NEW JERSEY STATE DEVELOPMENTS – Fall 2021

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I. CORPORATION BUSINESS (INCOME) TAX

A. Legislative Developments

1. New Jersey Moves from Separate-Company to Combined Reporting: On July 1, 2018, the legislature amended the corporation business tax ("CBT") act to require taxpayers to file on a unitary-combined basis beginning in 2019. Of note: a "unitary business" is defined as a single economic enterprise, and, by statute, the Division of Taxation (the "Division") can interpret "unitary business" to the broadest extent permitted under the United States Constitution; taxpayers can elect their combined group on a "water's edge," "affiliated," or "worldwide" basis; and taxpayers will now deduct net operating losses ("NOL") on a post-apportioned basis—NOLs were deducted on a pre-apportioned basis under prior law. P.L. 2018, c.48.

2. Amendments to Combined Reporting Statute: Through P.L. 2020, c. 118, the New Jersey Legislature amended the CBT's combined reporting provisions. Of note, the legislature: clarified that the dividends received deduction should always result in a combined group receiving a 95% deduction for dividends the group includes in income from 80% or more owned subsidiaries; expanded the affiliated group election to include foreign corporations with effectively connected income to the United States; adopted the federal consolidated return regulations; clarified that investment companies and real estate investment trusts are not part of a New Jersey combined group; and amended the due date of the CBT return (30 days after the taxpayer files their federal return).

3. Taxing Global Intangible Low-Taxed Income ("GILTI"): As a result of the federal Tax Cuts and Jobs Act of 2017, Internal Revenue Code ("IRC") § 951A requires shareholders of controlled foreign corporations ("CFCs") to include any GILTI for a taxable year in their federal gross income. GILTI is defined as: the shareholder's net CFC tested income for a taxable year over the shareholder's net deemed tangible income return for the taxable year. Essentially, GILTI is included in gross income if the shareholder's income from CFCs is greater than a 10% return on depreciable CFC assets.

At the federal level, a corporation is allowed a deduction for 37.5% of its foreign-derived intangible income ("FDII"). In addition, IRC § 250 permits taxpayers to deduct 50% of GILTI included in gross income for a taxable year.

Through P.L. 2018, c.131, New Jersey has coupled to the federal treatment of GILTI and the FDII deduction. Taxpayers must include GILTI in their line 28 taxable income, but are allowed a corresponding deduction "in the amount of the full value of the deduction" that they were allowed for federal income tax purposes.

4. Taxing "Deemed Dividends: The legislature reduced the dividends received deduction for dividends received from 80%-or-more-owned subsidiaries from 100% to 95% for periods beginning after December 31, 2016. Accordingly, 5% of any undistributed foreign earnings that were deemed to be repatriated pursuant to the Tax Cuts and Jobs Act under IRC § 965 will be included in the CBT base. P.L. 2018, c.48.

5. Market Sourcing for Services: Effective for tax years ending on and after July 31, 2019, the legislature amended the CBT to require taxpayers to source service receipts on a market basis. The default rule for services received by an individual customer is that the benefit of the service is deemed to be received at a customer's billing address. P.L. 2018, c.48. The Division of Taxation (the "Division") published rules concerning market sourcing on September 8, 2020. *See* N.J.A.C. 18:7–8.10A.

6. Surtax: Taxpayers with allocated net income above $1 million will be subject to a 2.5% surtax from 2018–2023. For taxpayers covered by the surtax, the total CBT tax rate for 2018–2023 will be 11.5%. *See* N.J.S.A. 54:10A–5.41.

B. Judicial Developments

1. <u>Statute of limitations applies to net operating loss adjustments</u>: In *R.O.P. Aviation, Inc. v. Director, Division of Taxation*, Docket No. 001323–2018 (N.J. Tax May 27, 2021), the Tax Court of New Jersey held that New Jersey's four-year statute of limitations applied to net operating loss ("NOL") adjustments.

   Specifically, the case involved a transfer pricing adjustment between the taxpayer and an affiliate for the 2012–2015 privilege periods. The Division hired an expert and conducted a transfer pricing study for those privilege periods. In addition, based on that transfer pricing study, at audit, the Division adjusted the taxpayer's income for the 2007–2011 privilege periods—years that were closed for audit under the statute of limitations at the time of the audit. The Division did not issue an assessment for the 2007–2011 privilege periods. Instead, the result of the Division's adjustments for those years was a reduction in the taxpayer's NOLs.

   For the 2007–2011 privilege periods, prior to the transfer pricing adjustment, the taxpayer had substantial losses. If the Division had not adjusted the losses in the 2007–2011 privilege periods, the taxpayer would have been able to offset the Division's entire assessment for the 2012–2015 privilege periods with its NOLs.

   One of the taxpayer's arguments was that the Division could not adjust its NOLs that it carried into 2012–2015 from the 2007–2011 privilege periods because the statute of limitations prohibited that adjustment. The Tax Court agreed with the taxpayer and held that the Division did not have the authority to adjust a taxpayer's NOLs in years that were closed under the four-year statute of limitations.

2. <u>Dividend Payments Are Not Deductible CBT Expenses</u>: In *Shore Building Contractors Inc. v. Director, Division of Taxation*, Docket No. 002298–2012 (N.J. Tax Oct. 3, 2019), the Tax Court of New Jersey held that distributions that a taxpayer made to its employees were not deductible for CBT purposes as wage expenses. (Taxpayers report wage expenses—a deduction—on Line 13 of their federal 1120 return. Therefore, the taxpayer's distributions would reduce the starting point for the CBT—Line 28.)

In reaching the holding, the Tax Court of New Jersey followed prior precedent in *Seventeen Thirty Corporation v. Director, Division of Taxation*, 18 N.J. Tax 168 (N.J. Tax 1999). In that case, the court analyzed whether a taxpayer's distributions were wage expenses or a dividend that a company paid to its employees. Further, in *Seventeen Thirty Corporation*, the Tax Court used a two-prong test to analyze the distributions: (1) whether the compensation was reasonable; and (2) whether the payments to employees were purely for services.

In applying that two-prong test to the facts of *Shore Building Contractors*, the Tax Court held that the compensation was not reasonable and was not for services; but instead, was a dividend that the taxpayer paid to its employees. That is because the distribution to one employee was almost three times the salary the employee received in a prior year, and the other employee never received a salary from the company. As a result, the court held that the taxpayer could not deduct the distributions from the tax base as wage expenses.

3. Tax Court of New Jersey Strikes Down Alternative Minimum Assessment: In *Stanislaus Food Products Co. v. Director, Division of Taxation*, Docket No. 011050–2017 (N.J. Tax June 28, 2019), the Tax Court of New Jersey held that New Jersey's alternative minimum assessment ("AMA") tax stood as an obstacle to Public Law 86–272 ("P.L. 86–272"), and therefore was invalid under the Supremacy Clause of the United States Constitution.

For the periods at issue (2012–2014), New Jersey imposed the CBT and the AMA on corporations. The CBT is a tax on a corporation's income. The AMA is a tax on gross profits or gross receipts. For the periods at issue, the legislature required corporations exempt from the CBT, by virtue of P.L. 86–272, to pay the AMA. (P.L. 86–272 is a federal provision that exempts corporations from a state's **income tax** if their only activity in a state is the solicitation of sales of tangible personal property.)

Under the Supremacy Clause, a state is preempted from enacting a law if it stands as an obstacle to a federal law. Therefore, the question for the court was whether P.L. 86-272 preempted the New Jersey legislature from imposing the AMA on taxpayers for the periods at issue.

The court held that P.L. 86–272 preempted the legislature from imposing the AMA on corporations exempt from CBT under P.L. 86–272. The court reasoned that the AMA was an "end-run around P.L. 86–272" because the legislature only imposed the tax on those companies exempt from CBT.

Further, a taxpayer exempt from CBT because of P.L. 86–272 could file a consent to CBT taxation, and no longer be subject to AMA. As a result, the court reasoned that through the AMA, the legislature coerced taxpayers to consent to CBT taxation. For example, a taxpayer with a higher AMA than the CBT could consent to CBT taxation and not pay the higher AMA tax. For that reason, the court found that when the AMA is greater than the CBT, the AMA becomes a de facto tax on income because the taxpayer would elect to pay the CBT (since it was less than the AMA). The court found irrelevant the fact that the AMA was not an income tax. Instead, the court stated that the constitutional analysis depends "not on the label given the tax, but on the economic effects of the tax." Here, the AMA stood as an obstacle to companies protected from income taxation by P.L. 86–272 because the AMA only targeted those companies otherwise exempt from New Jersey's CBT.

For these reasons, the court found that the AMA was invalid under the Supremacy Clause.

4. Tax Court Broadens Royalty Addback Exception: *Lorillard Tobacco Company v. Director, Division of Taxation*, Docket No. 008305–2007 (N.J. Tax Feb. 27, 2019) concerns the addback of related-party royalty expenses. For purposes of computing the CBT base, the general rule is that related-party royalty expenses must be added back. In *Lorillard Tobacco Company*, the taxpayer paid royalties to a subsidiary that was filing returns and paying CBT to New Jersey on the income stream. The taxpayer claimed a complete addback exception based on the so-called "unreasonable exception," which provides that addback is not required if the taxpayer can prove by clear and convincing evidence that denying a deduction would be unreasonable. The Division's policy, however, is to narrowly construe this exception. The Division's regulation provides that the unreasonable exception applies only to "the extent that the payee pays tax to New Jersey on the income stream." And under the Division's tax return instructions, the value of the exception is capped at the amount of CBT paid by the affiliated licensor on the royalty stream.

In effect, if the affiliated licensor's New Jersey apportionment is less than the licensee's New Jersey apportionment, the Division has historically allowed the licensor to claim only a partial addback exception.

In *Lorillard,* the taxpayer argued that it would be unreasonable to add back its related-party royalty expense because the affiliate paid New Jersey tax on the royalty stream. The Tax Court agreed. In rejecting the Division's longstanding policy, the court determined that the legislative intent of the royalty addback statute was to prevent income shifting. According to the court, the relative apportionment of the licensor and licensee was immaterial. As long as the affiliate paid at least some tax on the income stream, the legislative intent was satisfied and the licensee is entitled to fully deduct its royalty expense.

The Superior Court of New Jersey, Appellate Division, reversed the Tax Court's decision. Contrary to the Tax Court, the Appellate Division found that the Division's regulation was consistent with the legislative intent to prevent income shifting. As a result, the Appellate Division ruled that the taxpayer was only entitled to an exception to addback for the amount of tax that the taxpayer's subsidiary paid to New Jersey on the royalty income stream.

The Appellate Division remanded the case to the Tax Court for consideration of constitutional issues that the taxpayer presented.

5. Tax Court Issues Decision on Economic Nexus: *Crown Packaging Technology, Inc. v. Director, Division of Taxation*, Docket No. 003249–2012 (N.J. Tax Feb. 26, 2019) concerns CBT nexus. The issue was whether an intangible holding company had CBT nexus as a result of receiving royalty income from an affiliate that did business in New Jersey. The taxpayer argued that subjecting it to tax would violate the Commerce Clause and the Due Process Clause of the United States Constitution.

The court held that it lacked sufficient facts to definitively rule on the nexus issue. But the decision is nonetheless significant because the court determined that the Supreme Court of New Jersey's decision in *Lanco, Inc. v. Director, Division of Taxation*, 908 A.2d 176 (N.J. 2006), was not necessarily controlling. *Lanco* established the rule in New Jersey that physical presence is not required for CBT nexus. In both *Lanco* and *Crown Packaging*, the taxpayer received royalty income from an affiliate that did business in the state. But the Tax Court distinguished *Lanco* because Crown Packaging's affiliated licensee did not operate retail stores in New Jersey and thus had a more limited connection to the state.

If your holding company conceded nexus following *Lanco*, it may have a refund opportunity. The decision may also be relevant beyond mere intangible holding company arrangements.

For example, if your company conducts a financial or media business and derives receipts from New Jersey but lacks physical presence in the state, it should reconsider whether it has sufficient contacts with the state.

6. Tax Court Issues Decision on State Tax Addback: In *Daimler Investments US Corporation v. Director, Division of Taxation*, Docket No. 008165–2016 (N.J. Tax Jan. 31, 2019), the Tax Court of New Jersey decided that intercompany payments were not subject to the CBT's income tax addback provision—requiring the addback of state taxes "on or measured by profits or income, or business presence or business activity." (For more background on the statutory provision, see Section 0 below.)

   In *Daimler*, the taxpayer incurred intercompany expense to its parent for taxes paid in combined states. The expense was computed in accordance with a tax sharing agreement. The taxpayer didn't report this as income tax expense and thus didn't add it back when computing its New Jersey taxable income; rather, the parent added it back. On audit, the Division added back positive intercompany charges incurred by the subsidiary to the parent as state income tax expense.

   The Tax Court concluded that the intercompany charges weren't income tax expense. Accordingly, the court determined that intercompany charges for accrued or estimated tax were not subject to addback. Instead, the court concluded that a taxpayer is required to add back only its "pro rata share" of tax actually paid to combined states.

