No. 19-921

IN THE

Supreme Court of the United States

JOHN M. PAZ,

Petitioner,

v.

DIRECTOR, NEW JERSEY DIVISION OF TAXATION,

Respondent.

On a Petition for Writ of Certiorari to the Superior Court of New Jersey, Appellate Division

BRIEF OF *AMICUS CURIAE* TAX EXECUTIVES INSTITUTE IN SUPPORT OF THE PETITIONER

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INTRODUCTION AND STATEMENT OF INTEREST

Amicus curiae Tax Executives Institute, Inc. ("TEI") respectfully submits this brief in support of petitioner, John M. Paz.[1] Whether gain from the sale of assets used in a unitary business should be apportioned among all states in which the business conducted activity or allocated solely to the state of the business' commercial domicile must be determined using the standards mandated by the Due Process and Commerce Clauses of the U.S. Constitution, not a state statute. The Appellate Division of the Superior Court of New Jersey ("Appellate Division") failed to conduct this critical analysis and, as a result, Mr. Paz was subjected to double tax on the gain he recognized from selling his business. TEI urges this Court to grant the petition for a writ of certiorari to determine this question and ensure states tax such income consistently.

TEI is the largest organization representing taxpayers' interests on issues associated with tax administration. It is a voluntary, nonprofit association of corporate and other business executives, managers, and administrators responsible for the tax affairs of their employers. TEI was organized in 1944 under the laws of the state of New York and is exempt from taxation under section 501(c)(6) of the Internal Revenue Code. TEI dedicates itself to the development of sound tax policy, the uniform and equitable enforcement of tax laws, the minimization of administrative and compliance costs

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[1] All parties received at least 10 days' notice of TEI's intention to file this brief, and the brief is filed with the consent of all parties. No party or counsel for a party authored this brief in whole or in part. No party, counsel for a party, or person other than TEI, its members, or its counsel made a monetary contribution intended to fund the preparation or submission of this brief.

for governments and taxpayers, and the vindication of taxpayers' rights.

TEI's members are employed by a broad cross-section of the business community. The rules governing state taxes generally and, in particular, those governing the apportionment and allocation of income among multiple states, directly affect the multistate companies represented by TEI's membership.

As in-house tax professionals, TEI's members must evaluate tax laws, advise their companies regarding the tax consequences of various transactions and business decisions, and make practical judgments regarding their tax compliance obligations, including how to allot income to the states in which they conduct business for taxation. TEI's members have a vital interest in ensuring state courts correctly apply the tests articulated by this Court when determining whether a state's tax complies with the U.S. Constitution and avoiding the multiple taxation of income.

The New Jersey Tax Court's ("Tax Court") opinion, which the Appellate Division summarily affirmed, ignored the required constitutional analysis. Instead, the lower court relied upon New Jersey's statutory definition of "nonoperational" income and concluded such income need not be apportioned. This Court must intervene to correct this error and to ensure states only tax income the U.S. Constitution permits. TEI thus respectfully submits this amicus curiae brief.

ARGUMENT

I. BACKGROUND

John Paz is a Pennsylvania resident who owned Godwin Pumps of America, Inc. ("Godwin Pumps"), an S-corporation commercially domiciled in New Jersey. In 2010, Mr. Paz sold Godwin Pumps stock to ITT Corporation and one of its affiliates. Mr. Paz and the purchasers made an election under Section 338(h)(10) of the Internal Revenue Code to treat the sale of stock as a deemed sale of Godwin Pumps' assets.

Godwin Pumps conducted a unitary business in New Jersey and over 20 other states before the sale. Mr. Paz reported and paid state taxes on an apportioned share of the gain in New Jersey and the states where Godwin Pumps operated. The New Jersey Division of Taxation ("Division of Taxation") audited Mr. Paz and claimed that the gain from the sale was nonoperational income and fully allocable to Godwin Pumps' commercial domicile, New Jersey.

