Taxation Law Section Newsletter

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Chair's Column

by Alex Paul Genato

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Inside this issue

Newsletter Editors

Taxation Law Section Leadership

The New Jersey Estate Tax Has Been Repealed! What's Next?

by Glenn A. Henkel, Martin Shenkman and Richard Greenberg

The New Jersey estate tax will be phased out. The New Jersey estate tax exemption, formerly $675,000, the lowest in the country, increased to $2 million on Jan. 1, 2017, and will be eliminated after Jan. 1, 2018.

What does this mean for those living in New Jersey? What changes to planning and documents might be advisable to consider for New Jersey (and in some cases other states, such as New York) domiciliaries? What will it mean for those that at one time lived in New Jersey but 'changed' domicile to a no-tax state? What might this repeal mean to those living in nearby states that have an estate tax (*e.g.*, New York)? What changes to planning and documents might be advisable to consider?

While this article focuses on the recent changes and planning in New Jersey, this guidance, in many instances, will be useful to practitioners in other jurisdictions as well.

A deal was reached on Sept. 30, 2016, between the governor and key legislative leaders regarding funding for the Transportation Trust Fund (TTF).

The highlights are as follows:

- TTF has been reauthorized for eight years—$2 billion per year (which aggregates $32 billion when combined with all state and federal funding).
- There was a 23-cent per gallon increase in the gas tax.
- The earned income tax credit was increased from 30 percent of the federal limit to 35 percent.
- The New Jersey gross income tax exclusion for pensioners and retirees was reportedly increased to $100,000.
- The New Jersey estate tax will be reduced in phases, and then eliminated by 2018.
- The sales tax is phased down to 6.875 percent (effective Jan. 1, 2017), and then to 6.625 percent (effective Jan. 1, 2018).

On Oct. 5, 2016, both houses of the state Legislature were called into a special committee hearing and voting session, but needed to reconvene two days later to approve the legislation. The legislation was signed by Governor Chris Christie on Oct. 14, 2016. The cuts will amount to a $1.4 billion tax cut by the time of their full implementation in 2021, according to the Governor's Office.

The New Jersey law provides that there are no estate tax changes for 2016 decedents (leaving in place the $675,000 exemption threshold) and there is no tax for 2018 decedents.

However, for 2017 decedents, the tax imposed is based upon the prior I.R.C. Section 2011 'credit' rate chart as it existed in 2001, reduced by a 'credit' of $99,600 (the tax that would have been imposed on a $2,000,000 estate). Whether the state will be financially able to forgo the estate tax revenues in 2018 and thereafter remains to be seen, but that will be an issue for a future Legislature and a future governor.

Planning in a Decoupled State

New Jersey is one of a minority of states that retained a state estate tax after the changes to the Federal Tax Code after the Economic Growth Tax Relief and Reconciliation Act of 2001 (commonly referred to as the first 'Bush tax cuts'). As a result, planning in New Jersey has been complex and quite different from states that had not decoupled. Since 2002, New Jersey imposed a separate estate tax. In New Jersey, spouses could leave assets tax free to their spouse or tax free to charity, but a tax would be imposed on transfers to others, to the extent the value of those transfers exceeded $675,000. While the New Jersey estate tax rate has been much lower than the federal rate, it was and is still significant, with the marginal rate reaching 16 percent, and as a result has caused issues with respect to inter-spousal estate planning for New Jersey clients.

Beware: In addition to the estate tax, New Jersey also imposes an inheritance tax. However, the inheritance tax does not generally apply to transfers to a spouse, child, or grandchild, who are referred to as 'Class A' beneficiaries. Unfortunately for taxpayers, the recent legislation does not appear to have changed the New Jersey inheritance tax, which generally subjects transfers to siblings at a rate of 11 percent and to many others at a 15 percent rate. The New Jersey inheritance tax may thus remain a costly trap for unsuspecting taxpayers.

Another issue to consider is that since the federal American Taxpayer Relief Act of 2012 (signed Jan. 1, 2013), the federal government has permitted 'portability' of the federal estate tax exemption. Portability was designed with an eye toward eliminating the need for the complexity of traditional 'by-pass/credit shelter/family trust' planning used to shelter assets by preserving the estate tax exemption of each spouse of a married couple. In general terms, 'portability' of the estate tax exemption allows one spouse to inherit the assets of their deceased spouse without using the exemption permitted for non-marital and non-charitable transfers, while also inheriting the unused exemption. The technical term for this 'unused' exemption is the deceased spouse unused exemption (DSUE). Previously, in the context of planning for New Jersey domiciliaries, the low New Jersey exemption created estate planning challenges, necessitating the need to evaluate or employ complex options to maximize the benefits of the first spouse's DSUE.

Wills and Revocable Trusts May Have to be Updated

A common approach taken in wills (or revocable trusts when used as the primary dispositive document), is to incorporate a credit shelter trust and a marital disposition (either outright or in trust). The purpose of the credit shelter trust was generally to make assets available to the surviving spouse but to avoid them being included in the surviving spouse's estate for estate tax purposes.

In New Jersey, this was often addressed with a state tax exempt level credit shelter trust of $675,000, a 'gap' trust funded with the difference between the federal exemption and the New Jersey exemption (formerly $675,000). The excess above the federal exemption would be bequeathed to a qualified terminable interest property (QTIP) trust or other marital deduction-qualifying bequest. The estate, post-death, could then determine how to characterize the gap trust. For smaller estates, some practitioners may have relied on outright bequests and the provision of a disclaimer credit shelter trust. While this type of dispositive scheme might appear to not require any modification, that conclusion may stem from too superficial of an analysis. With this backdrop, practitioners must evaluate what might need to be done to update documents for the recent legislative developments

Here are some thoughts:

- What might need to be done to modify an existing will (or revocable trust) will depend on what provisions the document contains. Consider that the credit shelter trust and related planning could be structured in a number of ways:

  Fund the credit shelter trust with the amount that will not create a federal or state estate tax. For example, if the New Jersey estate tax exemption was $675,000 and the federal exemption $5 million, then $675,000 would be transferred to a credit shelter trust. But now that the New Jersey exemption has increased to $2 million, that amount, not $675,000, should pass, without further need for change, into the credit shelter trust. In 2018, if the New Jersey estate tax is repealed, the amount necessary to fund the credit shelter trust might increase to the federal exemption amount, which is $5 million inflation-adjusted—$5,490,000 in 2017.

  A key consideration for many people is what they anticipated their will accomplishing when it was written. If the credit shelter trust included children or other heirs (especially from a prior marriage), the result might not be the intent for them to have so much value directed to a trust for their benefit. Others might have only used a trust to reduce state estate taxes, which would no longer be relevant. The key issue is determining what the objectives were when the document was completed, what the client's current objectives are, and what the result of the provisions and new law may be.
- Some older wills might stipulate funding the credit shelter trust with a specific dollar amount (*e.g.*, $600,000 for very old wills, or perhaps $675,000 to fund the New Jersey lower exemption amount). In these cases, one might need to modify the will

to reflect the client's current intent. There may be no need or desire for a credit shelter trust under the new scenario (for smaller estates now desirous of the protections of a trust), or perhaps a higher amount might be warranted. These wills, in particular, should be updated. For smaller estates, a disclaimer or other approach may be preferable.

- Other older wills might stipulate funding the credit shelter trust to the maximum amount that will not create a federal estate tax. Under current New Jersey law, and through 2018 when the New Jersey estate tax is repealed, this type of formula could trigger a New Jersey estate tax, which might not be intended or desirable. In these instances, it has been and continues to be imperative to revise the document immediately, to avoid an unintended state estate tax. If the testator who signed the will does not have capacity to sign a will, perhaps the title (ownership) of assets can be modified to avoid the tax, or a reformation proceeding may have to be brought in court to modify the document to reflect current law.
- For smaller estates, the entire estate might be bequeathed outright to the surviving spouse, and the surviving spouse might be given the right to disclaim (renounce) any portion of that bequest by placing it into a credit shelter trust. This might avoid any tax issues. This is because the surviving spouse can simply opt to retain all assets on the first spouse's death, and not trigger the transfer of any assets into a credit shelter trust. In this way, whatever the New Jersey estate tax exemption may be, the surviving spouse can control the tax consequences. While a disclaimer might provide ultimate flexibility, for many it is an overly simplistic and inadvisable plan, as there is no protection afforded to the assets passing outright to a surviving spouse. With the incidence of elder financial abuse, divorce, lawsuits, etc., protecting the inheritance, not tax planning, could be of paramount importance. Estate planning is not only about reducing taxes.
- Some wills or trusts use a Clayton QTIP approach, in which assets are bequeathed to a marital or QTIP trust and the executor may elect which portion qualifies for the marital deduction with the remaining non-elected portion passing to a credit shelter trust. In some instances this might remain a viable technique, in others not.
- For clients who are ill or of advanced age, a more complex approach might be desirable to provide flexibility, not only for the implications of the New Jersey repeal but also to reflect possible changes to the federal estate tax laws that might be implemented by the Trump administration.