7. Tax Court Provides Guidance on Regular Place of Business Requirement: Before July 1, 2010, the only taxpayers entitled to three-factor apportionment were those that had a regular place of business ("RPOB") outside New Jersey. (This statutory requirement does not apply after July 1, 2010.) *ADP Vehicle Registration, Inc. v. Director, Division of Taxation*, Docket No. 014946–2014 (N.J. Tax Dec. 11, 2018) involves a tax year where the statutory RPOB requirement was in effect.

   Facts

   Taxpayer held a general partnership interest in another company—Computerized Vehicle Registration ("CVR"). CVR operated a nationwide computerized business that provided electronic vehicle title and registration services. CVR's partnership receipts were Taxpayer's only source of income. CVR had office locations outside NJ in California, Oregon, and Texas. (Because Taxpayer holds a general partnership interest in CVR—and is unitary with CVR—Taxpayer holds a RPOB wherever CVR maintains a RPOB. *See* N.J.A.C. 18:7–7.6(h)(1). For that reason, Taxpayer and CVR are used interchangeably below.)

Court's Reasoning

The court applied the Division's RPOB regulation. The RPOB regulation contains four factors to "assist" taxpayers "in the determination of what is a" RPOB. Those factors include: a bona fide office; space of the taxpayer; regularly maintained, occupied, and used by the taxpayer; and a regular employee must be under the control of the taxpayer. *See* N.J.A.C. 18:7–8.14. The court first determined that the Taxpayer was not required to meet each of the four factors, because the four factors in the RPOB regulation are intended to "assist" taxpayers. The court found that the plain meaning of "assist" is "to aid"; thus, requiring strict compliance with each of the four factors cuts against a plain reading of the RPOB regulation. The court then determined that Taxpayer maintained a RPOB outside of New Jersey in California and, as a result, was entitled to three-factor apportionment. The court rejected the argument that the employees at the California office were Taxpayer's parent's employees, rather than Taxpayer's employees. As support for that argument, the Division relied on a W-2 that listed as the payor Taxpayer's parent and CVR—the partnership of which Taxpayer was a general partner. In rejecting the argument, the court noted that Taxpayer's "method of employee remuneration recorded in the payroll records . . . does not control the outcome." Instead, the court noted that the record contained "ample proof to identify the employees as regular" Taxpayer employees.

8. Tax Court Strikes Down Division's Five Factor Apportionment Method: In *Canon Financial Services, Inc. v. Director, Division of Taxation*, Docket No. 000404–2014 (N.J. Tax Dec. 5, 2018), the Tax Court of New Jersey determined that the Division could not apply an alternative apportionment methodology to a taxpayer without promulgating a rule.

Background

Canon Financial Services ("Canon Financial") is headquartered in Mount Laurel, New Jersey, and is a wholly-owned subsidiary of Canon U.S.A., Inc., ("Canon USA") and Canon, Inc. ("Canon"). (Canon Financial did not have an office outside New Jersey.) Canon is known for manufacturing and selling products, such as printers. Canon USA performs the sales function for the business, by selling Canon's products to large corporations. Canon Financial performs the leasing function by offering lease financing to Canon's customers. When Canon Financial approved a customer's lease application, Taxpayer then purchased products from its parent, Canon, and leased those products to the customers.

To buy these products from its parent, Canon Financial entered into loan agreements with Canon U.S.A. The loan agreements provided: a principal amount; effective date; maturity date; interest rate, and repayment of principal and interest dates. The loan agreements did not contain collateral requirements and default provisions.

During the tax years at issue, the CBT statute required taxpayers maintaining a RPOB only in New Jersey to allocate 100% of their entire net income—the tax base—to New Jersey. The statute permitted taxpayers maintaining a RPOB outside New Jersey to allocate their income to the state using a three-factor apportionment method (property, payroll, and sales). Moreover, Section 8 of the statute gives discretion to the Division to develop an allocation factor that "properly reflect[s] the activity, business, receipts, [and] capital . . . of a taxpayer reasonably attributable to" New Jersey.

During an audit, the Division assessed Canon Financial by applying the statutory provisions above and: allocating 100% of its entire net income to New Jersey, but under Section 8, permitting Canon Financial a credit for taxes paid to other jurisdictions. Canon Financial appealed the assessment.

Alternative Apportionment Methodology

In 2016, the Tax Court issued an initial decision in *Canon* finding that the Division's 100% allocation of Canon Financial's income to New Jersey with a credit for taxes paid to other jurisdictions did not reasonably reflect Canon Financial's business activity in New Jersey. As a result, the court returned the case to audit for further consideration of an allocation factor that reasonably reflected Canon Financial's business activity.

After that initial decision, the Division proposed a five-factor allocation method: a double-weighted sales factor; a payroll fraction; a property factor representing Taxpayer's operating assets that it used in its business operations in New Jersey; and a property factor representing Canon Financial's leased assets. Splitting the property factor in two resulted in an increase in Financial's tax from the three-factor apportionment methodology. Canon Financial's operating assets (administrative and warehouse buildings) were nearly all located in New Jersey, so that factor was nearly 100% for the years at issue. Canon Financial leased property to customers throughout the United States, so that factor ranged from 8%–10% during the years at issue. The Division's five-factor method allocated between 40% and 43% of Canon Financial's entire net income to New Jersey—an allocation factor less than the Division's original 100% formula, but greater than Canon Financial's three-factor method, which would have resulted in a 28%–31% allocation factor.

The NJ Tax Court's Decision

The court reasoned that "under the circumstances where a taxpayer's activities are substantially performed within the State and application of the five-factor formula produces tolerant variances over the three-factor formula . . . the Director's exercise of discretion in applying the proposed five-factor formula can be considered fair and proper and does not unreasonably attribute plaintiff's income to the state." (Here, 90% of taxpayer's payroll was in New Jersey. And the five-factor formula produced an increase of the allocation factor by 9%–14% over the years at issue, which the court found "not so distortive as to result in substantial inequity" because 90% of the taxpayer's payroll was in New Jersey.)

However, because the Division applied the five-factor methodology to the taxpayer without going through the rulemaking process, the court struck down the Division's use of the five-factor methodology. As a result, the Canon Financial was entitled to allocate its income using the standard three-factor formula.

9. Tax Court Upholds Division's Use of 25:50:25 Rule to Source Receipts from Messaging Services: *Xpedite Systems, Inc. v. Director*, Docket No. 018847–2010 (N.J. Tax Sept. 5, 2018) involved how receipts from information services are sourced for CBT purposes. Rather than apply the market-sourcing method advocated by the taxpayer or the place-of-performance method advocated by the Division, the court ruled that the receipts could be sourced using a hybrid approach that combines both methods. The court's decision reflects the flexibility of New Jersey's sales-fraction sourcing rules and may provide potential opportunities or exposures for service providers depending on where their employees, equipment, and customers are located.

Background and summary of decision

Xpedite's business involves mass-marketing services. A customer provides Xpedite with an advertising message, which Xpedite then forwards to a list of targeted fax numbers provided by the customer. Although Xpedite's customers were located both within and without New Jersey, Xpedite was based in the state. New Jersey was where Xpedite performed its services and where the tangible and intangible property used to perform its services was primarily located.

During the period at issue, the New Jersey statute provided that services receipts are sourced to New Jersey if the underlying service is "performed within the State." Despite this clear place-of-performance rule, the Division's regulations provide alternative sourcing methods that account for the taxpayer's market.

These alternative methods include the following:

- *Pure market sourcing*. The regulation provides that receipts from long distance telecommunications services are sourced based on where the calls originate.

- *Hybrid method*. Receipts from certain services, including Internet access and ATM processing, are sourced using the so-called "25:50:25 rule." Under this approach, 25% of the receipts are sourced to where the transaction originates; 50% of the receipts are sourced to where the service is performed; and 25% of receipts are sourced to where the transaction terminates.

Xpedite took the position that it was engaged in a telecommunications business. In fact, for sales and use tax purposes, the Division treats Xpedite as a telecommunications provider and requires it to collect tax on its sales as such. Accordingly, Xpedite asserted that its receipts should be sourced for CBT purposes based on the special market-sourcing rule that applies to telecommunications providers. Under this market-sourcing approach, no more than 7% of its receipts were sourced to New Jersey. On audit, however, the Division re-sourced Xpedite's receipts using the 25:50:25 rule, which resulted in 76% of its receipts being included in the sales-fraction numerator. After the taxpayer appealed, the Division argued that up to 100% of Xpedite's receipts should be sourced to New Jersey based on where Xpedite performed its services and maintained its equipment.

The Tax Court upheld the Division's assessment. The court reasoned that:

- The Division's assessments are presumptively correct, and that to overcome an assessment, a taxpayer must provide clear, competent, and cogent evidence. To prevail, the taxpayer must show that the Division relied on an "aberrant methodology."

- Xpedite failed to meet this standard; rather, it merely pointed to an alternative sourcing method set forth in the regulation. The court further noted that Xpedite's proposed method applied only to long distance telephone providers. Because Xpedite's business was providing "mass messaging services via fax, e-mail and voice," the court concluded that the taxpayer's proposed alternative didn't apply.

The Appellate Division affirmed the Tax Court's decision. The Supreme Court of New Jersey denied review.

10. <u>Tax Court Clarifies Scope of Income Tax Addback</u>: In *Rockland Electric v. Director, Division of Taxation* (N.J. Tax April 30, 2018), the Tax Court ruled that taxpayers must add back the New Jersey Transitional Energy Facility Assessment ("TEFA") when computing taxable income for CBT purposes.

Background

The starting point for computing the CBT is a taxpayer's federal taxable income before the subtraction of any net operating loss deduction and special deductions. Under N.J.S.A. 54:10A–4(K)(2)(C), however, state taxes "on or measured by profits or income, or business presence or business activity" must be added back. The issue in *Rockland Electric* was whether the TEFA was a tax subject to addback. The TEFA was a temporary surcharge imposed by New Jersey on utilities following energy deregulation. Prior to its phase out in 2013, the TEFA was designed to offset the revenue loss that resulted from New Jersey's elimination of gross receipts and franchise taxes on utilities. When the TEFA was enacted, the legislature added a separate statutory provision to the CBT that deemed the TEFA to be a "state tax" and that required the amount paid under TEFA to be added back to entire net income "pursuant to" N.J.S.A. 54:10A–4(K)(2)(C).

Following the enactment of the TEFA, the Tax Court held that the only New Jersey tax required to be added back under N.J.S.A. 54:10A–4(K)(2)(C) was the CBT itself. Accordingly, Rockland argued that the TEFA was distinct from the CBT and thus not subject to addback.

Decision and Takeaways

The Tax Court disagreed with Rockland. Based on the plain language of the TEFA statute and the clear legislative intent, the court ruled that that the TEFA had to be added back to a taxpayer's entire net income. Because the TEFA expired in 2013, this is not a go-forward issue. Nonetheless, the court's analysis may be instructive for other appeals that involve issues of statutory construction.

- *Ambiguous statutes not construed in favor of taxpayers*. Despite prior case law, the Tax Court found that it did not have to construe any doubts in favor of the taxpayer with respect to questions of statutory interpretation. The decision illustrates that taxpayers should not expect much deference from the court—especially if there is any evidence of legislative intent.

- *Statute trumps case law*. The court placed more weight on the plain language of the statute rather than subsequent case law. After the TEFA was enacted, the Tax Court clarified that only income-based taxes had to be added back under the general CBT addback provisions. In effect, the court ignored this case law limiting the scope of the statutory addback in order to effectuate what it considered to be the legislature's intent.

The New Jersey Superior Court, Appellate Division, upheld the Tax Court's decision.

11. Foreign-Source Income Not Taxable: The Tax Court ruled that a foreign corporation was not subject to CBT on its income from sources outside the United States. *See Infosys Limited of India, Inc. v. Director, Division of Taxation*, Decision on Motion for Reconsideration, Docket No. 012060–2016 (N.J. Tax Mar. 19, 2018).

Background and Decision

Infosys is a multinational corporation headquartered and incorporated in India. It performed IT services in New Jersey and reported its CBT by including its worldwide income in the tax base. Infosys subsequently amended its CBT-100 returns to exclude its foreign-source income. (That income was not subject to federal income tax under IRC § 881 or the U.S.-India tax treaty.)

The starting point for computing a taxpayer's CBT is federal taxable income before the net operating loss deduction and special deductions. Last November, the Tax Court ruled that Infosys didn't have to include foreign-source income in its CBT base. The court reasoned that the starting point for computing CBT is the taxpayer's taxable income as reported on line 28 of its federal income tax return (or line 29 for a foreign corporation that files its federal income tax return on Form 1120-F) and that nothing in the statute requires the addition of foreign-source income in computing the CBT base. *See* Decision on Motion for Summary Judgment, Docket No. 012060–2016 (N.J. Tax Nov. 28, 2017). As a result, the court ordered the New Jersey Division to issue Infosys a refund.

The Division filed a motion for reconsideration. The court—once again—denied the Division's motion, ruling that the CBT statute didn't require the add-back of foreign-source income that is excluded from federal taxable income under the terms of a treaty.

On July 1, 2018, the legislature amended a statutory adjustment to entire net income—previously requiring taxpayers to addback amounts of any "specific exemption" under any law of the United States imposing any tax on or measured by income of corporations.

