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Murphy's Law: What Can Be, Will Be Taxed In New Jersey?

By **Mitchell Newmark and Eva Niedbala** (March 1, 2018, 5:49 PM EST)

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There is a new governor in town and his name is Phil Murphy. And like President Trump, New Jersey Gov. Murphy has taxes on his mind.

During his days as a candidate and now as New Jersey governor, Phil Murphy has been eager to change how New Jersey taxes businesses and individuals. His major tax proposals include shifting to mandatory unitary combined reporting for corporations and imposing a "millionaire's tax" on wealthy individuals.[1] This article explores those proposed changes and the effect that they might have on businesses and individuals if they are signed into law.

Mandatory Unitary Combined Reporting

Gov. Murphy supports New Jersey becoming a mandatory unitary combined reporting state.[2]

Currently, New Jersey is a separate company reporting state. This means that each company that has nexus with the state must file its own separate corporation business tax return. Under mandatory unitary combined reporting, affiliated companies that are engaged in a unitary business must file a combined report if at least one of them has nexus with New Jersey. Gov. Murphy believes that shifting to mandatory unitary combined reporting would close a purported tax loophole that allegedly allows multistate corporations to shift profits from New Jersey to lower-taxed states and would raise $290 million in new revenue.[3]

In 2016, supporters of a mandatory unitary combined reporting bill advocated that it would level the playing field between small New Jersey businesses and large multistate corporations because large multistate corporations would no longer be able to shift income to an affiliate in another state.[4] However, critics of the bill cautioned that the change would cause complexity and uncertainty and would result in increased litigation. The Council on State Taxation, or "COST," testified that mandatory unitary combined reporting under the bill:

arbitrarily assigns income to a state, negatively impacts the real economy, has an unpredictable effect on state revenue (particularly in states like New Jersey with related party expense disallowance rules), and imposes significant administrative burdens on both the taxpayer and the state.[5]

COST pointed to other states' negative experiences with mandatory unitary combined reporting and recommended that the New Jersey Legislature not pass the bill.[6]

Further, the New Jersey Office of Legislative Services opined that the fiscal impact of the change in law on state revenue was "[u]ncertain and variable" and that there was a "broad range of revenue estimates."[7]

These arguments are still relevant today.[8] For example, predicting how the use of losses on the net result of tax base and apportionment changes (New Jersey calls it allocation) is a monumental undertaking that will yield no clear immediate answers.

In addition, even though New Jersey's corporate tax reforms of 2002 granted the director of the Division of Taxation with the authority to compel combined reporting under certain conditions, the division has not pursued combined reporting in any public decisions.[9] This hesitation may be due to the division's unease with combined reporting and unease with how to properly address issues common to combined reporting. The division has for at least 20 years approached intercompany transactions through nexus attacks, transfer price adjustments, and related party addbacks. A shift to combined reporting will require retooling and retraining state auditors and supervisors that will take years to work through — therefore slowing the collection of revenue.

Also, New Jersey's audit manual is still in its infancy and is light in substance.[10] Shifting to mandatory unitary combined reporting would only further complicate audits.

Further, combined reporting can be a double-edged sword. That is, a company's New Jersey income may be offset against an affiliate's losses from another state under combined reporting. Under separate company reporting, the company with income would have to pay tax on the New Jersey income.

With combined reporting, New Jersey's related party expense disallowance rules would no longer be relevant within a unitary group inasmuch as transactions between affiliated unitary companies would be captured within a combined report. Company and state costs associated with litigating intercompany transactions could decrease. However, combined reporting would not address transactions outside the combined group. Therefore, any savings might be redirected to litigating the myriad combined reporting issues.

Millionaire's Tax

Gov. Murphy has also said that he would support a millionaire's tax.[11]

Under the most recent legislative millionaire's tax proposal, which was rejected by then-Gov. Chris Christie, the top marginal tax rate on taxable income exceeding $1 million would have been temporarily increased from 8.97 percent to 10.75 percent.[12] Gov. Murphy believes that such a tax could raise $600 million in revenue its first year.[13]

The Democratic-controlled state Legislature had tried to enact a millionaire's tax at least five times while Gov. Chris Christie was in office and, therefore, was eager to make the tax a reality once Phil Murphy took office.[14] However, the Legislature's support for the tax has since cooled due to federal tax reform, which has limited the state and local tax deduction to $10,000, although Gov. Murphy continues to support the tax.[15]

If New Jersey were to increase the tax rate, New Jersey would have the second highest personal income tax rate in the country, with California in the lead.[16] New Jersey already has the highest property taxes in the country.[17] With millionaire's tax, New Jersey could become one of the most expensive states to be in, and this could push people to move out of the state. United Van Lines' 2017 United Movers Study reports that 63 percent of New Jerseyans who contacted the company for moving services were leaving the state.[18] Your company's top executives would be squarely in the tax crosshairs on such a tax hike. A scramble to leave the state, especially by top executives, could lead to increased residency audits and litigation. A desire to limit exposure of your company's executives could prompt executive or headquarter moves out of New Jersey or deter the establishment of new headquarters or offices in New Jersey.

