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Allocation/Apportionment

On Dec. 19, 2008, New Jersey repealed the sales “throwout” and “the regular place of business” provisions for privilege periods beginning on or after July 1, 2010. However, on a retroactive basis—and generally until July 1, 2010—all New Jersey taxpayers are at risk for assessment under New Jersey’s inequitable allocation/apportionment regime. In this article, authors Douglas M. Sayuk, Matthew H. Fricke, and Shamen R. Dugger, of Clifton Douglas LLP, discuss how the risk of retroactive assessment can affect taxpayers, including a discussion of implications under FIN 48 and possibilities for challenging such assessments.

New Jersey Allocation: Prospectively Applied Repeal Provides Little Retroactive Relief to New Jersey Businesses

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INTRODUCTION

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On Dec. 19, 2008, New Jersey’s governor signed into law A.B. 2722, which repealed the sales “throwout” and “the regular place of business” provisions for privilege periods beginning on or after July 1, 2010. Though this prospective relief is a welcome change for New Jersey taxpayers frustrated with anachronistic New Jersey rules barring companies from apportioning income away from the state unless they have a regular place of business outside the state,¹ it

¹ New Jersey is the last state to have a rule barring companies from apportioning income away from the state unless they had a regular place of business outside the state. The repeal brings the state’s apportionment rules in line with its policies on economic nexus and “takes New Jersey from being one of the most restrictive states in terms of apportionment to one of the most liberal. Lorraine McCarthy, “New Jersey Governor

provides little respite on a retroactive basis to companies facing significant New Jersey allocation/apportionment-related assessments. In fact, the state has openly admitted that, although the rules are a “trap for the unwary and one of the Division’s most common audit issues,” it intends to apply New Jersey allocation/apportionment as originally enacted,² regardless of the repeal.

The Legislature is likely acting ... to prevent inundation of refund claims.

As initially proposed, A.B. 2722 involved only the repeal of throwout. Specifically, it deleted the language in the sales fraction section of the apportionment statute, which results in the throwout provision. That is, it included a deletion of the language that removes receipts from the denominator of the receipts fraction when those receipts are not subject to tax in another jurisdiction. As A.B. 2722 worked its way through the New Jersey Legislature, language was added to repeal the regular place of business requirement as well. That language prevents a corporation with New Jersey presence from apportioning its income if it does not maintain a regular place of business outside of New Jersey, regardless of its non-New Jersey activities. As a result of the language in the statute prior to amendment, such a corporation is required to allocate 100 percent of its income to New Jersey.³

It is likely the impetus for the New Jersey legislative changes are New Jersey court cases related to the sales throwout rule.⁴ Although the cases are still pending resolution, we believe the Legislature anticipates the throwout rule will be deemed facially unconstitutional (with the regular place of business outside New Jersey rule potentially following soon thereafter). Therefore, the Legislature is likely acting accordingly to prevent inundation of refund claims once a verdict is rendered. In addition, the Legislature’s motives could be related to improving New Jersey’s reputation with businesses in general, for as other practitioners have observed, “[t]hrowout has been wildly unpopular with corporate taxpayers and practitioners and has significantly contributed to New Jersey’s reputation for hostility towards business.”⁵

In this article, we summarize New Jersey’s “throwout” and “regular place of business outside New

Jersey” allocation/apportionment rules. We also offer options for challenging New Jersey assessments retroactively (primarily for the regular place of business outside New Jersey issue, as the throwout issue is currently pending in the New Jersey Superior Court Appellate Division). Finally, we address the FIN 48⁶ implications of accounting for such audit uncertainties.

BACKGROUND

Applicable Tax Law

Under New Jersey’s version of the throwout rule, if a taxpayer makes sales into a state where it is not subject to income tax, those sales are removed from the denominator of the sales factor when computing its apportionment ratio, thereby increasing the New Jersey apportionment percentage. Companies that are hit the hardest by throwout include intangible holding companies and companies that sell goods through sales representatives or that conduct lending or credit card activities.⁷ “What is particularly disturbing in the Pfizer situation is that Pfizer is not based in New Jersey, and the consequence of applying the throwout rule to Pfizer is that New Jersey ends up taxing sales that are made by a non-New Jersey company from locations outside of New Jersey to buyers who are not located in New Jersey.”⁸

Under New Jersey’s “regular place of business outside New Jersey” apportionment/allocation rules, New Jersey domiciled businesses are oftentimes hit the hardest if none of the business’ property and/or payroll exists outside the state. Moreover, because New Jersey’s regulations interpreting this statutory rule are so exact, it is difficult for companies that technically operate outside New Jersey via sales representatives and/or shared employees/functions with related entities to meet such rigid requirements. The result is an ironic penalizing of New Jersey-based businesses for locating their payroll and property within New Jersey, contrary to most state objectives to incentivize businesses to invest in the states where they operate.