The legislature deleted the word "specific." The Division may take the position that this statutory change supersedes the decision in *Infosys*. That is, prior to the statutory change, a "specific exemption" referred to an exact dollar amount exempt under law. (Thus, the reason the Division's argument that foreign source income was a "specific exemption" failed is because under the Internal Revenue Code, foreign source income does not refer to a "specific" dollar amount.) Whereas now, the amended statute requires taxpayers to addback any "exemption" of federally excluded income (which would appear to include the IRC's treatment of foreign-source income).

This case settled for nearly full relief.

12. Partnerships not Taxable Entities in New Jersey: The Tax Court issued yet another decision involving the taxation of partnerships and their nonresident limited partners in *National Auto Dealers Exchange, L.P. v. Director, Division of Taxation*. Docket No. 000028–2014 (N.J. Tax Feb. 27, 2018). The court found that a partnership is not a taxable entity for purposes of New Jersey's CBT.

The court's decision is consistent with the result in a prior Tax Court decision, *BIS L.P., Inc. v. Director, Division of Taxation* (see I.B.25 for more detail on the *BIS* case). But the court's reasoning in *National Auto Dealers* goes far beyond its prior guidance and creates further uncertainty concerning the application of statutory amendments made in 2014.

Background

National Auto Dealers Exchange, L.P. ("NADE") was a Delaware limited partnership that did business in New Jersey. Its limited partner, Manheim NJ Investments, Inc. ("Manheim"), provided NADE with the Division's Form NJ–1065E, consenting to nexus with New Jersey. Consistent with that form, Manheim filed CBT returns and paid tax on its distributive share of NADE's income. Manheim subsequently filed a refund claim in light of the appellate court's decision in *BIS*, which held that a corporate limited partner was not subject to CBT if its only connection to the state was through a non-unitary limited partnership.

After Manheim asserted that it lacked nexus with New Jersey, the Division issued an assessment to NADE. NADE protested the assessment, arguing that its CBT obligations were extinguished when it filed a copy of Form NJ–1065E with its original return. According to NADE, it was improper to assess tax on the partnership just because the partner files a refund claim.

Court's Decision

The court agreed with NADE and rejected the Division's assertion that partnerships are taxable entities under the CBT statute. Reading the statute as a whole, the court reasoned that partnerships are not defined as taxable entities even if they are required to withhold tax payments on behalf of nonresident partners in certain circumstances. N.J.S.A. 54:10A–2. As a result, the court granted NADE's motion for summary judgment and removed the Division's assessment.

The Tax Court denied the Division's motion for reconsideration on June 13, 2018. The Division did not appeal the Tax Court's decision.

13. Reed Smith Wins Toyota Credit Case at Appellate Division: On October 23, 2017, in a corporation business tax case handled by Reed Smith, the Appellate Division affirmed a 2014 Tax Court decision finding that Toyota Motor Credit Corporation ("Toyota Credit") was entitled to recompute its tax by reducing gains on the sale of depreciated property.

The Appellate Division unanimously affirmed the Tax Court's ruling that Toyota Credit was entitled to increase its tax basis in leased vehicles to the extent that prior-year depreciation deductions had not produced any tax benefit. In the years leading up to the tax years at issue, Toyota Credit had taken depreciation deductions on the leased vehicles. Those depreciation deductions had not reduced Toyota's actual New Jersey tax liability because it had been in a loss situation.

In 2003 and 2004, Toyota Credit sold the leased vehicles. Because Toyota Credit's tax basis in the vehicles had been reduced by depreciation deductions, it was less than the sale proceeds. So, when Toyota Credit sold the vehicles, the depreciation recapture resulted in a significant gain for federal income tax purposes.

In support of Toyota Credit's position, Reed Smith lawyers cited the CBT definition of entire net income, which imposes tax only on transactions that result in actual "gain," "profit," and "net income." Reed Smith lawyers relied upon New Jersey precedent prohibiting the assessment of New Jersey net income tax on "phantom income." The Division argued unsuccessfully that the precedent was inapplicable since it involved only individual taxpayers. The Appellate Division agreed with the Tax Court that the prohibition of tax on "phantom income" applied equally to the net income tax imposed on corporate taxpayers. This enabled Toyota Credit to increase its tax basis in the vehicles by the amount of the depreciation deductions that generated useless net operating losses, which reduced Toyota Credit's gains for New Jersey purposes.

The Division did not appeal the Appellate Division's decision in *Toyota Motor Credit Corporation*.

14. Limited Partner has Nexus with New Jersey: The Tax Court ruled in *Preserve II, Inc. v. Director, Division of Taxation* that a limited partner's interest in a partnership doing business in New Jersey created nexus for CBT purposes. Docket No. 010921–2013 (N.J. Tax Oct. 4, 2017). The decision creates uncertainty for taxpayers who had been relying on *BIS LP, Inc. v. Director, Division of Taxation*, a 2011 decision issued by New Jersey's appellate court. Both cases raised similar issues and had similar facts, yet the Tax Court ruled against the limited partner in *Preserve II*. *See* I.B.25 below for a full discussion of the *BIS* case.

Background

The case involved an out-of-state limited partner (Preserve) with a 99% interest in two partnerships that conducted homebuilding activities in New Jersey. The partnership agreements gave general partners (but not Preserve) "full, exclusive and absolute" authority to manage and control the partnerships. But Preserve and the general partners shared corporate officers, accounting and tax services, banking facilities, and other functions. The limited partner, general partners, and the underlying partnerships were indirectly owned by the same corporate parent.

Preserve argued that it lacked income tax nexus with New Jersey because it was merely a passive investor in the partnerships. The Division countered that Preserve and the partnerships were unitary because of the close relationship and shared functions between Preserve and the general partners.

Prior Nexus Guidance for Limited Partners

The Division's regulation provides that a limited partner has nexus with New Jersey if the limited partner: is also a general partner; takes an active part in the control of the partnership; has property in New Jersey; has payroll in New Jersey; or is integrally related with the business of the partnership. *See* N.J.A.C. 18:7–7.6(c). The New Jersey courts analyzed this regulation in *BIS LP, Inc.* 25 N.J. Tax 88 (N.J. Tax 2009), *affirmed* 26 N.J. Tax 489 (N.J. Super. Ct. App. Div. 2011). Like *Preserve II*, the *BIS LP* case involved a corporate limited partner whose only connection to New Jersey was a 99% interest in a partnership doing business in the state. But the Division had stipulated that the limited partner in *BIS LP* didn't have the right to participate in the management of the partnership, and that the limited partner and partnership were not in the same line of business. Accordingly, *BIS LP* held that the corporate partner was merely a passive investor and lacked nexus with New Jersey.

In a subsequent case, *Village Super Market*, the Division adopted a different litigation strategy. *See* 27 N.J. Tax 394 (N.J. Tax 2013), *affirmed* 2015 WL 998622 (N.J. Super. Ct. App. Div. March 9, 2015). Rather than stipulate to the facts like it did in *BIS L.P.*, the Division forced the taxpayer to participate in a multi-day trial. After a lengthy examination of the facts, the court determined that the corporate lines between the limited partner and partnership were so blurred that the limited partner had physical presence in New Jersey. After its success in *Village Super Market*, the Division followed a similar strategy in *Preserve II*.

Tax Court's Decision in *Preserve II*

In *Preserve II*, the Tax Court distinguished prior New Jersey precedent concerning out-of-state limited partners. In an opinion that included a lengthy discussion of the facts, Judge Sundar noted that the limited partner and the general partners had overlapping officers and key management personnel. She further noted that the limited partner had made a capital contribution of only $9,900, and found no credible evidence that the officers acted for the partner in a completely passive role of watching that contribution grow. The court also noted that some of the individual officers weren't aware of the limited partner's separate existence.

In the absence of any evidence of finite lines between the limited partner and the partnerships' home-building operations, the court concluded that Preserve was not a passive investor and thus had nexus with New Jersey.

The Appellate Division affirmed the Tax Court's decision in 2020 for substantially the same reasons as the Tax Court.

15. <u>Tax Court Issues Decision on Jeopardy Assessments</u>: The Tax Court issued a decision concerning jeopardy assessments in *Procacci Brothers Sales Corporation v. Director, Division of Taxation*. Docket No. 015626–2014 (N.J. Tax Aug. 30, 2017). The Division determined that a taxpayer—who had not filed CBT returns—was subject to CBT for 2001–2005. The Division then issued a jeopardy assessment, which the taxpayer paid immediately in order to obtain the release of its property. Thereafter, the taxpayer protested the jeopardy assessment.

    The taxpayer made two arguments before the Tax Court: that it did not timely protest the jeopardy assessment; and, even if taxpayer's protest was timely, its payment of the tax from the jeopardy assessment barred it from filing the protest.

    The court rejected both arguments. In doing so, the court first noted that the taxpayer's protest was clearly timely because protests of assessments follow the postmark rule in New Jersey, and the postmark on the envelope was "well within the prescribed 90-day" appeal period.

The court also found no support for the taxpayer's second argument—that payment of tax bars a protest.

Procedurally, the case is odd because taxpayers typically argue that their appeals are timely. Here, the taxpayer argued the opposite in an attempt to prevent the Division from assessing tax for the years covered by the jeopardy assessment.

In addition to an odd fact pattern, the decision does provide some important reminders for New Jersey taxpayers: protests follow the postmark rule in New Jersey; and if you have a jeopardy assessment, you must protest to preserve your appeal rights

16. Tax Court Issues Taxpayer Favorable Decision in Royalty Addback Case: New Jersey requires taxpayers to add back otherwise deductible intangible expenses and costs "directly or indirectly paid, accrued or incurred to" related members unless an exception applies. *See* N.J.S.A. 54:10A–4.3b. The court discussed one exception—the unreasonableness exception—when permitting a taxpayer to deduct intangible expenses and costs it paid to its parent in *BMC Software, Inc. v. Director, Division of Taxation*. Docket No. 000403–2012 (N.J. Tax May 24, 2017).

Facts of Case

The parent is in the business of developing software programs. The taxpayer—a wholly owned subsidiary of the parent—entered into an agreement with the parent to distribute the parent's software.

Under the agreement, the taxpayer had to pay to its parent a percentage of the revenue it earned from distributing the software as a royalty. The rate was determined by an arm's length royalty rate study.

On the parent's tax returns for the tax years at issue, it reported zero entire net income because its net operating losses and dividend deductions offset its otherwise positive taxable income.

By contrast, the taxpayer reported positive entire net income in each of the years at issue. The taxpayer deducted the majority of the royalty payments in each of the years at issue by claiming an exception to addback. Taxpayer claimed that its parent included the royalty amounts in its entire net income calculation, and as a result, adding back the royalty payments to the taxpayer's entire net income would be unreasonable.

The Division disallowed the taxpayer's deduction of the royalty expenses. The Division's principal reason for the disallowance was that Parent did not pay tax on the royalty income.

ReedSmith

NJ CBT—Judicial Developments

The Tax Court's Decision: Taxpayer Entitled to Exception to Addback

The court began its analysis by noting that the Legislature codified the addback provisions as "loophole closers"—a way for the Division to tax corporations with activity in the state that otherwise had avoided taxation. Yet, the court also stated that the legislature still allowed deductions for royalties paid to related members in non-tax avoidance situations.

And the court found this to be a non-tax avoidance situation. Specifically, the court found that it would be unreasonable to add back the royalties that the taxpayer paid to its parent because the taxpayer's agreement with its parent was nearly identical to agreements that its parent entered with third parties. Therefore, the agreement with its parent was arm's length. (The taxpayer made six other arguments as to why the addback of royalties would be unreasonable. The court rejected each of those arguments).

The decision is significant for several reasons. First, it provides taxpayers with guidance on royalty addback and how to meet the unreasonableness exception to addback. Here, the taxpayer was able to meet the unreasonableness exception by showing that the royalty rate it paid was similar to the rate that its parent entered with other third parties. Second, after the decision, if a taxpayer has a transfer pricing study—prepared in a similar fashion to the taxpayer's study here—the onus is on the Division to rebut that study. Finally, the court rejected the Division's argument that taxpayers can only qualify for an addback exception if tax is paid on the income stream. In doing so, the court largely relied on prior court precedent involving interest addback (for that prior precedent, *see* I.B.24 below).

(Under the Division's theory, taxpayers wouldn't be entitled to an exception to addback if, like here, "tax" isn't paid on the income stream because income is offset by losses).

17. Tax Court Issues Nonbusiness Income Decision: In *Xylem Dewatering Solutions, Inc. v. Director, Division of Taxation*, the issue was whether the gain from a deemed asset sale under IRC § 338(h)(10) recognized by a New Jersey-based S corporation was nonoperational (i.e., nonbusiness) income and thus 100% allocable to New Jersey, rather than subject to apportionment. Applying precedent developed under New Jersey's CBT, the Tax Court ruled that the deemed asset sale and liquidation resulted in nonbusiness income, and that New Jersey had the right to tax 100% of the gain. Docket No. 011704–2015 (N.J. Tax .April 7, 2017).

The decision is a warning for New Jersey-based taxpayers: the court concluded that the Division (not just taxpayers) can take advantage of nonbusiness income principles.