There are many other variations, but certainly the safest approach is to review how each client's documents are structured. With so many variations and ancillary considerations (asset titles, asset protection, divorce planning, and other concerns), relying on an old document, even if one believes it was drafted to account for the repeal of the New Jersey estate tax, is simply not prudent. The real challenge for practitioners will be to convince clients to spend the money on an update meeting. This will be particularly difficult for those clients who believe (correctly or not) that their estate is below the federal exemption.

Credit Shelter Trust Planning and the Impact of the New Jersey Estate Tax Repeal

Building flexibility into the client's plan is essential. This is not only because the values of assets may fluctuate after the execution of the estate planning documents, but also due to the fact that tax laws are now quite sensitive and highly subject to the political winds of change. Many plans have involved the use of a trust for the surviving spouse that can allow for the 'sheltering' of assets from the potential taxation at the passing of the survivor. This trust, as noted briefly above, was often modified to address the New Jersey estate tax.

The following is a general discussion of the fundamentals of credit shelter trusts, setting the foundation for a review of what impact New Jersey's repeal could have on such trusts for estate planning purposes. The credit shelter trust (sometimes referred to as either a bypass trust, residuary trust, or family trust) has historically been utilized when considering a plan for a married couple, in order to preserve (before portability) the estate tax exemptions of each spouse.

The credit shelter trust can generally:

- Allow the survivor to be sole trustee (with a HEMS standard)
- Grant the survivor the right to all income
- Grant the spouse the right to receive principal for health, maintenance and support in reasonable comfort (the so called 'ascertainable standard'), or a discretionary standard with an independent trustee

- Grant the spouse a right to withdraw the greater of five percent or $5,000 (whichever is greater)
- Grant a power to re-allocate funds in the trust among a 'special' or 'limited' class, called a limited power of appointment (LPOA)

Even with all of these powers being granted to the surviving spouse, the *corpus* of the credit shelter trust should not be 'included' in the taxable estate of the surviving spouse. This would hopefully generate an estate tax savings by 'sheltering' the credit (or exemption amount) of the first spouse to pass away. In other words, if the exemption of one spouse is sheltered by one exemption, the survivor's exemption is available to shelter additional assets from tax. The trust can be crafted with fewer powers and rights, depending on the family situation. However, because the trust was not included in the estate of the survivor, the basis of the assets transferred would not be adjusted or stepped up. For many moderate-wealth taxpayers domiciled in New Jersey, even if the increase in the federal estate tax exemption may have obviated worries about the federal estate tax, the continued risk of a New Jersey estate tax may have justified the use of such a trust. Once the estate tax repeal is fully implemented in 2018, assuming there is no potential federal estate tax for the client, the credit shelter trust will no longer protect the taxpayer from estate taxes, but instead may serve to deny the taxpayer a step-up in cost basis.

Another approach to crafting a trust could be to provide that the surviving spouse is the sole beneficiary of the trust, that the survivor has the right to all income of the trust (in a manner that the requirements for a 'qualified income interest for life' are met). Under Code Section 1014(b)(10), a family can choose to place assets in a trust when the first spouse passes and, if a QTIP treatment is elected under §2056(b)(7), the trust can receive 'step up' in basis at the death of the surviving spouse. Thus, this plan would give the surviving spouse/surviving parent the option of determining whether or not it is better to utilize a credit shelter trust to remove assets from the survivor's estate, or elect QTIP treatment and portability at the death of a predeceased spouse. More specifically, Code Section 1012 defines the 'basis' of an individual's asset for purposes of resale as cost.

Under Code Section 1014, the basis is 'stepped-up' or adjusted to the fair market value at the time of a decedent's passing.

In the event a married couple holds assets and has the option of placing assets in a trust in order to capture the estate tax exemption of both spouses, the basis would be adjusted or stepped up to the fair market value on the date of death of the first or predeceasing spouse. However, the basis would not receive a second step-up at the death of the surviving spouse. If there is substantial appreciation between the first death and the second, that appreciation would not be subject to estate tax; however, it would be subject to an income tax upon liquidation of the underlying investments. Once the New Jersey estate tax is fully repealed, the calculus for many taxpayers will change. The marginal aggregate federal/state estate tax rate will be lower and the relationship of the marginal estate tax rate to the capital gains rate will shrink. Thus, the benefit of a basis step-up versus estate tax exclusion will change.

As a result of the opportunity to receive a second step-up in cost basis, planners have recommended that clients forego the use of a credit shelter trust for the benefit of the surviving spouse/surviving parent, because portability affords the family the right to receive the benefit of the federal estate tax exemption while simultaneously receiving an opportunity to receive a second adjustment or a step-up in the cost basis of all assets at the death of the surviving spouse/surviving parent.

Flexibility Planning

Incorporating this type of plan into a couple's estate plan provides, at the time of the death of the first (or predeceasing) spouse, the executor with the option of determining, when filing an estate tax return, whether or not to incorporate the benefits of Code Section 2056(b)(7), which would grant the estate a 'marital deduction' over assets held in trust. In that event, the estate tax rule would treat the inherited assets as if they were owned by the surviving spouse. In that event, the DSUE can carry over to the surviving spouse. However, for income tax purposes the family would be afforded the opportunity to receive a step-up in cost basis occurring at the second death.

By contrast, should the family choose to utilize the alternate approach, whereby the credit shelter trust is funded with assets which are then excluded from the estate of the surviving spouse? In that case, no election to qualify under Code Section 2056(b)(7) for the marital deduction would be made. Setting forth a plan that calls for the creation of a credit shelter (or family) trust in the will, a planner can be assured that the decision can be left for a later date to determine whether or not the portability and second step-up approach is warranted or whether the credit shelter plan (with the removal of all appreciation from the estate of the surviving spouse) would constitute a better approach.

One of the difficulties with the possible use of portability for estates that will not be 'taxable' under the federal law (because the combined estate is less than the federal $5,490,000 exemption—the 2017 threshold) is that there are many assumptions that need to be considered to determine whether a family plan should shelter the estate tax exemption from tax or not. These include:

- How long will the surviving spouse live?
- How much will the assets appreciate?
- To the extent assets appreciate, will they be sold to incur the income tax?
- Will the family continue to reside in a state subjecting the estate of the surviving parent to tax?
- What will the income tax rates be on any future sale?
- Will the estate tax be reinstated at a state or federal level?

QTIP Election

Following the decoupling of the New Jersey estate tax from the federal Tax Code in 2002, practitioners have grappled with the possible impact of IRS Revenue Procedure 2001-38, 2001-24 IRB 1335, 2001-1 C.B. 1335 (Rev. Proc. 2001-38), on New Jersey estate tax planning. Specifically at issue in Rev. Proc. 2001-38 was a situation where trust assets would be sheltered from estate tax by exemption. The ruling held that the QTIP election would be ignored and the surviving spouse would not be subject to estate taxation on the trust *corpus* if no federal estate tax benefit will be achieved. Practitioners worried that if a New Jersey decedent funded a New Jersey bypass trust to $675,000 and a QTIP was used for the remaining estate to qualify for the state estate tax marital deduction, would that QTIP qualify, since there was no reduction in federal estate tax? Under some interpretations of Rev. Proc. 2001-38 it was not certain that such a QTIP would qualify for the federal estate tax marital deduction, and hence for the New Jersey estate tax marital deduction. Once the New Jersey estate tax is repealed, this issue would be obviated. However, the concerns about funding a New Jersey state-only QTIP have been obviated by a recently introduced revenue procedure.

On Sept. 27, 2016, the IRS announced Revenue Procedure 2016-49 (Rev. Proc. 2016-49), which essentially reversed Rev. Proc. 2001-38. In effect, this new rule indicates that when an estate is filing an estate tax return, the QTIP election will be respected, even if the election to be made is not necessary in order to avoid federal estate taxes. Rev. Proc. 2016-49 provides a procedure by which the IRS will disregard the QTIP election and treat it as null and void. Under §4.02 of that ruling, the taxpayer must file a Supplemental Form 706 and notify the IRS of the taxpayer's request to treat the prior QTIP election as null and void. Without the request to nullify the QTIP election, it would generally be respected. Moreover, the ruling indicates that where a portability election is made, the QTIP election will be respected. Thus, for existing New Jersey-only QTIPs, and for New Jersey-only QTIPs formed prior to 2018, the issue raised by some commentators has been obviated by Rev. Proc. 2016-49.

