NEW JERSEY ENACTS COMPREHENSIVE CORPORATION BUSINESS TAX LEGISLATION CHANGES

Summary

On July 1, 2018, New Jersey became the fourth state during 2018 to enact comprehensive changes to its corporation income tax, joining Kentucky, Missouri, and North Carolina. New Jersey's tax legislation (A. 4202) (the "Act") enacts various provisions effective in different tax years. For 2017 and after, the Act modifies the dividends received deduction and decouples from certain features of federal tax reform. For tax years 2018-2021, the Act establishes a temporary corporation business tax (CBT) surtax. And beginning in 2019, the Act establishes market-based sourcing for New Jersey's sales factor and makes New Jersey the latest state to adopt mandatory unitary combined reporting.

Details

Internal Revenue Code Decoupling

New Jersey will decouple from three key features of the federal Tax Cuts and Jobs Act, effective for tax years beginning after December 31, 2016. First, even though the calculation of New Jersey's gross income tax on individuals does not start with federal taxable income so as to include the IRC Section 199A qualified business income (QBI) deduction, the Act does decouple from and disallows the federal QBI deduction.

Further, the Act disallows the IRC Section 965(c) participation exemption deduction.

More significantly, while the Act does conform to the IRC Section 163(j) limitation, as amended by the Tax Cuts and Jobs Act, the legislation requires that the limitation be applied on a pro rata basis to interest expense paid to related and unrelated parties (regardless of whether any interest expense paid to a related party is subject to New Jersey's related party interest expense add-back statute) However, the statute does not explain how the pro rata allocation of the IRC Section 163(j) limitation is to be measured.

Modification of New Jersey's Dividends Received Deduction

Effective for tax years beginning after December 31, 2016, New Jersey's dividends received deduction (DRD) for dividends "paid or deemed paid" by an 80 percent-or-more owned subsidiary (and included in federal taxable income of the recipient) is reduced to a 95 percent DRD. As a result, actual (or constructive) dividends distributed, Subpart F income, and IRC Section 965(a) income received or deemed received during tax year 2017 and subsequent tax years from an 80 percent-or-more owned subsidiary are eligible for a 95 percent DRD and no longer a 100 percent DRD. With respect to deemed dividends included in the

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taxpayer's 2017 entire net income (e.g., IRC Section 965 deemed repatriation income) as a result of the new DRD provisions, the taxpayer apportions such amount to New Jersey based on the lower of its three-year average apportionment factor for tax years 2015 through 2017, or 3.5 percent.

A 50 percent DRD will be provided for dividends "paid or deemed paid" by a 50 percent-or-more owned subsidiary. Therefore, IRC Section 965(a) income with respect to a 50 percent-or-more, but less than 80 percent owned foreign corporation, is eligible for only a 50 percent New Jersey DRD. Further, for the 2017 tax year, the same apportionment-effected or 3.5 percent inclusion, if lower, is not applied to dividends received from a 50 percent-or-more owned subsidiary.

CBT Surtax

Although originally a nine percent surtax, after the governor vetoed an earlier version of the tax legislation, the Act enacts a CBT surtax, as follows:

- For tax years beginning on or after January 1, 2018, through December 31, 2019, a surtax of 2.5 percent is imposed on CBT taxpayers with entire net income (generally federal taxable income) greater than $1 million.
- For tax years beginning on or after January 1, 2020, through December 31, 2021, a surtax of 1.5 percent is imposed on CBT taxpayers.

Based on its definition of "taxpayer," the surtax appears to only apply to a business entity that is subject to the New Jersey CBT (i.e., has tax nexus with New Jersey) and not to a New Jersey combined group.

Foreign Tax Treaty Exception to Related Party Expense Add-Back

The legislation also modifies New Jersey's foreign tax treaty exception to required add-back of intangible expense and interest expense deductions for such expenses paid to a related party. Under current law, a taxpayer must simply establish that the intangible expense or interest expense was paid to a related party organized in a foreign country that has a comprehensive tax treaty in place with the United States. Effective for tax years beginning on or after January 1, 2018, taxpayers will now have to also establish that (a) the related party was also subject to tax on the intangible income or interest income, and (b) was taxed at an effective rate equal to or greater than three percent less than the rate of tax on the income applied by New Jersey.

Mandatory Unitary Combined Reporting

New Jersey becomes the latest (and with Kentucky, the 25th and 26th states) to adopt mandatory unitary combined reporting, effective for tax years beginning after December 31, 2018. In general, New Jersey requires corporations subject to the CBT to file a report of income and apportionment factors with a "combined group" when a group of corporations share "common ownership" and are engaged in a "unitary business." The Act defines the term "unitary business" and explains that the term will be applied "to the broadest extent permitted under the Constitution of the United States." "Common ownership" is generally defined as greater than 50 percent voting control of each member, directly or indirectly. Indirect voting control or "common ownership" will be determined based on IRC Section 318 ownership attribution.

