

September 13, 2010

## Taxpayer's Addback Exception Upheld

On August 31, 2010, the New Jersey Tax Court upheld a taxpayer's "unreasonable exception" from the New Jersey related party addback statute. With the growth of related party addback provisions (22 jurisdictions currently impose related party addback provisions), the ability to qualify for exceptions from addback requirements is growing in importance. While a few cases have been decided in other states, (e.g., *VFJ Ventures, Inc.* (Alabama) and *Family Dollar Stores of Ohio, Inc.* (Ohio)),<sup>1</sup> *Beneficial New Jersey, Inc.* is the first New Jersey case to address the related party addback.<sup>2</sup>

### I. Background

Beneficial New Jersey, Inc. (BNJ) is a subsidiary of HSBC Finance Corp. (HSBC) and is primarily engaged in providing loans to customers. BNJ borrowed capital from HSBC to conduct its lending operations. The rate of interest charged from HSBC to BNJ for this intercompany loan was set at the maximum Applicable Federal Rate.<sup>3</sup> BNJ and HSBC did not have a written loan agreement for the audit period of 2002-2004. Rather, BNJ and HSBC entered into a "Funding Agreement" dated December 30, 2005, and had an unwritten understanding prior to the execution of the Funding Agreement. BNJ deducted the interest paid to HSBC for New Jersey income tax purposes. The Director of the Division of Taxation (Director) disallowed these deductions.<sup>4</sup> BNJ and HSBC filed cross motions for summary judgment.

### II. New Jersey's Expense Disallowance Regime

New Jersey provides four exceptions to its interest addback requirement, including the "Subject to Tax Exception" (referred to as the "three percent" exception), the "Conduit Exception" (referred to as the "Guarantee" exception), and the "Unreasonable Exception."<sup>5</sup>

#### A. The Subject to Tax Exception

New Jersey tax law provides a subject to tax exception that permits related parties to deduct interest expense when (1) the principal purpose is not tax avoidance, (2) the interest is paid at arm's length, (3) the related member was subject to tax on its net income in another jurisdiction, (4) a measure of such tax includes the interest received, and (5) the *rate of tax* applied to the interest income earned by the lender is within three percentage points of the taxpayer's New Jersey effective tax rate ("Subject to Tax

<sup>1</sup> *VFJ Ventures, Inc. v. Surtees*, Circuit Court of Montgomery County, No. CV-03-3172, January 24, 2007; *Family Dollar Stores of Ohio, Inc. v. Wilkins*, Ohio Board of Tax Appeals, No. 2005-V-469, January 4, 2008.

<sup>2</sup> *Beneficial New Jersey, Inc. v. Director*, Division of Taxation Docket No. 009886-2007, August 31, 2010.

<sup>3</sup> See Treasury Reg. § 1.482-2(a)(2)(iii).

<sup>4</sup> See N.J.S.A. 54:10A-4(k)(2)(l).

<sup>5</sup> N.J.S.A. 54:10A-k(2)(l). The fourth exception applies to taxpayers where interest is directly or indirectly paid, accrued, or incurred to a related member in a foreign nation that has a comprehensive tax treaty with the United States, commonly referred to as the "Foreign Treaty" exception. *Id.*

Exception”).<sup>6</sup> New Jersey regulations define the term “rate of tax” as the “allocation factor times the tax rate percentage” – often referred to as a taxpayer’s effective rate.<sup>7</sup>

BNJ argued that it met New Jersey’s Subject to Tax Exception because HSBC was subject to tax by states imposing tax at a statutory rate within three percentage points of New Jersey’s 9% tax rate. BNJ claimed that the “rate of tax” means the other state’s statutory tax rate. The Director countered that BNJ did not qualify for the exception because HSBC’s *effective* tax rate was not within three percentage points of BNJ’s New Jersey effective tax rate. The court adopted the Division’s application of the exception and held that the 3% range applied to effective tax rates, not statutory tax rates.

**Sutherland Observation:** The court applied the effective tax rates of the interest payor and payee. However, the tax rate comparison utilizes the effective tax rates of both the borrower and the lender, as opposed to the New Jersey statutory rate of the borrower with the effective tax rate of the lender (as has been applied by some other states). Further, for purposes of determining the lender’s effective tax rate, the court appears to take into account the effective tax rate imposed by unitary states, contrary to the Division’s regulatory guidance in N.J.A.C. 18:7-5.18(a)5, Example 5. See *Footnote 2 of the decision*.

## B. The Conduit Exception

New Jersey provides for a conduit exception that permits a taxpayer to deduct related party interest expense if the interest is directly or indirectly paid, accrued, or incurred to an independent lender and the taxpayer *guarantees* the debt on such interest (Conduit Exception).<sup>8</sup> BNJ proved that the debt was indirectly paid to a third party; however, the court applied a very strict reading of the phrase “guarantee the debt” to hold that the taxpayer did not qualify for the Conduit Exception.

BNJ offered proof of its Funding Agreement and pre-existing unwritten agreements to demonstrate that it guaranteed the debt from HSBC to a third party. The court determined that BNJ did not meet the Conduit Exception because it had not guaranteed the debt as evidenced by the fact that the Funding Agreement was executed after the relevant tax periods; the Agreement was only between HSBC and BNJ and it did not mention the name of any third-party lenders; it did not provide other documents evidencing its role as “guarantor”; HSBC or BNJ could unilaterally withdraw from the agreement; and the document did not contain the word “guarantee.”

