

# New Jersey Tax Court holds intercompany royalties deductible

## Overview

On May 24, 2017, the Tax Court of New Jersey ("Tax Court") in a published opinion *BMC Software, Inc. v. Director, Division of Taxation* ("BMC") held that royalties paid by a company to its parent company were deductible and not subject to the addback provisions for corporate business tax ("CBT") purposes.<sup>1</sup>

This Tax Alert summarizes the relevant arguments and holdings in the *BMC* decision.

## Background

BMC Distribution, Inc. ("Subsidiary") entered into a non-exclusive agreement with its parent, BMC Software, Inc. ("BMC"), to license, market and distribute BMC's prewritten software.<sup>2</sup> BMC also granted similar licenses to unrelated third parties.<sup>3</sup> Subsidiary was required to pay 55 percent of its license and maintenance revenue as a royalty to BMC.<sup>4</sup> An economic consulting firm was asked to determine arm's length royalty rate within a month after the execution of the BMC/Subsidiary agreement.<sup>5</sup> The economic consulting firm recommended a 55% royalty rate, which was consistent with BMC's foreign licensees and was also consistent with comparable industry royalty rates.<sup>6</sup>

Subsidiary reported the payments and did not add back a portion of the payments as the payments were included in BMC's net income.<sup>7</sup> BMC reported the royalty income on its CBT returns for the fiscal years ended 2005 through 2008, the years at issue.<sup>8</sup> BMC paid no CBT as its entire net income was \$0 after the deduction of net operating losses and dividend exclusions.<sup>9</sup> On examination the New Jersey Division of Taxation disallowed the exception to the addback rule as the parent had not actually paid CBT on the royalties received because of available net operating losses and other adjustments for the years at issue.<sup>10</sup>

BMC challenged the resulting assessment, arguing that the payments were actually payments for tangible personal property and not royalties.<sup>11</sup> BMC further argued that, in the alternative, if the payments were considered royalties, it was unreasonable for the addback to be applied to the payments.<sup>12</sup> The Tax Court rejected the argument that the payments were for tangible personal property, noting that the agreement was called a license agreement, the payments were referred to as royalties in the agreement and title to the software was never transferred.<sup>13</sup>

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<sup>1</sup> *BMC Software, Inc. v. Dir., Div. of Taxation*, No. 000403-2012, 2017 N.J. Tax LEXIS 9, \*50 (N.J. Tax Ct. May 24, 2017), available [here](#).

<sup>2</sup> *Id.* at \*4.

<sup>3</sup> *Id.*

<sup>4</sup> *Id.* at \*5-6.

<sup>5</sup> *Id.* at \*8.

<sup>6</sup> *Id.* at \*8-9.

<sup>7</sup> *BMC Software, Inc. v. Dir., Div. of Taxation*, No. 000403-2012, 2017 N.J. Tax LEXIS 9, \*14 (N.J. Tax Ct. May 24, 2017).

<sup>8</sup> *Id.* at \*13.

<sup>9</sup> *Id.* at \*13-14.

<sup>10</sup> *Id.* at \*15-16.

<sup>11</sup> *Id.* at \*16.

<sup>12</sup> *Id.* at \*16-17.

<sup>13</sup> *BMC Software, Inc. v. Dir., Div. of Taxation*, No. 000403-2012, 2017 N.J. Tax LEXIS 9, \*28-29 (N.J. Tax Ct. May 24, 2017).

### The Addback Rules

The Tax Court looked to the state's addback provisions noting that a deduction was permissible if the taxpayer could show that the adjustments were considered unreasonable.<sup>14</sup> The Tax Court looked to the regulations at N.J. Admin. Code § 18.7-5.18(b), and noted that "a deduction is allowed if a portion of such expense was paid or received by an unrelated member, and the transaction between the taxpayer and the related member was not for the principal purpose of tax avoidance."<sup>15</sup>

In applying the reasoning in *Morgan Stanley & Co, Inc. v. Director, Division of Taxation* ("Morgan Stanley"),<sup>16</sup> the Tax Court noted that "non-payment of CBT upon the added back income ... due to offset of income by losses, does not bar a taxpayer from proving that the addback (or disallowance of a deduction) would be unreasonable."<sup>17</sup> The Tax Court stated: "By not insulating the royalty or other intangible income received by the related member payee from being offset by NOLs (or barring the related member payor from using NOLs), the Legislature's focus appears to have been to capture such income so it would be taxable. It was not that CBT be actually paid on the items of added back intangible expense."<sup>18</sup>

The Tax Court agreed that the license agreement between Subsidiary and BMC was similar enough to the agreements with unrelated third parties that the payments were "substantively equivalent to an unrelated party transaction."<sup>19</sup>

The period to appeal this case remains pending.

### Considerations

*BMC*, in concert with *Morgan Stanley* and *Kraft Foods Global, Inc. v. Director, Division of Taxation*,<sup>20</sup> reinforces the significance of closely reviewing the facts associated with a company's intercompany transactions (and the associated documentation) when analyzing the potential availability of the addback exception.

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<sup>14</sup> *Id.* at \*33.

<sup>15</sup> *Id.* at \*33-34 (referencing N.J. Admin. Code § 18.7-5.18(b)).

<sup>16</sup> 28 N.J. Tax 197 (2014). Link to Prior Alert [here](#).

<sup>17</sup> *BMC Software, Inc.*, 2017 N.J. Tax LEXIS at \*34-35.

<sup>18</sup> *Id.* at \*36.

<sup>19</sup> *Id.* at \*40, \*47.

<sup>20</sup> *Kraft Foods Global, Inc. v. Dir., Div. of Taxation*, No. 017974-2009, 2016 N.J. Tax LEXIS 9 (N.J. Tax Ct. Apr. 25, 2016). Prior alert available [here](#).

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