But the decision is also relevant for out-of-state taxpayers.

In ruling in favor of the Division, the court stated that there "is no constitutional requirement" that income from an asset sale and complete liquidation be apportioned. According to the court, such income can be allocated 100% to the domiciliary state. Presumably, the court must have thought that the gain was not merely nonbusiness income, but also nonunitary with the taxpayer's regular trade or business. This follows from U.S. Supreme Court case law and the U.S. Constitution, which "precludes one state from characterizing as 'nonbusiness' income, and taxing on an unapportioned basis, income that is taxable in other states on an apportioned basis." Based on this principle, New Jersey would have been able to tax 100% of the taxpayer's gain in Xylem only if such gain were nonunitary with the S corporation's regular trade or business and, thus, nontaxable by any other state.

The *Xylem* decision provides a potential opportunity for out-of-state taxpayers who dispose of their assets pursuant to a complete liquidation. New Jersey narrowed its nonbusiness income definition in 2014: gain from the sale of property is now subject to apportionment as long as "the acquisition, management, or disposition" of the property constitutes an integral part of the taxpayer's regular trade or business. Beginning in 2014, therefore, it has been difficult for a taxpayer to claim nonbusiness income treatment on the sale of assets that were previously used in the taxpayer's business operations. But under *Xylem*, a taxpayer doesn't need to rely on the statutory definition of nonbusiness income to exclude liquidation gains from its apportionable tax base. In effect, the court has established a bright-line test that the gain from an actual or deemed sale of assets, followed by a complete liquidation, is nonunitary and, thus, not subject to apportionment—regardless of whether the gain constitutes nonbusiness income under the statute.

Accordingly, out-of-state taxpayers can take the position that any gains related to a complete liquidation must be excluded from their New Jersey tax base.

The Appellate Division upheld the Tax Court's decision.

18. <u>60% Exemption for Holding Companies and Limited Partners</u>: In *Manheim NJ Investments, Incorporated v. Director*, Docket No. 015083–2014 (N.J. Tax Feb. 27, 2017), the taxpayer argued that it qualified as an "investment company" under N.J.S.A. 54:10A–4(f), which requires at least 90% of the taxpayer's business to relate to investment activities such as holdings, investing and reinvesting in stocks, bonds, notes, mortgages, debentures, patents, patent rights and other securities.

Investment companies are taxed only upon 40% of their entire net income. (The taxpayer's apportionment factor would have otherwise exceeded that percentage.) The taxpayer was a limited partner in a partnership doing

business in New Jersey and conducted no other activity. The Division's regulation, however, excluded from the definition of "qualifying investments activities" investments in non-publicly traded pass-through entities.

The court struck down the Division's regulation, holding that a passive investment in a partnership must be treated the same as stock for purposes of determining whether a holding company qualifies for exemption as an investment company.

The decision presents an opportunity for multistate taxpayers who invest in partnerships. New Jersey's investment company exemption is unconstitutional because it violates internal consistency. Multistate investment companies whose New Jersey apportionment factor is above 40%, therefore, are entitled to reduce their tax by 60%—just like a purely intrastate taxpayer.

This case has been settled.

19. File Federal Change with New Jersey? Apportionment Factor Must Also be Changed—Even if Statute of Limitations is Otherwise Closed: On February 22, 2017, the Tax Court issued its decision in *General Foods Credit Investors # 3 Corporation v. Director*, Docket No. 011330–2015. The primary issue involved whether certain sale-leaseback assets belonged in the taxpayer's property factor for CBT purposes. The court held that those assets should not be in the taxpayer's property factor because the taxpayer was deemed by the Internal Revenue Service not to be the owner of those assets.

In addition, the court held that a taxpayer's apportionment factor would be adjusted within four years of a federal change—even if the statute of limitations was otherwise closed. This conflicts with the Division's longstanding policy that a federal change reopens the statute only with respect to the taxpayer's entire net income. More recently, however, the Division has proposed amendments to its regulation that are consistent with the rule in *General Foods*. *See* 49 N.J.R. 52(b).

Accordingly, if your company reported a federal change to New Jersey and computed the resulting tax based on its apportionment factor as originally filed, you may have a refund opportunity based on making a corresponding adjustment to your apportionment factor. Of course, if the federal change increases your New Jersey apportionment, you may have an audit exposure.

On February 15, 2018, the Tax Court dismissed the *General Foods* case upon the taxpayer's request to withdraw its complaint.

20. <u>Throwout Doesn't Apply to P.L. 86-272 Receipts</u>: In *Elan Pharmaceuticals, Inc. v. Director, Division of Taxation*, Docket No. 010589–2010 (N.J. Tax Feb. 6, 2017), the taxpayer contested that throwout did not apply to receipts from sales of tangible personal property shipped from locations outside New Jersey to states in which the taxpayer was immune from tax under P.L. 86–272. The court agreed, ruling that the Division had improperly excluded receipts sourced to states in which the taxpayer was P.L. 86–272 protected.

    Under the court's reasoning, the only receipts subject to throwout are receipts shipped from New Jersey to states in which the taxpayer has no physical presence or is immune from income tax based on P.L. 86–272. (We think even that narrow application of throwout is overbroad; rather, based on the plain language of the statute, throwout is inapplicable to any sales of tangible personal property, as long as the taxpayer has some physical presence in both the origin state and the destination state, regardless of P.L. 86–272.)

    Although the throwout rule expired for tax years after 2010, many taxpayers have pending corporation business tax audits or appeals that include tax years for which throwout remains applicable. If your company was P.L. 86-272 protected and excluded any receipts from its sales-fraction denominator based on throwout, it is entitled to a refund.

21. <u>Interest and Fees from Credit Cards</u>: In *Bank of America Consumer Card Holdings v. Director*, Docket No. 000387–2012 (N.J. Tax Oct. 7, 2016), the taxpayer issued consumer credit cards and received interest, interchange fees, and service fees in connection with that business. The issue was whether those types of receipts had to be sourced to New Jersey if received from New Jersey cardholders. (The taxpayers had already conceded nexus.)

    With respect to interest, the Tax Court held that interest from New Jersey cardholders was earned within New Jersey and thus includable in the sales-fraction numerator. The court further concluded that interchange fees were essentially the same as interest; therefore, these fees were also includable in the sales-fraction numerator to the extent received from New Jersey cardholders.

Interestingly, for service fees, the court ignored the plain language of the statute (which sources service receipts based on performance). The court instead applied the "catch-all rule" of N.J.S.A. 54:10A–6, which includes receipts in the numerator to the extent they are "earned within the State." Based on this rule, the court concluded that service fees from New Jersey cardholders were earned entirely in New Jersey. Yet despite this holding, the court included only 50% of those service fees in the numerator because of the Division's "25:50:25" regulation. The court declined to invalidate the regulation but noted that the Division could rescind the regulation going forward.

The taxpayer withdrew the case after appealing to the Appellate Division.

22. Proceeds from Sale of Mortgage Loans Constitute Business Income: In *Flagstar, FSB v. Director, Division of Taxation*, Docket No. 019335–2010 (N.J. Tax Mar. 22, 2016), the taxpayer was a mortgage bank that originated loans, and acquired loans involving New Jersey borrowers. Flagstar held the loans for only a short time, then typically sold them to government-sponsored entities (e.g., Fannie Mae). Flagstar retained loan servicing rights and earned income from servicing the loans that it sold.

Although Flagstar was commercially domiciled in Michigan, Flagstar operated offices at several locations in New Jersey. Also, Flagstar had a few executives in New Jersey who developed relationships with correspondent lenders and mortgage brokers. Loans were serviced from Flagstar's Michigan headquarters.

The main issue in the case was whether the following receipts are sourced to New Jersey and, thus, includable in the sales-fraction numerator: (i) interest and origination fees on loans not originated by (but acquired by) Flagstar; (ii) proceeds on the sales of loans to government sponsored enterprises; and (iii) fees from loan servicing and proceeds from sales of loan servicing rights. The court concluded that the interest and origination fees on the loans and the proceeds on the sales of the loans were sourced to New Jersey because Flagstar's business activities in New Jersey included the origination and acquisition of mortgage loans to New Jersey borrowers. The court concluded that the loan servicing fees and proceeds were excluded from the numerator because the services were performed in Michigan.

The Tax Court's decision in *Flagstar* leaves taxpayers with guidance on sourcing and an opportunity to take positions on their returns. The decision does not apply to taxpayers with no New Jersey operations that earn interest income—even if the intangible receipts are from a New Jersey-based payor. The *Flagstar* case does not involve nexus either—Flagstar conceded nexus, presumably because of its in-state physical presence.

23. <u>Cancellation of Debt Income and Consolidated Companies</u>: *MCI Communication Services, Inc. v. Director*, Docket No. 013905–2010 (N.J. Tax Jul. 20, 2015), involved a taxpayer that was a subsidiary of MCI and filed as part of the MCI consolidated group for federal income tax purposes. Upper tier members of the group had cancellation of indebtedness income, which was excluded from federal taxable income because it was recognized in connection with bankruptcy proceedings. The upper tier members had limited tax attributes, so under the federal consolidated return rules, the taxpayer was required to adjust its own tax attributes (specifically, the taxpayer reduced the basis of certain assets, thereby reducing its depreciation expense for federal income tax purposes).

    Because New Jersey was a separate-company state for the year at issue, the taxpayer adjusted its line 28 federal taxable income (the starting point for computing CBT) to reverse the depreciation adjustment required under the federal consolidated return rules. Despite a long line of New Jersey case law that prohibits consolidated returns, the Tax Court determined that the taxpayer was required to follow the consolidated return rules. Although that resulted in a tax increase in MCI's case, other situations may provide taxpayers with potential refund opportunities. For example, following the court's logic, the consolidated return rules under Treas. Reg. § 1.1502–32 apply and, therefore, a parent's basis in its subsidiary stock should be increased to the extent of the subsidiary's undistributed earnings.

    The Superior Court of New Jersey, Appellate Division, affirmed the Tax Court's decision on June 15, 2018—for substantially similar reasons as the Tax Court. The Supreme Court of New Jersey denied certification.

24. <u>Intercompany Interest</u>: New Jersey requires an addback of interest paid to an affiliate unless an exception applies. One of the exceptions is an "unreasonableness" exception. The Division has interpreted that exception to apply only if the taxpayer demonstrates that tax was paid to another state on the interest received by the affiliate—if that criterion isn't met, the Division refuses to look further. The New Jersey Tax Court determined that the statute does not require a tax to be paid to qualify for the "unreasonableness" exception. By refusing to look beyond that criterion, the Tax Court determined that the Division abused its discretion. Therefore, the court ordered the Division to allow the deduction. *Morgan Stanley & Co. v. Director, Division of Taxation*, 28 N.J. Tax 197 (N.J. Tax 2014). The *Morgan Stanley* decision was not appealed by the Division.

    But the court has also recently ruled that a taxpayer could not deduct interest that it paid to its corporate parent. In that case, the corporate parent was able to obtain favorable interest rates from third-party bondholders.

    So, instead of the taxpayer issuing corporate debt, its parent issued debt and transferred the funds to the taxpayer. In exchange, the taxpayer provided

its parent with a promissory note paying interest at a rate equal to the rate its parent paid the third-party bondholders. In determining that the taxpayer did not qualify for the "unreasonable exception" to addback, the court emphasized that the taxpayer had no obligation to its parent or the bondholders to make interest payments on its parent's debt. *See Kraft Foods Global, Inc. v. Director*, Docket No. 017974–2009 (N.J. Tax April 25, 2016).

The Appellate Division, affirmed the Tax Court's decision in *Kraft Foods Global* on May 17, 2018. The Supreme Court of New Jersey denied certification.

25. Limited Partner Nexus: BIS LP, Inc. was a 99% limited partner in a partnership ("Solutions"). Solutions conducted a banking information processing and outsourcing business in New Jersey. But BIS itself had no property or payroll in New Jersey; its only connection to New Jersey was its interest in Solutions. BIS, as the limited partner, was not permitted to participate in the active management of Solutions. Rather, Solutions' business was managed by the general partner, who was also the 100% owner of BIS.

The Tax Court and Appellate Division held that BIS and Solutions were not integrally related, and that BIS lacked sufficient constitutional presence to be subject to tax in New Jersey. *BIS LP, Inc. v. Director,* 25 N.J. Tax 88 (N.J. Tax 2009); *aff'd*, Docket No. A–1172–09T2 (N.J. Sup. Ct. App. Div. Aug. 23, 2011).

Solutions had paid a withholding tax on BIS' share of its income. On remand, the Tax Court held that the limited partner, BIS, should receive the refund on account of the tax paid on its behalf by Solutions. *See BIS LP, Inc. v. Director, Division of Taxation*, Docket No. 007847–2007 (N.J. Tax Oct. 25, 2012). The Appellate Division affirmed in an April 11, 2014, order. The case is now final.

Meanwhile, the Division won a case in Tax Court by proving, through a multi-day trial, that a limited partner and limited partnership were operationally integrated. Thus, the limited partner had nexus. *Village Supermarkets of PA, Inc. v. Director, Division of Taxation*, Docket No. 021002-2010 (N.J. Tax Oct. 23, 2013). This case has been settled on appeal.

