New Jersey Tax Court Permits Adjustments to Federal Basis, Holding that "Fictitious Income" from Sale of Property Cannot Be Taxed For Corporation Business Tax Purposes

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Overview

The Tax Court of New Jersey recently rendered decisions in favor of taxpayers in two separate cases that addressed the question of whether a taxpayer may for New Jersey Corporation Business Tax ("CBT") purposes adjust the federal basis in its property to account for depreciation deductions for which it received no CBT benefit. In *Toyota Motor Credit Corporation v. Director, Division of Taxation*[1] and in *Ford Motor Credit Company v. Director, Division of Taxation*[2] the Tax Court ruled that when calculating the net gain from the sale of their respective capital assets, the taxpayers could increase the federal basis in the property they sold during the years at issue by the amount of depreciation that was unused for CBT purposes. Thus, the taxpayers were allowed to depart from the federal adjusted basis in calculating the gain to account for the combined effect of New Jersey's federal bonus depreciation decoupling and temporary net operating loss ("NOL") suspension, resulting in reduced entire net income subject to the CBT. In rendering its decisions, the Tax Court reasoned that the New Jersey Division of Taxation ("Division") cannot tax the "fictitious income" that was attributable to depreciation deductions taken by the taxpayers for federal income tax purposes but that provided no benefit for CBT purposes.

The Tax Court in *Toyota Motor Credit Corporation* also addressed two additional issues:

- Whether New Jersey's 2002 federal bonus depreciation decoupling statute[3] includes all assets acquired after September 10, 2001, rather than only assets that were acquired starting from the first taxable year beginning on or after January 1, 2002.
- Whether it was erroneous for the Division to remove (under New Jersey's former "throwout rule") the taxpayer's receipts sourced to Nevada, South Dakota, and Wyoming from the denominator of the receipts fraction used to determine CBT liability.

Although the Division has not appealed either decision, the appeal period remains open. Accordingly, these cases are not yet final. In this Tax Alert we summarize the two Tax Court decisions and offer some taxpayer considerations.

Toyota Motor Credit Corporation v. Director, Division of Taxation

The taxpayer in *Toyota Motor Credit Corporation,* a California corporation operating in various states including New Jersey, purchased leased vehicles from automotive dealers whereby an auto dealership first would enter into a vehicle lease agreement with a consumer and then assign the lease agreement to the taxpayer. The taxpayer would then collect the lease payments from the consumer, and once the lease expired, would sell the underlying used vehicle – which generally resulted in a net gain due to basis reductions for depreciation expense.

During its fiscal tax years ending in 2003 and 2004, the taxpayer recognized federal depreciation recovery gain of approximately $484 million and $1.3 billion, respectively, from the sale of leased vehicles. Initially, the taxpayer used the federal adjusted basis to compute its corresponding gains for CBT purposes. Subsequently, the taxpayer filed amended CBT returns to decrease the previously reported CBT gains by excluding the depreciation recovery gains from the entire net income used to determine its CBT liability, essentially reflecting an increase in the federal tax basis of the sold vehicles to the extent of depreciation deductions taken in prior periods for which it did not receive any CBT benefit.

[1] *Toyota Motor Credit Corporation v. Director, Division of Taxation*, Tax Court of New Jersey, Dkt. No. 002021-2010, 2014 N.J. Tax LEXIS 19 (August 1, 2014).
[2] *Ford Motor Credit Company v. Director Division of Taxation,* Tax Court of New Jersey, Dkt No. 015751-2009 (August 5, 2014).
[3] Ch. 40 (A.B. 2501), Laws 2002, amending N.J. REV. STAT. § 54:10A-4(k)(12)(A).

In periods prior to the fiscal years ending in 2003 and 2004 at issue, the taxpayer was allowed federal depreciation deductions of approximately $2 billion that were in excess of its CBT "entire net income," and which resulted in increased NOLs by the same amount to carry forward. As such, for the tax years at issue, the taxpayer normally would have offset the increased NOLs against the corresponding depreciation recovery gains for CBT purposes. However, New Jersey had suspended[4] the use of NOLs for these fiscal tax years, thus depriving the taxpayer the ability to offset the resulting gains under the CBT. To the extent the NOLs were created by the depreciation deductions, and citing N.J.S.A. 18:7-5(a)(2)(iv) that expressly allows for a basis adjustment upon retirement of assets for CBT purposes, the Tax Court in a published decision drew a parallel with the ruling in *Moroney v. Director, Division of Taxation*[5] and disallowed the Division from taxing the fictitious income[6] arising from the unused depreciation deductions that decreased the federal basis in the sold assets.

In *Moroney*, the individual taxpayer used the purchase price rather than federal basis as the basis for rental property it sold for New Jersey Gross Income Tax ("GIT") purposes, because the property had generated losses for which the taxpayer had not received any offsetting GIT benefit. The Division contended that *Moroney* was a GIT case that did not apply to the CBT as doing so would contravene the statutory suspension on CBT NOL carryforwards during the relevant tax years. However, the Tax Court reasoned that the GIT ruling in *Koch v. Director, Division of Taxation*[7] and its principles applied in *Moroney* also applied to the CBT, furthering the CBT statutory objective to tax only the actual gains realized by an entity through the sale of its capital assets. In *Koch,* the New Jersey Supreme Court concluded that where a taxpayer has not derived any benefits from the use of losses in the prior years, he can be taxed only on his actual economic gain and not on fictitious income. Therefore, the taxpayer here was allowed to depart from the federal adjusted basis on vehicles sold during tax years 2003 and 2004 to the extent of the depreciation deductions taken in prior periods for which it did not receive any CBT benefit, resulting in reduced net gains under the CBT.