Under New Jersey law, a “regular place of business” is defined as any bona fide office (other than a statutory office), factory, warehouse, or other space of the taxpayer which is regularly maintained, occupied, and used by the taxpayer in carrying on its business and in which one or more regular employees are in attendance.⁹ New Jersey regulations define key allocation-related terms and provide additional interpretative guidance as follows:

1. *Bona fide office*: An office in which an employee in attendance performs significant duties related to the business of the taxpayer. A token office, space of the taxpayer or any place where an employee does not actually perform significant duties constituting part of taxpayer’s business does not constitute a regular place of business.

⁶ Financial Accounting Standards Board, *Interpretation No. 48, Accounting for Uncertainty in Income Taxes*.

⁷ CCH, *State Income Tax Alert*, Vol. XVI, No. 1 (Jan. 15, 2007).

⁸ *Id.*

⁹ N.J. Rev. Stat. §54:10A-6, N.J. Regs. § 18:7-7.2.

Signs Bill Repealing ‘Regular Place of Business,’ ‘Throwout Rules,’” 245 *Daily Tax Report* H-3 (Dec. 22, 2008).

² *Id.*

³ *Id.*

⁴ On Oct. 30, 2008, the New Jersey Supreme Court granted the motions for leave to file interlocutory appeals brought by Federated Brands Inc., Whirlpool Properties Inc., and Pfizer Inc., in their respective challenges to the New Jersey throwout. The New Jersey Supreme Court agreed that the issue of whether the throwout rule is facially unconstitutional should be heard on appeal now, rather than at the end of each case, and remanded the matter to the Appellate Division. We are anticipating further action with respect to the facial unconstitutionality of throwout in the Appellate Division during 2009.

⁵ Grant Thornton, *State and Local Tax Alert* (Dec. 23, 2008).

2. *Space of the taxpayer:* The taxpayer must be directly responsible for the expenses incurred in maintaining the regular place of business and must either own or rent the facility in its own name and not through a related person or entity. The regular place of business should be identifiable as belonging to the taxpayer by, for example, reflecting the taxpayer's name on the exterior and interior of the building and being listed in the taxpayer's name in a telephone book.

3. *Regularly maintained, occupied and used by the taxpayer in carrying on its business:* The taxpayer must regularly maintain, occupy and use the premises by employing one or more regular employees who are in attendance during normal working hours. Premises are not regularly maintained, occupied and used in the event employees are in attendance only on a part time basis and, in their absence, telephone messages are received by an answering service or recording device.

4. *Regular employee:* A regular employee must be under the control and direction of the taxpayer in transacting the taxpayer's business and/or performing work on behalf of the taxpayer.

5. A taxpayer does not have a regular place of business outside New Jersey solely by consigning goods to an independent factor outside New Jersey for sale at the direction of either the consignor or consignee.

6. The mere fact that a taxpayer is subject to an income or franchise tax in other jurisdictions shall not be determinative as to whether the taxpayer maintains a regular place of business outside of New Jersey where taxable status in that jurisdiction is based on criteria other than a regular place of business.¹⁰

Implications for New Jersey Taxpayers

Beginning July 1, 2010, New Jersey taxpayers, whether domiciled within the state or located outside the state, should receive equitable treatment under New Jersey tax law on a prospective basis. However, on a retroactive basis and generally until July 1, 2010, all New Jersey taxpayers are at risk for assessment under New Jersey's inequitable allocation/apportionment regime. And that risk of assessment can be significant, depending on a company's facts and circumstances. Unfortunately, our experience has been that the New Jersey taxing authorities are true to their word offering little cooperation to companies with facts that do not fit squarely within New Jersey legal provisions. This means that for most taxpayers receiving notices related to New Jersey allocation/apportionment assessment, the battle will most certainly be uphill.