Disclaimer Trust Planning: More Likely in Many Situations

With the repeal of the New Jersey estate tax for many taxpayers, a disclaimer plan will become the default planning approach for moderate-wealth taxpayers. Unfortunately, the default plan for most taxpayers below the federal exemption may be 'I love you' wills, outright bequests with no trusts. The move to simplistic wills may well fuel a growth in clients using online legal services rather than attorneys, or a general practice attorney rather than estate-planning specialists. The result will likely be a significant decline in the use of trusts and the protective benefits they afford.

For clients of moderate wealth who use counsel, there will likely be a greater reliance on the use of a disclaimer trust. For example, if a husband and wife have been married for a long time and the children are 'common children' of the marriage, such that it could be anticipated that a surviving spouse would not be expected to disinherit the children of the predeceasing spouse, then a disclaimer trust may provide the greatest opportunity for flexibility. Disclaimer trusts, however, are ineffective in achieving non-tax planning objectives.

A disclaimer trust estate plan would devise the entire estate to the surviving spouse. If the inheritance is 'disclaimed' by the survivor, the will or revocable trust can direct the inheritance to a trust for the spouse as permitted by I.R.C. § 2518. By granting a surviving spouse this option, the surviving spouse can choose whether funding the trust with the estate is appropriate based upon a variety of circumstances at that time, such as: 1) the size of the combined estates at the first death; 2) the applicable federal estate tax exemption; and 3) the likelihood the surviving spouse will reside in a state with a state estate tax.

While all of these uncertainties may remain at the death of the first spouse, this flexible plan is premised on the assumption that one may know more at that time than when the wills and estate plan were drafted. Without the New Jersey estate tax and with the potential of a high federal estate tax exemption, this will be a plan that will retain its popularity. If the couple plan to utilize a 'disclaimer' trust option, it is still important to title the assets to divide the family estate equally between the husband and wife. While a one-half interest in real property can be disclaimed pursuant to both Treasury Regulation § 25.2518-2(c)(4)(ii) and N.J.S.A. 3B:9-2, other intangibles should be divided between the spouses.

Using this type of plan will provide for greater ease of administration if the couple has a plan in mind regarding how the disclaimer trust will operate at the death of either spouse. Some estate planners dislike the use of disclaimer trusts because they are concerned that a surviving spouse, in an emotional state, may be unwilling or emotionally unable to make the required evaluation of the need to disclaim in the short time permitted. Others feel that if properly addressed in the planning phase, the surviving spouse will be able to carry through with this task as an entirely financial matter (not emotional). As a general rule, the disclaimer must be completed and filed (in the county surrogate's office) within nine months of death. For real estate, it must also be filed in the recorder of deeds. Note that the New Jersey disclaimer statute does not require the disclaimer be filed within nine months. The only limitation under New Jersey law is that the disclaimant cannot accept the property.[1] For federal tax purposes, the disclaimer must be completed within nine months.[2]

If the disclaimer meets the requirements of Code Section 2518, it is a 'qualified disclaimer' (a tax-sensitive term). In such instances, the transfer is not treated as a gift by the disclaimant for gift tax purposes, and it is treated as a gift/bequest directly by the decedent as if the disclaimant had predeceased. The nine-month time frame is usually a sufficient period of time to deal with the emotional aspects of death of a loved one and make a rational financial choice—particularly if it has been considered earlier in the planning phase. Certainly, it is not something that must be considered shortly after the first spouse's death. However, assuming the spouse does not retitle assets into his or her individual name (which tends to be a natural desire), there should be adequate time to meet, discuss the financial options and make an informed choice about whether or not to execute on the disclaimer trust plan.

This planning option provides substantial flexibility. Obviously, the couple must be confident that the surviving spouse will carry through with the testamentary desires of the predeceasing spouse. Thus, it may not be appropriate in the second marriage, where there are alternate heirs (*i.e.*, children of a previous marriage). If the spouses have planned to leave their entire estate to the survivor, or the purpose of establishing a trust was simply related to the tax opportunities, then this type of plan may need reconsideration.

Another consideration is whether the surviving spouse will need the entire balance of the funds received from the predeceasing spouse. There are two mechanisms to consider in connection with this plan. First, if the surviving spouse feels he or she does not need the entire estate, the survivor can also, likewise, disclaim an interest in the disclaimer trust, either in whole or in part. Thus, for purposes of testamentary disposition, this will be treated as if the property passed directly from the predeceasing spouse to the alternate heirs (presumably children or grandchildren). An alternate plan would be to devise the disclaimer trust in a fashion that allows principal to be used for the benefit of the heirs in addition to the surviving spouse. This is explicitly permitted by IRS Treasury Regulation 25.2518-2(e)(2), assuming the power of distribution is limited by an ascertainable standard.

The challenge for many New Jersey practitioners post-repeal of the New Jersey estate tax is to convince clients with wealth levels under the federal exemption of the need for better planning. The threat of a New Jersey estate tax clearly was a driver pushing clients to estate planners. Absent that starting in 2018, practitioners will have to educate clients about a range of considerations that would justify the cost of professional planning. These might include:

With increased longevity, the likelihood of remarriage following the death of a prior spouse will increase. The need for trusts on the first death to protect those assets is more important than most realize.

Go to Index

Elder financial abuse is burgeoning. The use of online document preparation services is unlikely to provide the independent guidance to address this significant risk.

Life Insurance Trusts May Need to be Revisited

Some taxpayers may have life insurance trusts that were created to hold life insurance to pay an estate tax. Even if the increases in the federal estate tax exemption eliminated the federal estate tax, some taxpayers may have retained an insurance trust in place to fund the New Jersey estate tax. If the New Jersey estate tax is, in fact, repealed, perhaps there is no longer an estate tax justification for the insurance trust, but for some estates the New Jersey inheritance tax may still support such a plan, if the inheritance tax is not also repealed. While in many instances insurance trusts and life insurance serve a range of other purposes, if the elimination of the New Jersey estate tax eliminates the last relevant purpose, options could be explored for both the insurance coverage and the trust owning it.

Life insurance may have been purchased to pay an estate tax that might be eliminated, but insurance may also provide long-term care benefits, an alternative asset class to provide ballast for other investments that are more risky, a fund to borrow against in retirement, and more.

Durable Power of Attorney (and Revocable Trusts) Gift Provisions Might Warrant Reconsideration

If a taxpayer's power of attorney has a gift provision and the sole purpose of that gift provision was to save estate tax, then the power of attorney (or revocable trust if that too had a gift provision) should be reevaluated. If there is no other purpose for the gift provision, consideration should be given to revising the document to reduce or eliminate the gift provision. Given the incidence of elder financial abuse using a durable power of attorney, if there is no reason to retain a gift provision, it may be preferable to revise the document and eliminate it.

Title to Assets Should Be Revisited

Some taxpayers intentionally divided assets so that either spouse could have assets to fund a credit shelter trust no matter who died first. If this was done for taxpayers with estates under the federal estate tax exemption, it may be feasible to again change the ownership of assets back to whatever would be preferable without regard to the estate tax. For example, if a couple in New Jersey had a $5 million estate, they were well below the federal estate tax exemption. They may have divided assets to fund a bypass trust under each of their wills. Assume the wife was a physician and the husband a teacher. It might be preferable to have all assets in the husband's name, to minimize liability exposure in the wife's name. The repeal of the New Jersey estate tax might warrant changing the title to those assets back to only the husband's name.

A better but more complex approach might be to use some of the assets to fund an *inter-vivos* QTIP trust to provide protection and more control over the disposition of the assets. If the *inter-vivos* QTIP is formed in a state that permits self-settled trusts, or has express language permitting a bypass back to the grantor spouse, on the death of the first spouse the assets will return to the settlor spouse in a bypass trust, thus permitting both spouses to benefit from the assets while providing asset protection. The practical issue is that, absent the threat of a federal or state estate tax, will the couple undertake the planning?