Ford Motor Credit Company v. Director, Division of Taxation

Four days subsequent to its published decision in *Toyota Motor Credit Corporation*, the Tax Court released an unpublished decision involving a very similar fact pattern and concerning the same argument for adjusting the federal basis in property sold. For the tax periods 2002 and 2003, the taxpayer in *Ford Motor Credit Company* had approximately $5.2 billion in depreciation deductions that were recaptured in calculating the gains on vehicles sold for federal income tax purposes, and argued that under *Moroney* it was entitled to depart from the federal adjusted basis when calculating the corresponding net gain for CBT purposes. In effect, the taxpayer contended that the CBT suspension on the use of NOLs prevented it from benefitting under the CBT from approximately $5.2 billion in depreciation deductions available to it under federal income tax law. The Tax Court, noting that the material facts and issues in this case were similar to that in *Toyota Motor Credit* Corporation, once again drew a parallel to the decision in *Moroney* and ruled that if the basis in the sold vehicles was not adjusted for CBT purposes, it would inappropriately result in taxing fictitious income from the depreciation recapture for which the taxpayer did not receive any CBT benefit. As in *Toyota Motor Credit Corporation*, the Tax Court reasoned that a "Moroney adjustment" must be made to the federal basis in this case as it furthers the CBT statutory objective to tax only the economic gain a taxpayer realizes from the sale of property.

Other CBT Issues Addressed in *Toyota Motor Credit*

The Tax Court also ruled in the taxpayer's favor regarding certain timing of the application of New Jersey's bonus depreciation decoupling provision. While the Division and the taxpayer agreed that the decoupling provision under N,J.S.A 54:10A-4(k) first applied to privilege periods starting on or after January 1, 2002, they disagreed on the timing of the asset acquisition to which the provision applied. The taxpayer asserted that it included all assets acquired after September 10, 2001, while the Division argued that it only included assets acquired during any privilege period beginning on or after January 1, 2002 (which, in this case, began on October 1, 2002). The Tax Court agreed with the taxpayer and concluded that the statute was clear in

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[4] N.J.S.A. § 54:10A-4(k)(6)(E) suspended the use of NOL carryovers for privilege periods beginning during calendar years 2002 and 2003, thus prohibiting NOL carryovers for this taxpayer for its fiscal years 2003 and 2004.
[5] 868 A.2d 1132 (N.J. Super. Ct. App. Div. 2005).
[6] The Tax Court noted that the applicable provision N.J.S.A. 54:10A-4(k) defines entire net income as including profit gained through sale of capital assets, hence drawing a distinction between economic gain versus fictitious gain.
[7] 722 A.2d 918 (N.J. 1999).

that it included all assets acquired on or after September 10, 2001. In doing so, the Tax Court ruled that the Division's administrative regulation,[8] limiting the application to assets acquired only on or after January 1, 2002 and during a fiscal year commencing on or after January 1, 2002, was an unreasonable exercise of the Division's authority. Accordingly, the taxpayer could apply the federal bonus depreciation decoupling provisions to all vehicles it purchased after September 10, 2001, even if the property was purchased prior to the start of the taxpayer's fiscal year on October 1, 2002, thereby resulting in depreciation decoupling for a more expansive subset of vehicles sold and permitting added corresponding "Moroney adjustments" to federal basis for the tax years at issue.

The Tax Court lastly addressed an issue related to New Jersey's former "throw-out" rule.[9] For the fiscal years 2003 through 2006, the Division had made an adjustment to the taxpayer's CBT apportionment factor by removing receipts sourced to Nevada, South Dakota, and Wyoming from the denominator of the receipts fraction as these states did not impose an income or other business activity tax on these receipts. The Tax Court concluded that the taxpayer had substantial physical presence in these three states during the relevant tax years and, applying the external consistency principles enunciated in *Whirlpool Properties, Inc. v. Director, Division of Taxation*,[10] ruled that the throw-out rule did not apply to receipts from sales to these states. In doing so, the Tax Court explained that the "policy decision" made by these states to not tax corporate income or business activities is not a constitutionally permissible basis on which to exclude receipts from these states from the denominator of the taxpayer's receipts fraction for CBT purposes.

Considerations

Although the appeal period related to these two Tax Court decisions remains open, and thus the cases are not yet final, taxpayers may wish to consider whether the Tax Court's reasoning and analysis may provide potential opportunities for similarly situated taxpayers in New Jersey, as well as in other states that had suspensions or limitations on NOL carryforwards, to adjust their federal basis in property sold during open periods.

Contacts

If you have questions regarding the New Jersey Tax Court's decisions in these two cases, or pertaining to other New Jersey tax matters, please contact any of the following Deloitte Tax LLP professionals.

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[8] N.J.A.C. 18:7-5.2(a)(2)(iv) had provided that the bonus depreciation decoupling provision applied to property acquired only during any privilege period beginning on or after January 1, 2002.
[9] The New Jersey throw-out rule, which was subsequently repealed effective tax years beginning on or after 2010, had excluded from the sales factor denominator receipts that "would be assigned to a state, possession or territory of the United States or the District of Columbia or to any foreign country in which the taxpayer is not subject to a tax on or measured by profits or income, business presence or business activity."
[10] 208 N.J. 141 (2011).