AVAILABLE CHALLENGES

In all honesty, the challenges available to New Jersey taxpayers against the "regular place of business outside New Jersey" and "sales throwout" rules are few. As discussed above, the state's stalwart intention to enforce these rules as originally enacted prior to the 2010 repeal allow for minimal argument without a pristine factual

¹⁰ N.J. Regs. §18:7-7.2.

foundation upon which to rely. That being said, a taxpayer should consider its legal recourse, not only from an assessment abatement/mitigation perspective, but also from a FIN 48 perspective. It is likely most taxpayers will be required to account for the New Jersey income tax uncertainty for financial reporting purposes long before actual settlement is obtained.

Follow the Rules

Remembering that New Jersey is a separate filing state, if your company does, in fact, "maintain a regular place of business outside New Jersey," then that is your best course of action. However, we caution that you must have robust support for your position, such as employment and lease agreements as, based on our experience, New Jersey will readily enforce each and every section of the applicable statutes and regulations outlined above, regardless of how minute or trivial they may seem in light of overall company operations.¹¹

Tax Planning

Tax planning is another viable alternative, the obvious option being creating a "regular place of business outside New Jersey" as defined by New Jersey law to prevent the 100 percent New Jersey allocation. However, that option is often not economically or strategically ideal, and may not be approved retroactively. Generally the better tax planning option, assuming a unitary business, is to reduce New Jersey taxable income via performance of a transfer pricing study. Such a study may validate that certain expenses associated with intercompany activities should be borne by the New Jersey taxpayer. Appropriate allocation of these expenses to New Jersey could reduce New Jersey taxable income to such an extent that the state's 100 percent allocation results in a reduced assessment. We caution that before applying this tax planning opportunity, the benefits be weighed from a reduced New Jersey assessment against the costs associated with performance of a transfer pricing study.

New Jersey Supreme Court Arguments for Equity

There are various New Jersey Supreme Court cases that address New Jersey allocation/apportionment laws, though not directly on point with respect to the "regular place of business outside New Jersey" and "throwout sales" rules. However, this case law emphasizes the court's focus on ensuring New Jersey allocation/apportionment is fair and equitable, especially toward New Jersey domiciled businesses having

¹¹ The New Jersey Division of Taxation will not change the way it administers two recently repealed corporate tax law provisions prior to the July 1, 2010, effective date of the repeal, Lee Evans, chief of office audit for the Taxation Division, said Feb. 4. During a teleseminar sponsored by Reed Smith State Tax Group, Evans said the division sees no reason not to continue administering the unpopular income apportionment-related rules the same way it has in the past in the time remaining before the effective date of A.B. 2722.

payroll and property within the state.¹² For example, in *Stryker v. New Jersey Dir., Div. of Taxn.*,¹³ concurring Justice Stein referred to the importance of the double-weighted sales factor to provide an incentive for investment and employment in New Jersey and to shift the tax burden to corporations that sell their products in New Jersey and away from corporations that employ people or have capital investment in New Jersey.

In earlier cases, the same theme resounds: is it fair and proper to apply New Jersey allocation guidelines “to the letter” without concern for the greater good of New Jersey domiciled businesses? According to the court, such a vacuous application is not acceptable as it found continually in favor of the department when deciding apportionment/allocation-related cases for corporations domiciled outside New Jersey. It would be reasonable to assume that in the opposite situation relating to a New Jersey-domiciled corporation the court would apply a reasonableness standard in favor of the New Jersey based company maintaining employment and property within the state.

