

New Jersey enacts sweeping Corporate Business Tax changes

Overview

On July 1, 2018, Governor Murphy signed Assembly Bill 4202¹ (A4202) effecting broad and foundational changes in the New Jersey Corporate Business Tax (CBT) which are applicable to privilege periods beginning on or after either January 1, 2017, January 1, 2018 or January 1, 2019 as is detailed below.

This tax alert outlines the significant New Jersey tax law changes contained in A4202 and provides some taxpayer considerations.

Mandatory Combined Filing

Effective for privilege periods beginning on or after January 1, 2019, A4202 requires the determination of entire net income on a combined basis for unitary members of an affiliated group.² This new combined filing also includes certain group elections more fully described below.

Default Water's-Edge Combined Filing Group. A4202 adopts mandatory unitary combined reporting, for privilege periods beginning on or after January 1, 2019. "Combined group" is defined to mean the group of all companies that have common ownership and are engaged in a unitary business, where at least one company is subject to tax in New Jersey. If no worldwide or affiliated group election is made (described below), the combined group is determined on a water's-edge basis.³ Generally, all US-incorporated, commonly-owned unitary members are included under this water's-edge methodology. However, members with 80% or more of its payroll and property outside the U.S. are excluded. Commonly-owned unitary members, wherever incorporated or formed, with at least 20% of property and payroll located in the US during the privilege period are also included in the combined filing.⁴ Additionally, any member that earns more than 20% of its income, directly or indirectly, from intangible property or related service activities that are deductible against the income of other members of the combined group is included in the water's-edge group. Finally, each member that has income and has "sufficient nexus" in New Jersey is also included.⁵

For New Jersey's CBT combined group, "common ownership means that more than 50% of the voting control of each member of a combined group is directly or indirectly owned by a common owner or owners, as determined by IRC Section 318, either corporate or non-corporate, whether or not the owner or owners are members of the combined group."⁶ Note that the combined group can include a captive insurance company.⁷

A4202 provides that "unitary business" means 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." In addition, "[u]nitary business shall be construed to the broadest extent permitted under the Constitution of the United States."⁸ The combined return will also include the direct or indirect distributive share of a partnership's unitary business income.⁹ In computing

¹ NJ A.N. 4202 (July 1, 2018.) A copy of the adopted law is available [here](#).

² NJ A.N. 4202, Sec. 18. See Sec. 33 for effective dates.

³ NJ A.N. 4202, Sec. 23 a.

⁴ Sec. 23 a (1)-(3).

⁵ Sec. 23 a (4). The exact meaning of this provision remains unclear.

⁶ Sec. 3 (aa).

⁷ Sec. 3 (y).

⁸ Sec. 3 (gg).

⁹ Sec. 18 (c).

the allocation factor for the combined group, the “taxable member shall use the combined group’s denominator”, and the numerator shall only include “that taxable member’s receipts assignable to this state.”¹⁰ Additionally, “in determining the numerator and denominator of the allocation factors of taxable members, transactions between or among members of the combined group shall be eliminated.”¹¹

Worldwide Filing Election. A4202 provides that the managerial member may make a worldwide filing election on a timely filed, original return which would be binding for the period for which the election is made and the five succeeding periods and can be revoked prior to the expiration of the election period with the Director’s permission.¹² For an affiliated group electing to have the combined group determined on a worldwide basis, foreign members of a worldwide combined return are required to produce US GAAP-adjusted foreign currency based P&L statements. Statements and apportionment factors are required to be translated to US dollars and further adjusted for book-tax differences as required by federal or state law.¹³

Affiliated Group Election. A4202 provides that the managerial member may also elect to file on an affiliated group basis if made on a timely filed, original return.¹⁴ For CBT purposes, A4202 provides that affiliated group has the same meaning as defined in IRC Section 1504,¹⁵ the “common parent corporation” of the affiliated group can be any recognized entity and references to “at least 80%” shall be read as “50% or more.”¹⁶ Additionally, the affiliated group is determined without regard to whether the group includes 1) corporations included in more than one federal consolidated return, 2) corporations engaged in one or more unitary businesses, or 3), corporations that are not engaged in a unitary business with any other members of the affiliated group” (potentially including non-US corporations).¹⁷

If the combined group elects to include all affiliated members, it is required to apportion income by including the entire net income and loss and allocation factors of all members regardless of any members’ nexus with New Jersey.¹⁸ This election is similarly binding for the electing year and five subsequent periods and can be revoked prior to the expiration of the election period with the Director’s permission.

