

## NJ Tax Court: Director did not err in finding that taxpayer failed to qualify for the unreasonable exception to interest add-back

### Overview

On April 25, 2016, the Tax Court of New Jersey in *Kraft Foods Global, Inc. v. Director, Division of Taxation*, held that the Director of the Division of Taxation (Director) did not err in determining that Kraft Foods Global, Inc. (Taxpayer) failed to establish that it was entitled to deduct interest payments made to its parent company during tax years 2005 and 2006 from its taxable income base for corporate business tax (CBT) purposes.<sup>1</sup> Upon the issuance of a final judgment by the Tax Court, an appeal may be sought to the Appellate Division of the Superior Court.

This Tax Alert summarizes the Tax Court's decision in *Kraft Foods Global, Inc. v. Director, Division of Taxation* and provides some taxpayer considerations.

### Background

The Taxpayer was an out-of-state corporation with activity in New Jersey that filed CBT returns for the years at issue and did not add back to its federal taxable income the deductions for interest payments it made to its parent, based on its contention that it satisfied the unreasonable exception to New Jersey's interest add-back requirement, provided in N.J. Rev Stat. § 54: 10A-4(k)(2)(l).<sup>2</sup> The parent had issued public debt in the form of bonds, and then transferred amounts equal to the bond proceeds to the Taxpayer.<sup>3</sup> After each transfer, the Taxpayer had executed a promissory note in favor of the parent in the amount equal to the transfer, and agreed to pay interest on the loans in amounts equivalent to the interest the parent was obligated to pay on its bonds.<sup>4</sup> The notes did not include a guarantee to the bondholders, did not provide for any recourse against the Taxpayer in the event that payment was not made on the notes, and did not mention the parent's bond obligations.<sup>5</sup> The Taxpayer asserted that the parent was able to secure more favorable interest rates than the Taxpayer would have otherwise been able to secure on its own and that without payments on the notes by the Taxpayer, the parent would not have been able to satisfy its obligations to the bondholders.<sup>6</sup>

After an audit of the Taxpayer's CBT returns for the 2005 and 2006 tax years, the Division of Taxation issued an assessment which included an adjustment adding back the interest payments made by Taxpayer to its parent.<sup>7</sup> In its notice, the Division asserted: "The debt between [Taxpayer] and [parent] is not at arm's length as [parent] is charging the same interest as it is paying. Also, [Taxpayer] is not a legal guarantor of the debt."<sup>8</sup>

### Taxpayer did not establish that it qualified for the unreasonable exception

In its analysis, the Tax Court first noted other New Jersey authority which had reached the conclusion that certain taxpayers qualified for the unreasonable exception.<sup>9</sup> This included its 2014 ruling in *Morgan Stanley & Co., Inc. v. Director, Division of Taxation*, wherein it held in favor of a taxpayer asserting the unreasonable exception and provided a list of factors relevant to the analysis.<sup>10</sup> The Tax Court also considered the Division's Technical Advisory Memorandum 2011-13(R),<sup>11</sup> which included a summary of its unpublished opinion that held that a taxpayer qualified for the unreasonable exception.

However, noting that N.J. Rev Stat. § 54: 10A-4(k)(2)(l) includes the phrase "as determined by the director," the Tax Court stated that "[i]t is evident that the Legislature intended to delegate to the Director in the first instance the authority to evaluate the evidence produced by the taxpayer and to determine whether it would be unreasonable to

<sup>1</sup> *Kraft Foods Global, Inc. v. Dir., Div. of Taxation*, No. 017974-2009, 2016 N.J. Tax LEXIS 9, \*1-2, \*29-31 (N.J. Tax Ct. Apr. 25, 2016).

<sup>2</sup> *Id.* at \*2-3, \*6-7.

<sup>3</sup> *Id.* at \*4.

<sup>4</sup> *Id.*

<sup>5</sup> *Id.* at \*5.

<sup>6</sup> *Id.* at \*4, \*6.

<sup>7</sup> *Id.* at \*7.

<sup>8</sup> *Id.*

<sup>9</sup> *Id.* at \*17-21.

