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Did New Jersey Turn New York Into a Tax Haven?

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New Jersey, facing a huge budget deficit this year and believing that the "Corporate Business Tax (CBT) is broken,"[1] adopted, retroactive to January 1, 2002, sweeping changes to the CBT that will affect all corporations in the state, but will have a particularly significant impact on large multinational corporations.

A strange but appropriate question to ask is: Did New Jersey just make neighboring New York a "tax haven" that may attract New Jersey's large multistate and multinational corporations?

The major changes that affect these companies include:

1. adopting an alternative minimum tax on gross receipts or gross profits,
2. disallowing the deduction for royalty payments made to a related entity,
3. disallowing the deduction for interest paid to a related entity,
4. restricting the dividends received exclusion, and
5. adopting a "throw-out" rule, under which receipts that another state does not tax are disregarded in calculating the three-factor (property, payroll, receipts) apportionment formula.

Taken together, these changes drastically alter New Jersey's corporate tax landscape making it inhospitable to large corporations. Moreover, a comparison of New Jersey's new regime with New York's corporate tax system, which for more than fifty years has been structured to accommodate and attract such companies to locate their headquarters in New York, could encourage a migration across the border to the "tax haven" of New York.

New Jersey Corporate Tax Changes

Alternative Minimum Assessment

Corporations must now pay the higher of their regularly computed CBT or an Alternative Minimum Assessment (AMA). The AMA is particularly onerous to businesses with high volume and low profit margins. The AMA is based either on New Jersey gross receipts or New Jersey gross profits (defined as gross receipts less cost of goods sold), and an election as to which is used is "locked-in" for five years. The AMA is capped at $5 million in tax for a single corporation and $20 million for an affiliated group with five or more taxpayers.

Interest, Royalties and Dividends

Prior to adoption of the current legislation, New Jersey's corporate tax required each corporation to file a separate tax return. No consolidated or combined report was permitted. Each company was entitled to deductions for interest or royalty payments incurred in connection with its business operations. A company also excluded dividends received from an 80% owned subsidiary and 50% of all other dividends. Examining the changes to each of these provisions shows just how drastically a multistate corporation will feel the effects of these amendments.

A parent company with ready access to funds at favorable interest rates usually borrows centrally and relends to its affiliates. To the extent that rates and terms among affiliates meet arm's-length standards (issues that are already subject to audit adjustments), such arrangements are routine business matters. But now, New Jersey has restricted the deduction for interest on certain intercompany debt.

Interest paid to a related entity will be disallowed unless the:

1. recipient is subject to tax on the interest by another state, possession of the U.S., or foreign country and the rate of tax imposed is not less than a rate three percentage points lower than the rate of tax applied by New Jersey,
2. related party is in a foreign country that has a tax treaty with the U.S.,
3. taxpayer can prove that the interest is paid in connection with borrowing from an independent third party and guaranteed by the taxpayer, or
4. taxpayer can prove by "clear and convincing" evidence that the disallowance is unreasonable.

A company with excess cash from one line of business may not need third party financing. For example, if a parent corporation with cash-generating operations in Nevada, a state without a corporate income tax, lends funds to its subsidiary in New Jersey, the New Jersey corporation will not be allowed to deduct interest expense since the borrowing was not from a third-party lender and the recipient of the interest does not pay tax on it in its home state.

New Jersey already claims the right to tax companies that receive payments from New Jersey businesses for the use of intangibles within the State.[2] Adding another arrow to its quiver, royalty payments to related entities for using intangibles will be disallowed under the new law unless the taxpayer can show "by clear and convincing evidence that adjustments are unreasonable," or the payment is made to an affiliate in a country that has a tax treaty with the U.S. In addition, the deduction will not be disallowed if the taxpayer can show both that the payment was passed through to an unrelated party and the principal purpose of the transaction was not tax avoidance. This amendment contravenes structuring and planning done for legitimate business reasons to protect patents, copyrights and trademarks.

Another change to the CBT is the elimination of the exclusion for dividends received by New Jersey companies from less than 50% owned corporations. As finally adopted, dividends from an 80% owned subsidiary will continue to be excluded, as would 50% of the dividends from a 50-80% owned company. No deduction or credit for taxes paid to any foreign country will be permitted.

Throwout Rule

Generally, state corporate taxes are apportioned based upon a formula comparing the property, payroll and receipts attributed to each state to total property, payroll and receipts. Certain states, by choice or because of the protection of federal law, do not impose a tax even though a company has receipts from sources within the state. Under federal law (P.L. 86-272), a corporation that merely solicits sales of tangible personal property within a state cannot be required to pay a state's corporate income tax, notwithstanding that it ships products into the state and therefore has receipts sourced to the state. Such receipts that are included in an apportionment formula but not subject to tax have been referred to as "nowhere sales" because they are included in the denominator of the receipts factor fraction and never show up in the numerator of a particular state imposing tax.

New Jersey adopted a "throw-out rule" which eliminates "nowhere sales" from the denominator of the receipts factor. This has the effect of reducing the denominator and thereby increasing the receipts factor in favor of New Jersey. In other words, the income apportioned to New Jersey will increase even though sales were made in other states.

