

## New Jersey Tax Court rules IRC tax attribute reductions may not be reversed

### Overview

The Tax Court of New Jersey (Tax Court) recently held that a taxpayer could not adjust its New Jersey entire net income Corporate Business Tax (CBT) base to reverse the impact of reductions in tax attributes required under the Internal Revenue Code (IRC) and related consolidated return regulations.<sup>1</sup> On August 25, 2015, MCI Communications Services, Inc. (taxpayer) appealed the Tax Court's decision. Accordingly, the case remains pending. This Tax Alert summarizes the Tax Court's decision and offers some taxpayer considerations.

### Background

During the 2005 tax year, the taxpayer was a wholly owned subsidiary of MCI, Inc. (MCI).<sup>2</sup> As a consequence of a Chapter 11 reorganization,<sup>3</sup> a substantial amount of debt of MCI and its affiliated subsidiaries was cancelled in 2005.

MCI filed a consolidated return for federal purposes consisting of MCI and affiliates for the tax year 2005. Pursuant to applicable IRC provisions,<sup>4</sup> the income from cancellation of indebtedness (CODI) was excluded from the income of the members of the consolidated group for federal purposes. However, these provisions also require the reduction of certain tax attributes to the extent of the excluded CODI.<sup>5</sup> As MCI (the upper tier member) had limited tax attributes, the federal consolidated return regulations required MCI to "push down" the CODI to other members in the group to offset against their tax attributes.

As a result of the application of the federal income tax provisions, the taxpayer was required to reduce its tax attributes by approximately \$3.584 billion, the majority of which was the result of CODI attributed to the taxpayer that was pushed down from the upper tier members. For tax year 2005, the taxpayer effected the reduction in tax attributes by a reduction in the basis of depreciable assets, which resulted in an increase in its 2005 CBT entire net income in the amount of \$271 million due to lower depreciation deductions. On its 2005 New Jersey CBT return, the taxpayer sought to deduct the \$271 million from its entire net income as a reversal of the federal tax attribute adjustment. Upon examination, the New Jersey Division of Taxation disallowed the deduction.

### The Tax Court's decision

Before the Tax Court, the taxpayer presented a number of arguments in support of its position in favor of the reversal, for New Jersey CBT purposes, of the income attributed to the reduction of tax attributes. Since New Jersey does not permit a consolidated return, the taxpayer argued that the federal consolidated return regulations requiring push down of CODI do not apply in the New Jersey setting. The taxpayer asserted that its entire net income would not have increased by \$271 million if it reflected entire net income as if it had filed a separate federal return as required under N.J. Admin. Code §18:7-11.15. Thus, the push-down adjustments to basis for the CODI of the upper tier members would not have occurred.

The Tax Court rejected this argument, holding that the taxpayer—as a member of the MCI group filing a consolidated return for federal purposes—consented to such filing and "must accept [the] consequence[.]" taking into account the excess CODI from the upper tier members and thereby increasing its federal taxable income.<sup>6</sup> In a footnote to its decision, the Tax Court also noted that under the definition of "separate taxable income" pursuant to Treas. Reg. §1.1502-12, the taxpayer "would be required to calculate its separate taxable income with reference to the reductions in tax attributes associated with the CODI pushed down to it from its upper tier members."<sup>7</sup>

<sup>1</sup> *MCI Communication Services, Inc. v. Director, Divisions of Taxation*, Tax Court of New Jersey, Dkt. No. 013905-2010 (Jul. 20, 2015).

<sup>2</sup> In April 2004, Worldcom, Inc. emerged from bankruptcy and merged into MCI, Inc., the latter of which became the surviving entity.

<sup>3</sup> IRC §108(a) uses the phrase Title 11 of the US Bankruptcy code for what is commonly referred to as a Chapter 11 reorganization.

<sup>4</sup> IRC §108(a)(1)(A) excludes income from discharge of indebtedness pursuant to a Title 11 bankruptcy filing.

<sup>5</sup> IRC §108(b)(2) requires reduction of certain tax attributes whether they are net operating losses, tax credits, or basis of assets that would generate deductions, including depreciation deductions, to the extent of CODI excluded pursuant to IRC §108(a)(1)(A). See also, Treas. Reg. §1.1502-28T.