The title to assets can be relevant to estate tax planning, and in particular to obtaining an increase (step-up) in cost basis on death (if the first to die holds the assets, the cost basis will be increased and the survivor can sell those assets without a capital gain). Assets might be retitled into the name of the spouse who is anticipated to die first, but not within one year of the spouse's death (unless further planning is undertaken). Alternatively, a community property trust could be created in Alaska, South Dakota or Tennessee, so that, whichever New Jersey (a non-community property state) spouse dies first, arguably all assets should qualify for basis step-up. If the appreciation potential in the estate is large enough, perhaps this might be advisable.

Be cautious about a myriad of ancillary issues before changing the title to assets. What are the matrimonial implications to retitling assets? Even if there are arguably only limited legal implications because of equitable distribution, might there be a strategic impact? Should a post-nuptial agreement be created to address the retitling of assets?

Changing the title to a house might affect property taxes (*e.g.*, senior citizen or veterans benefits), insurance coverage, and other matters.

Changing a legal document such as a will, without addressing title to assets, may accomplish nothing. Taxpayers need to understand that the elimination of the tax does not eliminate the need for planning and follow-up. For professionals of all stripes, this is going to be a hard sell: "I need to bill you to do work that may not save your heirs taxes." The key to this pitch will be all advisers echoing the same mantra. But will all players on the team really cooperate? Will wealth managers really do the right thing and push clients back to their estate planners?

New Jersey Inheritance Tax Trap

Will the New Jersey inheritance tax also be repealed? It does not appear so. Perhaps the revenue loss from both the repeal of the estate and inheritance tax at one time was deemed too costly. This will remain a trap for the unwary. Taxpayers will likely assume that since the estate tax has been repealed, there remain no New Jersey death taxes, until their estates are tagged with a costly New Jersey inheritance tax. For those taxpayers bequeathing assets to beneficiaries subject to inheritance tax, gifts prior to death, and/or retaining life insurance to pay inheritance tax may be worthwhile.

Perhaps durable powers of attorney (and/or revocable trusts if those are the primary dispositive document) should be revised to permit or restrict advancement of testamentary gifts that might trigger a New Jersey inheritance tax. In New Jersey, inheritance tax is imposed on gifts within three years of death, unlike the federal rule upon which the New Jersey estate tax was based.

Personal Goals Become More Important

Estate planning should never be only about reducing estate taxes. There are a myriad of important personal goals that should be considered. One-dimensional planning is rarely effective. Plans that were implemented merely to avoid New Jersey estate tax for taxpayers with estates under the federal exemption should be revisited to assure that robust and broad-based planning was addressed, and that the plan was not merely a tax fix that is no longer effective. Did the documentation and planning address personal goals and issues? Was later life planning addressed, if relevant? What steps were taken to reduce the risks of elder financial abuse? Does the client have religious goals or personal financial objectives for heirs that were overlooked in the focus of planning on taxes?

Does New Jersey Repeal Matter to the Ultra-Wealthy?

The New Jersey repeal does matter to the ultra-wealthy. Many estate plans for wealthy persons domiciled in New Jersey might have funded three trusts: a New Jersey credit shelter trust up to $675,000, a gap trust with the difference between the federal estate tax exemption in the year of death, and a QTIP for the remaining estate. The issue was how the gap trust might be characterized for estate tax purposes. Once the New Jersey estate tax is fully repealed, there will be no detriment to fully funding a bypass trust to the federal estate tax exemption. Until that time, the multiple trust approach might still make sense.

For some wealthy taxpayers, an outright bequest might have been provided to the surviving spouse. The surviving spouse may have, according to the plan, intended to receive all assets outright from the deceased spouse and then make a gift to a self-settled trust. In that way, no New Jersey estate tax would be incurred and the full federal exemption for the first to die spouse could be used. This plan still has an advantage in that the irrevocable trust using the exemption will be a grantor trust regarding the surviving spouse, providing ongoing tax burn for his or her estate. However, the calculus of the advantages and risks of that plan will change substantially if the New Jersey estate tax is repealed. It may be preferable to have the will or revocable trust of the first-to-die spouse fully fund a credit shelter trust on death and avoid the risk of the surviving spouse not carrying through on the intended plan, creditors of the surviving spouse reaching the assets bequeathed outright, etc.

Language in wills and revocable trusts should be reviewed to assure that it accomplishes the planning goals during the phase-out of the tax and following the repeal.

Should the Client 'Repatriate?'

Many wealthy taxpayers established domicile in states without an estate tax (*e.g.*, Florida). Some of these clients really moved and changed their nexus out of New Jersey. Other clients may maintain that they have moved but may not have really made sufficient changes. In a few cases taxpayers merely take a position that they were no longer domiciled in New Jersey to avoid the New Jersey estate tax. In the latter cases, and perhaps in the former, these taxpayers might wish to revisit their domicile decisions and status in light of the repeal. In such cases, not only might all estate-planning documents have to be updated to reflect a New Jersey domicile, but a range of other decisions and steps might have to be modified as well.

Other Considerations Make Changes Complicated

There are a host of other considerations that should be factored into the analysis. Before documents, planning, insurance, asset title or other matters are changed, consider:

- Nothing in the tax world is certain. What changes today may change tomorrow.
- Planning should have been and should remain flexible. If current documents were not designed with flexibility in mind, perhaps they should be revised on that basis alone.
- Will the New Jersey estate tax repeal actually take effect as indicated?
- What will happen with the federal estate tax under the current administration? Will it be repealed? Will the exemption instead be increased significantly?
- Asset protection, elder financial abuse and other considerations may be relevant.
- Mobility is important to consider too. Where might the taxpayer move in the future?

Conclusion

If the New Jersey estate and inheritance tax are, in fact, repealed, it will be a welcome relief to those affected, and might actually increase tax revenues to the state of New Jersey, given how many taxpayers move out of the state (or say they do) to avoid the state's estate tax. Planning will be significantly simplified for those with estates near or under the federal estate tax exemption. In light of this, everyone should review their existing estate planning documents, title to assets, life insurance coverage and anything else affected.

The disturbing part of the repeal is taxes on the wealthiest are being reduced while sales and gas taxes that disproportionately weigh on those of more modest means, where the additional dollars involved can create a real hardship, have been increased.

The pros and cons of the estate tax repeal, coupled with the other tax changes, are debatable; the need to revisit and potentially revise estate-planning documents in light of those changes is not.

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Endnotes

1. N.J.S.A. 3B:9-9.
2. I.R.C. § 2518.

Significant New Jersey Tax Cases in 2016

by Mitchell A. Newmark and Kara M. Kraman

Several significant tax cases were decided by the New Jersey Tax Court in 2016. Those cases mainly addressed issues related to New Jersey's corporation business tax (CBT), including the 'unreasonableness' exception to the add-back of interest, alternative apportionment, the sourcing of business receipts from mortgage activities, and the sourcing of business receipts from credit cards. Other tax court decisions addressed the 'square corners doctrine' and the 'manifest injustice doctrine,' and their impact on the ability of the director of the Division of Taxation to assess gross income tax retroactively on lottery winnings and sales tax applied to services provided in connection with pre-written software.

Although the New Jersey Supreme Court did not decide any tax cases in 2016, significantly, it did deny the director's petition for certification to review the Appellate Division's taxpayer-friendly ruling that the director may not apply dual nexus standards for purposes of applying the throw-out rule, in *Lorillard Licensing Co., LLC v. Director, Division of Taxation*.[1]

A brief discussion of each case is provided below.

Corporation Business Tax/Throw-Out

On June 14, 2016, the New Jersey Supreme Court, in *Lorillard Licensing*, denied the director's petition for certification to review the Appellate Division's final judgment that the director may not apply dual nexus standards for throw-out purposes.

Lorillard, a North Carolina company, owned, managed and licensed intellectual property to, and received royalty payments from, its parent, Lorillard Tobacco Company (LTC). Lorillard had no employees, tangible personal property or real property located in New Jersey and, therefore, did not file New Jersey CBT returns. The director audited Lorillard for the 1999 through 2004 tax years and determined that: 1) Lorillard was subject to the CBT because it licensed trademarks and trade names to LTC and LTC sold products using those trade names and trademarks in New Jersey, and 2) Lorillard should apply the so-called throw-out rule[2] to all receipts that were not taxed by another state for the 2002-2004 tax years.[3] The director issued Lorillard a notice of assessment asserting its position.