Therefore, corporate partners whose only contact with New Jersey is a limited partnership interest and that have paid CBT may still be entitled to a refund—especially if the limited partner is merely a holding company or is not otherwise operationally integrated with the limited partnership.

26. Tax Court Finds Taxpayer's $4.3M Assessment Protest Untimely: The Tax Court issued a decision in *Merrill Lynch Credit Corporation v. Director,*

Division of Taxation, Docket No. 004230–2017 (N.J. Tax Sept. 28, 2018), finding that the taxpayer failed to protest timely a CBT notice of assessment. As a consequence, the court determined that the taxpayer failed to preserve appeal rights related to a $4.3 million assessment.

Background

The taxpayer merged into another corporation. After the merger, the Division conducted an audit of the taxpayer. The taxpayer consented to a waiver of the statute of limitations under the taxpayer's pre-merger name, Merrill Lynch Credit Corporation. When signing the consent, a corporate officer noted that the consent included the taxpayer's pre-merger name and address. (The merger occurred four years before the consent was signed.) As a consequence, when the Division issued its notice of assessment—which it sent through certified mail—it sent it to the address listed on the consent. Taxpayer did not appeal the notice within the 90 day time period for protesting a notice of assessment in New Jersey.

After the Division began collection activities, the taxpayer filed a protest arguing that: the notice of assessment was addressed to the wrong entity; and the notice was sent to the wrong address. The Division cross-moved for summary judgment, asserting that its notice was valid.

Summary of Decision

The court rejected both of the taxpayer's arguments. Here's why:

Notice Sent to Wrong Entity: The statute requires that the Division mail a notice of assessment "to the person for whom it is intended." N.J.S.A. 54:50–6(a). The taxpayer alleged that the Division should have named the corporation with which the taxpayer merged on the notice, not the taxpayer's former corporate name. The court found this argument "disingenuous" because a corporate officer of the taxpayer signed a consent to extend the audit and statute of limitations—four-years after the merger—listing the taxpayer's former name on the consent: Merrill Lynch Credit Corporation.

Sent to Incorrect Address: The statute states that the Division may personally serve or mail a notice "to the person for whom it is intended, addressed to such person at the address given in the last report filed by that person." Taxpayer argued that the Division's notice listed the wrong zip code on its certified mailing. The court rejected Taxpayer's argument because Taxpayer's own records indicated that it received the notice of assessment.

C. Administrative Developments

1. Market Sourcing for Services: Effective for tax years ending on and after July 31, 2019, the legislature amended the CBT to require taxpayers to source service receipts on a market basis. The default rule for services received by an individual customer is that the benefit of the service is deemed to be received at a customer's billing address. P.L. 2018, c.48. The Division of Taxation (the "Division") published rules concerning market sourcing on September 8, 2020. *See* N.J.A.C. 18:7–8.10A.

2. Combined Reporting Technical Bulletins: Thus far, the Division has issued the following technical bulletins on New Jersey's switch from separate-company to combined reporting. See below for a summary of each of those technical bulletins. *See, e.g.*, P.L. 2018, c. 48 (July 1, 2018); P.L. 2018, c. 131 (Oct. 4, 2018). (For more background on those changes, see Section I.A.)

Technical Bulletin 84 ("TB-84"): In this TB, the Division provides a broad overview of the legislative changes to the CBT. In each of the following TBs the Division provides guidance on narrow issues from the legislative changes.

Technical Bulletin 85 ("TB-85"): TB-85 concerned how to include GILTI and FDII in the income tax base and apportionment. The Division has since recalled TB-85, as obsolete, and has replaced TB-85 with TB-92 (discussed below).

Technical Bulletin 86 ("TB-86"): TB-86 has several significant takeaways:

- **Minimum tax.** Some observers had warned that the Division might broadly construe the statute and require every member of a combined group filing in New Jersey to pay the $2,000 minimum tax—even non-corporate members and members that didn't have independent nexus with the state. For a combined group with many members, this could have resulted in millions of additional tax liability each year. Such an interpretation would have raised serious constitutional concerns and contradicted the legislative intent.

  Fortunately, in TB-86, the Division clarified that the minimum tax applies only to a member of a combined group if that particular member has nexus with New Jersey. The Division further clarified that the minimum tax doesn't apply to disregarded entities or entities that are treated as partnerships for federal income tax purposes.

- **P.L. 86–272.** TB-86 effectively eviscerates the immunity provided by P.L. 86–272, which prohibits a state from imposing income tax

on an entity whose only activity in the state involves the solicitation of sales of tangible personal property. The bulletin states that if one member of a group has nexus and is subject to tax, "no member that has nexus with New Jersey may claim P.L. 86–272 protection." In other words, the New Jersey sales of a member that was immune from CBT prior to combination are expected to be included in the sales-fraction numerator used to apportion the income of the combined group. The Division's position has constitutional problems and may violate the plain language of the statute. If a member of your combined group otherwise qualifies for immunity under P.L. 86–272, you may want to consider these potential challenges and pay no more than the $2,000 minimum tax for that member.

Technical Bulletin 87 ("TB-87"): TB-87 addresses New Jersey's conformity to IRC § 163(j) and the application of the federal consolidated return rules to the CBT.

- **IRC § 163(j).** Under IRC § 163(j), as amended by the Tax Cuts and Jobs Act, the deduction for business interest is limited to the sum of the taxpayer's: business interest income; 30% of adjusted taxable income; and floor plan financing interest. In Notice 2018–28, the IRS stated that it intends to apply the business interest limitation rules at the level of the consolidated group.

  In response to the Tax Cuts and Jobs Act, the New Jersey Legislature amended the CBT to provide that the interest deduction limitation in IRC § 163(j) "shall apply on a pro-rata basis." N.J.S.A. 54:10A–4(k)(2)(K). The statute, however, didn't define "pro-rata." (Further complicating matters, New Jersey also adopted combined reporting.)

  To provide taxpayers with guidance on how to allocate the federal limitation to members of a federal combined group for CBT purposes, the Division issued TB-87. In that guidance, the Division explains that taxpayers should report the interest expense that they report for federal purposes—regardless of whether the CBT reporting period is separate or combined, or whether differences exist between the federal and New Jersey combined group.

- **Federal Consolidated Return Rules.** In TB-87, the Division also states that in *MCI Communication Services, Inc. v. Director, Division of Taxation*, it "successfully litigated" the principle that "a taxpayer's entire net income as reported on a federal consolidated return must match the taxpayer's entire net income on line 28." 2015 WL 4537743 (N.J. Tax July 20, 2015). (In *MCI*, the taxpayer reduced its depreciation deductions for federal income tax purposes, as a result of the application of the consolidated return rules to cancellation of indebtedness income. For CBT purposes, the taxpayer claimed the disallowed depreciation deductions because of a New Jersey regulation permitting taxpayers to compute their tax as if they had filed their federal return on a separate-company basis. N.J.A.C. 18:7–11.15. The Tax Court ruled in favor of the Division, disallowing the depreciation deductions, because the New Jersey statute does not permit an adjustment to entire net income as a result of cancellation of indebtedness.)

  The Division's statement that it "successfully litigated" the principle that a taxpayer's entire net income as reported on a consolidated return must match the taxpayer's entire net income reported on line 28 affects New Jersey separate reporting and combined reporting years.

  For open separate reporting years, if deferring intercompany gain or increasing the basis in the stock of a disposed-of subsidiary under the consolidated return regulations is beneficial to taxpayers in computing their CBT, then they should rely on TB-87 to do just that. For combined reporting years, the New Jersey Legislature specifically incorporates the deferral of intercompany gain. However, the legislature did not incorporate any other provisions from the consolidated return regulations. If beneficial, taxpayers can rely on TB-87 to apply those other consolidated return regulation provisions to their CBT computations.

Technical Bulletin 88 ("TB-88"): TB-88 addresses GILTI and related-party addbacks.

- **GILTI.** The Division states that if a taxpayer includes a controlled-foreign corporation ("CFC") that generates GILTI income in its New Jersey combined return (through a group election), then the group should exclude any GILTI income from the CFC that was already included in a group member's federal tax base.

- **Related-Party Addbacks.** For separate-company reporting years, taxpayers must add to their entire net income interest and royalties paid to related parties. For combined reporting years, these addbacks do not apply to members of a combined group.

  The statute does not address what occurs when related members are part of different New Jersey combined groups. The Division provides guidance on that scenario in TB-88. In those instances where related members are not part of the same combined group, the Division states that it will allow members to claim an exception to addback. Further, in circumstances where a CFC that generates GILTI is not part of a related member's combined group, the Division may also permit an exception to addback for expenses related to payments the related member makes to the CFC.

Technical Bulletin 89 ("TB-89"): TB-89 addresses New Jersey combined group elections (water's edge, affiliated group, and worldwide). The bulletin is consistent with the statute. Moreover, the Division provides additional guidance on issues the legislature referenced in the statute for the water's edge and affiliated group election.

- **Water's Edge.** The water's edge group includes members that earn more than 20 percent of their income from intangible property and service activities. The statute does not define "intangible property and service activities." TB-89 states that "intangible property and service activities" include "management fees and other intercompany service fees for managing, licensing, intellectual property defense, or other such fees or payments related to the intangible property as well as certain research and development payments."

- **Affiliated Group.** The statute defines the affiliated group by reference to IRC § 1504 and includes all domestic corporations. TB-89 states that taxpayers can also include in the affiliated group corporations incorporated under the laws of a foreign nation that are treated as U.S. domestic corporations for federal purposes.

  In addition, the Division states that a taxpayer's affiliated group election does not foreclose other affiliates from filing a New Jersey combined return. For example, if a taxpayer makes an affiliated group election and other affiliates have independent nexus with New Jersey, then those affiliates must file a CBT return.

Technical Bulletin 90 ("TB-90"): TB-90 concerns taxpayers' utilization of tax credits. Consistent with the statute (and unlike net operating losses),

group members may freely share tax credits, even if a group member generated a tax credit prior to joining a combined group.

Technical Bulletin 91 ("TB-91"): TB-91 concerns how national banks should file separate-company and combined returns. The CBT statute requires banks to pay CBT like regular corporations (non-banks). Unlike regular corporations, the CBT statute distinguishes between a privilege period and the tax measurement period for banks. For regular corporations, a privilege period is synonymous with the measurement period for the CBT. However, for banks, the statute requires that the tax be based on the income earned by the bank using the calendar year preceding the current privilege period. Thus, for example, for a calendar year regular corporation, the 2016 privilege period is calendar year 2016, and the CBT is based on the income that that corporation earned during the 2016 privilege period (from January 1, 2016–December 31, 2016). Compare that to a bank. For a calendar year bank, the tax for the 2016 privilege period is based on the income that the bank earned during 2015 (from January 1, 2015–December 31, 2015).

As a result of this privilege period, measurement period mismatch, the Division developed a method for banks to file separate company and combined returns. **This method is not in the CBT statute.**

For calendar-year banks, the Division's policy in TB-91 is that the bank must file two CBT returns as part of the transition to combined reporting (for privilege periods ending on or after July 31, 2019): a 2019 BFC-1 that reports the bank's 2018 income; and, then a combined return (reporting the bank's 2019 income as part of the combined group).

For fiscal-year banks, the Division's policy in TB-91 is that the bank must file three CBT returns as part of the transition to combined reporting: a BFC-1 reporting its 2018 calendar year income; a short period return (a BFC-1-F) reporting its income for the period from January 1, 2019–through the end of the month of the combined group's group privilege period; and a combined return (reporting the bank's income for the fiscal-year end 2020 privilege period).

Technical Bulletin 92 ("TB-92"): In TB-92, the Division revoked its previously-announced sourcing policy for GILTI and FDII. (The Division previously set a policy for sourcing GILTI and FDII to New Jersey by a gross domestic product methodology.)

In TB-92, the Division states that taxpayers must include the "net GILTI and net FDII income amounts in the numerator (if applicable) and the denominator of the allocation factor on Schedule J."

Following TB-92 the Division released a clarification stating that it was not aware of any situations where taxpayers would have to include GILTI or FDII income in the numerator of their apportionment factor. However, the Division chose to include the phrase "if applicable" in TB-92 as a means to preserve its right to include GILTI and FDII in the numerator.

Technical Bulletin 93 ("TB-93"): In TB-93, the Division provided additional guidance on the "unitary business principle" for combined groups. The statute defines a "unitary business" as a single economic enterprise, and, by statute, the Division can interpret a "unitary business" to the broadest extent permitted under the United States Constitution.

Through TB-93, the Division explains United States Supreme Court case law discussing the "unitary business principle."

Technical Bulletin 94 and Technical Bulletin 95 ("TB-94" and "TB-95"): In TB-94 and TB-95, the Division provided additional guidance on New Jersey net operating losses. When the legislature enacted combined reporting and market sourcing, the legislature also amended the net operating loss provisions of the statute to convert New Jersey net operating losses from pre-apportioned losses to post-apportioned losses. Thus, losses that combined groups generate will be deducted on a post-apportionment basis.