Combined Reporting

New Jersey referred to the changes related to interest, royalties and dividends as "loop-hole closers." The CBT provides an ingenious, some might say disingenuous, alternative to being subject to these new provisions. A corporation can choose to avoid all of the loop-hole closers—*i.e.*, be allowed to deduct royalties, interest and exclude dividends—on the condition that it elects to include in its New Jersey CBT return all affiliates included in its federal consolidated return.

California and several other states belonging to the Multistate Tax Commission have long championed the concept that all affiliates engaged in a "unitary" business be included in a combined corporate tax report.[3] Under such a rule, all U.S. affiliates are included whether or not the separate corporation is doing business within the state. Such a system, called "combined unitary reporting," requires that all corporate entities in the same or related lines of business be included in one report. The amount of tax paid to each state is based upon the entire group's net income multiplied by the apportionment percentage (property, payroll and receipts) attributable to each state.

New Jersey (as well as New York) had steadfastly resisted going to unitary reporting, which is perceived not to be business friendly. In fact, in testimony before the New Jersey State Legislature, New Jersey's Treasurer stated: "[w]e do not propose to mandate California-style 'combined unitary' reporting." Notwithstanding this claim, the reality is that large corporations may have no real option but to file a consolidated return in New Jersey.

New Jersey has gone *beyond* the California unitary system. The legislation gives the Director of Taxation discretion to require a taxpayer "to file a consolidated return of the entire operations of the affiliated group" whether or not the members of the group are engaged in a unitary business. Once a consolidated return is demanded by the Director, it must be filed within 60 days. This is an unreasonable administrative burden and may be very costly to taxpayers.

In addition, taxpayers that are members of a federal affiliated or controlled group must, within 90 days after being requested, disclose "the amount of all inter-member costs or expenses, including but not limited to management fees, rents, and other services" and the amount of revenue generated from any products or services acquired from another member of its affiliated group.

New York's Treatment of Multistate and Multinational Corporations

In order to appreciate how New York has tried to deal constructively with the business issues encountered by complex multinational corporations that New Jersey has just addressed, a brief description of the New York corporate tax is necessary for comparison.[4]

New York permits deduction of royalty payments and interest paid to affiliates. Of course, just as under the federal income tax, adjustments may be made to non-arm's-length transactions. New York also excludes income (*i.e.*, interest, dividends and capital gains) from subsidiary capital. While there is, in the discretion of the tax commissioner, a disallowance of deductions attributable to subsidiary capital, gains on the sale of the stock of a subsidiary, as well as interest on loans to a subsidiary and dividends from a subsidiary are not taxed by New York.

New Jersey currently taxes investment income of companies headquartered in the state and other New Jersey corporate taxpayers unless the company can prove the income is "non-operational." There is a heavy burden on the taxpayer of proving that income is not operational.

New York has a unique and, if properly implemented, favorable apportionment for investment income. New York uses an investment allocation percentage based upon the allocation factor of the payor to determine how much investment income is allocated to New York. For example, under this scheme, a New York corporate taxpayer who receives interest, dividends or capital gains on qualified investment capital (*i.e.*, notes, securities, etc., from non-affiliated corporations) pays tax only to the extent the corporation in which it invested does business in New York. Properly planned, investments in corporations with low allocation factors to New York result in little tax paid to New York.

New York has no "throw-out" rule. Under New York's apportionment formula, all receipts are sourced to the appropriate location whether the other state chooses to impose a tax on the company or not.

While New York corporations, which may elect "combined reporting," face issues of which companies should be included or excluded from its combined corporate tax returns, New York is clearly not a unitary state. Again, with proper planning, arm's-length pricing and sufficient documentation, New York taxpayers may structure their transactions with affiliates so as to file on a combined basis with those it chooses. New York may only force combination when there is distortion caused by intercompany transactions. Companies holding trademarks, copyrights and patents have not been forced into a combined return.[5] In some cases, investment companies have been excluded,[6] and there are even cases in which the taxpayer was able to exclude affiliates the state wanted to include in the combined report and include those the state wanted to exclude.[7] All of these cases demonstrate that with proper planning, a taxpayer may structure its combined filing to withstand a challenge upon audit.

Although New York's corporate tax policies may not be in perfect harmony with every taxpayer's wishes, considering the tenor and far-reaching impact of New Jersey's new CBT, New York might be considered by some large multinational corporations to be an attractive tax haven.

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[1] Exemplified by the decline of corporate tax revenue from about 15 percent of the state's total tax revenue twenty years ago to 6 percent in fiscal 2001.

[2] NJ Reg. 18:7-1.9(b) Example.

[3] See *Barclay's Bank v. Franchise Tax Board*, 114 S. Ct. 2268 (1994), modified January 9, 1995.

[4] In the respects discussed herein, New York City's general corporation tax is identical to New York State's corporate franchise tax.

[5] *Sherwin-Williams*, NYS Tax Appeals Tribunal, Division of Tax Appeals, ALJ Determination June 7, 2001. *Toys-R-Us*, NYC Tax Appeals Tribunal, ALJ Unit, Determination August 4, 1999.

[6] *U.S. Trust*, NYS Tax Appeals Tribunal, decided April 11, 1996.

[7] *New York Times*, NYS Tax Appeals Tribunal, decided August 10, 1995.