Significant New Jersey Tax Cases in 2014

by Mitchell A. Newmark and Kara M. Kraman

Several significant tax cases have been decided in New Jersey in 2014. Perhaps even more notably, nearly all of them have been decided in favor of the taxpayer. The decisions address a broad spectrum of issues, including the imposition of the amnesty and late payment penalties and various aspects of the corporation business tax (CBT), including add-backs, federal depreciation deductions, the throw-out rule, operational versus non-operational income, and the ability of corporate limited partners to apply for refunds of CBT liabilities paid on their behalf. A brief discussion of each case is provided below.

Late Payment and Amnesty Penalties

On Dec. 4, 2014, the New Jersey Supreme Court affirmed the decisions of the tax court and Appellate Division and held that the director did not properly exercise his discretion when he declined to waive late payment penalties, and that the amnesty penalty did not apply where a taxpayer timely filed tax returns, paid all reported tax liabilities, and was found to be liable for additional taxes following an audit where the assessment was issued after the close of the amnesty period.[1]

The Supreme Court held that, regarding the tax liability resulting from the director's imputation of interest on certain disputed transfers under the UPS cash management system, an issue for which there was "no directly pertinent legal authority then in existence," the taxpayer had demonstrated an "honest misunderstanding of fact or law" that supported a finding of reasonable cause to waive penalties. The Court, therefore, concluded that the director's failure to waive the penalties was an improper exercise of his discretion.

The Court also held that the director's imposition of the amnesty penalty was improper. It agreed with the Appellate Division and the tax court that the amnesty statute is ambiguous. In light of the ambiguity, it relied on the legislative history, which stated that the amnesty penalty was not meant to apply to "a question of law or fact uncovered through routine audits of taxpayers otherwise in compliance with filing and payment requirements of State taxes." The Court determined that it did not apply in this case, where the bases for the assessments against the taxpayer were discovered during an audit of the taxpayer's timely filed and paid tax returns. The Supreme Court's decision is important because it clarifies that a taxpayer that timely files tax returns, pays all reported tax liabilities, and is found to be liable for additional taxes following an audit has not "failed to pay any State tax" on or before the day on which the tax is required to be paid within the meaning of the amnesty statutes.[2]

Add-Back (State Taxes)

In *Duke Energy Corporation v. Director, Division of Taxation*,[3] the tax court held that the taxpayer was not required to add the electric utilities taxes it paid to North Carolina and South Carolina back to its federal taxable income when calculating its entire net income for CBT liability purposes. The taxpayer was a North Carolina corporation that distributed and transmitted electricity in North Carolina and South Carolina. The taxpayer added back the taxes it paid to North Carolina and South Carolina on its net corporate income when calculating its CBT liability, but did not add back the additional electric utilities taxes it paid to those states. The director audited the taxpayer's CBT returns and increased the taxpayer's net income by the amounts of the electric utilities taxes.

The tax court held that the add-back of the electric utilities taxes was not permitted because neither tax was "measured by profits or income, or business presence or business activity," as required by the statute.[4] The tax court based its conclusion on the fact that the North Carolina utilities tax was a tax measured by gross receipts, and applied regardless of whether the company was profitable, and the fact that the South Carolina electric utilities tax, which it found to be "materially similar" to the North Carolina tax, was also not measured on profits or business activity, but instead was measured on gross receipts and the value of real property.

A few months earlier, the tax court reached a similar conclusion regarding the add back of certain Pennsylvania taxes in *PPL Electric Utilities Corp. v. Director, Division of Taxation*.[5] In that case, the tax court held the taxpayer's CBT obligations to New Jersey did not require the taxpayer to add Pennsylvania gross receipts tax and Pennsylvania capital stock tax back to its entire net income when calculating its CBT liability. It reasoned that the gross receipts tax was an excise tax which is "levied, determined and calculated according to the actual sale of electricity in Pennsylvania," and not a tax based on the business presence or business activity of a taxpayer in Pennsylvania, and that the Pennsylvania capital stock tax was a property tax measured by the value of the taxpayer's assets, and not a tax based on profits or business activity.

The director did not appeal the *PPL* decision. The *Duke* matter is still pending.