In addition, the statute permits individual taxpayers that are part of combined groups to convert their losses prior to the effective date of combined reporting (privilege periods ending on or after July 31, 2019) to a prior net operating loss conversion carryover (a "PNOL"). The guidance provides additional information on converting pre-combined reporting losses into a PNOL. Importantly, unlike the combined group losses, only the individual taxpayer that generated the losses converted into a PNOL may utilize the PNOL.

Technical Bulletin 96 ("TB-96"): In TB-96, the Division provided guidance on the deferred tax impact deduction—a deduction the legislature codified when enacting combined reporting. The deduction applies to taxpayers who are negatively affected—from a book perspective—from New Jersey's switch from separate company reporting to combined reporting. To qualify for the deduction, taxpayers needed to file a form with the Division, quantifying the deduction, by July 1, 2020.

Technical Bulletin 97 ("TB-97"): In TB-97, the Division summarized changes to the CBT as a result of the legislature's enactment of P.L. 2020, c. 118. A summary of P.L. 2020, c. 118 is included in Section I.A.2 above.

NJ CBT—Administrative Developments

Technical Bulletin 98 ("TB-98"): By statute, the Director of the Division can require taxpayers to submit "pertinent extracts" of their federal income tax returns. *See* N.J.S.A. 54:10A–14(a). In TB-98, the Division issued guidance concerning what federal forms taxpayers must include with their New Jersey combined return.

Technical Bulletin 99 ("TB-99"): TB-99 is a follow-up on TB-91 concerning how banking corporations should file separate-company and combined returns in New Jersey. In TB-99, the Division states that if the switch from separate-company reporting to combined reporting results in "an unfair or distorted reflection of income, the banking corporation may request relief from the director, which may be granted at the director's discretion."

Technical Bulletin 100 ("TB-100"): TB-100 provides the Division's interpretation of the impact of the legislature amending the statute to define a "combined group" as "one taxpayer" in P.L. 2020, c. 118 for privilege periods ending on and after July 31, 2020. To the Division, the change impacts the dividends received deduction and P.L. 86–272 companies. For the dividends received deduction, the change corrects an issue whereby the combined group will receive a dividends received deduction for a taxable member that receives dividends from an 80%-or-more owned subsidiary—as the statute provides. (Prior to P.L. 2020, c. 118, combined groups would not receive a dividends received deduction for taxable members with no New Jersey receipts.)

In addition, the Division provided its position on P.L. 86–272 companies as a result of P.L. 2020, c. 118. Prior to P.L. 2020, c. 118, the Division's policy was that if one member of the combined group exceeded the protection of P.L. 86–272, then no member could claim P.L. 86–272 protection. Because of the legislature's change to the definition of "combined group"—defining the "combined group" as "one taxpayer." The Division cites the legislative change as further support for its position.

Technical Bulletin 101 ("TB-101"): In TB-101, the Division provides guidance on how foreign members of a combined group should report their income to New Jersey. Under the statute, a foreign company may use "accounting principles generally accepted in the United States" for the presentation of its income. In TB-101, the Division states that International Financial Reporting Standards ("IFRS") qualifies as an "accounting principle generally accepted in the United States."

Technical Bulletin 102 ("TB-102"): In TB-102, the Division issued guidance concerning the impact of a merger on a combined group's net operating losses ("NOLs") and prior net operating losses ("PNOLs"). Here are the takeaways from that technical bulletin:

- **For members already part of the same combined group**: consistent with N.J.S.A. 54:10A–4.5(b), NOLs and PNOLs survive a merger.

- **For members of a group that had not previously filed a combined return together prior to November 4, 2020**: NOLs and PNOLs may survive a merger based on the "facts and circumstances."

- **For members of a group that had not previously filed a combined return together after November 4, 2020**: NOLs and PNOLs survive a merger even if the members did not previously file as part of the same combined group. This is consistent with the legislature's change to N.J.S.A. 54:10A–4.5 in P.L. 2020, c. 118.

Technical Bulletin 103 ("TB-103"): In TB-103, the Division provided guidance to taxpayers on New Jersey's conformity to the federal consolidated return rules. By statute, the consolidated return rules generally apply to a taxpayer's computation of its CBT. *See* N.J.S.A. 54:10A–4.6(n).

3. State Tax Addback: For purposes of computing the CBT, the statute requires a taxpayer to add back any taxes paid to other states on or measured by profits or income, or business presence or activity. On March 15, 2017, the Division released Technical Bulletin 80 ("TB-80") that, for the first time, explains its policy concerning which taxes are subject to addback. In general, TB-80 provides that a tax is not required to be added back if it is measured by the value of the taxpayer's assets or akin to a property tax, excise tax, payroll tax, or sales tax.

   Interestingly, TB-80 states that taxpayers shouldn't add back Pennsylvania bank shares tax. This might surprise some taxpayers. The Division's regulations specifically identify Pennsylvania bank shares tax as a "business presence or business activity" tax. In addition, in *Duke Energy Corporation v. Director, Division of Taxation*, the New Jersey Tax Court suggested that taxes imposed by other states in lieu of income taxes—such as the Pennsylvania bank shares tax—should be added back when computing the CBT. Based on this prior guidance, some banks may have been adding back their Pennsylvania bank shares tax.

   Under the Division's new technical bulletin, however, Pennsylvania bank shares tax should not be added back. If your company added back this tax on its originally filed New Jersey returns, it has a refund opportunity. A refund opportunity may also exist for other bank taxes, such as the Ohio financial institutions tax and the Virginia bank franchise tax.

4. Interest and Royalty Add Back: On February 24, 2016, the Division issued a revised technical advisory memorandum concerning interest add back.

The revised memorandum follows the Tax Court's decision in *Morgan Stanley*. (For a discussion of *Morgan Stanley*, *see* I.B.24). As a result, taxpayers should rarely be required to add back interest expenses from intercompany transactions—or royalty expenses, because the rules for royalty expenses mirror those for interest expenses.

5. Providing Guidance on Nexus: On July 30, 2015, the Division issued a new technical bulletin concerning CBT nexus and the scope of federal immunity under P.L. 86–272. The guidance closely mirrored the Division's regulations—except that the Division advised that "[d]elivering goods sold in own vehicles" is outside the protection of P.L. 86–272. This change represented a complete reversal of the Division's decades-long policy. After this was brought to the Division's attention, it issued a revised technical bulletin two weeks later. Consistent with the Division's historical policy, the revised bulletin provides that delivery of goods by a seller in its own trucks does not, by itself, cause the seller to lose its immunity under P.L. 86–272. TB-79(R) (Aug. 13, 2015).

D. Trends/Outlook for 2022

1. Additions to Income, Treaties, and Refunds: In I.B.10, above, we discussed the Tax Court's decision in *Infosys Limited of India, Inc. v. Director, Division of Taxation*. Here is how that decision can impact your company.

Treaties benefits will not be set aside. The court acknowledged that the CBT base must be computed without the exclusion or deduction of "any specific exemption or credit allowed in any law of the United States" imposing any tax on income. N.J.S.A. 54:10A–4(k)(2)(A). But the court concluded that this add-back didn't apply to income that is not taxable by the United States under a treaty between the United States and another nation. In the court's view, a treaty is not a "law of the United States." Accordingly, New Jersey cannot set aside the benefits allowed under a treaty, absent specific legislation.

More to come on "specific exemptions." The Division had argued that the exclusion of foreign-source income from federal taxable income was a "specific exemption," and as a result, had to be ignored under the statute in computing the CBT base. *See generally* IRC §§ 11(d), 882(b), 6114. The taxpayer countered by arguing that a "specific exemption" is an exemption limited to a specific dollar amount (for example, a specific exemption of $5,000 against a corporation's taxable income). The court agreed that the federal limitations on taxing foreign-source income were not "specific exemptions" but provided little in the way of analysis.

Therefore, expect to see more litigation on this issue going forward, especially after the Legislature's removal of the word "specific" from the

statutory adjustments to entire net income. (For more information see I.B.11 above.)

What about that refund? The court did revise its original decision in *Infosys* concerning the timing of the refund payment. The court accepted the Division's argument that the factual record was insufficiently developed to compute the exact amount of the refund. But the court gave the parties only until July 30, 2018, to agree to a refund amount. (The parties later settled.) This is a good sign for taxpayers. It means that if a taxpayer prevails at Tax Court, the court may not require the taxpayer to wait until all appeal rights are exhausted before receiving the refund.

2. Limited Partner Nexus: In I.B.14 above we outlined the New Jersey Tax Court's decision in *Preserve II*. *See* Docket No. 010921–2013. Here are some take-aways from that decision:

Out-of-state limited partners: *tax years before 2014*. The Division has now won two straight cases on the issue of whether an out-of-state limited partner has nexus with New Jersey. But this does not mean that other taxpayers should necessarily abandon their refund claims. If a limited partner is limited in name only and is closely affiliated with the general partner, it will clearly have a difficult time convincing the Division or a court that it lacks nexus with New Jersey. If, however, the partner is truly a passive investor or is unrelated to the other partners, it may be able to distinguish its situation from the facts in *Preserve II*.

Out-of-state limited partners: *2014 and forward*. Effective in 2014, the New Jersey legislature amended the CBT partnership statute. A partnership with non-resident partners must pay tax on behalf of those partners. The tax paid is credited to the partners, but only a partner that concedes nexus is entitled to claim the credit. If a non-resident partner lacks nexus, the statute does not permit the partner to obtain a refund. In effect, the statute imposes an entity-level tax on partnerships—but only on partnerships with out-of-state partners. Because of this clear discrimination, partnerships with non-resident partners should consider challenging the rule. Although the Division may try to defend this discriminatory treatment based on the compensatory tax doctrine, the Division would have a difficult time prevailing because that doctrine does not generally apply to income taxes.

New Jersey's unitary business test. In *BIS LP*, the appellate court affirmed a taxpayer-friendly application of the unitary-business test. Like *Preserve II*, the *BIS LP* case involved a 99% limited partner. But in *BIS LP*, the court ruled that the partner and partnership were non-unitary because they conducted different businesses: the partner was a holding company, whereas the partnership was an IT company. Although *Preserve II* addresses the unitary-business test, it provides little analysis concerning its application. Therefore, taxpayers can still rely on the appellate court's guidance in *BIS LP*. This is significant. Even if a corporate partner has nexus with New Jersey, there is significant flexibility concerning whether to flow-up partnership income and factors, or to compute the tax due using separate accounting.

Expansion of nexus standard? The Tax Court noted that in 2002, the legislature extended the reach of the CBT statute to corporations that derived receipts from New Jersey sources. *See* P.L. 2002, c. 40. Based on this standard, the court concluded that Preserve is "undoubtedly subject" to CBT. The court's application of this nexus standard could embolden the Division to assert economic nexus in other situations where an out-of-state company has investments in New Jersey.

Special apportionment for investment companies. The Tax Court's decision may make it more difficult for a holding company to qualify for special apportionment as an investment company. If a company limits its activities to investing in corporate stock, debt, other securities, limited partnership interests, or patents, the CBT statute provides a 60% tax reduction. Based on the court's decision in a prior case, (*Manheim*—see I.B.18 above) many taxpayers believed that limited partners automatically qualified for this special treatment. But after *Preserve II*, a limited partner won't qualify unless it can show that it is truly a passive investor. The 60% tax reduction was designed to apply only to New Jersey-based holding companies. But there are obvious constitutional problems with this. If your out-of-state holding company is taxable in New Jersey, and would otherwise qualify as an investment company, it should reduce its tax by 60% so that it's treated the same as a New Jersey-based taxpayer.

Effective date of regulations. The *Preserve II* decision marked the second time a court has criticized the Division for making a regulation effective on a particular date (rather than as of a particular tax year, which is the approach used by the legislature for new or amended statutes). The court observed that this could lead to absurd results, explaining that "taxpayers in identical situations will be disparately treated simply because of the date they each chose to file their tax returns."

Last year, the Division promulgated a number of new CBT regulatory provisions with an effective date of May 18, 2017. *See* 49 N.J.R. 52(b). If your company is adversely affected by any of the new provisions, the Tax Court's decision in *Preserve II* provides another basis for challenging them.

3. Net Operating Loss Suspension—Four More Years: New Jersey suspended, in whole (in 2002–2003) and in part (2004–2005), the deductibility of NOLs during the period 2002 through 2005. The legislation that suspended the deductions for this four-year period gave taxpayers the right to extend the normal seven-year carryover period by four years for any loss carried into the period of suspension (or fewer, if the loss was generated during the suspension period). The Division of Taxation, however, promulgated a regulation in 2007 that limits the extension to only those NOLs that would have otherwise expired during the four-year 2002–2005 suspension period.

This regulation is not supported by the statute. The better rule, as a matter of statutory construction and as a matter of sound tax policy, is that any loss carried into the 2002–2005 suspension period should be extended by four years. Therefore, taxpayers with significant losses should consider using the statutory rule (see far right column of table) rather than the Division's rule.

Tax Period of Loss	Without Suspension NOL Expires After	Division's Rule: NOL Expires After	Statutory Rule: NOL Expires After
2004	2011	2011	2012
2003	2010	2010	2012
2002	2009	2009	2012
2001	2008	2008	2012
2000	2007	2007	2011
1999	2006	2006	2010
1998	2005	2006	2009
1997	2004	2006	2008
1996	2003	2006	2007
1995	2002	2006	2006

(In addition to the statutory rule above, companies that conducted research and development in any state from 1999–2001 can extend their losses an additional 8 years).