Other Proposed Tax Changes

Gov. Murphy also wants to legalize and tax sales of marijuana, as well as tax "carried interest," which represents fees earned by hedge fund managers and private equity managers.[19] It has been estimated that taxation of marijuana could result in $300 million of additional revenue (although this could be merely a pipe dream), while taxation of carried interest could raise $100 million of additional revenue.[20]

Gov. Murphy has proposed many tax changes. Only time will tell whether it will take all of the foregoing tax changes to satisfy Gov. Murphy. However, such changes could very well transform New Jersey taxation for years to come. Stay tuned.

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[1] Christian Hetrick, Exclusive: Murphy Plans to Raise $1.3 Billion in Taxes, Observer, Aug. 17, 2017; Claude Brodesser-Akner, Phil Murphy's spending would raise N.J. taxes $1.3 billion. Here's who'd get soaked., NJ.com, Aug. 18, 2017.

[2] Hetrick, supra note 1; Brodesser-Akner, supra note 1.

[3] Hetrick, supra note 1; Brodesser-Akner, supra note 1.

[4] N.J. Policy Perspective, Letter to Members of the New Jersey State Legislature (May 4, 2016). See also S.982, 217th Leg., Reg. Sess. (N.J. 2016) (mandatory unitary combined reporting bill).

[5] Ferdinand Hogroian, COST, Testimony to the New Jersey Legislature, Senate Budget and Appropriations Committee, Opposing Senate Bill 982, Mandatory Unitary Combined Reporting (Feb. 29, 2016).

[6] Id.

[7] Office of Legis. Servs., Legislative Fiscal Estimate to Senate No. 982, 217th Leg., Reg. Sess. (N.J. Mar. 1, 2016). See also Office of Legis. Servs., Legislative Fiscal Estimate to Senate No. 982, Second Reprint, 217th Leg., Reg. Sess. (N.J. Oct. 6, 2016).

[8] See, e.g., Sheila Reynertson, N.J. Policy Perspective, Fixing New Jersey's Broken Corporate Tax Code Will Help Small Businesses, Boost the Economy (2017) (advocating for mandatory combined reporting).

[9] See, Legislative Fiscal Estimate to Senate No. 982; Legislative Fiscal Estimate to Senate No. 982, Second Reprint.

[10] See N.J. Div. of Taxation, New Jersey Manual of Audit Procedures (2017).

[11] Hetrick, supra note 1; Brodesser-Akner, supra note 1; Matt Arco, Property taxes, pensions, marijuana & more: How your next N.J. governor stands on big issues, NJ.com, Nov. 16, 2017.

[12] A.4602, 216th Leg., Reg. Sess. (N.J. 2015). See also Hetrick, supra note 1.

[13] Hetrick, supra note 1; Brodesser-Akner, supra note 1.

[14] Hetrick, supra note 1; Samantha Marcus & Brent Johnson, Top Democrat says millionaires tax pushed by Phil Murphy is now 'absolutely last resort,' NJ.com, Feb. 9, 2018.

[15] David Levinsky, Will Phil Murphy raise NJ's taxes (and 4 other poli[ti]cal questions for 2018)?, Burlington County Times, Jan. 1, 2018; Marcus & Johnson, supra note 14.

[16] Cf. Cal. Franchise Tax Bd., 2017 California Tax Rates and Exemptions, https://www.ftb.ca.gov/forms/2017-California-Tax-Rates-and-Exemptions.shtml#itr (last visited Feb. 22, 2018).

[17] See Jeff Goldman, N.J. had highest property taxes in nation in 2016 (again), study finds, NJ.com, Apr. 6, 2017.

[18] United Van Lines, 2017 United Movers Study, https://www.unitedvanlines.com/contact-united/news/movers-study-2017 (last visited Feb. 22, 2018).

[19] Hetrick, supra note 1; Brodesser-Akner, supra note 1.

[20] Hetrick, supra note 1; Brodesser-Akner, supra note 1.