Add-Backs (Interest Deductions)

In *Morgan Stanley & Co. v. Director, Division of Taxation*,[6] the tax court ruled for the taxpayer in an add-back dispute involving related party interest deductions, holding that the director abused his discretion when he failed to properly apply the "unreasonable exception" to the add-back statute. New Jersey law provides that for CBT purposes, entire net income is determined without the exclusion or deduction of interest paid, accrued or incurred to a related party unless an exception applies. One exception is that the taxpayer establishes "that the disallowance of the deduction is unreasonable."[7]

In analyzing whether the director abused his discretion in not applying the "unreasonable exception," the tax court first rejected the taxpayer's argument that the exception should apply because the taxpayer demonstrated the transaction had a business purpose and had economic substance, holding that something more was needed to demonstrate "unreasonableness." However, the tax court next rejected the director's assertion that the unreasonable exception to the add-back did *not* apply because the taxpayer failed to demonstrate a tax had been paid to another state on the interest income relating to the interest expense.

The tax court held that the director's position making the payment of tax to another state a "*de facto* requirement for the unreasonable exception....runs contrary to the intent of the statutory exception, the division's own regulations and published guidance." Accordingly, the tax court held the director abused his discretion by failing to analyze anything other than whether tax was paid in another jurisdiction in determining whether the unreasonable exception applied. This matter is still pending.

Depreciation and the Throw-Out Rule

In *Toyota Motor Credit Corporation v. Director, Division of Taxation*,[8] the tax court ruled for the taxpayer on issues related to both depreciation and the throw-out rule. First, the tax court held that when calculating the net gain from the sale of capital assets for CBT purposes, the taxpayer could increase its basis in the capital assets (in this case leased automobiles) by the amount of the federal depreciation deductions that were unused for CBT purposes. The tax court explained that the language of the CBT Act and appellate precedent under the Gross Income Tax Act established that there is a broad state tax policy against the assessment of tax on "phantom income" that would result from depreciation deductions used by the taxpayer for federal purposes, but which resulted in no New Jersey tax benefit because those federal deductions were not permitted for New Jersey purposes.

Second, the tax court held that the plain language of the federal bonus depreciation decoupling statute[9] enacted in the wake of the events of Sept. 11, 2001, makes it clear that it applied to all assets acquired after Sept. 10, 2001. The tax court accordingly determined that to the extent the director's regulation purported to limit the decoupling amendment to assets acquired during taxable years beginning on or after Jan. 1, 2002, it was invalid.

Third, the tax court rejected the director's attempt to throw out the taxpayer's receipts sourced to Nevada, South Dakota, and Wyoming from the denominator of the receipts fraction for CBT purposes under the so-called 'throw-out' provision.[10] It concluded that application of the throw-out provision was not appropriate because the New Jersey Supreme Court's holding in *Whirlpool Properties, Inc. v. Director, Division of Taxation*[11] was unequivocal—only receipts that are not taxed because the other state lacks jurisdiction to tax may be thrown out.[12] The throw-out provision cannot apply where another state chooses to not have a corporate income tax.[13]

The tax court also issued a letter opinion in *Re: Lorillard Licensing Co., LLC v. Director, Division of Taxa-*

tion[14] in 2014, which amplified its Aug. 9, 2013, bench opinion granting partial summary judgment in favor of the taxpayer on the issue of the standard the director must use when applying the throw-out rule. The tax court's letter opinion rejects the director's argument that summary judgment on the throw-out issue was not warranted because further investigation was necessary to determine if the taxpayer, an owner of trademarks, filed returns and paid tax in the other states. The court explained that in *Lanco, Inc. v. Director, Division of Taxation*,[15] the New Jersey Supreme Court held that a trademark owner's receipt of royalty payments from sales in the state by a related entity gave the company sufficient nexus with New Jersey, even though it had no physical presence in the state, to permit taxation under the United States Constitution. The Court further explained that under *Whirlpool Properties, supra*, the relevant inquiry is whether other states have authority under the United States Constitution to tax the taxpayer, not whether those states actually do tax the taxpayer. The tax court held that, based on the holding approving the director's subjectivity position in *Lanco*, all 50 states had, under New Jersey's view of subjectivity, the constitutional authority to tax Lorillard Licensing, and therefore, under the holding in *Whirlpool*, none of its receipts could be thrown out. The director appealed this decision to the Appellate Division.

Operational v. Non-Operational Income

In *Elan Pharmaceuticals, Inc. v. Director, Division of Taxation*,[16] the tax court issued a letter opinion holding that the gain from a pharmaceutical company's sale of the U.S. and Canadian rights to one of its pharmaceutical drugs, along with certain related assets, resulted in "operational income." The pharmaceutical company, relying heavily on *McKesson Water Products Co. v. Director, Division of Taxation*,[17] argued that the gain was "nonoperational income" from the partial liquidation of the business, and therefore properly allocable to the taxpayer's principal place of business, California. The director argued the gain from the sale was apportionable operational income. The tax court ruled for the director, finding that the facts were distinguishable from those in *McKesson*, in part because the taxpayer did not completely divest itself of the business and retained certain rights relating to the drug after the sale.