<sup>6</sup> *MCI Communication Services, Inc.* at 12.

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

The Tax Court was also unpersuaded that taxpayer's deduction, reversing the basis reduction, was supported by the absence of any provision in the CBT requiring attribute reduction. Citing the decision in *International Business Machines Corp. v. Division of Taxation*,<sup>8</sup> the Tax Court stated that "it is precisely the absence of any provision in the CBT to reverse the §108(b) adjustments in determining taxable income that requires they be taken into account in determining Entire Net Income under the N[ew] J[ersey] CBT."<sup>9</sup> The Tax Court ruled that the CBT definition of entire net income under N.J. Stat. Ann. §54:10A-4(k) includes the effect of the federal adjustment made pursuant to reduction in tax attributes under IRC §§108 and 1502.

The Tax Court also rejected the taxpayer's argument that the disallowance of a deduction to reverse the impact of the reduction in tax attributes effectively "creates and taxes" phantom income,<sup>10</sup> a practice which the taxpayer asserted was rejected in *Toyota Motor Credit Corporation v. Division of Taxation*.<sup>11</sup> Distinguishing the facts in *Toyota*, which involved the implications of a depreciation deduction allowed for federal purposes for which the taxpayer received no New Jersey tax benefit, the Tax Court in the instant matter noted that the taxpayer was not denied depreciation deductions for New Jersey purposes that were otherwise allowed on the federal return. The Tax Court held that reduction of tax attributes required under IRC §108(b) is not similar to the issue in *Toyota*, where there "was an inequality of treatment between the federal and New Jersey law, while in the matter now before the court the same benefit (or lack thereof) accorded to [the taxpayer] under federal law is identical to that being accorded [the taxpayer] under New Jersey law."<sup>12</sup>

Finally, the Tax Court considered the applicability of the statement by the New Jersey Division of Taxation Director (Director) in the Winter 1996 *New Jersey State Tax News* with regard to net operating losses (NOLs).<sup>13</sup> In the 1996 article, the Director stated that New Jersey will not require a reduction in NOLs with respect to CODI because no CBT provision exists requiring a reduction in tax attributes related to CODI.<sup>14</sup> Noting that entire net income for CBT purposes under N.J. Stat. Ann. §54:10A-4 (k) is defined as federal taxable income before deduction for NOLs, the Tax Court held that the Director's statement with regard to NOLs "has no bearing on the effect of the federal requirement that taxable income be calculated with reference to all reductions in tax attributes required by IRC §108(b)."<sup>15</sup> Thus, the reduction of tax attributes related to reduction in basis of depreciable assets is required to be taken into account for CBT entire net income purposes.

### Considerations

As noted previously, the taxpayer has filed an appeal with the appellate division of the New Jersey Superior Court. Although this case is not final, taxpayers may wish to consider the impact of the Tax Court's reasoning in this decision relative to adjustments on their federal consolidated return and the respective separate company reporting for CBT purposes as the decision is potentially inconsistent with certain New Jersey regulations<sup>16</sup> and general principles of separate company tax reporting.

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<sup>8</sup> *International Business Machines Corp. v. Division of Taxation*, 26 N.J. Tax 102,112 (Tax 2011).

<sup>9</sup> *MCI Communication Services, Inc.* at 12.

<sup>10</sup> *Id.* at 12.

<sup>11</sup> *Toyota Motor Credit Corporation v. Division of Taxation*, 28 N.J. Tax 96, 115-116 (Tax 2014).

<sup>12</sup> *MCI Communication Services, Inc.* at 15.

<sup>13</sup> *New Jersey State Tax News* (Winter 1996), at 15; available [here](#).

<sup>14</sup> *Id.* Note that for tax years beginning after June 30, 2014, the CBT was amended to require taxpayers to reduce their NOLs by the amount of CODI excluded under IRC § 108(a).

<sup>15</sup> *MCI Communication Services, Inc.* at 17.

<sup>16</sup> See N.J. Admin. Code §18:7-11.15(b) ("[W]here a taxpayer has filed a consolidated return with the Internal Revenue Service for Federal income tax purposes, it must complete its return under the act and must reflect its entire net income and entire net worth as if it had filed its Federal return on its own separate basis.").

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