Deduction to mitigate financial reporting impact for publicly-traded companies. Similar to other states which have recently shifted from separate filing to mandatory unitary combined filing,¹⁹ A4202 provides for a CBT deduction for the aggregate (net) increase in deferred tax liabilities or net decrease in deferred tax assets or a net change from deferred tax asset to deferred tax liability. The deduction is delayed until five years after the first combined filing and is deducted in 10% increments for a ten-year period. The deduction is computed based on a formula of the change in the deferred tax asset or liability divided by the tax rate applicable further divided by the apportionment factor used by the combined group. In order to apply the deduction, a statement is required to be filed with the Director on or before July 1 of the year subsequent to the year of which the first combined return is required.²⁰

Conversion of pre-combined filing net operating losses. Similar to New York’s shift to mandatory combined filing in 2015, A4202 revises the CBT carryforward rules for NOLs as a result of the change from separate entity filing to combined filing. NOLs carried forward from the period immediately prior to the first combined filing year (Base Year) are required to be converted from pre-apportioned to post-apportioned NOLs by applying the base year apportionment factor (Base Year BAF).²¹ The resulting carryforward for the Converted NOL (CNOL) remains available for 20 years from the privilege period that the taxpayer incurred the loss (i.e., no restart in 2019).²² A4202 also revises the rule for merged survivor companies

¹⁰ This is commonly referred to as the *Joyce* methodology.

¹¹ NJ A.N. 4202, Sec. 19 a-c.

¹² Sec. 23 b.

¹³ Sec. 18 b.

¹⁴ Sec. 23 b-c.

¹⁵ Sec. 3(x)(4).

¹⁶ *Id.*

¹⁷ *Id.*

¹⁸ Sec. 23 c. This is commonly referred to as the *Finnigan* methodology.

¹⁹ Massachusetts and Connecticut, for example.

²⁰ NJ A.N. 4202, Sec. 3.4 (16)(A) –(F).

²¹ “Base year” means the last privilege period prior to the effective date of the mandatory unitary combined reporting aspects of A4202. Sec 3.4 (u)(1).

²² Sec. 3.4(u)(2)(B).

allowing for the carryover of NOLs resulting from mergers among combined group members included in a New Jersey combined return filing.²³

A prior net operating loss (PNOL) is permitted to offset only the entire net income of the corporation that created the PNOL.²⁴ Any loss brought into a combined group will only be deductible for the member that incurred the loss or members of the group from the year in which the loss was incurred.²⁵

Added Surtax

A4202 imposes a CBT surtax on a temporary basis for privilege periods 2018 to 2021. The base CBT tax rate is 9%. For privilege periods beginning on or after January 1, 2018 through December 31, 2019, an incremental tax of 2.5% is added to the 9% CBT tax rate for allocated net income over \$1 million. For privilege periods ended on or after January 1, 2020 through December 31, 2021, an incremental tax of 1.5% is added to the 9% CBT tax rate for allocated net income over \$1 million.²⁶ Credits such as R&D credits are not permitted to offset the surtax though installment payments, estimated payments or overpayments from prior privilege periods may offset the surtax.²⁷

Dividend Received Deduction Limitation

For 2017 and later years, A4202 provides that the dividend received deduction (DRD) is reduced for a CBT taxpayer that owns 80% or more of a subsidiary - from 100% to 95%. For 2017, taxpayers are required to apportion the includible amount of the dividend by applying the lesser of 3.5% or the average apportionment factor for privilege periods 2015 through 2017. While A4202 provides that the 95% DRD limitation also applies for privilege periods beginning on or after January 1, 2018, application of this alternative three-year average apportionment rule (in lieu of 3.5%) remains unclear.²⁸

A4202 also requires a taxpayer to addback any deduction associated with IRC Section 965(c) retroactive to the privilege period beginning after December 31, 2016.

