A New Jersey Jughandle[1]—New Legislation Brings Combined Reporting, a 95% DRD and Market-Based Sourcing to the Garden State

Two weeks ago, we provided a Legal Update on the then-current version of the New Jersey budget legislation. Crumple that up and throw it away, as the enacted legislation is different from that earlier version, with moderate changes to some aspects (e.g., the surtax), significant changes to others (e.g., the Dividends Tax, which is now a 95% dividend received deduction ("DRD")), and the sudden appearance of some major changes (e.g., mandatory combined reporting, with an apparent common ownership election). New Jersey's Legislature had a busy weekend: In addition to passing this much-revised budget bill, enacted as P.L. 2018, c. 48 (the "Act"), the legislature passed a bill requiring the Division of Taxation to establish a 90-day amnesty period that ends by January 15, 2019 (P.L. 2018, 46), another making changes to the Gross Income Tax (P.L. 2018, c. 45), and one that would require marketplace facilitators to collect sales tax and would adopt a bright-line sales tax collection standard of $100,000 of sales or 200 transactions (A. 4261, which has not as yet been signed by the governor). Governor Phil Murphy signed the Act into law July 2, 2018, making the Act's changes a third quarter event.

At first blush, many aspects of the Act look a lot like those enacted by New Jersey's neighbor to the north (New York)—such as the brand new prior year net operating loss conversion—but on closer inspection, looks are quite deceiving.

As to addressing the impact of federal tax reform, a few federal provisions are addressed head-on, such as the I.R.C. § 965 toll charge and the I.R.C. § 163(j) interest limitation, but others are not explicitly addressed at all, e.g., the Global Intangible Low-Taxed Income ("GILTI").

The Act has significant implications to virtually all Corporate Business Tax ("CBT") taxpayers. Some highlights:

Adopts mandatory unitary combined reporting ("MUCR") on a water's edge basis for years beginning on or after January 1, 2019, with an apparent common ownership election for non-unitary corporations

- "Unitary business" is to be construed "to the broadest extent permitted under the Constitution of the United States." Rather than adopt the traditional test of centralized management, functional integration, and economies of scale, the Act defines a unitary group as "a single economic enterprise that is made up either of separate parts of a single business entity or of a group of business entities under common ownership that are sufficiently interdependent, integrated, and interrelated through their activities so as to provide a synergy and mutual benefit that produces a sharing or exchange of value among them and a significant flow of value among the separate parts."
- Water's edge treatment is the default method, but world-wide combination can be elected; such election is binding for the current and succeeding 5 years. However, a group can apply to revoke the

election for reasonable cause, for example, if there is a substantial change in the composition of the group.

- Water's edge groups will include: (i) US corporations formed under US law, unless 80% or more of both their property and payroll are located outside the United States (including the District of Columbia) or a US territory or possession, (ii) non-US entities regardless of where incorporated or formed if 20% or more of both their property and payroll are located in the United States (including the District of Columbia) or a US territory or possession, (iii) any member that earns more than 20% of its income directly or indirectly from intangible property that is deductible by other members and (iv) members that have income and nexus in New Jersey.
- More than 50% of direct or indirect voting control is required, but if a member receives income from a unitary partnership, the direct and indirect shares of the member's income are includible in the combined group's income.
- It appears that an affiliated group election can be made to include affiliated companies that are not engaged in a unitary business in the combined group. The Act sometimes uses the phrase "affiliated group" and at other times uses "commonly owned." We presume the terms are intended to have the same meaning. Interestingly, as written, it would appear that the affiliated group election can only be made by the managerial member of a combined group. This would imply that you must first have a unitary combined group and then can elect to include other non-unitary corporations in the group. It is unclear whether that is what was intended or whether the affiliated group election can be made by related entities, none of which are engaged in a unitary enterprise.
- New Jersey S corporations can elect to be included in a combined return.
- Allocation (New Jersey's term for apportionment) is on a *Joyce* basis, with income subject to tax determined by applying each member's allocation factor (its numerator over the group's denominator) to the combined group's entire net income.
- A managerial member is to be assigned. It will be the common parent corporation if it is taxable. If it is not taxable, then another taxable member of the group can be selected.
- Certain captive insurance companies are includible in a combined group. (Captive insurance companies that are not included in a combined group continue to be subject to the Insurance Premiums Tax.)
- The Act adopts a take-off of New York's prior net operating loss carryover ("PYNOLC") scheme, which converts pre-allocation net operating losses ("NOLs") for years beginning prior to January 1, 2019, to a post-allocation net operating loss amount. However, unlike New York's PYNOLC, each prior year's loss amount retains its source year for purposes of carryover, i.e., 20 years after the period of the initial loss, rather than combining the losses into a pool with a new carryforward period. In addition, also unlike New York's, the New Jersey PYNOLC can only be used by the corporation from which it was derived. New NOLs (those arising in MUCR years) can be used by the group, but NOLs arising in years that the company was not a member of the combined group can only be used by that member.
- The use of prior year alternative minimum assessment ("AMA") credits is addressed.
- The Act allows public corporations that file a statement with the director of the New Jersey Division of Taxation (the "Director") to deduct the tax-effected allocated portion of the increase to their deferred tax liabilities or decrease in their deferred tax assets over a 10-year period (starting with January 1 of the fifth year after MUCR was enacted, i.e., 2024) that arises due to New Jersey's adoption of mandatory combined reporting.
- Certain intercompany transactions are eliminated and the interest add-back provision therefore applies only to related parties that are not included in the combined group.
- Business income from intercompany transactions are deferred in a manner similar to Treas. Reg. § 1.1502-13.