The Tax Court agreed with the Division of Taxation, concluding the gain was nonoperational income under New Jersey's statutes and *McKesson Water Products v. Director, Division of Taxation*, 23 N.J. Tax 449 (Tax 2007), aff'd 408 N.J. Super. 213 (App. Div.), cert. denied 200 N.J. 506 (2009). *See Xylem Dewatering Solutions, Inc. v. Director, Division of Taxation*, 30 N.J. Tax 41, 66 (Tax Ct. 2017). The Tax Court acknowledged "the *business income* of a unitary business must be apportioned among all the jurisdictions in which it conducts business," but held the gain on the sale of Godwin Pumps' assets constituted nonoperational/nonbusiness income. *Id*. at 68. The Tax Court then held "[t]here is no constitutional requirement that such income be apportioned and it is appropriately allocated to the domiciliary state, New Jersey." *Id*.

The Appellate Division affirmed the Tax Court's decision. *Paz v. Director, Division of Taxation*, No. A-4452-16T4 (Jan. 31, 2019). Mr. Paz thus paid tax to New Jersey on 100 percent of the gain on Godwin Pumps' asset sale. He also paid tax on an apportioned share of that gain to the over 20 states in which Godwin Pumps conducted its unitary business, resulting in double taxation of that gain.

II. THE DUE PROCESS AND COMMERCE CLAUSES OF THE U.S. CONSTITUTION LIMIT STATES' ABILITY TO TAX INCOME AND GAIN RECOGNIZED BY MULTISTATE TAXPAYERS

By focusing on the statutory definition of nonoperational income, the lower courts ignored the limits imposed by the Due Process and Commerce Clauses on states' ability to tax multistate businesses.

This Court has long held that the U.S. Constitution prohibits states from taxing value earned outside their borders. *See ASARCO Inc. v. Idaho Tax Comm'n*, 458 U. S. 307, 315 (1982); U.S. Const. art. I, § 8, cl. 3; U.S. Const. amend. XIV, § 1. The Due Process Clause requires "some definite link, some minimum connection, between a state and the person, the property or transaction it seeks to tax."' *Miller Brothers Co. v. Maryland*, 347 U. S. 340, 344-345 (1954). The Commerce Clause protects multistate operations: "In a Union of 50 States, to permit each State to tax activities outside its borders would have drastic consequences for the national economy, as businesses could be subjected to severe multiple taxation." *Allied*

Signal, Inc. v. Director, Division of Taxation, 504 U.S. 768, 777-78 (1992).

This Court has used the unitary business principle to "permit States to tax a corporation on an apportionable share of the multistate business carried on in part in the taxing state." *Allied-Signal*, 504 U.S. at 778. "The unitary business rule is a recognition of two imperatives: the States' wide authority to devise formulae for an accurate assessment of a corporation's intrastate value or income; and the necessary limit on the States' authority to tax value or income that cannot in fairness be attributed to the taxpayer's activities within the State." *Id*. at 780.

The unitary business principle provides a state's tax base is calculated first by defining the scope of the unitary business. This Court has applied several tests to make this determination. When examining whether two businesses are conducting unitary operations, this Court has considered whether the businesses have the "hallmarks" of a unitary relationship – functional integration, centralized management, and economies of scale. *MeadWestvaco Corp. v. Illinois Department of Revenue*, 553 U.S. 16, 30 (2008) (*citing Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425, 438 (1980)). When examining whether an asset is part of the unitary business conducted within a state, this Court has analyzed whether the asset served an operational or investment function in such business. *See MeadWestvaco*, 553 U.S. at 28.

Dividing the unitary business' income between the taxing and other jurisdictions is the second step of this analysis. States have some latitude in how they apportion such income, and this Court has declined to establish "a single constitutionally mandated method of taxation." *Container Corp. of America v. Franchise*

Tax Board, 463 U.S. 159, 171 (1983). States are nonetheless subject to constitutional limits, especially concerning income derived from multistate commerce.

III. STATES MUST COMPLY WITH CONSTITUTIONAL STANDARDS WHEN DETERMINING WHETHER INCOME IS APPORTIONABLE OR ALLOCABLE TO A SINGLE STATE

States have adopted statutory definitions to classify income as apportionable or allocable income. Business/operational income is apportioned among all states in which the unitary business is conducted, whereas nonbusiness/nonoperational income is allocated to a single state. During the period at issue, New Jersey defined "operational income" as "income from tangible and intangible property if the acquisition, management, *and* disposition of the property constitute integral parts of the taxpayer's regular trade or business operations and includes investment income serving an operational function." N.J. Stat. Ann. § 54:10A-6.1 (emphasis added). "Income that a taxpayer demonstrates with clear and convincing evidence is not operational income is classified as nonoperational income . . . ." *Id*.

