



NEW JERSEY’S AGGRESSIVE NEW TAX STANCE: HOW DOES IT AFFECT MY INSTITUTION?

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Summary

Companies that do business with customers in New Jersey, including banking institutions, face potential tax liabilities for New Jersey business taxes due to recent developments. Not only could institutions be liable for taxation on New Jersey income going forward, it is possible that New Jersey could collect unpaid taxes retroactively to 2002. Financial institutions located outside of New Jersey but with loan activity, credit card activity, or other similar business dealings with New Jersey residents could be looking at significant tax dues to New Jersey, with the potential for severe penalties and interest due as well. While challenges to this stance may be forthcoming, it would appear very uncertain that such challenges would be successful. An institution will need to determine its potential liability to New Jersey given what has occurred, as well as explore possible actions to mitigate the impact of New Jersey retroactively assessing taxes.

Description of New Jersey’s CBT amendment

On August 15, 2011, the state of New Jersey adopted an amendment to its corporate business tax (CBT) regulations.¹ The amendment’s purpose was to “make explicit the responsibilities to file and pay tax for certain taxpayers receiving income from

New Jersey sources” and to “make clear that certain taxpayers performing services and domiciled outside the State that solicit business within the State or receive gross receipts from sources within the State must file a corporation business tax return and pay the applicable tax to New Jersey.”² Of particular interest to the banking community, the amendment goes on to state that a “financial business corporation, a banking corporation, a credit card company or similar business that has its commercial domicile in another state is subject to tax in this State if, during any year, it obtains or solicits business or receives gross receipts from sources within the State.”³

The CBT amendment makes clear New Jersey’s viewpoint on taxing out-of-state companies, clearly moving from a “physical presence” perspective to an “economic activity” perspective. This change is not at all unique to New Jersey. West Virginia was one of the first states to formally adopt rules that were based on “economic activity” when taxing out-of-state banks, with the ruling by the West Virginia supreme court in *The Tax Commissioner of*

¹ Proposed amendment to N.J.A.C. 18:7-1.8, PRN 2011-038.

² New Jersey Division of Taxation Regulatory Services Branch Technical Advisory Memorandum TAM-6.

³ N.J.A.C. 18:7-1.8, as amended.

the State of West Virginia v MBNA American Bank, NA, 640 S.E. 2d 226 in 2006. The MBNA decision is specifically referenced by New Jersey in its amendment.

Of particular significance to banking institutions is New Jersey's view that the purpose of the amendment is to "make explicit" the changes made to the CBT by the 2002 Business Tax Reform Act.⁴ It is New Jersey's stance that the provisions outlined in the newly adopted amendment pertain to all tax years after 2001. A non-New Jersey bank with taxable income considered derived from New Jersey, which has not filed a New Jersey tax return, could be liable for New Jersey tax, not only going forward, but also retroactively from 2002 on, including interest and penalties.

"Physical presence" vs. "economic activity"

Prior to the MBNA case, the overriding theory behind state tax nexus was the "physical presence" test. This theory was based on long-standing court decisions that concluded that in order to be taxable to a state, a taxpayer must have some physical presence in that state.⁵ The MBNA case, decided in 2006, was a movement away from this theory and towards the new thinking of the "economic activity" test. In MBNA, West Virginia was successful in taxing a Delaware-domiciled bank that had no physical presence in the state of West Virginia and only had activity in that state consisting of credit card customers who resided in West Virginia. The court's reasoning was that the Delaware bank had such substantial economic activity in West Virginia that it was not relevant that the "physical presence" test was not met. Since the MBNA decision, several states, including Alabama, Idaho, Indiana, Kentucky, Massachusetts, Minnesota, and New

⁴ N.J.A.C. 18:7-1.8, as amended.

⁵ *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), *National Bellas Hess, Inc. v. Department of Revenue*, 386 U.S. 753 (1967).

York, have all enacted provisions that, to varying degrees, incorporate the "economic activity" theory.

New Jersey's actions

The new provisions make it clear that New Jersey intends to tax banks domiciled outside of New Jersey, with no physical presence in New Jersey, on the basis of whether the bank "obtains or solicits business or receives gross receipts for services within the State." Under these provisions, a bank located in Pennsylvania, with loans to customers made to acquire and secure New Jersey property, would have "New Jersey-sourced" income (the interest on the loan), which would be taxable to New Jersey based on New Jersey allocation and CBT rules. The same could be said for income earned on unsecured lines of credit to New Jersey residents, fees earned on credit cards issued to New Jersey residents, and other similar transactions.