Notably, the tax court did not agree with the director's assertion of apportionability because the taxpayer treated the gain from the sale of the pharmaceutical drug as "business income" in California. The tax court noted that "this court should be guided by...New Jersey's [statute] for taxing operational income, and the binding law construing that statute, not the consequent result of such treatment in another State."

Subsequent to the tax court's decision in *Elan Pharmaceuticals*, and in response to the Appellate Division's decision in *McKesson*, the Legislature amended the definition of operational income contained in N.J.S.A. § 54:10A-6.1(a) to include "income from tangible and intangible property if the acquisition, management, *or* disposition of the property constitute integral parts of the taxpayer's regular trade or business." (Emphasis added)[18] Previously, operational income had been defined as income from "the acquisition, management, and disposition" of the property constituting integral parts of the taxpayer's regular trade or business. The amendment applies to privilege periods ending on or after July 1, 2014.

Refund Claims

In *BIS LP, Inc., v. Director*,[19] the Appellate Division affirmed the judgment of the tax court and held that BIS LP was entitled to a refund of the taxes paid to New Jersey on its behalf by an affiliate. BIS had filed a 2003 CBT return, but the tax owed on the return was paid by an affiliate pursuant to a contractual servicing arrangement. BIS subsequently requested a refund of the tax paid on its behalf on the grounds that BIS had no nexus with New Jersey. The tax court granted the refund, and the Appellate Division affirmed the tax court's decision. However, the Appellate Division remanded the case back to the tax court to consider the limited issue, raised by the director, of whether only the entity that actually paid the tax (which was time-barred from making a refund claim), could be entitled to a refund of that tax. On remand, the tax court held that BIS was entitled to the refund even though it did not actually pay the tax. The Appellate Division affirmed, rejecting the director's argument that BIS did not provide sufficient "consent to taxation" to apply for a refund of that tax.

In response to the Appellate Division's decision in *BIS LP*, the Legislature amended N.J.S.A. 54:10A-15.11(b) to provide that payments made by a partnership on behalf of its nonresident partners are only refundable to a nonresident partner that files a New Jersey tax return, and reports income that is subject to tax in New Jersey, and that a partnership that pays tax pursuant to N.J.S.A. 54:10A-15.11 is not entitled to claim a refund of payments credited to the account of any of its nonresident partners.[20] The amendment applies to privilege periods ending on or after July 1, 2014.

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Endnotes

1. *United Parcel Service General Services Co. v. Director, Division of Taxation*, 2014 N.J. LEXIS 1246 (Dec. 4, 2014).
2. N.J.S.A. § 54:53-17(a), -18(a).
3. Dkt. No. 010448-2008 (Dec. 2, 2014).
4. N.J.S.A. § 54:10A-4(k)(2)(C).
5. Dkt. No. 000005-2011, 2014 N.J. Tax LEXIS 21 (Oct. 2, 2014).
6. Dkt No. 007557-2007, 2014 N.J. Tax LEXIS 23 (Oct. 29, 2014).
7. N.J.S.A. § 54:10A-4(k)(2)(I).
8. Dkt. No. 002021-2010, 2014 N.J. Tax Lexis 19 (Aug. 1, 2014).
9. N.J.S.A. § 54:10A-4(k)(12)(A).
10. N.J.S.A. § 54:10A-6(B). The throw-out provision was repealed in 2008, effective for privilege periods beginning on or after July 1, 2010. L. 2008, c. 120, § 2.
11. 208 N.J. 141 (2011).
12. A few days after the tax court issued its opinion in *Toyota Motor Credit*, and citing to *Toyota Motor Credit*, the tax court also issued an opinion in favor of the taxpayer regarding the same federal depreciation deduction issue on materially similar facts in *Ford Motor Credit Company v. Director, Division of Taxation*, Dkt No. 015751-2009, 2014 N.J. Tax LEXIS 19 (Aug. 5, 2014).
13. *Id.*
14. Dkt No. A-2033-13T1, 2014 N.J. Tax LEXIS 3 (Jan. 14, 2014) (unpublished).
15. 188 N.J. 380 (2006).
16. Dkt. No. 010589-2010 (N.J. Tax Ct. May 1, 2014).
17. 408 N.J. Super. 213 (App. Div.), *certif. denied*, 200 N.J. 506 (2009).
18. P.L. 2014, c. 13 (June 30, 2014).
19. Dkt. No. A-1647-12T3, 2014 N.J. Tax LEXIS 6 (April 11, 2014).
20. P.L. 2014, c. 13 (June 30, 2014).