TAM 2011-13R – Revised July 25, 2023
Tax: Corporation Business Tax

INTEREST ADD-BACK REQUIREMENT FOR PRIVILEGE PERIODS ENDING BEFORE JULY 31, 2023

N.J.S.A. 54:10A-4(k) (2) (I) requires corporations to add back interest expenses that were deducted as an expense and paid to a "related member." A "related member" is defined in N.J.S.A. 54:10A-4.4 and N.J.A.C.18:7-5.18(a) (4).

Note: For privilege periods ending on and after July 31, 2023, the related party addback provisions have been repealed.

EXCEPTIONS

The law establishes exceptions to this general rule.

1. "THREE PERCENT TAX RATE" EXCEPTION

N.J.S.A. 54:10A-4(k)(2)(I) provides that "a deduction shall be permitted to the extent that the taxpayer establishes by clear and convincing evidence, as determined by the director, that (i) a principle purpose of the transaction giving rise to the payment of the interest was not to avoid taxes otherwise due under the Revised Statutes or Title 54A of the Revised Statutes; (ii) the interest is paid pursuant to arm's length contracts at an arm's length rate of interest; and (iii)(aa) the related member was subject to tax on its net income or receipts in this State or another state or possession of the United States or in a foreign nation,(bb) a measure of the tax includes the interest received from the related member, and (cc) the rate of tax applied to the interest received by the related member is equal to or greater than a rate three percentage points less than the rate of tax applied to taxable interest by the State."

In N.J.A.C. 18:7-5.18(a) (4) (viii), the Division interprets "rate of tax" to mean the allocation factor times the tax rate percentage. The 3% tax rate means the effective rate. This interpretation was upheld in *Beneficial New Jersey v. Div. of Taxation, No. 009886-2007 (N.J. Tax Ct. 2010).*

2. "UNREASONABLE" AND "ALTERNATIVE APPORTIONMENT METHOD" EXCEPTIONS

N.J.S.A. 54:10A-4(k)(2)(I) further provides: "A deduction shall also be permitted if the taxpayer establishes by clear and convincing evidence as determined by the Director, that the disallowance is unreasonable, or the taxpayer and the director agree in writing to the application or use of an alternative method of apportionment under section 8 of P.L. 1945, c. 162 (C.54:10A-8); nothing in this subsection shall be construed to limit or negate the director's authority to otherwise enter into agreements and compromises otherwise allowed by law."

Pursuant to this section, the Director will recognize the following fact patterns as examples of situations in which a disallowance of the deduction would be "unreasonable:"

(1) The taxpayer has both a receivable and a payable from the exact same entity, which results in both interest income and interest expense. The Division will permit the interest income and interest expense to be netted so that only the excess of interest expense over interest income will be subject to the general add back rule. This exception only applies to interest income and expense related to the same entity. Interest income from one related member will not be permitted to offset the interest expense of another.

(2) There exists a "cash sweep" cash management system with related members. A cash sweep cash management system is defined as an agreement between related parties wherein one affiliate is responsible for handling all of the cash activities of the group. All cash is automatically "swept" in the bank account of the cash manager. The cash manager pays all expenses of the related parties and the cash balances are accounted for by intercompany accounts receivables and payables. If both parties to this cash sweep arrangement conduct business at arm's length, then the interest expense generated would not be subject to the general add back rule. In order to qualify, all cash must be handled through the cash sweep structure and the cash manager must charge arm's length interest rates and make a profit on its cash sweep margins;

(3) In the case of *Beneficial New Jersey v. Div. of Taxation*, No. 009886-2007 (N.J. Tax Ct. 2010), the New Jersey Tax Court issued a ruling about the "unreasonable exception." In Beneficial, the corporation (BNJ) borrowed money from its parent, HSBC Finance Corp (HSBC), which borrowed funds from unrelated third parties. HSBC charged interest on the loans to BNJ at the maximum Applicable Federal Rate. BNJ deducted the interest payments associated with these loans to arrive at New Jersey entire net income on its Corporation Business Tax returns. After auditing BNJ, the Division disallowed BNJ's interest deductions for the 2002-2004 years by adding them back pursuant to N.J.S.A. 54:10A-4(k)(2)(I);

First, the court concluded that, for purposes of the "three percent" exception, the phrase "rate of tax" meant the "effective tax rate," and that BNJ did not qualify for the "three percent" exception. Second, the court concluded that the documentation for the loan agreement between HSBC and BNJ did not satisfy the "guarantee" exception. Finally, however, in addressing the "unreasonable exception," the court determined that it would be unreasonable to deny the deduction because there was "economic substance" to the loans.