New Jersey takes the position that the new amendment is not a change but a clarification of the BTRA of 2002, which states that taxes are due "for the privilege of deriving receipts from sources within the state."⁶ While this law has been applied inconsistently, New Jersey's view that this is a "clarification" rather than a change enables New Jersey to collect prior-year unpaid taxes going back to 2002.

Is a VDA the right move?

A non-New Jersey-domiciled bank, which believes it may have New Jersey-sourced income and has not filed a New Jersey tax return in the past, may be able to avoid having the state go back to 2002 if it decides to enter the New Jersey Voluntary Disclosure Program to request a voluntary disclosure agreement (VDA). To use this option, the taxpayer must concede that it has had previous nexus with New Jersey and, in return, the state will agree to go back only three years in collecting the

⁶ The Business Tax Reform Act, P.L. 2002, c. 40, enacted July 2, 2002.

back taxes. In many cases, penalties may also be abated. Entering into a VDA is dependent on the taxpayer filing the back returns; paying the tax and interest, if applicable; and filing New Jersey tax returns in the future. One other requirement of the program is that the taxpayer cannot have already been contacted by New Jersey regarding nexus. Once New Jersey has identified and contacted a possible taxpayer, the VDA is no longer a viable option.⁷

Given New Jersey's position that it will be able to go back to 2002 for back taxes, the three-year look-back limitation of the VDA may be attractive to some taxpayers. But each institution should consult with its own accounting and legal counsel and consider the following questions:

- How much tax may be owed to New Jersey, and what portion of that tax is attributable to the years 2002-2007? Bear in mind that New Jersey's CBT has some anomalies. For example, the state has unique "throw-out" rules⁸ and treats tax-exempt income and depreciation in a manner that can have a significant effect on taxable income.⁹
- How will accepting a VDA affect the calculation of taxes going forward? New Jersey will be changing its apportionment factor calculation, from one that currently involves three factors (with receipts being double-weighted) to one that includes receipts only.¹⁰ This could have the effect of increasing the amount of tax a business may have to pay to New Jersey in future years.

⁷ See New Jersey Division of Taxation Voluntary Disclosure Program information available at: <http://www.state.nj.us/treasury/taxation/voldisc.shtml>, last accessed October 14, 2011.

⁸ New Jersey Corporation Tax Forms for Banking And Financial Corporations instructions Line 35(e).

⁹ New Jersey Corporation Tax Forms for Banking and Financial Corporations instructions Line 16, Sch. A.

¹⁰ N.J.S.A. Sec 54:10A-6.

Challenging the amendment

If it is determined that nexus with New Jersey does exist, the other possible course of action could be to challenge the amendment—or more likely, waiting and hoping that a successful challenge is undertaken by someone else. While every state is different, a look at the MBNA case in West Virginia does not provide much hope that the result in New Jersey would be different.

New Jersey refers directly to the MBNA case in the amendment, indicating its confidence in the decisions made in that case. All of the arguments that could be used against changing the definition of nexus away from "physical presence" tests and towards "economic activity" were present in MBNA. The danger of waiting for a judicial decision that is unlikely to be favorable is that as time passes, interest and penalties continue to accrue on unpaid back taxes.

Uncertain tax positions

The actions of New Jersey could have an impact on more than just the actual taxes paid. Generally accepted accounting principles (GAAP) require that any uncertain tax position be recorded as a liability of a company. These "FIN 48" rules require that the benefits from a tax position are only to be recorded if it is "more likely than not that the benefit will be sustained." If this threshold cannot be met, the benefit cannot be recorded by the company under GAAP. Even if the "more likely than not" test is met, measurement of the benefit may be required and an uncertain tax liability may still need to be recorded. Given New Jersey's recent actions, it would seem unlikely that an institution with possible New Jersey-sourced income could take a position of not filing New Jersey tax returns or paying New Jersey tax and be able to survive the "more likely than not" test.

Conclusion

Financial institutions with New Jersey-sourced income must quantify potential liability as soon as

possible and measure the impact on its uncertain tax position liability. The institution should consider the benefits and risks of entering into the New Jersey Voluntary Disclosure Program.

Unfortunately, the additional burdens put on all businesses, not just financial institutions, as a result of this current movement towards “economic activity” standards are only going to increase. The New Jersey situation closely mirrors that of West Virginia with the MBNA case, and, other states are likely to follow. Given this new reality, all financial institutions should closely monitor their income make-up by state, so that proper decisions can be made regarding state tax issues.

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