Lorillard filed a motion for summary judgment with the tax court on the issue of whether the throw-out rule's application, which is limited to receipts not taxed by other states because the other states lacked jurisdiction to tax those receipts, is applied using New Jersey's view of subjectivity to taxation. The tax court held that the New Jersey Supreme Court's holding in *Whirlpool Properties, Inc. v. Director, Division of Taxation*,[4] that throw-out only applies to receipts that are not taxed by other states because they lack the authority to tax those receipts (either by constitutional limitation or because of federal protection) applies to Lorillard, and that New Jersey must use its own view of subjectivity to taxation that it successfully asserted in *Lanco, Inc. v. Director, Division of Taxation*.[5]

The Appellate Division upheld the tax court's decision in full. Like the tax court, the Appellate Division noted that in *Lanco, supra*, the New Jersey Supreme Court held that a trademark owner's receipt of royalty payments from sales in the state by a related entity that conducted business in the state gave the company sufficient nexus with New Jersey, even though it had no physical presence in the state, to permit taxation under the United States Constitution. The Appellate Division then noted that under *Whirlpool Properties, supra*, when applying the throw-out rule, the proper inquiry is whether other states have authority under the United States Constitution to subject the taxpayer to tax in that state, not whether those states actually do tax the taxpayer. The Appellate Division held that, based on the federal constitutional nexus standard set forth in *Lanco, supra*, all 50 states (which are subject to the same federal Constitution) would have the same constitutional authority as New Jersey to tax Lorillard, and, therefore, none of its receipts could be thrown out.

The director did not petition the U.S. Supreme Court for a *writ of certiorari* to review the Appellate Division's *Lorillard* decision.

Corporation Business Tax/Alternative Apportionment

In *Canon Financial Services, Inc. v. Director, Division of Taxation*,[6] the New Jersey Tax Court held that a corporation whose only place of business was in New Jersey did not have to allocate 100 percent of its income to New Jersey for CBT purposes because such an apportionment failed to fairly reflect the company's business activities in New Jersey. The tax court also held that the taxpayer was not entitled to allocate its income using the standard three-factor formula. (New Jersey uses the term 'allocate' when it refers to the portioning of income referred to by the U.S. Supreme Court as 'apportionment.' Therefore, in order to conform with U.S. Constitutional convention on this issue, the authors will refer to it as apportionment).

The taxpayer in *Cannon* was a commercial financial services company headquartered in New Jersey that provided lease financing to purchasers of its wholly owned parent's products. The taxpayer's lessees were located in all 50 states. On its CBT returns, the taxpayer apportioned its income using the three-factor apportionment formula. On audit, the director adjusted the taxpayer's CBT liability by using the statutory 100 percent apportionment method applicable to taxpayers that did not maintain a place of business outside of New Jersey that was in effect during the years at issue,[7] and by providing a credit for taxes the taxpayer paid to other states.

The tax court concluded that neither the 100 percent apportionment factor with credit for taxes paid to other states, nor the three-factor formula accurately reflected the taxpayer's income earned in New Jersey. The tax court found that the director's method resulted in a CBT liability that was 221 percent to 310 percent greater than that which would exist using the standard three-factor formula and was, therefore, distortive. However, the tax court also found the standard three-factor formula, which would have resulted in an apportionment factor of approximately 30 percent, also failed to accurately reflect the business activity of the taxpayer in New Jersey. Therefore, the tax court remanded to case to the director, directing it to consider other apportionment methods that would accurately reflect the taxpayer's business activity in New Jersey.

Corporation Business Tax/Add-back of Interest Deduction

The tax court held that the director did not err in determining that the taxpayer did not qualify for the 'unreasonableness' exception to the add-back to income for interest payments made to related parties in *Kraft Foods Global, Inc. v. Director, Division of Taxation*.[8]

The taxpayer, an out-of-state corporation engaged in business activity in New Jersey, filed CBT returns for the years at issue and did not add back to its federal taxable income deductions for interest payments it made to its parent.

The parent issued debt to third parties in the form of bonds, and transferred amounts equal to the proceeds of the bonds to the taxpayer. After each transfer, the taxpayer executed a promissory note in favor of the parent in an amount equal to the funds transferred to it by its parent. The taxpayer agreed to pay interest on the loans in amounts equivalent to the interest the parent was obligated to pay on its bonds. The notes did not include a guaranty to the bondholders, and did not explicitly provide recourse against the taxpayer in the event the taxpayer failed to make the payments. It was undisputed that the parent was able to secure more favorable interest rates on its debt than the taxpayer would have been able to secure.

The director audited the taxpayer's CBT returns and issued an assessment, which included an adjustment adding back the interest payments the taxpayer made to its parent. If the taxpayer had borrowed directly from the third parties, the interest would have been deductible. The director's explanation for the adjustment was that: 1) the debt between the taxpayer and its parent was not arm's length, as the parent was charging the same interest to the taxpayer as it was paying to the bondholders; and 2) the taxpayer was not the legal guarantor of the debt.

The tax court upheld the director's assessment, holding that the statutory language "as determined by the director" means the director's determination is entitled to deference and should not be overturned "so long as it is not plainly unreasonable."[9] While the tax court discussed its decision in *Morgan Stanley Co. v. Director, Division of Taxation*,[10] and the division's 2014 technical advisory memorandum,[11] it ultimately found the director's determination was not unreasonable. The precedential value of *Morgan Stanley* is unclear in light of the tax court's decision in *Kraft*.

The taxpayer has filed an appeal with the Appellate Division.

Corporation Business Tax/Sourcing of Mortgage-related Receipts

The New Jersey Tax Court in *Flagstar Bank, FSB v. Director, Division of Taxation*[12] addressed whether receipts received by a bank from acquiring, originating, servicing and selling mortgages and mortgage-backed securities should be included in the bank's New Jersey receipts factor numerator. The taxpayer, a Michigan-based bank, originated mortgage loans at retail loan centers in New Jersey. It also acquired mortgage loans made to New Jersey borrowers from independent mortgage brokers. The taxpayer sold the vast majority of the loans it originated and acquired in exchange for mortgage-backed securities, which it then immediately sold to broker-dealers. When the taxpayer sold a mortgage, it usually retained the right to service the mortgage, but it occasionally sold the mortgage servicing rights to a third party. The taxpayer included in its New Jersey receipts factor numerator only the interest income it received from the loans originated at its retail locations in New Jersey.

The tax court ruled that the taxpayer was required to include the interest income and gross proceeds from sales of all loans made to New Jersey borrowers, including the gross proceeds from sales of mortgage-backed securities it received in exchange for mortgages. The tax court rejected the director's position that the location of the loan collateral should determine whether the income from the loan was included in the receipts factor numerator.

The tax court found that the taxpayer's purchased mortgage loans were integrated with the taxpayer's New Jersey activities, and that the receipts related to those purchased loans should, therefore, be included in the numerator of the receipts factor pursuant to N.J.S.A. § 54:10A-6. In so finding, the tax court noted that the taxpayer had New Jersey account representatives who worked with local brokers to acquire loans made to New Jersey borrowers, and that, with only one small distinction, the taxpayer's activities were essentially identical for mortgages it purchased and mortgages it originated. The tax court consequently found that the distinction between loans that the taxpayer acquired versus loans it originated was of "no consequence."[13]

The tax court also found "the transfer of mortgage loans in exchange for mortgage-backed securities and the virtual simultaneous sale of those securities [we]re so inextricably intertwined as to make them the same transaction."[14] Accordingly, the tax court found interest income and gross proceeds from sales of mortgage loans made to New Jersey customers in exchange for mortgage-backed securities, and proceeds from the subsequent sale of those securities to broker-dealers, were also includable in the New Jersey receipts factor numerator.

The tax court ruled that mortgage service fee income and income from sales of mortgage servicing rights were not includible in the New Jersey receipts factor numerator. The tax court concluded that the mortgage servicing receipts were generated based on the underlying services performed, and should, therefore, be sourced to the place of performance. The tax court also ruled that the right to service a mortgage loan did not arise until after the loan was sold, and that, therefore, those receipts were not associated with the original New Jersey intangible mortgage loan and did not need to be included in the New Jersey receipts factor.

Further, citing *Lorillard, supra*, and *Whirlpool Properties, supra*, the tax court ruled that the throw-out rule did not apply to the receipts.