The court found there was economic substance because Beneficial of New Jersey's parent, HSBC, borrowed money and then loaned the borrowed funds to its subsidiaries, which included Beneficial of New Jersey, as HSBC received more favorable interest rates than could the subsidiaries as independent borrowers. The money that HSBC borrowed was loaned to subsidiaries other than BNJ. HSBC paid taxes on income including BNJ's interest payments, in 17 jurisdictions. The court found that, under this set of circumstances, it would be unreasonable to add back the interest deductions. The court also stated that its decision to apply the "unreasonable" exception in this case "in no way creates a general rule of applicability." Thus, such decisions will be made on a case-by-case basis, based on the totality of the circumstances;

(4) In the case of *Morgan Stanley & Co. v. Director, Div. of Taxation*, 28 N.J. Tax 197 (2014), the New Jersey Tax Court issued a ruling on the application of the "unreasonable exception." Morgan Stanley and Co., Inc. ("MS&Co") is wholly owned by Morgan Stanley ("MS"). MS&Co entered into a number of financial transactions with MS and/or MS's various subsidiaries and affiliates, including a Cash Subordination Agreement and Subordinated Revolving Credit Agreement (Subordinated Debt); an arrangement termed a "Cash Management Arrangement;" and numerous intercompany transactions. These financial transactions with related parties resulted in interest that was initially added back on MS&Co's CBT-100 return. The taxpayer filed an amended return to remove the related party interest and claimed a refund of the tax previously paid. The Division denied the refund, computed the taxpayer's interest expense add-back, and assessed additional tax on the basis that the "unreasonable exception" requires that the corporation pays tax on the interest income in another state.

The court held that a denial of the "unreasonable exception" on this basis alone was not supported under N.J.S.A. 54:10A-4(k) (2)(I) because the statute does not contain this requirement. The court determined that the Division had not adequately considered the totality of the taxpayer's facts and circumstances in its analysis of the "unreasonable exception."

The court further noted that based on the legislative intent in enacting the unreasonable exception, a taxpayer's documentation of the following situations may provide grounds for claiming that the disallowance of the deduction would be unreasonable:

1. Unfair duplicative taxation;
2. A technical failure to qualify the transactions under the statutory exceptions;
3. An inability or impediment to meet the requirements due to legal or financial constraints;
4. An unconstitutional result;
5. Transaction for all intents and purposes is an unrelated loan transaction.

3. "FOREIGN NATION" AND "CONDUIT GUARANTEE" EXCEPTIONS

Finally, N.J.S.A. 54:10A-4(k)(2)(I) provides that a deduction "shall also be permitted to the extent the taxpayer establishes by a preponderance of the evidence, as determined by the director, that the interest is directly or indirectly paid, accrued or incurred to (i) a related member in a foreign nation which has in force a comprehensive income tax treaty with the United States, provided, however, that the taxpayer shall disclose on its return for the privilege period the name of the related member, the amount of the interest, the relevant foreign nation, and such other information as the director may prescribe, or (emphasis added) (ii) to an independent lender and the taxpayer guarantees the debt on which the interest is required."

As noted in N.J.A.C. 18:7-5.18(a)3ii, the Division interprets the latter exception to mean that the interest is directly or indirectly paid, accrued or incurred to an independent lender through a related member as conduit, provided the taxpayer legally guarantees the debt on which the interest is required. Further, as noted in the discussion above related to the *Beneficial* case, the guarantee must be memorialized at the time of the loan origination.

REGULATION

N.J.A.C. 18:7-5.18 provides further definitions and examples. Exceptions to the add back of interest are claimed on Schedule G-2.

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