A New Jersey unitary combined report will default to a "water's-edge group" unless a worldwide unitary or federal affiliated group election is made on an original return. The worldwide and affiliated group elections will be binding for the tax year of the election plus the five subsequent tax years; however, a taxpayer may make a written request to revoke the worldwide election prior to the expiration of the binding period for reasonable cause (i.e., substantial change in ownership). A water's-edge group generally means all U.S.-organized corporations that are commonly owned (as defined above) and that are engaged in a unitary business, except a U.S. corporation with 80 percent-or-more of the average of its property and payroll assigned to a non-U.S. location is excluded. Any corporation, regardless of where organized, that has 20 percent-or-more of the average of its property and payroll assigned to U.S. locations is included in the water's-edge group. Likewise, any corporation, regardless of where organized, that earns 20 percent-or-more of its income from intangible property or related services activities with respect to water's-edge group members that are deductible against income of those members is included. Although insurance companies are generally excluded, certain captive insurance companies are included in a New Jersey combined group.

A corporate partner's distributive share of income (or loss) and factors, if engaged in a unitary business with a partnership (determined without regard to ownership percentage) are included in the New Jersey combined report. However, the distributive share of income (or loss) and factors of a corporate limited partner of a qualified investment partnership are not considered part

of a unitary business unless the corporate limited partner and general partner are commonly owned members of the same New Jersey combined group.

Each "taxable member" (i.e., a combined group member with New Jersey CBT nexus) is treated as a separate taxpayer, and that entity's apportionment numerator includes only that taxable member's receipts sourced to New Jersey (i.e., the "Joyce rule"), while the denominator includes the combined group's receipts.

The New Jersey combined group will be entitled to a "net deferred tax liability" deduction to the extent the transition to mandatory unitary combined reporting results in an increase to the combined group members' deferred tax liability, a decrease in the members' tax deferred asset, or the change of a deferred tax asset to a deferred tax liability. The deduction will be allowed for 10 years starting with the group's first tax year beginning five years after July 1, 2018. The deduction will be available only to publicly traded companies.

Market-Based Sourcing

For tax years beginning on or after January 1, 2015, New Jersey's single sales factor apportionment formula became fully phased in. However, under current law, gross receipts from services are generally sourced for New Jersey CBT purposes based on place of performance. Beginning for tax years on or after January 1, 2019, sales of services will be sourced to New Jersey if the benefit of the service is received in New Jersey. If the benefit of a service is received inside and outside New Jersey, gross receipts will be sourced based on the percentage of the value of the benefit received in New Jersey compared to the value received outside New Jersey (or based on a reasonable approximation). If the value of the benefit received in New Jersey cannot be determined, then services receipts will be sourced, as follows:

- For services provided to an individual customer, receipts are sourced to the billing address of the customer.
- For services provided to a business customer (including a sole proprietor), receipts are sourced to the location where the customer ordered the services. If such location cannot be determined, then the receipts are sourced to the customer's billing address.

Unlike other states that apply market-based sourcing to licenses or sales of intangibles, New Jersey's existing sourcing provisions with respect to intangibles will continue to apply instead of market-based sourcing.

Net Operating Losses

Net operating losses (NOLs) incurred in a tax year starting on or after January 1, 2019, will be carried forward for a period of 20 years. Such NOLs will not include any NOL incurred in a tax year prior to January 1, 2019. Instead, these NOLs will be treated as a "prior NOL conversion carryover." The prior NOL conversion carryover NOLs are converted to "unabsorbed portion of net operating loss," calculated on a post-apportionment basis and pursuant to a formula calculation set forth in the new statute. The prior NOL conversion carryover may be carried forward and deducted for a period of 20 years.

Insights

- The foregoing only summarized some of the key features of New Jersey's comprehensive CBT tax legislation enacted on July 1, 2018. A number of the provisions, especially the calculation of "prior NOL conversion carryover" and "unabsorbed portion of net operating loss," as well as New Jersey's new mandatory unitary combined reporting are notably complex and dependent on a taxpayer's particular facts and circumstances.
- Taxpayers should evaluate the New Jersey tax legislation and plan for its impact on their operations and activities in or with respect to New Jersey and for purposes of their 2017, 2018, and 2019 tax years.
- Taxpayers affected by A. 4202 should consult with their financial statement auditor and tax advisor to evaluate and determine the potential financial statement implications under ASC 740, including the impact on current and deferred taxes, uncertain tax benefits, and disclosures.