We encourage any taxpayer to consider using the carryover period listed in the "statutory rule" column of this table, rather than the period listed in the "Division's rule" column.

4. Foreign Dividends: If your company was required to include a major repatriation of foreign earnings in income, consider this issue.

   Under New Jersey law, the dividend-received deduction is computed after the deduction for NOL carryovers. Thus, a dividend, even if it will be deducted by virtue of a dividend received deduction, absorbs NOLs.

   Many taxpayers repatriated significant dividends under the Tax Cuts and Jobs Act. Those dividends have been paid, often by foreign corporations that are managed and operated completely separate from the domestic business. Because of water's edge treatment in many unitary states, and *Kraft*-mandated dividend-received deductions in many separate reporting states, taxpayers have not focused on whether those dividend-paying subsidiaries are unitary because the dividends are excluded from income, regardless.

   But if the subsidiary is not unitary, then the dividend paid by the subsidiary should not absorb the NOL carryover of the unitary group. After all, under *Hunt Wesson*, a state cannot tax by indirect means what it cannot tax by direct means. So if New Jersey cannot impose a tax on a dividend from a foreign subsidiary because that foreign subsidiary is separately managed and thus not unitary, then New Jersey cannot reduce the NOL of the taxpayer by reference to the amount of the dividend.

   As a consequence, taxpayers who received a deemed distribution from a foreign subsidiary under IRC § 965 or other amounts treated as a dividend from a foreign subsidiary should consider the authority of the *ASARCO* and *Woolworth* cases, in which the Supreme Court determined that foreign subsidiaries engaged in the same business as the domestic parent were, nonetheless, not unitary with the domestic parent if the subsidiaries were sufficiently independent. If your foreign subsidiaries are also not unitary, then your New Jersey NOL should not be reduced by the amount of the foreign dividend.

NJ SUT—Legislative Developments

II. SALES AND USE TAXES

A. Legislative Developments

1. Implementing Remote Seller Nexus: With P.L. 2018, c.132 New Jersey is implementing the remote seller nexus provisions blessed by the Supreme Court in *South Dakota v. Wayfair*, 138 S.Ct. 2080 (2018). (In *Wayfair*, the Supreme Court impliedly found that South Dakota's nexus standard was sufficient. That standard applied to sellers that weren't physically present in the state and annually either: (1) made sales to South Dakota purchasers in excess of $100,000; or, (2) made 200 or more separate transactions for delivery to South Dakota.)

2. Tax on Transient Accommodations: The legislature amended the sales and use tax act to impose tax on transient accommodations. That is, "a room, group of rooms, or other living or sleeping space for the lodging of occupants, including but not limited to residences or buildings used as residences." P.L. 2018, c.49. The tax on transient accommodations only includes those rooms rented through a transient space marketplace (a marketplace or travel agency) or the rental of a professionally managed unit. P.L. 2019, c.235.

B. Judicial Developments

1. Materials Used in the Manufacturing Process: In *Liscio's Italian Bakery, Inc. v. Director, Division of Taxation*, Docket No. 009658–2017 (N.J. Tax Oct. 1, 2019), the Tax Court held that baking racks a taxpayer purchased were exempt from sales and use tax as equipment that the taxpayer used directly and primarily in the manufacture of baked products.

   N.J.S.A. 54:32B–8.13a. exempts "machinery, apparatus or equipment for use or consumption directly and primarily in the production of tangible personal property by manufacturing, processing, assembling or refining."

   At taxpayer's plant, taxpayer makes and sells 250 varieties of baked products (bread, sandwich breads, rolls, and specialty items). The production process includes: preparing dough, shaping, proofing, refrigerating, de-activating, re-activating, and baking dough.

   The tangible personal property at issue in this appeal was baking racks that taxpayer used to produce bread. Taxpayer's employees unload dough pieces, load the dough onto a baking pan, and place the baking pan into a slot on the baking rack. Taxpayer had a vendor specifically make racks for its bakery. Taxpayer uses the baking racks to transport dough to different parts of the bakery where the dough goes through different processes (for example, proofing, staging seeding, baking).

The Division of Taxation determined that the baking racks were not used directly in the manufacture of a finished product.

The court rejected the Division's final determination. In doing so, the court found that the baking racks were directly and primarily used in the manufacturing process and held that baking racks were machinery, apparatus, or equipment under the statute.

First, in holding that the baking racks were directly used in the manufacturing process, the court relied on the dictionary definition of "directly"—meaning to "sustain." The court found that the baking racks "sustain" the manufacturing process because the racks transport the products through every step of the process (the preparation, shaping, proofing, refrigeration, de-activation, and re-activation of the dough).

Second, the court reasoned that the taxpayer primarily used the racks in the manufacturing process because the "only down-time [for the racks] during an eight-hour work day was when about 40–50 racks of the 200 or so, are waiting in line to be used for the next production loop."

Next, the court determined that the racks were exempt "machinery, apparatus, or equipment." That's because the racks fit within the Division's regulatory definition of "apparatus" and "equipment." An "apparatus" is a "set of materials or equipment designed for a particular use." And "equipment" is the "implements used in an operation or activity." Because the racks are material used in the production of bread, the court found that the racks were "apparatus" or "equipment" under the statute and regulation.

As a result, the court found that the baking racks were apparatus or equipment directly and primarily used in the manufacturing process.

2. <u>Sourcing of Sales of Tangible Personal Property</u>: On November 16, 2017, the Tax Court of New Jersey issued a ruling in *Spirit Halloween Superstores, Inc. v. Director, Division of Taxation*, concerning the sourcing of sales of tangible personal property for sales tax purposes. *See* Docket No. 012526–2015 (N.J. Tax Nov. 16, 2017). The decision confirms that a sale is not necessarily sourced to New Jersey for sales tax purposes just because the invoice has a New Jersey "ship-to" address and title transfers to the purchaser in New Jersey at the location of a common carrier. The ruling also provides guidance on the evidentiary standards for obtaining a sales tax refund.

Background

The case involved a New Jersey-based retailer (“Spirit”) that operated more than 1,100 retail stores across the United States, including 119 stores in New Jersey. Spirit purchased signage and printed materials from a New Jersey-based vendor. According to Spirit, the purchased items were for retail stores across the United States, but all of the invoices listed Spirit’s New Jersey headquarters as the shipping address. The vendor charged New Jersey tax on all of the purchases and Spirit filed a refund claim with the Division, seeking relief for tax paid on items shipped outside the state. The Division denied the claims and Spirit appealed to the Tax Court.

Taxpayer Failed to Meet Evidentiary Standard

Spirit filed a motion for summary judgment in which it asked the Tax Court to order the requested refund. In support of its motion, Spirit submitted:

A letter from the vendor stating that the “ship to” address on the invoices did not represent the actual destination of the items sold; rather, FedEx typically picked up the items for delivery to Spirit’s in-state and out-of-state retail locations. Although the letter was signed by the vendor’s Vice-President of Finance and printed on the vendor’s letterhead, it was unauthenticated and uncertified.

An affidavit from Spirit’s senior manager attesting that the purchased items were shipped directly to Spirit’s retail locations. The affidavit further provided that the proportion of items shipped to New Jersey corresponded with the percentage of Spirit’s retail stores located in New Jersey.

The court found this evidence to be neither credible nor reliable. With respect to the letter from the vendor, the court rejected it as unauthenticated hearsay. The court similarly rejected Spirit’s affidavit, noting that it referenced documents that were not attached to the affidavit or otherwise submitted to the court. As a result, the court denied Spirit’s motion and the requested refund.

The Tax Court’s decision serves as a warning to taxpayers not to rely on unauthenticated documents. Although letters from employees or vendors may be persuasive on audit, that type of evidence may be insufficient when submitted as part of an appeal. Even if a taxpayer submits an affidavit, it is likely to be disregarded unless the attested facts are put into context (for example, by attaching the underlying documents or business records).

Sourcing Sales of Tangible Personal Property

The Division filed its own motion for summary judgment seeking to have Spirit's claim dismissed. The Division argued that the ultimate destination of the purchased items to out-of-state locations was irrelevant. According to the Division, title to the items passed to Spirit when the vendor delivered the items to FedEx in New Jersey. As a result, the Division argued that it was proper to impose New Jersey sales tax on all of Spirit's purchases.

The court concluded that delivery to FedEx in New Jersey did not necessarily mean that New Jersey sales tax was due on the transactions. Although the Division's position may have been supported by prior law, the Division never addressed the statutory sourcing provisions that New Jersey adopted in 2005 to conform to the Streamlined Sales and Use Tax Agreement. *See Media Graphics, Inc. v. Director, Division of Taxation*, 8 N.J. Tax 321 (N.J. Super. Ct. App. Div. 1986); *see also* N.J.S.A. 54:32B–3.1. Accordingly, the court denied the Division's motion.

Spirit submitted additional evidence and filed another motion for summary judgment. The court denied Spirit's second motion for summary judgment on September 6, 2018, finding that Spirit's additional evidence (certifications, deposition testimony, and an uncertified letter) did not prove that Spirit received the purchased materials outside of New Jersey.

3. New Jersey Provides Guidance on Extraordinary Transactions: On October 25, 2017, the New Jersey Tax Court denied a Division motion for summary judgment when determining that a transaction from a sales and use tax audit could qualify as "extraordinary." *See Statewide Commercial Cleaning, LLC v. Director, Division of Taxation*, Docket No. 003504–2015 (N.J. Tax Oct. 25, 2017).

At issue was whether a transaction should have been removed from an auditor's block sample. The Division argued that the taxpayer did not preserve its right to contest the transaction it sought to remove from the sample.

Viewing the facts in a light most favorable to the non-moving party—the standard for a motion for summary judgment—the court determined that, at trial, the taxpayer may be able to prove that it preserved its ability to contest the transaction as extraordinary.

The court also noted that under the Division's Manual of Audit Procedures, the transaction may be extraordinary. The Division's manual states that extraordinary transactions should be removed from a sample, but does not provide guidance on what constitutes an extraordinary transaction.

To that end, the court looked to California's audit manual to define an extraordinary transaction, including these "guideposts" from that manual: (1) the size of the transaction compared to other transactions in the sample; (2) whether the transaction "was omitted or included due to some unusual circumstances;" and (3) whether the transaction typically occurs within the taxpayer's business. The court reasoned that, at trial, the taxpayer may be able to prove that the transaction is extraordinary—using the guideposts above or other state guidance on extraordinary or unusual transactions.

Trial occurred in this case in March 2018. A decision will likely be issued later this year.

4. New Jersey Tax Court Issues Responsible Party Decision: On September 12, 2017, the New Jersey Tax Court determined that the Division was not required to serve personally a final audit determination on both a corporation and the corporation's "responsible person." *See My Way B&G, Inc. v. Director, Division of Taxation*, Docket No. 016627–2013 (N.J. Tax Sept. 12, 2017).

At issue was whether a timely protested Notice of Finding of Responsible Person Status preserves the responsible person's right to challenge a Notice of Assessment against a corporation.

The Division issued a final audit determination ("Final Determination") for plaintiff, My Way B&G, Incorporated ("My Way"), and a few months later a Finding of Responsible Person Status Notice to plaintiff, Rapuano ("Rapuano"). Rapuano had managed the day-to-day operations of My Way since the corporation's inception. Rapuano timely protested the Responsible Person Notice, but neither Rapuano nor My Way timely protested the Final Determination.

Rapuano argued that the Division was required to personally serve the Final Determination on him, and as a result, his timely protest of the Responsible Person Notice preserved his right to appeal the Final Determination.

The Tax Court rejected Rapuano's argument. Instead, the court noted that the Division properly served Rapuano through the corporation for which he was responsible. As a result, Rapuano's appeal rights to contest the assessed tax ran from the date of the Final Determination.

5. <u>New Jersey Tax Court Clarifies Sales Tax on Software</u>: On January 9, 2017, the New Jersey Tax Court reversed its prior decision in *Premier Netcomm Solutions, L.L.C. v. Director, Division of Taxation*, Docket No. 016307–2012 and concluded that pre-written software sold on tangible media is treated as tangible personal property for sales and use tax purposes. Because it specifically addresses only transactions occurring before October 2005, the court's decision will have limited relevance for most taxpayers. Still, we think the court's decision serves as an important reminder that most business purchases of software and related services are not taxable in New Jersey.

   New Jersey's current sales tax statute exempts electronically delivered software used exclusively in the conduct of the purchaser's business. The exemption applies even if purchaser receives written manuals or training manuals. Although New Jersey imposes sales tax on charges for installing, repairing, servicing, and maintaining software, the Division's regulations define these services very narrowly. For example, taxable installation services are limited to "the act of loading an executable file . . . onto a device or equipment." Any other services provided by the installer—such as modification or customization services—should be nontaxable. With respect to a company's existing software applications, any services that enhance or improve that software should also be nontaxable.

   This means that businesses should not be paying New Jersey sales tax on the vast majority of their purchases of software and software-related services.

