



SALT Alert!



SALT Alert! 2018-11: Significant Corporation Business Tax Changes Enacted in New Jersey

On July 1, 2018, New Jersey Governor Phil Murphy signed and conditionally vetoed a number of bills that implement numerous tax changes required to balance the state's budget. After the Legislature approved the Governor's proposed changes to the conditionally vetoed bills, they became law once the governor signed them.¹ On the Corporation Business Tax side, Assembly Bill 4202, which was approved on July 1, significantly revises New Jersey's Corporation Business Tax laws, as discussed in more detail below.

Temporary Corporation Business Tax Increase

Assembly Bill 4202 imposes a so-called "surtax" on Corporation Business Tax taxpayers, except public utilities, that have allocated New Jersey net income in excess of \$1 million. For the privilege periods beginning on or after January 1, 2018 through December 31, 2019, the surtax, which is actually an additional imposition of tax, is imposed at a rate of 2.5 percent. For privilege periods beginning on or after January 1, 2020 through December 31, 2021, the surtax rate is 1.5 percent. No credits are allowed against surtax liability, except for credits for installment payments, estimated payments made with a request for an extension of time for filing a return, or overpayments from prior privilege periods. Under the law as currently enacted, the surtax will expire beginning in 2022.

Tax Reform and Other Tax Base Changes

Dividends-Received Deduction: For privilege periods ending on or before December 31, 2016, a 100 percent exclusion applies to dividends that were included in federal taxable income and paid to the taxpayer from 80 percent or more-owned subsidiaries. For privilege periods beginning after December 31, 2016, an exclusion applies to 95 percent of dividends included in federal taxable income that were paid or deemed paid by 80 percent of more-owned subsidiaries. For the 2017 privilege period only, for purposes of calculating the tax liability owed for the deemed dividends included in entire net income, a taxpayer will use either its three-year average allocation factor for the taxpayer's 2015 through 2017 tax years reported on the taxpayer's tax returns or 3.5 percent, whichever is lower. To the extent a subsidiary received dividends from other subsidiaries, included those dividends in its entire net income and paid tax on those dividends, a taxpayer receiving those same dividends from the subsidiary will exclude those dividends from its entire net income based on the allocation factor used by the subsidiary in determining its tax liability. For privilege periods beginning on and after January 1, 2017, for the purposes of computing

entire net income, a taxpayer is not allowed any deduction, exemption, or credit allowed under IRC section 965.

Revised “treaty exception” to addback rules: Assembly Bill 4202 revises the foreign treaty exception to the related party addback requirement for interest expense and intangible expenses paid to foreign related members. As revised and effective for tax years beginning on or after January 1, 2018, the addback will not be required if the foreign related member’s income received from the transaction is taxed at a rate equal to or greater than three percent of the rate of tax applied by New Jersey.

Internal Revenue Code section 163(j) Limitation: For privilege periods beginning after December 31, 2017, the interest deduction limitation in IRC section 163(j) is applied on a pro-rata basis to interest paid to both related and unrelated parties, regardless of whether the related parties are subject to the state’s related party interest addback rules.

Section 199A Deduction: Assembly Bill 4202 provides that for privilege periods beginning after December 31, 2017, no deduction will be allowed for amounts deducted for federal income tax purposes under IRC section 199A.

Market-Based Sourcing for Service Receipts

Since 2014, corporate taxpayers have apportioned their income to New Jersey using a single-sales factor formula. Under current law, service receipts are sourced to New Jersey if the services were performed in the state. Effective for privilege periods beginning on or after January 1, 2019, service receipts will be sourced to New Jersey if the benefit of the service is received at a location in the state. If the benefit of the service is received both at a location within and outside of New Jersey, the portion of the sale attributed to New Jersey is based on the percentage of the total value of the benefit of the service received at a location in New Jersey or a reasonable approximation to the total value of the benefit of the service received in all locations both within and outside New Jersey. If the state or states of assignment of services cannot be determined for an individual customer (not including an individual who is a sole proprietor), the benefit of the service is deemed to be received at the customer’s billing address. If the state or states of assignment of services cannot be determined for a business customer (including a sole proprietor), the benefit of the service is deemed to be received at the location from which the services were ordered in the customer’s regular course of operations. If the location from which the services were ordered in the customer’s regular course of operations cannot be determined, the benefit of the service is deemed to be received at the customer’s billing address.

Mandatory Unitary Combined Reporting

Definitional Changes: To implement combined reporting, the Corporation Business Tax Act has been amended to adopt new definitions of the following terms: “combined group,” “common ownership,” “**combinable captive insurance company**,” “group privilege period,” “unitary business,” “managerial member,” “nontaxable member,” and “taxable member.”

Unitary Group Composition: The New Jersey combined group includes entities that have common ownership and are engaged in a unitary business. “Common ownership” means that more than 50 percent of the voting control of each member of a combined group is directly or indirectly owned by a common owner or owners, either corporate or non-corporate, whether or not the owner or owners are members of the combined group. Whether voting control is indirectly owned is determined in accordance with IRC section 318. The term “unitary business” is to be construed to the “broadest extent permitted under the Constitution of the United States.”