<sup>10</sup> 28 N.J. Tax 197, 220 (2014). Notably, in *Morgan Stanley*, there was not the development of the details regarding the intercompany debt. For additional information on *Morgan Stanley*, Deloitte's May 22, 2015, Tax Alert summarizing the case is available [here](#).

<sup>11</sup> N.J. Div. of Taxation, Technical Advisory Memorandum 2011-13(R) (Feb. 24, 2016).

deny an exception to the interest add-back provision.”<sup>12</sup> In this light, the Tax Court found that the Director’s determination that the Taxpayer did not qualify for the unreasonable exception “is entitled to deference by this court and will not be overturned ‘so long as it is not plainly unreasonable.’”<sup>13</sup>

The Tax Court next considered that the legislature provided a straightforward way for a taxpayer to qualify for an add-back exception by creating the guarantee exception,<sup>14</sup> wherein “the taxpayer need provide only a preponderance of evidence that it has guaranteed the underlying loan.”<sup>15</sup> While the Tax Court acknowledged that the legislature, in creating the unreasonable exception, must have also contemplated other ways to qualify for an add-back exception without having to guarantee the underlying debt,<sup>16</sup> the Tax Court stated that in order to qualify under the unreasonable exception, “the taxpayer has a higher burden of proof” and must show through “clear and convincing evidence that disallowance of the interest deduction is unreasonable.”<sup>17</sup>

The Tax Court then considered the evidence put forth by the Taxpayer, focusing on the fact that the Taxpayer was not responsible for its parent’s debt to the bondholders.<sup>18</sup> The Tax Court noted that the Taxpayer was not required to make interest payments on the bond debt, and that the parent was not obligated to use the interest it received from the Taxpayer to pay the bondholders.<sup>19</sup> It also noted that the notes did not refer to the bonds, and that the bondholders ultimately had no rights of recourse against the Taxpayer.<sup>20</sup> Therefore, the Tax Court reasoned, the Director came to a reasonable conclusion that the parent’s “debt was not, legally or effectively, ‘pushed down’ to the [Taxpayer],” and that the notes in favor of the parent represent “financial transactions entirely independent” from the parent’s debt to its bondholders.<sup>21</sup>

The Tax Court also stated that the company made a business decision to have the parent borrow the money and not to have the Taxpayer serve as guarantor, which would presumably have qualified the interest expense for the guaranteed debt prong of the interest add-back statute.<sup>22</sup> Thus, the Taxpayer “must...accept the tax consequences of those business decisions,”<sup>23</sup> and held that the Director had “acted reasonably when he determined that [the Taxpayer] did not meet its evidentiary burden.”<sup>24</sup>

### Considerations

The Tax Court’s holding in *Kraft* highlights the significance of the facts relative to whether a taxpayer may be eligible for an exception to New Jersey’s interest add-back statute. Taxpayers evaluating their own eligibility for the unreasonable exception to New Jersey’s interest add-back statute should give consideration to this decision, as well as the Tax Court’s 2014 decision in *Morgan Stanley & Co., Inc.*, in which it outlined a “totality of the circumstances” analysis, based upon certain broad indicators.

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<sup>12</sup> 2016 N.J. Tax LEXIS at \*23-24.

<sup>13</sup> *Id.* at \*24 (quoting *Metromedia, Inc. v. Dir., Div. of Taxation*, 97 N.J. 313, 327 (N.J. 1984)).

<sup>14</sup> N.J. Rev Stat. § 54: 10A-4(k)(2)(l) (2016).

<sup>15</sup> 2016 N.J. Tax LEXIS at \*28.

<sup>16</sup> *Id.* at \*28-29.

<sup>17</sup> *Id.* at \*29.

<sup>18</sup> *Id.*

<sup>19</sup> 2016 N.J. Tax LEXIS at \*29-30.

<sup>20</sup> *Id.*

<sup>21</sup> *Id.* at \*30.

<sup>22</sup> *Id.* at \*31 (citing *General Trading Co., Inc. v. Dir., Div. of Taxation*, 83 N.J. 122, 136-37 (N.J. 1980)).

<sup>23</sup> 2016 N.J. Tax LEXIS at \*31.

<sup>24</sup> *Id.* at 29.

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