¹² See *Reuben H. Donnelley v. New Jersey Dir., Div. of Taxn.*, 607 A.2d 1281, 128 N.J. 218, where the court noted allocation formula ensures that tax liability reflects only those portions of entire net worth and income fairly attributable to corporation’s activities in New Jersey; *Bendix Corp. v. New Jersey Dir., Div. of Taxn.*, 592 A.2d 536, 125 N.J. 20, where the court noted (albeit from a unitary perspective) that substance not form controls and we must look at the underlying activities, the economic realities of the corporation, not the form in which the income is received or other vagaries of formalism; *Metromedia Inc. v. New Jersey Dir., Div. of Taxn.*, 478 A.2d 742, 97 N.J. 313, where the court noted it is the implicit premise of the New Jersey Corporation Business Tax Act that the statutory three-ply formula can only approximate the taxpayer’s true net worth and income generated by its New Jersey activities. Hence, the act gives the director broad authority to adjust the allocation factor in order to reflect more accurately and fairly the activity, business, receipts, capital, entire net worth, or entire net income of a taxpayer reasonably referable to the state; *Avco Finl. Svcs. Consumer v. New Jersey Dir., Div. of Taxn.*, 494 A.2d 788, 100 N.J. 27, where the court noted the test is whether the tax liability is out of all appropriate proportion to the business transacted; *Silent Hoist & Crane v. New Jersey Dir., Div. of Taxn.*, 494 A.2d 775, 100 N.J. 1, where the court noted that in each case the resulting tax liability must not be out of all appropriate proportion to the business transacted in the taxing state itself and cited a U.S. Supreme Court case where 80 percent of a taxpayer’s income was being attributed to North Carolina when only 17 percent was warranted (*Hans Rees’ Sons Inc. v. North Carolina*, 283 U.S. at 135, 51 S.Ct. at 389, 75 L.Ed. at 908).

¹³ *Stryker v. New Jersey Dir., Div. of Taxn.*, 773 A.2d 674, 168 N.J. 138 (2001).

Is it fair and proper to apply New Jersey allocation guidelines “to the letter” without concern for the greater good of New Jersey domiciled businesses?

Doctrinal Arguments for Equity

The economic crises over the past several years have created various economic movements, some new and some resurrected from years past, in the interest of restoring stability and credibility within our nation’s financial sector. Although these movements have primarily focused on improved financial reporting, they are equally important in other aspects of finance, including corporate taxation. Therefore, such arguments may prove favorable in mitigating retroactive New Jersey assessments, though likely without much impact as they are secondary authority.

Renewed Emphasis of Principles Over Rules

The nation as a whole is acknowledging the importance of principles-based approaches over those that are rules-based, albeit with some concerns as expected. This is clear from the emphasis placed on the proposed convergence of generally accepted accounting principles (GAAP) with international financial reporting standards (IFRS). The Securities and Exchange Commission (SEC) acknowledged the benefits of such a principles-based approach in a staff study prepared by the Office of the Chief Accountant and the Office of Economic Analysis.¹⁴ The study

[R]ecommends that accounting standards should be developed using a *principles-based* approach and that such standards should have the following characteristics: (1) be based on an improved and consistently applied conceptual framework; (2) clearly state the accounting *objective* of the standard; (3) provide sufficient detail and structure so that the standard can be “operationalized” and applied on a consistent basis; (4) minimize the use of exceptions from the standard; (5) avoid use of percentage tests (“bright-lines”) that allow financial engineers to

¹⁴ Securities and Exchange Commission, *Study on Adoption by the U.S. Financial Reporting System of a Principles-Based Accounting System*, 2003-86, July 5, 2003.

achieve technical compliance with the standard while evading the intent of the standard.

Although the SEC study is focused on accounting principle development and application, it pertains, from a logical perspective, equally to state tax statutes and regulations. A principles-based approach would achieve technical compliance with state tax law while maintaining the intent of the law. It would also hold state taxing authorities responsible for ensuring that state tax law complies with the objective of the law, which in the case of New Jersey taxpayers is fair and reasonable New Jersey apportionment instead of arbitrary “all-or-nothing” allocations.

Continued Focus on Substance Over Form

The “substance over form” argument is perhaps one of the most exploited in federal and state income tax law, but it is also one of the most genuine. All tax law is created with an underlying purpose, be it economic, social, environmental, and/or equitable, that should be furthered regardless of the “legal package” used to apply it to concrete situations.

The U.S. Supreme Court in *Helvering v. F. & R. Lazarus & Co.* summarized the doctrine as follows: In the field of taxation, administrators of the laws and the courts are concerned with substance and realities, and formal written documents are not rigidly binding.¹⁵ The substance-over-form doctrine provides that the legal formalities of a transaction may be overlooked when the true substance of the transaction is determinative of the incidence of taxation.