The tax court upheld the imposition of an underpayment penalty on the grounds that there was no reasonable cause for failure to include the income arising from the intangibles that were integrated with the taxpayer's New Jersey business. However, citing *United Parcel Service General Services Co., v. Director, Division of Taxation*,[15] the tax court held that the director's imposition of the amnesty penalty was unreasonable because the final determination was not issued until after the underlying amnesty period had ended. In *United Parcel Service*, the New Jersey Supreme Court held that the amnesty penalty could not apply to assessments issued after the close of the amnesty period, and that cases of first impression qualify for reasonable cause penalty waiver.[16]

Corporation Business Tax/Sourcing of Credit Card Receipts

The New Jersey Tax Court addressed how receipts received by a credit card issuer from interest, interchange fees, and service fees derived from New Jersey cardholders should be treated for purposes of computing the CBT in *Bank of America Consumer Card Holdings v. Director, Division of Taxation*.[17] The tax court largely followed *Flagstar, supra*.

In *Card Holdings*, the taxpayer issued credit cards to customers in all 50 states. The taxpayer generated revenue through interest, interchange fees, and service fees. On its original New Jersey CBT returns, the taxpayer sourced its receipts from interest, interchange fees, and service fees based on customer location. The taxpayer realized its error and filed amended returns sourcing those receipts outside of New Jersey, and requested a refund. The director denied the taxpayer's refund request.

The tax court addressed each type of receipt in turn. First, the tax court addressed interest receipts, and held that those receipts must be sourced to New Jersey to the extent that they were derived from credit card holders located in New Jersey. The tax court rejected the taxpayer's argument that the taxable *situs* of an intangible is the commercial domicile of the creditor. Instead, the tax court applied the director's regulation,[18] and ruled that interest income received from New Jersey cardholders is included in the receipts factor numerator.

Next, the tax court addressed the taxpayer's receipts from interchange fees. The tax court held that the interchange fees were the economic and functional equivalent of interest and should be treated as such, rather than as fees. As a result, the tax court referred to its ruling regarding interest receipts, and ruled that interchange fees paid by New Jersey cardholders should also be sourced to New Jersey.

Finally, the tax court addressed how certain service fees, such as late fees, return check fees, over the limit fees, non-sufficient funds fees, and annual fees, should be sourced. The tax court held that such fees should be sourced pursuant to the director's "25-50-25" regulation.[19] That regulation provides that 25 percent of service fee receipts are sourced to the state of origination, 50 percent of service fee receipts are sourced to the state of performance, and 25 percent of service fee receipts are sourced to the state in which the transaction terminates. Under that regulation, the court concluded that service fee receipts should only be sourced 50 percent to New Jersey, as New Jersey was the place of origination and termination, but not the place of performance.

Citing *Lorillard, supra*, the tax court also held that the throw-out rule could not be applied to that taxpayer's credit card receipts where the taxpayer had receipts in all 50 states.

Gross Income Tax/Retroactivity and the 'Square Corners Doctrine'

In three separate but related cases, the tax court held that the director could not retroactively impose gross income tax on New Jersey lottery winnings from drawings that took place prior to June 29, 2009.[20] Retroactive taxes are some of the state actions that are most harmful to the due process that all taxpayers deserve.

On June 29, 2009, New Jersey enacted a law requiring individuals to include lottery winnings of over $10,000 in their taxable income, effective Jan. 1, 2009.[21] Prior to the law's enactment in June 2009, New Jersey advertised to the public that lottery winnings were not subject to New Jersey income tax. New Jersey State Lottery officials admitted these representations were a selling point intended to generate lottery ticket sales and to exploit a perceived business advantage over neighboring states.

The three cases before the tax court had varying facts, but in each case the lottery winnings on which the director imposed tax were from drawings that took place before June 29, 2009. In *Milligan*, the taxpayers won $46 million in 2000, and opted to collect their winnings in installments over a 26-year period. In *Harrington*, the plaintiffs purchased a winning lottery ticket in March 2009, and collected their winnings in a lump sum payment later that same month. In *Leger*, the plaintiffs won the lottery in Dec. 2008, but collected their winnings in a lump sum payment in May 2009.

In all three cases, the tax court held that the retroactive imposition of income tax on lottery winnings would be unfair, because the lottery claimed in promotions that such winnings were not subject to state tax. The tax court found that "[t]o hold otherwise would ignore the State's obligations to act with integrity when engaging in financial transactions with members of the public."[22] In so holding, the tax court cited the 'square corners doctrine,' which states that government agencies must deal with their citizens fairly and "comport itself with compunction and integrity."[23]

Further, in *Leger*, the tax court also found that the retroactive tax violated the 'manifest injustice doctrine.' That doctrine "is designed to prevent unfair results that do not necessarily violate any constitutional provision."[24]

Although the tax court's decision held in favor of the taxpayers, it did not specifically reverse the director's denial of the taxpayer's refund claims, nor did it expressly compel a refund. The director subsequently refused to refund the taxes paid on the grounds that the tax court's orders were not immediately enforceable because not all of the claims in the taxpayer's complaints were resolved by the orders. The taxpayers filed a motion for a judgment reversing the director's denial of the refund claims, and compelling a refund of the tax paid on the lottery winnings. The tax court subsequently held that there was no legal basis for refraining from entering judgment directing the issuance of refunds to the plaintiffs, and accordingly entered judgment reversing the final determinations at issue, and compelling the refund of gross income tax, plus interest, to the taxpayers.[25]

Sales Tax/Taxation of Services in Connection with Pre-written Software

In *Premier Netcomm Solutions, LLC v. Director, Division of Taxation*,[26] the tax court ruled that the taxpayer failed to overcome the presumption that the director's assessment of sales tax on sales of services performed in connection with pre-written computer software was correct, but cancelled the portion of the director's assessment relating to sales made before the law making pre-written software 'tangible personal property' went into effect, in Oct. 2005. However, just before this article went to press, the tax court granted the director's motion to reconsider its ruling regarding the taxability of the sales made prior to Oct. 2005, and reversed, ruling that those sales were also subject to sales tax.[27]

The taxpayer in *Premier Netcomm* was audited for tax periods Jan. 1, 2004, through Dec. 21, 2010. During those periods, the taxpayer entered into service contracts with customers, agreeing to provide a variety of information technology services for either an hourly charge or a monthly fee. The taxpayer's bills did not contain a breakdown or itemization of the services being billed.

The director audited the taxpayer and, using a methodology based on the auditor's review of the taxpayer's books and records, assessed additional sales tax on the taxpayer's sales of services in connection with pre-written software. The tax court upheld the director's assessment for the period Oct. 2005 to Dec. 2010, because it found the taxpayer failed to overcome the presumptive correctness of the director's assessment. The tax court also concluded the director's assessment of sales tax on sales made in 2004, and the first three quarters of 2005, was improper because the law making pre-written computer software taxable 'tangible personal property,' (and thus making services performed in connection with that tangible personal property taxable), was not enacted until Oct. 2005.

Nevertheless, upon the director's motion for reconsideration, the tax court reversed its decision regarding those pre-Oct. 2005 sales. In reversing its decision, the tax court explained that the issue is "whether the public had any notice or knowledge of taxability of pre-written computer software, at least until October 2005." Citing Technical Bulletin 51, which the court noted the director had neither cited nor alluded to in its case below, the tax court concluded that the public did have notice that the director considered pre-written software to be tangible personal property.

In ruling for the director, the tax court stated that "[h]ere, and also because there was no challenge to whether software itself (as opposed to the computer or other physical tangible device that contains or uses the software program) was taxable, the court agrees with Taxation that the 2004 Bulletin provided guidance to the public as to when software is taxable as tangible property (prewritten or modified prewritten without a breakdown of charges for modification) and when it is deemed intangible, thus, nontaxable."

