THE NATIONAL LAW REVIEW

Favorable Guidance from the New Jersey Tax Court on the 'Unreasonable' Exception to the Related-Party Intangible Expense Add-back

Thursday, June 29, 2017

In a recent decision, the New Jersey Tax Court provided some long-awaited guidance on the "unreasonable" exception to the state's related-party intangible expense add-back provision. In *BMC Software, Inc v. Div. of Taxation*, No 000403-2012 (2017), the Tax Court held that payments made by a subsidiary to its parent for a software distribution license were intangible expenses that were subject to the add-back provision, but that the statutory exception for "unreasonable" adjustments applied so that the subsidiary was able to deduct the expenses in computing its Corporation Business Tax (CBT). The court first determined that the expense was an intangible expense and not the sale of tangible personal property between the entities because the contract specifically called the fee a royalty, the parent reported the income as royalty income and the parent retained full ownership of the intellectual property rights indicating that no sale had taken place. Thus, the court determined that the intangible expense add-back provision did apply. The most interesting aspect of this case, however, was the court's application of the "unreasonable" exception to the intangible expense add-back provision because that had not yet been addressed by the courts in New Jersey.

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The Tax Court established two critical points with respect to the add-back of related-party intangible expenses: first, that the "unreasonable" exception *does not* require a showing that the related-party recipient paid CBT on the income from the taxpayer; and secondly, that a showing that the related-party transaction was "substantively equivalent" to a transaction with an unrelated party is sufficient evidence that the add-back is "unreasonable."

The "unreasonable" exception to the CBT add-back provision does not require that the related-recipient pay CBT on the income.

With respect to the first point, the Tax Court partially relied on its decision in *Morgan Stanley & Co. Inc. v. Director, Div. of Taxation,* 28 N.UJ. Tax 197 (2014) that a similarly worded unreasonable exception applied even if the affiliate recipient of the payment had not paid CBT on such payment. While *Morgan Stanley* involved the interest add-back provision, not the intangible expense add-back, the Tax Court in *BCM Software* relied on *Morgan Stanley* because both add-back provisions contained similarly worded "unreasonable" exceptions. The court held that its conclusion that the "unreasonable" exception applied regardless of whether CBT had been paid by the recipient on the payment was consistent with the Legislature's intent—the add-back was adopted to ensure that the related-party income was captured in taxable income and was subject to tax, not that CBT was actually paid on the income, so that it was not necessary that the recipient *pay* CBT on the income (rather than use net operating losses (NOLs) to offset the income) for an exception to apply.

In *BCM Software*, the affiliate recipient was subject to the CBT but did not pay the CBT on the income because it had NOLs. The court did not opine on whether the "unreasonable" exception could apply when the related-party recipient is not subject to the CBT.

A showing that the related-party transaction was “substantively equivalent” to a transaction with an unrelated party is sufficient evidence that the add-back is “unreasonable.”

Again relying on *Morgan Stanley*, the Tax Court determined that while it was not necessary that the recipient pay CBT on the payment for the “unreasonable” exception to apply, the “unreasonable” exception required more than a mere showing that the related-party transaction had a non-tax motive and economic purpose. The court held that the taxpayer’s evidence that the terms of the related-party transactions were “substantively equivalent” to transactions with unrelated third parties was sufficient for the “unreasonable” exception. In this case there was evidence of third-party license transactions between the parent and third parties and the taxpayer and third parties. In comparing such transactions to the related-party transactions at issue, the court noted that the terms of the agreements with unrelated parties were “barely different” from the agreements between the parent and the taxpayer—for example, in both the licenses were non-exclusive and non-transferable and both gave the licensor the right to audit the licensee’s records. Although the related-party royalty payments to the parent were computed by use of one rate for all income streams, while the payments to third parties were computed using a tiered system where different rates applied to different income streams, the court was unpersuaded that this distinction was material because the subject of the contracts were the same and the lump sum computation resulted in a comparable expense to the expense computed using the tiered rates.

What does this mean for the intangible add-back in New Jersey?

This case is a published Tax Court case and, thus, is precedential and may significantly narrow the applicability of the add-back for related-party intangible expenses in New Jersey. The decision (particularly the court’s interpretation of the add-back statute’s legislative history) provides favorable authority for taxpayers that make payments to related parties that have NOLs and, therefore, are subject to (but do not pay) the CBT. However, arguably this case may even permit taxpayers that pay an intangible fee to a related party that does not have nexus with New Jersey to deduct the related-party expense if the transaction is “substantively equivalent” to an unrelated-party transaction. Furthermore, while the taxpayer in *BMC Software* presented contracts with third parties as evidence that its related-party transactions were “substantial equivalents” to transactions with unrelated parties, it is possible that even transfer pricing studies or the terms of comparable transactions to which neither the taxpayer nor the recipient is a party could be evidence that the transaction is “substantively equivalent” to transactions with unrelated parties.

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