Apportionment and allocation are different ways of doing the same thing — assigning income to jurisdictions — and are thus mutually exclusive classifications. *See Mobil Oil*, 445 U.S. at 444-45, *citing Standard Oil v. Peck*, 342 U.S. 382, 384 (1952) ("Taxation by apportionment and taxation by allocation to a single situs are theoretically incommensurate . . . ."). Apportionment and allocation of the same income by different states using disparate standards potentially subjects interstate commerce to multiple and unfairly apportioned taxation. *MeadWestvaco Corp.,* 553 U.S.

at 24 (*citing Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159, 170-71 (1983); *Armco, Inc. v. Hardesty*, 467 U.S. 638, 644 (1984)).

Notably, this Court specifically declined to adopt the Uniform Division of Income for Tax Purposes Act's definition of "business income" as its constitutional test for a unitary business. In *Allied-Signal*, this Court noted that the definition of "business income," which is identical to New Jersey's definition of "operational income" at the time of the Godwin Pumps sale, might be compatible with the unitary business principle in the abstract. *Id*. Nonetheless, this Court held that "the unitary business principle is not so inflexible that as new methods of finance and new forms of business evolve it cannot be modified or supplemented where appropriate." The Court instead used a constitutional analysis to examine the nature of the relationship between the asset and the unitary business conducted in the state.

The Appellate Division failed to conduct this constitutional analysis, simply concluding gain realized on Godwin Pumps' assets constituted nonoperational income under New Jersey's statute and prior case law, and nonoperational income did not have to be apportioned. The New Jersey legislature's subsequent amendment of its definition of business income demonstrates this fallacy. The legislature amended the definition so the income constitutes apportionable, operational income if "the acquisition, management, *or* disposition of the property is an integral part of the taxpayer's regular trade or business operations" for tax years ending after July 1, 2014. *See* New Jersey Division of Taxation, NOTICE: CORPORATION BUSINESS TAX LEGISLATION ADJUSTS AND CLARIFIES CERTAIN STATE TAX COMPLIANCE STANDARDS AND RESTRICTS

CERTAIN STATE TAX BENEFITS (P.L. 2014, c. 13).[2] The Division of Taxation explained the change of the word "and" to "or" was in response to the holding in *McKesson Water Products* – the case the Tax Court relied upon for its holding in this case, which New Jersey lost – requiring all three activities to be integral parts of the taxpayer's regular trade or business for income to constitute apportionable operational income. *Id*.[3]

Permitting New Jersey to determine whether income is apportionable or allocable solely by reference to its state statute vitiates the unitary business principle. States cannot expand or contract constitutional standards at will. Moreover, allowing states to condition apportionment or allocation solely by reference to a state statute results in uneven U.S. constitutional standards that differ by state. Such an outcome provides no constitutional standard at all and potentially subjects multistate businesses to double taxation on any substantial transaction, as it did in this case.

New Jersey cannot ignore the constraints of the Due Process and Commerce Clauses and merely rely on a state statute to allocate all of the gain from the sale of Godwin Pumps' assets to itself. This Court should grant the petition for a writ of certiorari to address the

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[2] Available at https://www.state.nj.us/treasury/taxation/corp_business_tax.shtml (accessed Feb. 14, 2020).

[3] In *McKesson Water Products*, the business' state of commercial domicile was California. The Division of Taxation argued gain from the disposition of the business with a Section 338(h)(10) election constituted operational income, therefore entitling New Jersey to tax an apportioned share of the gain. *McKesson Water Products*, 23 N.J. Tax at 25-16. The Division of Taxation made the opposite argument in this case, where the state of commercial domicile was New Jersey.

appropriate standard for apportioning and allocating income and ensure states tax such income consistently.

CONCLUSION

The Court should grant the petition for a writ of certiorari for the foregoing reasons.

Respectfully submitted,

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