

New Jersey Tax Court Refuses to Tax Foreign Income: IBM v. Director

January 27, 2011

On January 26, 2011, the New Jersey Tax Court agreed with IBM that foreign source income excluded from federal taxable income is also excluded from New Jersey entire net income. Taxpayers should consider filing refund claims.

On January 26, 2011, the New Jersey Tax Court issued a consolidated decision in favor of International Business Machines Inc. (IBM), represented by McDermott Will & Emery, and Crestron Electronics Inc., agreeing with the taxpayers that certain foreign income should not be included in New Jersey taxable income. The decision provides clear guidance for companies that included foreign income that was excluded from federal taxable income under former Internal Revenue Code Section 114 on their New Jersey Corporation Business Tax returns (or that were forced to do so upon audit) and raises potential refund opportunities for companies that included other types of foreign source income in New Jersey entire net income.

IBM's New Jersey Entire Net Income

New Jersey Statutes Section 54:10A-4(k) defines New Jersey taxable income, referred to as "entire net income." The statute expressly indicates the starting point in calculating entire net income is line 28 from the taxpayer's federal tax return (taxable income) and then provides specific modifications (additions and subtractions) that are required to reach New Jersey entire net income.

During the years at issue, Internal Revenue Code Section 114 provided an exclusion from federal taxable income for certain foreign source income, called extraterritorial income. On a federal tax return a taxpayer was required to include extraterritorial income as income but then was allowed to subtract that amount on line 26 (other deductions). Thus, IBM's federal tax return reflected extraterritorial income being added and then subtracted to reach line 28 taxable income.

On its New Jersey Corporation Business Tax return, IBM reported its federal line 28 amount, which did not include extraterritorial income. During audit, the Division of Taxation added IBM's extraterritorial income to reach New Jersey entire net income based on a regulation that purported to require the add-back of "all income from sources from outside the United States which has not been included in computing Federal taxable income." N.J.A.C. 18:7-5.2(a)(1)(xi).

The Tax Court's Decision

Presiding Judge Patrick DeAlmeida held that the extraterritorial income was not included in New Jersey entire net income:

- First, the plain language of N.J.S.A. 54:10A-4(k) unambiguously links New Jersey entire net income to line 28 of the federal tax return.
- Second, none of the express modifications to the line 28 amount address extraterritorial income.
- Third, the first sentence of Section 54:10A-4(k), which provides entire net income “shall mean total net income from all sources, whether within or without the United States,” is merely introductory language that must be read in conjunction with the more specific coupling language in the remainder of the statute, which clearly provides that New Jersey entire net income is federal taxable income as specifically adjusted in the New Jersey statute.
- Fourth, Regulations Section 18:7-5.2(a)(1)(xi) does not apply because extraterritorial income was “included in computing” the line 28 amount. Further, if the regulation did apply, it would be invalid because it would exceed the authority of the statute.

Implications

It is unclear whether the Division of Taxation will move for leave to appeal this interlocutory decision.

Taxpayers that added extraterritorial income on their New Jersey corporation business tax returns (or that were forced to upon audit) should consider filing refund claims for any years for which the statute of limitations remains open. Additionally, taxpayers that added or were forced upon audit to add any other types of foreign source income should consider what authority the Division of Taxation used to require the addition. If the authority was anything other than a specific statutory addition (e.g., if the Division relied upon Regulations Section 18:7-5.2(a)(1)(xi)), refund claims should also be considered; while the Court did not invalidate the Regulation in its entirety (the Court did not need to do so to find in favor of IBM and Crestron), there appears to be no statutory support for this Regulation subsection.

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