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Go to Index

Endnotes

1. 29 N.J. Tax 275, *certif. denied*, 226 N.J. 212 (June 14, 2016).
2. Under the throw-out rule, receipts that are attributable to a state in which the corporation is not subject to tax would not be included in the denominator of the receipts factor of the CBT apportionment formula.
3. N.J. Stat. Ann. § 54:10A-6(B)(6). The throw-out rule was enacted as part of the 2002 Business Tax Reform Act (L. 2002, c. 40) and was not in effect for the 1999- 2001 tax years. The throw-out rule was repealed in 2008, effective for privilege periods beginning on or after July 1, 2010. L. 2008, c. 120.
4. 208 N.J. 141 (2011).
5. 188 N.J. 380 (2006). *Whirlpool*, *Lorillard*, and *Lanco* were all represented by the authors' firm, Morrison & Foerster LLP.
6. *Canon Financial Services, Inc. v. Director, Division of Taxation,* Dkt. No. 000404-2014, 2016 N.J. Tax Unpub. LEXIS 48 (Oct. 13, 2016).
7. N.J. Stat. Ann. § 54:10A-6. The statute has since been amended to delete the 100 percent allocation factor for a taxpayer not maintaining a regular place of business outside the state for tax years beginning on or after July 1, 2010. *See*, L. 2008, c. 120, §§ 2 and 3.
8. *Kraft Foods Global, Inc. v. Director, Division of Taxation,* 29 N.J. Tax 224 (April 25, 2016). Kraft is represented by the authors' firm, Morrison & Foerster LLP, in its appeal.
9. *Id*. at 240.
10. 28 N.J. Tax 197 (Oct. 29, 2014).
11. TAM-2011-13(R) (Feb. 24, 2016).
12. *Flagstar Bank, FSB v. Director, Division of Taxation,* Dkt. No. 019335-2010, 2016 N.J. Tax LEXIS 6 (March 22, 2016).
13. *Id.* at 30.
14. *Id.* at 31.
15. 220 N.J. 90 (Dec. 4, 2014).
16. The authors represented United Parcel Services in its Appellate Division and New Jersey Supreme Court wins.
17. *Bank of America Consumer Card Holdings v. Director, Division of Taxation*, 29 N.J. Tax 427 (Oct. 6, 2016).
18. N.J. Admin. Code § 18:7-8.12(e).
19. N.J. Admin. Code § 18:7-18.10(c).
20. *Milligan v. Director, Division of Taxation*, 29 N.J. Tax 381 (Sept. 26, 2016); *Leger v. Director, Division of Taxation*, 29 N.J. Tax 354 (Sept. 26, 2016); and *Harrington v. Director, Division of Taxation*, 29 N.J. Tax 370 (Sept. 26, 2016).
21. N.J. Stat. Ann. § 54A:6-11; L. 2009, c. 69, §§ 3 and 5.
22. *Milligan, supra*, at 384.
23. *Id*. at 399.
24. *Leger, supra*, at 365.
25. *Milligan v. Director, Division of Taxation*, Dkt. No. 007048-2011, *et al.*, 2016 N.J. Tax Unpub. LEXIS 61 (Dec. 16, 2016); *Harrington v. Director, Division of Taxation*, Dkt. No. 009529-2011, et al., 2016 N.J. Tax Unpub. LEXIS 58 (Dec. 13, 2016).
26. N.J. Stat. Ann. § 54:32B-2(g). *Premier Netcomm Solutions, LLC v. Director, Division of Taxation,* Dkt. No. 016307-2012, 2016 N.J. Tax Unpub. LEXIS 50 (Oct. 25, 2016).
27. *Premier Netcomm Solutions, L.L.C. v. Director, Division of Taxation*, Dkt. No. 016307-2012 (Jan. 9, 2017).
28. N.J. Div. of Taxation, Jan. 20, 2004.

Go to Index

Recent Tax Reform Proposals and Their Potential Impact on Corporate Taxpayers

by James D. Sipple

There has not been significant tax reform in the United States since the Tax Reform Act of 1986. As a result, the United States business tax system has become less competitive with the rest of the world. Countries with advanced economies have lowered their corporate tax rates and adopted a territorial tax system (versus a worldwide system). In addition, they have placed greater reliance on border adjustable taxes such as a value added tax, or VAT.

Although enactment of tax reform legislation in the near future is by no means certain, the odds for reform being enacted soon appear higher than they have been at any other time since the Tax Reform Act of 1986. The Republican Party controls the Senate, the House of Representatives and, after the 2016 election, the presidency.

This article will highlight the tax proposals of President Donald Trump and the House Republican Blueprint (issued in June 2016), which may impact corporate taxpayers if enacted. In some cases Trump and the blueprint have parallel provisions and in other cases they have divergent provisions.

Prospective Taxation of Foreign Income

A prior tax reform plan released by Trump's campaign in 2016 proposed to tax future profits of foreign subsidiaries of United States companies as the profits are earned. The current Trump proposal released on April 26, proposes a 'territorial system' but no specific details were provided. Currently, the United States is on a worldwide tax system, which means a corporation headquartered in the United States must pay the corporate income tax on all its income, regardless of whether it is earned in the United States or overseas. The corporation pays this tax when the foreign earnings are 'repatriated' by bringing the income back to the United States. The new Trump proposal seeks to impose a one-time tax on the cash held by United States multinationals overseas. No further details were provided in the proposal.

Under the blueprint, the United States would prospectively apply a 'territorial system,' meaning distributions from foreign subsidiaries and income earned through foreign branches would be exempt from United States tax, and foreign tax credits would be disallowed. Additionally, the Controlled Foreign Corporation (CFC) anti-deferral rules would be streamlined to apply only to passive income (foreign personal holding company income). The Subpart F rules for various types of 'foreign base company income' would no longer apply.

The blueprint would introduce border adjustments to the taxation of products, services and intangibles that are imported into or exported from the United States. The border adjustments would be intended to mimic the border adjustments applied by other jurisdictions to VATs, on the theory that the revised United States business tax would apply on a cash flow basis and, therefore, would be comparable to a VAT. Border adjustments would rebate United States tax on items exported from the United States and impose United States tax on items imported into the United States. These adjustments would eliminate United States tax on products, services and intangibles produced in the United States, meaning these items would be taxed only by the jurisdiction where they are consumed.

A more detailed discussion of border adjustments follows later in this article.

Tax Rates of Income Generated by Pass-Through Entities

Under the Trump proposal, business income would be taxed at a 15 percent rate. The proposal states that this rate would be "available to all businesses, both big and small that want to retain the profits within the business." It is unclear whether the 15 percent rate would also apply to income of pass-through entities, as some sources have reported based on the reference to small businesses, or whether the 15 percent rate would only be available to entities that elect to incorporate, with income of a partnership or S-corporation being taxed at the maximum 33 percent rate.

Under the blueprint, active business income earned by small businesses, sole proprietorships, and other pass-through businesses (including partnerships, limited liability companies, and S-corporations) would be taxed at a maximum rate of 25 percent. However, as discussed below, such businesses would be required to pay reasonable compensation to service provider owners, which would offset the tax benefit of the reduced rate of tax on the income (provided the service provider's individual tax rate is greater than 25 percent). Although the tax rate applicable to corporations would be five percent less than the tax rate applicable to sole proprietorships and other pass-through entities, after taking into account the 16.5 percent individual income tax rate on corporate dividends, the overall effective tax rate applicable to sole proprietorships and pass-through entities would still be lower. Further, it is unclear whether large S-corporations or partnerships would be eligible for the 25 percent tax rate on active business income or whether this would be limited to small businesses.

Taxation of Carried Interest

Under the original Trump proposal, carried interest would be taxed as ordinary compensation income (at a top marginal rate of 33 percent). The blueprint is silent regarding whether carried interest would be taxed as ordinary income or continue to retain the character of the income generating the carry. Carried interest was not specifically addressed in the new Trump proposal.

Reasonable Compensation Requirement

Under the blueprint, sole proprietorships and pass-through entities, including S-corporations and partnerships, would be required to pay reasonable compensation to their owners or sole proprietors (which would be taxable as compensation income). The Trump proposal does not contain a similar requirement.

Since the compensation payment would be deductible by the business, the compensation may actually reduce the overall tax burden on the owner or sole proprietor to the extent that the owner or sole proprietor's individual tax rate is less than 25 percent. However, the benefit of the 25 percent tax rate would be reduced if the owner or sole proprietor is taxed at a 33 percent rate.

It is unclear how the IRS would apply the reasonable compensation requirement, particularly in the context of businesses generating income from the provision of services.

Corporate Tax Rates

The Trump proposal would reduce the highest corporate income tax rate from 35 percent to 15 percent. The blueprint would reduce the highest corporate income tax rate to 20 percent. Both the Trump proposal and the blueprint would repeal the corporate alternative minimum tax.

Immediate Expensing of Capital Investment

Under the original Trump proposal, companies engaged in manufacturing in the United States may elect to immediately expense capital investments. However, such electing companies would be required to forego the deduction for interest expense. An election to expense once made would only be revocable within the first three years of the election. If revoked, returns for prior years would need to be amended to show revised status. Capital investment was not specifically addressed in the new proposal.

Under the blueprint, the cost of capital investment would be fully and immediately deductible, rather than being subject to depreciation deductions taken over time. Unlike the Trump proposal, the immediate expensing of capital investment would be automatic, and a taxpayer would not be required to make an election in order to expense the cost of capital investment. Such expensing would be available for all business investment (including buildings, tangible and intangible assets), other than land. The intended effect of immediate expensing would be to transform the United States tax system for businesses from an income tax to a cash flow- or consumption-based tax.