In the case of New Jersey taxpayers, it could be argued New Jersey’s vacuous application of state statutes and regulations ignores the substance of the issue, which is fair and reasonable apportionment to New Jersey businesses. An intricate dissection of a taxpayer’s activities outside New Jersey is substantively irrelevant to the ultimate objective of fair New Jersey apportionment. New Jersey, in promoting the substance over form doctrine, should consider the issues from a high level and observe what an equitable result would be in light of the related facts and circumstances. The state should not concern itself with inconsequential minutia regarding whether taxpayer activities outside New Jersey fit perfectly within mechanical definitions of vague terms like “office,” “space,” “employee,” and “regular maintenance.”

Increased Demand for Transparency Over Complexity

Similar to the “substance over form” argument, an increased demand for transparency over complexity began with Enron and Worldcom and has only increased momentum fueled by the financial institution debacle. Even the FASB has conceded complexity in the financial sector over the past decade has reached an all-time high, and has worked to reduce its oftentimes confusing levels of authority to one set of accounting standards through its codification.¹⁶ It could be argued New Jer-

sey should follow suit instead of requiring companies to engage in lengthy deliberations over what constitutes an “office,” a “space,” an “employee,” and “regular maintenance.” Such debates are futile, not to mention an albatross on company and governmental productivity.

Constitutional Arguments

From a U.S. Constitutional perspective, any taxpayer having income from business activity that is taxable within and without the state may allocate and apportion income. In other words, the right to allocate and apportion income only exists where the taxpayer is liable for tax in more than one jurisdiction. A taxpayer is taxable in another state if, in general, it is subject to a net income tax, franchise tax measured by net income, a franchise tax for the privilege of doing business, or a corporate stock tax. A taxpayer may be deemed “taxable in another state” if a state has jurisdiction to subject the taxpayer to a net income tax, regardless of whether, in fact, the state does or does not impose the tax.

Arguably, New Jersey is defying constitutional doctrines of due process and interstate commerce with its arbitrary 100 percent allocation requirement with respect to any New Jersey taxpayer *subject* to a net income tax, franchise tax measured by net income, a franchise tax for the privilege of doing business, or a corporate stock tax. A jurisdiction does not actually have to impose such tax to justify interstate apportionment. The fact that New Jersey tax law allows a credit for taxes paid to other states does not change the fact that its 100 percent allocation crosses constitutional lines.

Litigate

This is an option of last resort as, oftentimes, litigation is costly and, based on court decisions, uncertain, especially outside tax courts where judges are generally not as experienced in tax law. That being said, the New Jersey Supreme Court (and lower courts to a certain extent) have proven reasonable when it comes to deciding cases involving New Jersey domiciled companies with considerable payroll and property within the state, as previously discussed.

ACCOUNTING FOR NEW JERSEY AUDIT UNCERTAINTY

As previously noted, it is important to evaluate the arguments presented above in order to account for the uncertainty related to a New Jersey assessment on allocation/apportionment issues prior to the 2010 repeal. Such evaluation will require the standard two-prong recognition/measurement approach to income tax uncertainties originally outlined under FIN 48 and codified as indicated below.

sues Task Force, Accounting Principles Board) but no longer for financial statements issued for interim and annual periods ending after Sept. 15, 2009. As of that date, all nongovernmental entities are required to use the FASB Accounting Standards Codification (ASC), which will be the sole source of authoritative U.S. accounting and reporting standards, in addition to guidance issued by the Securities and Exchange Commission (SEC).

¹⁵ *Helvering v. F. & R. Lazarus & Co.* 308 U.S. 252 (1939).

¹⁶ Guidance regarding accounting for income taxes was previously found within various levels of authority (e.g., Financial Accounting Standards, FASB Staff Position, Emerging Is-

Recognition

FASB ASC 740-10-25-6 provides “an entity shall initially recognize the financial statement effects of a tax position when it is more likely than not, based on the technical merits, that the position will be sustained upon examination.” The term “more likely than not” means a likelihood of more than 50 percent; the terms “examined” and “upon examination” also include resolution of the related appeals or litigation processes, if any. For example, if an entity determines that it is certain that the entire cost of an acquired asset is fully deductible, the more-likely-than-not recognition threshold has been met. The more-likely-than-not recognition threshold is a positive assertion that an entity believes it is entitled to the economic benefits associated with a tax position. The determination of whether a tax position has met the more-likely-than-not recognition threshold shall consider the facts, circumstances, and information available at the reporting date. The level of evidence that is necessary and appropriate to support an entity’s assessment of the technical merits of a tax position is a matter of judgment that depends on all available information.