Other Responses to Federal Tax Reform

A4202 decouples from the new deduction for pass through entities included in new federal IRC Section 199A by not permitting the associated deduction for privilege periods beginning after December 31, 2017. This limitation applies for both CBT and gross income tax purposes.²⁹ Also, effective after December 31, 2017, New Jersey provides that the 30% limitation included in IRC 163(j) is to be applied on a pro rata basis and includes intercompany interest which would otherwise be required to be added back to New Jersey entire net income. There is no definition or other guidance to clarify the meaning or application of the term pro rata in this context.³⁰

Apportionment, Tax Base and Credits

Market-based sourcing for services. A4202 adopts market-based sourcing for income related to services for privilege periods beginning on or after January 1, 2019. Sales of services are to be included in the numerator of the apportionment formula if the benefit of the service is received in New Jersey. If the benefit is received both within and without the state a reasonable approximation of the value can be applied to the service received within the state. Where the location of the benefit cannot be determined, under certain circumstances sales are sourced to where the services were ordered or customer billing address.³¹

Amendments associated with treaty exemptions. A4202 amends the treaty exemption required for the addback of interest and intangible expenses made to related companies in nations with a comprehensive tax treaty with the United States. An addback would not be required to the extent the related entity is subject to tax in a foreign country that

²³ Sec. 25 b.

²⁴ Sec. 18 g(1).

²⁵ Sec. 18g(3). Further consideration of the manner in which combined group losses are generated and applied for privilege periods beginning on or after January 1, 2019 is beyond the scope of this alert.

²⁶ Sec. 1a (1)-(2).

²⁷ Sec. 1b.

²⁸ Sec. 3.5(a)(i)-(iii).

²⁹ Sec. 3.4(k)(2)(J)(ii).

³⁰ Sec. 3.4(k)(2)(K).

³¹ Sec. 7.6(B)(4).

includes the payment in the taxable base and was taxed at an effective tax rate equal to or greater than a rate that is 3 percentage points less than the rate of tax applied to taxable interest by New Jersey. The effective date for the new limitation is January 1, 2018.³²

A4202 also potentially broadens the type of modifications to federal taxable income required to arrive at the starting point for New Jersey CBT purposes by removing the modifier “specific” which previously existed in the modification to CBT entire net income for “the amount of any *specific* exemption or credit allowed in any law of the United States imposing any tax on or measured by the income of corporations.”³³

Non-refundability of Research and Development (R&D) credit. Effective January 1, 2018, A4202 provides that the R&D credit is no longer refundable.³⁴

Penalty and Interest Abatement Provisions

A4202 includes provisions to potentially abate statutory interest and penalties if additional tax liability results from the amendments provided in A4202.³⁵ For privilege periods before 2019, taxpayers are required to make catch-up payments either with the second estimated payment subsequent to the enactment of A4202 (December 31, 2018 for a calendar year taxpayer for a privilege period beginning on or after January 1, 2017) or by the first estimated payment due after January 1, 2019 for privilege periods beginning on or after January 1, 2018.

In the first year that a mandatory combined return is due, A4202 provides that “no penalties or interest will accrue due to underpayment that may result from the switch from separate returns to mandatory combined returns.”³⁶ Finally, any overpayment by a member of the combined group from a prior year will be credited against any amount owed by the combined group.³⁷

Considerations

For taxpayers that have filed 2017 privilege period CBT returns prior to the passage of A4202, amended returns may be necessary to incorporate the retroactive provisions of A4202, e.g., with regard to a DRD claimed on CBT return relative to deemed repatriation income recognized pursuant to IRC Section 965. This is just one of many complex changes to the CBT regime that will require careful analysis, and consultation with New Jersey tax advisors is recommended.

Contacts:

³² Sec. 4.5c (1).

³³ Sec. 3.4(k)(2)(A). It remains unclear as to the exact intent and scope of this provision.

³⁴ Sec. 6.1(b).

³⁵ Sec. 24.

³⁶ *Id.*

³⁷ *Id.*

External Multistate Tax Alert

If you have questions regarding A4202 or other New Jersey tax matters, please contact any of the following Deloitte professionals:

Norm Lobins
Managing Director
Deloitte Tax LLP,
Parsippany
+1 973 602 5373
nlobins@deloitte.com

Mike Bryan
Managing Director
Deloitte Tax LLP,
WNT, Philadelphia
+1 215 977 7564
mibryan@deloitte.com

Kevin Friedhoff
Senior Manager
Deloitte Tax LLP, Parsippany
+1 973 602 4216
kfriedhoff@deloitte.com

For further information, visit our website at www.deloitte.com

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