal property, as long as the orders are accepted outside the state and the goods are shipped from outside the state. Over the years, the Supreme Court has interpreted P.L. 86-272 to include a small amount of other activities, such as providing ancillary services.[2]

A number of states have never been happy with having their taxing powers restricted, and have devised ways to attempt to circumvent the federal mandate. For example, certain states have replaced their corporate income taxes with gross receipts or other net-income proxies, such as Ohio's Commercial Activity Tax, the Texas Margin Tax and the Michigan Modified Gross Receipts Tax.

Other states, including New Jersey, have attempted another ploy: enactment of alternative computations within their corporate tax structure that target companies that are not taxable on their net income or that earn only minimal net income.

New Jersey Background

New Jersey first enacted the AMA as part of its 2001 Business Tax Reform Act (BTRA)[3] to target companies with P.L. 86-272 protection[4] as well as other companies with economic presence in the state but lacking entire net income sourced to the state.[5]

The AMA, which does not appear as a separate chapter or act but, rather, sits right within the income tax provisions of the CBT, has two bases for computation: gross receipts or gross profits (gross receipts with some deductions, such as costs of goods sold).[6] Taxpayers are required to elect whether to use the gross receipts or gross profit method the first year that they are subject to the AMA, and the election is binding for the following four years.[7]

As originally enacted, all companies with sufficient nexus were required to compute both the income tax portion of the CBT and the AMA and then pay the greater of the two. Beginning July 1, 2006, however, the New Jersey legislature created a disconnect between companies protected by P.L. 86-272 and those that are not protected.

For those with P.L. 86-272 protection, nothing changed. But for those without P.L. 86-272 protection, the AMA tax rate was reduced to zero percent.[8] As a result, companies without P.L. 86-272 protection would have an AMA liability of zero, whereas companies with P.L. 86-272 would have some AMA liability. Starting in 2007, companies with P.L. 86-272 were magnanimously allowed the option of "consenting" to pay the CBT to have their AMA reduced to zero.[9]

Defending Against New Jersey's Position

There are a number of problems with New Jersey's imposition of AMA on P.L. 86-272-protected companies. For starters, we believe the imposition offends at least three provisions of the U.S. Constitution: the Commerce Clause, the Equal Protection Clause and the Supremacy Clause.

The most obvious concern is that a state would design (as New Jersey acknowledged it had) a tax regime to strip companies of a congressionally sanctioned privilege of tax relief — a goal which would violate the Supremacy Clause, Article VI, Clause 2, of the U.S. Constitution, which has been interpreted as invalidating state laws that frustrate congressional purpose.

Less apparent is the discrimination that results from the way in which New Jersey has imposed the AMA. Prior to July 1, 2006, the AMA likely did not discriminate against interstate commerce since the AMA was computed identically for all corporations (protected or not). However, since July 1, 2006, a P.L. 86-272-protected company will always have a higher AMA liability than an otherwise identical unprotected company.

For example, imagine two nearly identical sellers of goods. Company A is headquartered in New Jersey and Company B is headquartered in Pennsylvania. Each sells half of its goods into New Jersey and the other half into Pennsylvania. Company A will have no AMA liability; Company B will have an AMA liability.

Stated another way, the more a company does in New Jersey, the more likely it is to have an AMA liability of zero. This certainly looks like discrimination against interstate commerce, in violation of equal protection and in violation of the fourth prong of Complete Auto Transit, which provides that the tax imposition must be fairly related to the services provided by the state to the purported taxpayer.[10]

In addition to the constitutional violations, there is a real question as to whether the New Jersey Legislature was even successful in adopting a regime that could reach companies protected by P.L. 86-272. One can certainly take the position that the AMA is not itself a separate imposition but, rather, is merely a part of the income tax, which cannot be imposed on protected companies.

For example, the AMA statutes are woven in among the income tax statutes, and the form for computing and reporting AMA is the same form for paying the corporate income tax. In addition, the gross profits method for computing AMA may be properly characterized as an income tax.

For more than a decade, we have been critical of the AMA as applied to protected companies.[11] During that period, there did not seem to be a substantial amount of Division of Taxation activity in this area. But there is now. Of course, because AMA liabilities are often small, many companies will pay them rather than fight. But we think the better "alternative" is to challenge AMA assessments, regardless of size. Unconstitutional is unconstitutional, whether the impact is $1 million or just $1.

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[1] Northwestern Portland Cement Co. v. Minn., 358 U.S. 450 (1959).

[2] Wisconsin Dep't of Revenue v. Wrigley, 505 U.S. 214 (1992).

[3] The BTRA also brought us other gems, such as the now-defunct Throw Out Rule.

[4] Id. ("The AMA also assures a fair measure of support for State services from firms that exploit the State's marketplace, but are exempt from a tax like the CBT pursuant to federal Publ. L. 86-272 ... this reform will effectively capture the value of the activities of out-of-state companies that currently pay no corporate income taxes in New Jersey.").

[5] Assembly Budget Committee Statement to A. 2501 (June 27, 2002) ("the Bill creates an alternative minimum assessment to measure a company's economic activity to New Jersey in situations where the traditional 'taxable income' measure is not a fair measure.").

[6] Only corporations that have $2 million of gross receipts or $1 million of gross profit are subject to the AMA (yes, it's a cliff), and the tax is capped at $5 million for a single corporation or at $20 million for an affiliated group. N.J.S.A. § 54:10A-5a; N.J.A.C. 18:7-18.4.

[7] Id.

[8] N.J.S.A. § 54:10A-5a(e).

[9] Id.

[10] Complete Auto Transit Inc. v. Brady, 430 U.S. 274 (1977).

[11] See, e.g., Leah Robinson, New Jersey's Alternative Minimum Assessment is Unconstitutional, State Tax Notes (April 7, 2014); Hollis L. Hyans and Amy F. Nogid, New Jersey's Business Reform Act — The Issues Abound, State Tax Notes (July 14, 2003).