FASB ASC 740-10-25-7 further provides that “in making the required assessment of the more-likely-than-not criterion:

- a) It shall be presumed that the tax position will be examined by the relevant taxing authority that has full knowledge of all relevant information.
- b) Technical merits of a tax position derive from sources of authorities in the tax law (legislation and statutes, legislative intent, regulation, rulings, and case law) and their applicability to the facts and circumstances of the tax position. When the past administrative practices and precedents of the taxing authority in its dealings with the entity or similar entities are widely understood, for example, by preparers, tax practitioners and auditors, those practices and precedents shall be taken into account.
- c) Each tax position shall be evaluated without consideration of the possibility of offset or aggregation with the other positions.

Although arguments can be made both for and against recognition based on a company’s set of particular facts and circumstances, we recommend no related benefit be recognized and a FIN 48 liability be recorded for all amounts related to these New Jersey allocation/apportionment issues, including interest and penalties. The reality is that the current statute and interpretative regulations favor the state. Moreover, the state has publicly indicated its intention to assess New Jersey tax to the full extent of New Jersey allocation/apportionment tax law. There are equitable arguments to the contrary, as discussed above, but none as overriding as New Jersey statutes and regulations. That being said, tax planning and/or extensive factual analysis may change this result, but as long as such mitigating efforts have not been pursued, the full exposure remains and a commensurate FIN 48 liability should be recognized.

Measurement

If your company’s facts and circumstances are such that you believe, with clarification, New Jersey will re-

verse its 100 percent allocation assessment to reflect the apportionment as originally filed, then your company will be required to “measure” the benefit, that is recognize the largest amount of benefit that is greater than 50 percent likely of being realized upon settlement.¹⁹ FASB ASC 740-10-55-4 acknowledges that “relatively few disputes are resolved through litigation, and very few are taken to the court of last resort. Generally, the taxpayer and taxing authority negotiate a settlement to avoid the costs and hazards of litigation. As a result, the measurement of the tax position is based on management’s best judgment of the amount the taxpayer would ultimately accept in a settlement with taxing authorities.”

Ongoing FIN 48 Evaluation

In light of the ongoing debate among taxpayers, New Jersey taxing authorities, and the judicial system with respect to New Jersey allocation/apportionment issues prior to the 2010 repeal, taxpayers should evaluate their original FIN 48 accounting based on new developments pertaining to these issues and adjust that accounting accordingly.

FASB ASC 740-10-25-8 provides that:

If the more-likely-than-not recognition threshold is not met in the period for which a tax position is taken or expected to be taken, an entity shall recognize the benefit of the tax position in the first interim period that meets any one of the following conditions:

- a) The more-likely-than-not recognition threshold is met by the reporting date.
- b) The tax position is effectively settled through examination, negotiation, or, litigation.
- c) The statute of limitations for the relevant taxing authority to examine and challenge the tax position has expired.

Accordingly, a change in facts after the reporting date but before the financial statements are issued or are available to be issued shall be recognized in the period in which the change in facts occurs.

Other Financial Reporting Considerations

In addition to FIN 48 concerns, it is important to note that deferred tax assets and liabilities must be “measured at the enacted rates expected to apply to taxable income in the years that the liability is expected to be settled or the asset recovered.”²⁰ Therefore, companies with New Jersey operations should currently be recording deferred inventory at a blended state statutory rate taking into account the changed New Jersey apportionment laws effective during 2010.

CONCLUSION

For company’s facing assessment related to New Jersey allocation/apportionment as the law exists prior to

¹⁹ FASB ASC 740-10-55-5.

²⁰ FASB ASC 740-10-55-23.

July 1, 2010, there are not many options available to mitigate additional tax. Recourse may be found in intricate factual analyses, tax planning, or equitable arguments. As a last resort, litigation is also an option, albeit likely with significant costs and uncertainty. Regardless of the course a company decides to take, uncertainty related to the New Jersey assessment must be considered from a FIN 48 perspective for financial reporting pur-

poses. Such an analysis may prove challenging in light of the many moving pieces surrounding this issue and should be supported by clear memoranda and related legal/factual documentation. Moreover, FIN 48 recognition and measurement for these uncertainties should be reviewed on a regular basis for new developments requiring financial reporting adjustments.