- Each member of the combined group is jointly and severally liable for the tax due from any taxable member of the group.

Adoption of MUCR has long been on the Division of Taxation's "wish list" of statutory changes. As we know, MUCR has winners and losers, and whether New Jersey will see its CBT collections increase is an open question. In fact, the governor's FY 2019 revenue estimate of the original CBT "modernization" revisions was just $110.0 million, which included combined reporting with a limited water's edge election, market-based sourcing, reinstitution of the taxation of international holding companies, a one-time tax on the redeemed repatriation of foreign-held assets and various changes to avert impacts of the federal Tax Cuts and Jobs Act.

New Jersey's Act requires the Director to promulgate regulations necessary for the implementation of its provisions, including computation of the combined allocation percentage, application of the PYNOLC and implementation of the new combined reporting regime. With only a few months before the new combined reporting regime goes into effect, corporations will be scrambling to determine the impact of the Act on their New Jersey tax burden.

Adopts market-based sourcing for years beginning on or after January 1, 2019

- Services are sourced where the benefit is received, and, if the benefit is received in multiple locations, an allocation of the total benefit is to be made.
- If the states where the benefit is received cannot be determined, the billing address shall be used for customers who are individuals. If the states where the benefit is received cannot be determined for a business customer, the taxpayer should look first to where the services are ordered and then, if necessary, to the business customer's address.

New Jersey joins neighboring states, New York, Connecticut and Pennsylvania in adopting market-based sourcing. Of course, the catchall bucket of "all other business receipts" was not altered and remains assigned to where "earned." With no change in the statutory language, we will have to wait and see whether the Division of Taxation changes its interpretation of the catchall provision.

Changes the computation of new operating losses from a pre-apportionment basis to a post-apportionment basis

- This item is discussed in detail above in the MUCR section but is repeated here as it applies to separate filers as well as to groups. See above for more details.

Imposes a surtax of 2.5%, presumably on allocated entire net income for 2018 and 2019

- The surtax is reduced to 1.5% for 2020 and 2021 on taxpayers (other than public utilities) with more than $1 million of net income allocated to New Jersey. The surtax cannot be reduced by business incentive credits.

The last-minute legislative revisions deleted the language that imposed the surtax on "a taxpayer's allocated net income." We expect that this glitch will be corrected and the base on which the surtax is imposed will be clarified. We also note that the surtax was a mixed bag; the Act extended the surtax period from two to four years, and, for companies having entire net income over $25 million, the surtax was reduced from 4% to 2.5% for 2018 and 2019 and to 1.5% for 2020 and 2021. However, all in at 11.5% (2018 and 2019) or 10.5% (2020 and 2021), New Jersey's CBT rates stand out as being among the highest nationwide. Further, the cliffs for application of the surtax remain in the Act, leaving open the prospect of constitutional challenges.

Replaces the Dividends Tax with a DRD topping out at 95%

- The hefty Dividends Tax that appeared in prior versions of the legislation was eliminated. In its place, the Act reduces the DRD that a company is entitled to take.