Filing Options: The default filing method for the New Jersey combined group is water’s-edge combination. The income and allocation factors of the following members are included in the New Jersey water’s-edge group: (1) all domestic entities formed in the United States,

D.C., or in any United States territory or possession, excluding entities that have 80 percent or more of their payroll and 80 percent of their property located outside the U.S.; (2) all entities (including foreign entities) that have 20 percent or more of their payroll and 20 percent or more of their property located within the United States, D.C., or any territory or possession; (3) any member that earns more than 20 percent of its gross income from intangible property or service-related activities, the costs of which are generally deductible for federal income tax purposes against the income of other group members; or (4) each member that has income as defined under the Corporation Business Tax Act and has sufficient nexus with New Jersey.

A combined group wishing to file on a worldwide basis or on an affiliated group basis may elect to do so on a timely filed, original return for the income year. These elections are generally binding for six years. An "affiliated group," for purposes of the election, is all members of the federal affiliated group (as defined under IRC section 1504, but expanded to include all domestic corporations that are commonly owned), regardless of whether the members are engaged in a unitary business, and whether or not such members are doing business in New Jersey.

Unitary Entire Net Income Determination: A taxable member of a combined group determines its entire net income from the unitary business as its share of the entire net income of the combined group. The entire net income from the unitary business of a combined group is the sum of the entire net incomes of each taxable member and each nontaxable member of the combined group derived from the unitary business, which is determined as follows:

- (1) For a U.S. member, the income included in income of the combined group is the member's entire net income otherwise determined pursuant to the Corporation Business Tax Act.
- (2) For a non U.S. member, the income to be included in entire net income is to be determined from a profit and loss statement that has been adjusted to conform to U.S. accounting principles and has been translated into U.S. currency. (There is also an option to use a consistent method to "reasonably approximate" a foreign member's income.)
- (3) The amount of partnership income to be included in the combined group's entire net income is the member's direct and indirect distributive shares of the partnership's unitary business income. Note that the distributive share of income received by a limited partner from a qualified investment partnership will not be considered to be derived from a unitary business unless the general partner of such investment partnership and such limited partner have common ownership.
- (4) Dividends paid by one member to another member of the group are eliminated from the income of the recipient.
- (5) Business income from intercompany transactions between members of the combined group are deferred in a manner similar to Treas. Reg. § 1.1502-13. However, the deferred business income will be restored to the income of the seller if certain enumerated events occur.
- (6) Charitable deductions incurred by a member of a combined group are subtracted first from the combined group's entire net income (subject to income limitations applied to the group as a whole) and any remaining amount may be carried forward.
- (7) A prior net operating loss conversion carryover can be deducted in computing entire net income, but can offset only income of the corporation that created the prior net operating loss carryover and cannot be shared with other members of the combined group. The prior net operating loss conversion carryover deduction is to be applied before the regular net operating loss deduction.
- (8) A net operating loss carryover incurred by a member of the combined group after the implementation of combined reporting can be deducted and can be shared with other unitary group members.
- (9) Credits earned by taxable group members for privilege periods before and after the adoption of combined reporting can be shared with other taxable members of the combined group.

- (10) The expense of any member of the combined group that is directly or indirectly attributable to income that New Jersey cannot tax is disallowed as a deduction in computing the combined group's entire net income.

The income and factors of an insurance company that is not a combinable captive insurance company (as defined) will not be included in a combined unitary tax return. Likewise, a corporation that is regulated, in whole or in part, by the Federal Energy Regulatory Commission, the New Jersey Board of Public Utilities or similar regulatory body of another state will not be required file a combined return.

Unitary Group Apportionment: Each taxable member of the combined group determines its allocation factor using its applicable statutory methodology. In computing a taxable member's sales factor denominator, the taxable member will use the combined group's denominator. In computing the sales factor numerator, each taxable member is treated as a separate taxpayer and that taxable member's numerator will include only that taxable member's receipts assignable to this state. In other words, New Jersey has adopted the so-called *Joyce* apportionment methodology. Transactions between members of the combined group will be eliminated in computing the allocation factors of taxable members. If 50 percent or more of a combined group's income is derived from transporting freight by air or ground, the group will use a special formula, the numerator of which is the ton miles traveled by the combined group's mobile assets in New Jersey and the denominator of which is the total ton miles traveled by the combined group's mobile assets everywhere.

Prior Net Operating Loss (NOL) Conversion Carryover: As discussed above, a combined group member is allowed a deduction for losses that the member generated prior to the adoption of unitary combined reporting. These pre-combined reporting loss carryovers are referred to as "prior net operating loss conversion carryovers," which is a concept borrowed from New York's corporate tax and bank tax reform legislation.