**Sutherland Observation:** The court’s extremely narrow view of the guarantee requirement of the Conduit Exception frustrates the true purpose of the exception – to allow a deduction for interest that is indirectly paid to an unrelated third party. Taxpayers should review their intercompany loans and consider modifying them to meet the court’s requirements.

<sup>6</sup> N.J.S.A. 54:10A-4(k)(2)(l), emphasis added.

<sup>7</sup> N.J.A.C. 18:7-5.18(a)(4)(viii).

<sup>8</sup> N.J.S.A. 54:10A-4(k)(2)(l), emphasis added.

### C. The Unreasonable Exception

The Unreasonable Exception permits a taxpayer to deduct related party interest expense when the taxpayer establishes by clear and convincing evidence that the disallowance of such a deduction is unreasonable.<sup>9</sup>

The court held, based on the totality of the circumstances, that the facts of this case were the kind contemplated by the Unreasonable Exception. The court opined that the related party loans had economic substance; that there were credible reasons for BNJ to require such loans; that HSBC received more favorable interest rates from third-party lenders than its subsidiaries; and that HSBC pays taxes in other jurisdictions on the interest income earned from BNJ. The Director argued that there are only two scenarios where a taxpayer can qualify for the Unreasonable Exception: (1) where a taxpayer can demonstrate double taxation in New Jersey with the related party to which it pays interest and (2) where a taxpayer shows that the corporate group has a centralized cash management system.<sup>10</sup> The court held that although these situations are perhaps unreasonable they are not the “alpha and omega” of unreasonable situations. Accordingly, the court determined that the facts of BNJ fell within the Unreasonable Exception.

The court specifically stated that the decision to apply the Unreasonable Exception in no way creates a general rule of applicability; however, the decision does clarify that the Unreasonable Exception may very well apply in instances other than the two examples the Division provided in its 2010 Notice.<sup>11</sup>

### III. Conclusion

New Jersey auditors are likely to adopt the court’s narrow views of the addback exceptions. Moreover, financial statement auditors are likely to scrutinize taxpayers’ New Jersey tax reserves relating to related party addbacks as a result of the decision. *Beneficial New Jersey* represents a significant taxpayer win, but the state will likely attempt to limit its holding and its applicability



*If you have any questions about this development, please feel free to contact any of the attorneys listed below or the Sutherland attorney with whom you regularly work.*

Michele Borens	202.383.0936	<a href="mailto:michele.borens@sutherland.com">michele.borens@sutherland.com</a>
Jeffrey A. Friedman	202.383.0718	<a href="mailto:jeff.friedman@sutherland.com">jeff.friedman@sutherland.com</a>
Stephen P. Kranz	202.383.0267	<a href="mailto:steve.kranz@sutherland.com">steve.kranz@sutherland.com</a>
Marc A. Simonetti	212.389.5015	<a href="mailto:marc.simonetti@sutherland.com">marc.simonetti@sutherland.com</a>
Eric S. Tresh	404.853.8579	<a href="mailto:eric.tresh@sutherland.com">eric.tresh@sutherland.com</a>
W. Scott Wright	404.853.8374	<a href="mailto:scott.wright@sutherland.com">scott.wright@sutherland.com</a>
Diann L. Smith	202.383.0884	<a href="mailto:diann.smith@sutherland.com">diann.smith@sutherland.com</a>
Andrew D. Appleby	212.389.5042	<a href="mailto:andrew.appleby@sutherland.com">andrew.appleby@sutherland.com</a>
Zachary T. Atkins	404.853.8312	<a href="mailto:zachary.atkins@sutherland.com">zachary.atkins@sutherland.com</a>

<sup>9</sup> N.J.S.A. 54:10A-4(k)(2)(l).

<sup>10</sup> *Beneficial New Jersey, Inc.* cites to N.J.A.C. 18:7-5.18(a)(2), however, see also Notice, New Jersey Division of Taxation, June 10, 2010.

<sup>11</sup> Notice, New Jersey Division of Taxation, June 10, 2010.

# SUTHERLAND

Michael L. Colavito	202.383.0870	<a href="mailto:mike.colavito@sutherland.com">mike.colavito@sutherland.com</a>
Miranda K. Davis	404.853.8242	<a href="mailto:miranda.davis@sutherland.com">miranda.davis@sutherland.com</a>
Jonathan A. Feldman	404.853.8189	<a href="mailto:jonathan.feldman@sutherland.com">jonathan.feldman@sutherland.com</a>
Lisbeth A. Freeman	202.383.0251	<a href="mailto:beth.freeman@sutherland.com">beth.freeman@sutherland.com</a>
Charles C. Kearns	202.383.0864	<a href="mailto:charlie.kearns@sutherland.com">charlie.kearns@sutherland.com</a>
Jessica L. Kerner	212.389.5009	<a href="mailto:jessica.kerner@sutherland.com">jessica.kerner@sutherland.com</a>
Pilar Mata	202.383.0116	<a href="mailto:pilar.mata@sutherland.com">pilar.mata@sutherland.com</a>
David A. Pope	212.389.5048	<a href="mailto:david.pope@sutherland.com">david.pope@sutherland.com</a>
Page Scully	202.383.0224	<a href="mailto:page.scully@sutherland.com">page.scully@sutherland.com</a>
Melissa J. Smith	202.383.0840	<a href="mailto:melissa.smith@sutherland.com">melissa.smith@sutherland.com</a>
Maria M. Todorova	404.853.8214	<a href="mailto:maria.todorova@sutherland.com">maria.todorova@sutherland.com</a>
Mark W. Yopp	212.389.5028	<a href="mailto:mark.yopp@sutherland.com">mark.yopp@sutherland.com</a>