- For 80% or more owned subsidiaries, the Act revises the DRD from 100% for periods ending on or before December 31, 2016, to 95% for periods beginning after December 31, 2016.
- For 2017, the 5% of deemed dividends included in entire net income is to be "allocated" using the lower of the taxpayer's 3-year average of its New Jersey apportionment factors for 2015, 2016 and 2017 or 3.5%. To the extent the deemed dividend is the result of application of I.R.C. 965, it appears that inclusion of the gross amount is contemplated.
- Dividends that flow up through multiple tiers will entitle the parent to exclude those dividends from entire net income based on the subsidiary's apportionment factor (though if the multiple tiers were already included in the combined group, the amounts would have been eliminated already).
- Presumes IRC § 965 repatriation toll charge amounts are included in taxable income (at 95%, allocated using the 3-year average mentioned above or 3.5%, whichever is lower), but related deductions are not allowed.

The Act corrected some of the troubling aspects of earlier bill iterations that had proposed a separate 9% tax on dividends (presumably targeting deemed repatriation earnings under IRC § 965). However, because 5% of such repatriated earnings are still subject to tax on a basis that may not reflect the business, income or capital of the taxpayer, the provision may be subject to challenge.

Disallows the IRC § 199A deduction for qualified business income from pass-through entities for periods beginning after December 31, 2017

Applies the IRC § 163(j) interest expense limitation on a pro-rata basis to interest paid to both related and unrelated parties, regardless of whether the related parties are subject to the interest add-back provision

- We understand this provision is intended to ensure that a taxpayer does not have to add back amounts greater than the amount for which it received the benefit of a deduction.

Changes to treaty-protected income

- The Act removes the statutory requirement that there be an express exemption from state income taxation in a treaty to qualify for an exemption from the interest add-back and intangible add-back requirements (a good move, since treaties generally do not address state taxation).
- However, the treaty exemption will now require that the related member be subject to tax in the foreign nation on a tax base that includes the income and that the income be taxed at an effective rate equal to or greater than a rate of 3 percent points less than the tax applied to taxable interest by New Jersey.

The provision was presumably intended to overrule *Infosys Limited of India, Inc. v. Director, Division of Taxation*, Dkt. 012060-2016 (N.J. Tax Ct. Nov. 28, 2017), *aff'd on reconsideration* (Mar. 19, 2018).

Given the increase in New Jersey's tax rates due to the new surtax, it may still be difficult for companies to establish that they qualify for the exemption from the interest add-back requirement, particularly given the onerous definition of "effective tax rate" used in New Jersey and approved by New Jersey courts.

Repeals (finally) the AMA for years beginning on or after January 1, 2018

The AMA was enacted as part of the Business Tax Reform Act of 2002 and initially applied to all CBT taxpayers. However, the AMA sunset for taxpayers other than companies protected by P.L. 86-272 for years beginning on or after July 1, 2006. The constitutionality of imposing the AMA on just P.L. 86-272-protected companies, while setting the AMA rate to zero for all other companies, is currently being litigated.[2]

Requires the adoption of a tax amnesty period

As part of separate legislation, New Jersey created an incentive to taxpayers to clean up their acts in light of the significant changes to the CBT (and changes enacted to the Gross Income Tax by P.L. 2018, c. 45, and proposed for the Sales Tax by A 4261) by requiring the Division of Taxation to establish a 90-day amnesty program that ends no later than January 15, 2019. It would apply to "any State tax" accruing for periods after New Jersey's last tax amnesty in 2009. Only half the statutory interest as of November 1, 2018, would be due, and no late payment penalty, late filing penalty, delinquency penalty, or cost of collection or recovery fee would be imposed. However —and this is unusual—civil fraud and criminal penalties are required to be paid. In addition, a 5% amnesty penalty is imposed, which is not subject to waiver or abatement. (Of course, New Jersey's Supreme Court has recognized that, at least in certain circumstances— e.g., where legal or factual issues come to an otherwise compliant taxpayer after the amnesty period is closed—the amounts due are not subject to imposition of amnesty penalties.[3]) Although taxpayers that have been notified that they are subject to criminal investigation are not eligible to participate in the program, taxpayers that have administrative or judicial appeals pending may be eligible if the Director expressly so approves.

Conclusion

There is a more to digest here in these new provisions than there is in a meal from the Rutgers' grease trucks. We expect corrections, clarifications, and interpretations to be released over the next several months. So stayed tuned for more.

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Endnotes

[1] For those whose travels do not include New Jersey, a "jughandle" (also known as a "New Jersey left" although some other lucky states also use them) is a ramp on the right side of the road that allows drivers to make a left or a U-turn. These ramps are called "jughandles" because – you guessed it – the loopy ramps look like the handles on jugs.

[2] Mayer Brown is representing companies in such litigation.

[3] *United Parcel Svc. Gen'l Svcs. V. Dir., Div. of Taxation*, 220 N.J. 90 (2014).

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