To determine a taxpayer's New Jersey prior net operating loss conversion carryover, a taxpayer must first compute the value of its unabsorbed NOLs for the base year (which is the last privilege period prior to the effective date of the combined reporting provisions) and each preceding privilege period for which there is an unabsorbed NOL. This amount is multiplied by the taxpayer's base year allocation factor. The resulting product is the taxpayer's prior NOL conversion carryover, which can be carried over for a period not to exceed the 20 privilege periods following the privilege period of the initial loss. The entire amount of the prior net operating loss conversion carryover for any privilege period shall be carried to the earliest of the privilege periods to which the loss may be carried.

ASC 740 Fix: If the adoption of mandatory unitary combined reporting results in an aggregate increase to the members' net deferred tax liability, or an aggregate decrease to the members' deferred tax assets, or an aggregate change from a net deferred tax asset to a net deferred tax liability, the combined group is entitled to a new deduction. Generally, the term "net deferred tax liability" means deferred tax liabilities that exceed the deferred tax assets of the combined group, computed in accordance with generally accepted accounting principles (GAAP). "Net deferred tax asset" means that deferred tax assets exceed the group's deferred tax liabilities, computed in accordance with GAAP. Only publicly traded companies and those affiliates that participate in the filing of a publicly traded company's financial statements prepared in accordance with GAAP are eligible for this deduction. The reference to GAAP in the bill is not limited to U.S. GAAP and may apply to companies that utilize other similar accounting principles (e.g., international financial reporting standards).

The deduction, which will be taken over a ten-year period beginning with the combined group's first privilege period beginning on or after January 1 of the fifth year after the effective date of the combined reporting law, will be equal to one-tenth of the amount necessary to offset the increase in the net deferred tax liability or decrease in the net deferred tax assets, or the aggregate change thereof from a net deferred tax asset to a net deferred tax liability as a result of the implementation of combined reporting. The change in net deferred tax liabilities or assets shall be computed without taking into account the

availability of the deduction. It is important to note that the deduction will not be reduced as a result of any events happening subsequent to the calculation, such as assets being abandoned or disposed of. Any deduction in excess of the combined group's entire net income may be carried forward.

Any combined group intending to claim the deduction must file a statement with the Commissioner on or before July 1 of the year subsequent to the first privilege period for which a combined return is required (July 1, 2020 for calendar year taxpayers). The statement must specify the total amount of the deduction the group will claim. No deduction will be allowed except to the extent claimed on a timely-filed statement.

Administrative Matters: The managerial member of the combined group is the party responsible for filing the combined return and paying the tax on behalf of the taxable members, as well as responding to notices and assessments and taking care of other administrative matters. If the combined group has a common parent corporation and that common parent corporation is a taxable group member, the common parent corporation will be the "managerial member." If the common parent corporation is not a taxable member, the combined group will designate a taxable member as its managerial member. This election is binding for the ten successive privilege periods. If the group fails to select its managerial member, the director shall designate a taxable member of the combined group as managerial member. The privilege period for the group is the privilege period of the managerial member. If a combined group member has a different fiscal or calendar accounting period from the group privilege period, that member must report amounts from its return for its fiscal or calendar accounting year that ends during the group privilege period. Each taxable member of the group is jointly and severally liable for the tax due from any taxable member.

Penalty Abatement

Assembly Bill 4202 includes provisions designed to provide relief for underpayments of tax related to the retroactive tax changes. Specifically, no penalties or interest will accrue for the underpayment of tax resulting from the retroactive changes applying to returns filed for tax years 2017 and 2018. However, additional payments must be made by either the second next estimated payment subsequent to the enactment of the bill (i.e., December 31, 2018) for tax years beginning on or after January 1, 2017, or by the first estimated payment due after January 1, 2019 for tax years beginning on or after January 1, 2018.

In the first tax year that a mandatory combined return is due, no penalties or interest will accrue due to underpayments that may result from the switch from separate returns to mandatory combined returns, and any overpayment by a member of the combined group from the prior tax year will be credited as an overpayment of the tax owed by the combined group, credited toward future estimated payments by the combined group.

Research Credit

Assembly Bill 4202 provides that for privilege periods beginning on or after January 1, 2018, New Jersey removed the date-specific conformity to Internal Revenue Code section 41 as of June 30, 1992 (meaning rolling conformity now exists for research credit purposes), and the state research credit is not refundable. Furthermore, if Internal Revenue Code section 41 is terminated, the New Jersey research credit will continue to apply.

Next steps



There are many instances in the bill where the Director of the Division of Taxation is instructed to promulgate regulations and rules. However, it's unclear when this guidance will be forthcoming. In the interim, these are sweeping changes that affect almost every company doing business in New Jersey.

Please contact [Jim Venere](#) at 973- 912-6349 with questions.

Footnote

¹ The tax changes in the various other pending and enacted bills include, but are not limited to, adopting sales and use tax economic nexus provisions, implementing a tax amnesty program, increasing personal income tax rates on high-income individuals, and imposing taxes on ride-sharing services and alternative lodging services. These will be addressed in a subsequent Alert.

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