Multistate Tax
EXTERNAL ALERT

New Jersey Tax Court Interprets Exceptions to Expense Add-back Statute

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Overview

The Tax Court of New Jersey recently rendered a decision in *Morgan Stanley & Co. v. Director, Division of Taxation*, interpreting the application of the "subject-to-tax" and "unreasonable" exceptions to New Jersey's Corporate Business Tax ("CBT") related-party add-back statute.[1] In *Morgan Stanley,* the Tax Court concluded that the while the taxpayer did not qualify for the "subject-to-tax" exception, the New Jersey Division of Taxation ("Division") "acted unreasonably" in the application of the "unreasonable" exception.[2] In analyzing the "unreasonable" exception, the court also outlined several factors that may be relevant for taxpayers with related-party interest potentially subject to the statutory add-back.

In this Tax Alert we summarize the arguments and holdings in the *Morgan Stanley* decision.

Background

In determining the CBT base, taxpayers are required to add back "[i]nterest paid, accrued or incurred for the privilege period to a related member . . ." unless such interest qualifies for an exception.[3] In *Morgan Stanley*, the taxpayer, a Delaware corporation, had entered into several financial transactions with related parties that resulted in interest that the taxpayer added back on its originally filed CBT return. Subsequently, the taxpayer filed an amended return on which it did not add back the related-party interest and claimed a refund of tax previously paid. The Division denied the refund, recalculated the taxpayer's interest expense add-back and assessed additional tax.

In its argument before the Tax Court, the taxpayer contended that the interest paid to related parties qualified under the statutory "subject-to-tax" and "unreasonable" exceptions.

"Subject-to-tax" Exception

The New Jersey statutes provide an exception to the related-party interest add-back provision based on a multi-pronged test that includes a requirement that the taxpayer establish that the related party was subject to tax in another jurisdiction and the measure of tax included interest received.[4] The taxpayer in *Morgan Stanley* argued that transactions with related parties that were part of its New York combined return met the requirements of the subject-to-tax exception.

For the year in question the taxpayer had filed a combined return in New York wherein the interest payments made to certain affiliates were included. However, the taxpayer reported a taxable loss on a combined basis on its pro forma federal consolidated return, which is the starting point for computing New York entire net income. Consequently, the taxpayer did not pay a tax on income in New York, but rather paid the fixed dollar minimum tax of $1,500. The Tax Court concluded that since it was clear that the taxpayer had not paid the tax in New York on a measure of income that included the interest received, but rather the fixed dollar minimum tax, the taxpayer did not qualify for the subject-to-tax exception. Furthermore, the court noted that the taxpayer did not provide any evidence other than its New York return to support qualification for this exception.

"Unreasonable" Exception

Next the Tax Court addressed the "unreasonable" exception. After reviewing the legislative history of the add-back statute and the statutory language, the court rejected the taxpayer's position that all that is necessary for application of the "unreasonable" exception is a valid non-tax business purpose and economic substance.

[1] *Morgan Stanley & Co. v. Director, Div. of Taxation*, No. 007557-2007, 2014 N.J. Tax LEXIS 23 (N.J. Tax Ct. Oct. 29, 2014).
[2] *Morgan Stanley*, 2014 N.J. Tax LEXIS 23, at *44.
[3] N.J. Rev. Stat. § 54:10A-4(k)(2)(I).
[4] *Id*.

However, the court also rejected the Division's argument that the taxpayer had to prove that it had paid tax to another jurisdiction on the interest to avail itself of the "unreasonable" exception. According to the court, the "unreasonable" exception can apply in circumstances such as, but not limited to,

> unfair duplicative taxation; a technical failure to qualify the transaction under the statutory exceptions; an inability or impediment to meet the requirements due to financial constraints; an unconstitutional result; [or] a demonstration that the transaction for all intents and purposes is an unrelated loan transaction.[5]

Applying the foregoing standards, the Tax Court found that the taxpayer was entitled to the "unreasonable" exception based on an examination of the "totality of the circumstances" as established in an earlier Tax Court decision in *Beneficial New Jersey v. Division of Taxation.*[6] According to the court in *Morgan Stanley*, the Division failed to examine the totality of facts and circumstances to determine whether the add-back was unreasonable. The court therefore concluded that the Division "acted unreasonably" when it applied the "unreasonable" exception.[7] On this basis, the court ruled in favor of the taxpayer.[8]

Considerations

Although the appeal period related to the Tax Court's decision in *Morgan Stanley* remains open, and thus the case is not yet final, taxpayers who are under audit or have added back interest expense on their returns may wish to consider whether they may qualify for the "unreasonable" exception based on the various indicators outlined above.

Contacts

If you have questions regarding the New Jersey Tax Court's decisions in *Morgan Stanley* or *Beneficial*, or pertaining to other New Jersey tax matters, please contact either of the following Deloitte Tax LLP professionals.

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[5] *Morgan Stanley*, 2014 N.J. Tax LEXIS 23, at *34.
[6] *Beneficial New Jersey v. Div. of Taxation*, No. 009886-2007 (N.J. Tax Ct. Aug. 31, 2010).
[7] *Morgan Stanley*, 2014 N.J. Tax LEXIS 23, at *44.
[8] *Morgan Stanley*, 2014 N.J. Tax LEXIS 23, at *44-45.