6. <u>Wrapping Supply Exemption for Packaging Shipped to Related Entity</u>: The Tax Court granted a taxpayer's motion for summary judgment, finding that purchases of wrapping supplies by a warehouse company used to ship merchandise to retail stores owned by various affiliated entities were exempt from tax. The taxpayer received merchandise from third parties that it then repackaged and shipped to affiliated retail stores, and filed a refund claim for tax paid on the packaging materials used to ship the merchandise to the affiliates. At court, the Division conceded that the various external and internal packaging materials at issue constituted wrapping supplies; however, the Division contested the taxpayer's claimed refund on the basis that the wrapping supplies were for "internal use" and not part of transactions with "another party." The Tax Court rejected the Division's argument, finding that the warehouse company and its affiliates were separate legal entities, and that nothing in the statutory language would preclude the exemption from applying to transactions between related parties.

Further, the court rejected the Division's substance over form argument, finding that the Division failed to provide sufficient justification for ignoring the taxpayer's corporate form. *Burlington Coat Factory Warehouse Corp. v. Director, Division of Taxation*, Docket No. 007007–2013 (N.J. Tax Dec. 2, 2014).

C. Letter Rulings/Other Guidance

1. Hotel Occupancies and New Jersey Taxes: The Division issued a publication concerning sales and use tax for hotels and occupancies. Of note, since the Division's last publication on Hotel Occupancies, the Division added guidance concerning sales and use tax and resort fees, including:

   - Mandatory resort fees—that is, those fees that guests cannot opt out of—are part of the sales price of the occupancy and subject to tax;

   - Optional charge resort fees are not subject to tax, so long as each component of the resort fee is not subject to tax.

   Components of resorts fees that are not considered subject to tax are: daily access to fitness centers or pools; daily newspaper delivery; and Wi-Fi access. (By contrast parking fees are considered components of resort fees that are subject to tax, and as a result, if the resort fee contains parking fees, the entire resort fee is subject to tax.).

2. Entry Fees for Online Fantasy Sports: The Division issued guidance concerning entry fees for daily fantasy sports contests. The taxpayer does business in New Jersey and allows New Jersey residents to enter fantasy sports contests. The taxpayer's customers must pay entry fees to play in daily fantasy contests. Those entry fees vary. When customers enter contests, they receive contest details, including: number of participants, the payout structure for the contest, and information about the players they select for their contest. The Division advised the taxpayer that the entry fees are not taxable because entry fees are not an enumerated service. The Division determined that the taxpayer was not providing an information service to the taxpayer, but instead a charge for an entry fee to online daily fantasy sports contests. Letter Ruling 2016–2–SUT (Oct. 5, 2016).

3. Electronics Recycler's Shredding Services: The Division issued guidance concerning charges for services that a recycler of universal waste consumer electronics performed in connection with the destruction and disposal of computer hard drives. Many of the taxpayer's customers have data security concerns. To alleviate those concerns, the taxpayer destroys its customers' hard drives and provides its customers with a destruction certificate.

The Division advised the taxpayer that the shredding and provision of destruction certificates constitutes the processing of tangible personal property which is subject to sales tax. The Division also advised the taxpayer that separately-stated charges for a third-party waste disposal service for the hard drive would not be taxable if performed on a regular contractual basis. Letter Ruling 2016–3–SUT (Oct. 5, 2016).

D. Administrative Developments

1. Transient Accommodations: Consistent with the legislative history supporting the application of sales and use tax on transient accommodations (including "transient space marketplaces"), the Division issued Technical Bulletin 81, which states that a transient state marketplace does not include an online travel agency (such as, Expedia). The Division reasons that a travel agency "books rooms on behalf of customers, and the hotel bills and collects any applicable taxes and fees from the travel agency." As a result, the hotel remits any taxes to New Jersey, not the travel agency.

2. "Hotels": New Jersey generally charges a 5% occupancy fee on "occupancies" that are subject to sales tax—"occupancies" provide guests with "the use or possession or the right to the use or possession, of any room in a hotel." The occupancy of a room in a "hotel" is subject to sales tax in New Jersey. On March 31, 2017, the Division issued a bulletin stating that "privately owned properties may be operated in a manner consistent" with hotels, and as a result, can be "hotels" under New Jersey law.

3. Software and Software Services: The Division revised its regulations regarding the sales tax treatment of software and related services (e.g., whether software services constitute taxable repairs, maintenance, installation, or servicing).

   The revised regulations reduce the scope of taxable services by: (i) limiting taxable installation services to "loading executable files" onto a computer; (ii) broadly defining non-taxable modification services to include any service to enhance, improve, or customize software other than installation services or servicing; (iii) limiting taxable servicing of software to repairs and maintaining compatibility with other hardware and software products; (iv) expanding the definition of custom software to include software developed using prewritten functions and routines; and (v) permitting taxpayers to break out taxable and non-taxable components of software maintenance contracts—even if they were not separately stated on the invoice. *See* N.J.A.C. 18:24-25.1, 25.6, and 25.7 (amended effective December 1, 2014).

III. ADDITIONAL ITEMS

1. Surcharge on Uber/Lyft: The legislature enacted a surcharge of $.50 per ride on any "rider" for "prearranged rides"—Uber and Lyft—that begin and terminate in New Jersey. (If the "ride" is shared between multiple "riders," then a $.25 surcharge is imposed on each "rider.") The law is effective for rides on or after October 1, 2018. *See* P.L. 2018, c.47.

2. Deemed Repatriation of Foreign Held Assets: On March 16, 2018 the Division of Taxation issued a notice concerning its treatment of the deemed repatriation of earnings of foreign subsidiaries under IRC § 965. Under the current provisions of the Corporation Business Tax Act, the Division stated that the deemed repatriation of those earnings will be treated as a dividend and excluded from entire net income under the CBT's dividend received deduction. *See* N.J.S.A. 54:10A–4(k)(5). The only exceptions to this treatment would be for taxpayers not meeting the ownership requirements for the CBT's dividend received deduction. If a taxpayer does not meet those ownership requirements, then the deemed repatriation of those earnings will be included in the taxpayer's entire net income.

3. Insurance Premiums Tax: In *Johnson & Johnson v. Director, Division of Taxation*, Docket No. 013502–2016 (N.J. Tax June 15, 2018), the Tax Court of New Jersey denied a taxpayer's claim for refund of insurance premiums tax paid based on premiums for risks located in the United States. The taxpayer argued that it should only pay tax on premiums for risks located in New Jersey.

   Background

   Companies seeking high risk insurance generally obtain that insurance in one of two ways: through a broker (surplus lines insurance); or by organizing a captive insurance company and procuring the insurance directly through that captive (self-procured insurance).

   In 2010, however, Congress enacted the Nonadmitted and Reinsurance Reform Act ("NRRA"), which streamlined state tax compliance by providing a "home state" rule. In effect, the NRRA prohibited any state, except the state in which the insured had its principal place of business, from taxing premiums paid to nonadmitted insurance companies. Nonadmitted insurance includes surplus lines insurance placed through a licensed broker with an out-of-state (unlicensed) insurer. But it is unclear whether the NRRA applies to insurance placed directly with an out-of-state (unlicensed) captive insurer.

   In response to the NRRA, New Jersey amended its surplus lines statute in 2011 to implement a home state rule. These 2011 amendments require a surplus lines agent to collect premiums tax from New Jersey-based insureds. The tax is 5% of the total premiums paid, including premiums related to risks outside the state.

But the 2011 amendments did not change the sourcing provisions with respect to captive insurance, which are codified in N.J.S.A. 17:22–6.64. The statute still provides that self-procured insurance premiums are taxable in New Jersey only to the extent they relate to "a subject of insurance resident, located or to be performed within this State . . . ." In other words, the statute limits the tax on captive insurance to risks allocable to New Jersey. Despite this, New Jersey's Department of Banking and Insurance has issued guidance that a New Jersey-based insured must pay a 5% tax on the total premiums paid to captive insurance companies—even if the covered risk is outside New Jersey.

In *Johnson & Johnson*, the taxpayer—a New Jersey corporation with a captive insurance company located in Vermont—challenged the Department of Banking and Insurance's position that a New Jersey based insured must pay a 5% tax on the total premiums paid to its captive—including those risks outside New Jersey. J&J's primary argument was that the 2011 New Jersey amendments only applied to surplus lines insurance; not self-procured insurance.

The Tax Court's Decision

The Tax Court upheld the Department of Banking and Insurance's position. That is, a taxpayer—even one procuring insurance directly through its own captive—must pay a 5% tax on all United States risks, not just those risks located in New Jersey.

The court determined that:

- In doing so, the court reviewed the enactment of the surplus lines law and the self-procurement insurance law.
- It reasoned that the legislature enacted the surplus lines law simultaneously with the self-procurement law.
- As a result, the legislature's action was clear: to treat self-procured insurance the same as surplus lines insurance.
- Therefore, the court ruled that the NRRA's home-state rule applied to both surplus lines insurance and self-procured insurance—that is, New Jersey could tax both insurance on risks allocated throughout the United States, not just those risks in New Jersey.

The Appellate Division recently overturned the Tax Court's decision. The Appellate Division reasoned that the 2011 New Jersey amendments only applied to surplus lines insurance, and not self-procured insurance, because the amendments did not change the statutory treatment of self-procured insurance.

The Supreme Court of New Jersey affirmed the Appellate Division's decision.

NJ—Additional Items

4. Unclaimed Property Update—Reporting of Unclaimed Store Credits: The Appellate Division ordered New Jersey to refund more than $1 million to Bed Bath & Beyond for over-reporting store credits redeemable for merchandise to the state's Unclaimed Property Administration ("UPA"). The court clarified that credits redeemable for merchandise only were not reportable to the UPA to the extent issued before July 1, 2010. Further, any such credits issued after that date were to be remitted at 60% of their face value.

   New Jersey's Uniform Unclaimed Property Act requires holders of unclaimed property to file an annual report with the UPA and remit the unclaimed property to the state. N.J.S.A. 46:30B–46. "Property" under the Act is presumed abandoned after three years. N.J.S.A. 46:30B–42. Before the 2010 Amendments, "property" included "credit memoranda." N.J.S.A. 46:30B–6(r) (as in effect in 2002).

   After the 2010 Amendments, "property" now also includes "stored value cards." N.J.S.A. 46:30B–6(r) (as in effect on July 1, 2010). Such property is presumed abandoned after five years and only "60% of the value of the card" is presumed abandoned. N.J.S.A. 46:30B–42.1b.

   Bed Bath & Beyond ("Bed Bath") claimed a refund from the UPA for unclaimed store credits that it issued before and after the 2010 Amendments. As the store credits were not redeemable for cash, Bed Bath argued that the credits were not reportable under the New Jersey authority in effect before the 2010 Amendments, and that it was entitled to a full refund for the unclaimed store credits issued before the 2010 Amendments that it had remitted to the state. (By contrast, the New Jersey Treasurer, acting on behalf of the UPA, argued that these unclaimed store credits were properly remitted to the state as "credit memoranda.")

   Bed Bath also claimed a refund for unclaimed store credits that it issued after the 2010 Amendments. It had initially reported this property to the state as "credit memoranda," and thus reported the full value of the unclaimed store credits to the state. The company claimed a refund on the basis that the "unclaimed store credits" qualified as "stored value cards," and as a result, it should have only remitted 60% of the value of the credits to the UPA.

   The Appellate Division reversed the UPA's denial of Bed Bath's refund claim, agreeing with the company's interpretation of the New Jersey statute. First, the court determined that the "unclaimed store credits" were not within the purview of the UPA prior to the 2010 Amendments. The decision clarifies that the Act's definition of "property" covered "claims for the payment of money." *See Bed Bath & Beyond Inc. v. Treasurer, Sate of New Jersey*, Docket No. A–2973–14T3 (N.J. Super. Ct. App. Div. Sept. 21, 2017). Bed Bath's claim for refund concerned only store credits that it issued as redeemable for other merchandise or services, but not for cash.

As a result, Bed Bath was entitled to a refund of the full value of the unclaimed store credits issued before the 2010 Amendments that it had remitted, plus interest.

The Appellate Division also determined that the company was entitled to a refund of 40% of the value of escheated unclaimed store credits that it issued after the 2010 Amendments. The court relied on the broad definition of "stored value cards," which is not limited to traditional plastic gift cards, but includes "a promise, made for monetary or other consideration." N.J.S.A. 46:30B–6t. In determining that Bed Bath's unclaimed store credits were "stored value cards," the court noted how the inclusion of the property type within the law in the 2010 Amendments expanded the Act to property issued for non-monetary consideration. Because Bed Bath's refund did not concern store credits redeemable for cash, the Appellate Division concluded that those credits were properly characterized as "stored value cards."

5. Manual on Audit Procedures Released: On March 7, 2017, the Division released its audit manual. Of note, the audit manual provides guidance on sampling. Historically, Division auditors have favored block sampling with respect to sales and use tax audits. But, the audit manual provides that taxpayers may request stratified sampling and statistical sampling. It also notes that auditors should remove extraordinary items—those items that are "not routine in the normal course of the taxpayer's business"—from a sample.

If you are interested in any pleadings or briefs in any of the cited cases, please send an email to kdicicco@reedsmith.com

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