The blueprint would also disallow deductions for net interest expense. One motivation for doing so is to equalize the tax treatment of debt and equity financing. Unspecified special rules would apply to financial services companies, such as banks, insurance companies and leasing companies. Under these proposals, capital investment would include fixed assets, such as computers and servers.

Domestic Production Activities Deduction and Tax Credits

Under the original Trump proposal, most credits and the domestic production activities deduction would be eliminated. However, the proposal would not eliminate the research and development credit. Tax credits and the production activities deduction were not specifically addressed in the new proposal.

Under the blueprint, tax deductions and credits applicable to 'special interests' would be repealed, other than a credit for research and development conducted in the United States.

Net Operating Losses

Under the blueprint, net operating losses would be carried forward indefinitely (but not carried back), and increased by an interest factor. A net operating loss carryforward could be used to offset only 90 percent of taxable income determined before the carryforward. The Trump proposals do not discuss the treatment of net operating loss carryforwards. Under current law, net operating losses are carried back two years and carried forward 20 years, after which they expire. A taxpayer may elect not to use the carryback period, and instead only carry the net operating loss forward.

Border Adjustment

The blueprint provides for provisions exempting exports and taxing imports within the context of a new business tax system. It utilizes a cash flow-based approach, which will replace the current income-based approach for taxing corporate taxpayers. It would be a 'consumption-based' tax system applied on a destination basis. A destination-based tax means tax is imposed based upon the consumption of the goods or services, rather than the source of income or the residence of the taxpayer.

Border tax adjustments are a standard provision in VAT regimes in 167 countries, including the 34 OECD[1] member countries. Exports would be exempt from tax, and imports would be charged a 35 percent tax. It is intended to create incentives for foreign companies to move operations to the United States.

Economists believe either prices or exchange rates would adjust quickly to offset the impact of this border adjustment, the theory being that with a price or exchange rate offset, a uniform border tax adjustment would not change domestic consumption or the United States trade balance.[2]

The blueprint indicates the proposed border adjustments would be consistent with World Trade Organization rules regarding indirect taxes. There is no equivalent Trump proposal with respect to a border adjustment, other than statements made in the press with respect to having Mexico pay for a border wall.

Conclusion

Even though the conditions appear to be ideal, enactment of tax reform is not a sure thing. The process could still be derailed. Some economists have estimated that the new Trump proposal could cost approximately $5.5 trillion in lost revenue over the next decade. There are different views, even among Republicans, regarding the possible use of tax reform to fund infrastructure spending, and the priority of tax reform relative to other agenda items. As is typically the case with significant tax law changes, winners and losers can be created. It can alter the competitive landscape. There will be pressure on House and Senate members from constituents, industry groups, businesses, lobbyists, and others that can make it difficult to craft a politically palatable tax package that achieves policy objectives, as well as satisfies constituencies. The Senate would require some Democratic support since legislation generally requires 60 votes for approval. Still, House Republicans appear to want to move quickly so the process should commence soon. However, it remains to be seen if significant tax reform will result.

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Endnotes

1. The Organization for Economic Co-operation and Development (OECD) is an intergovernmental economic organization with 35 member countries, founded in 1960 to stimulate economic progress and world trade.
2. Martin Feldstein, The House GOP's Good Tax Trade-Off, *Wall Street Journal*, Jan. 6, 2017.

Tax-Exempt Organizations: Too Much UBIT and Defensive Use of a Taxable Subsidiary

by Peter J. Ulrich

Under Section 511 of the Internal Revenue Code of 1986, as amended, an annual unrelated business income tax (UBIT) is imposed on the unrelated business taxable income (UBTI) of a number of different types of exempt organizations, including Section 501(c)(3) charities and Section 501(c)(6) business leagues. In addition, if one or more unrelated business activity of a tax-exempt organization is so substantial that the organization is considered to have a primary purpose of carrying on an unrelated trade or business, the organization should lose its tax-exempt status.

Under IRS Code Section 513, an unrelated trade or business is "any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption...."

A tax-exempt organization conducting one or more trades or businesses, or other activities that may be inconsistent with its tax-exempt status, possesses some limited choices of how to address those situations, but perhaps the most frequently used approach is to transfer the non-exempt purpose activity to a taxable subsidiary.

Taxation and Implications of UBTI

A tax-exempt organization conducting an unrelated trade or business needs to file IRS Form 990-T annually once its gross annual unrelated business taxable income exceeds $1,000. The tax rates for corporations subject to UBTI are the general graduated rates for corporations, which, *e.g.*, are applied at 34 percent for taxable income in excess of $75,000 and range up to 35 percent with certain catch-up rates that act to take back the lower rates at lower income thresholds.[1]

Form 990-T, like Form 990, must be made available to the public for inspection after filing with the IRS.[2] For this reason alone, some boards of trustees of tax-exempt organizations are not comfortable operating unrelated trades or businesses.

Evaluating Whether an Activity Endangers an Organization's Exempt Status

Unfortunately, there is no statutory or regulatory definition of when an unrelated business activity becomes excessive relative to the other activities and purposes of an exempt organization. Cases often focus on the gross revenues or expenditures in connection with an unrelated activity, but have also looked at the time expended by officers and board members with respect to the activity.[3] In a number of cases, courts have determined that if the ratio of revenues or expenditures of a UBTI activity relative to other exempt purpose activities is five percent or 10 percent, it should not endanger the exempt status of an entity.[4] Depending on the facts, however, once an activity generates between 20 percent or 30 percent of the gross revenues of an organization, most tax advisors would caution that exempt status is at risk.

For Section (c)(3) organizations, Treasury Regulation §1.501(c)(3)-1(c)(1) states:

> An organization will be regarded as "operated exclusively" for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such exempt purposes specified in section 501(c)(3). An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.

Consistent with this, there are cases that state that a single non-exempt purpose, if substantial in nature, will destroy the (c)(3) exemption.[5]

Adding to the difficulty of determining whether an organization risks its exempt status with an activity that might constitute a UBTI activity, Treasury Regulation §1.501(c)(3)-1(e)(1) states:

> An organization may meet the requirements of section 501(c)(3) although it operates a trade or business as a substantial part of its activities, if the operation of such trade or business is in furtherance of the organization's exempt purpose or purposes and if the organization is not organized or operated for the primary purpose of carrying on an unrelated trade or business, . . .

Needless to say, it will be the rare situation where the operation of a trade or business is in furtherance of an organization's exempt purpose. One example might be a clothing thrift shop that is operated by volunteers and sells items that are either donated or received on consignment, and distributes all profits to other (c)(3) organizations.[6]

Business leagues exempt under Code Section 501(c)(6) must have an exempt purpose of promoting the common business interest of the persons comprising its members or its industry.[7] This regulation also states that a business league's "activities should be directed to the improvement of business conditions of one or more lines of business as distinguished from the performance of particular services for individual persons. An organization whose purpose is to engage in a regular business of a kind ordinarily carried on for profit, even though the business is conducted on a cooperative basis or produces only sufficient income to be self-sustaining, is not a business league."

When a business league's activity is operated primarily for individual members as a convenience and economy in the conduct of their respective businesses, rather than for the improvement of business conditions within the industry generally, the activity is not one consistent with exempt status. In testing whether a (c)(6) organization's activity is an exempt purpose activity or a particular service activity, the IRS and courts focus on whether the services provided by the nonprofit are supported by fees and assessments in approximate proportion to the benefits received.[8]

Limited Approaches Available to Address Risks of Too Much UBTI

An exempt organization that realizes it may be conducting a more-than-insubstantial UBTI activity will not have many choices regarding how to address the situation. Some possibilities include:

- attempt to restructure the activity in a manner to operate it consistent with its exempt purposes;
- sell the activity to a third party; or
- contribute the activity to a controlled corporation (a blocker).

Restructure Activity

An attempt to restructure a UBTI activity so that it would be consistent with exempt purposes would require a fundamental restructuring of the activity's business model, probably in a manner to fundamentally change how revenues are collected and the service is provided. Critically, the activity would likely need to be restructured to make the activity substantially related (aside from the need of the organization for the income or funds generated) to the exercise or performance by the organization of its charitable, educational, or other exempt purpose.[9]

A practical difficulty with the restructuring approach is that it may be very hard to determine whether any particular restructuring would really protect the organization from too much UBTI. If an organization decided to attempt a restructuring of a UBTI activity, it might be wise to seek a private letter ruling from the IRS, which cannot be assumed to be a simple or risk-free undertaking.

Sell Activity to a Third Party

Another approach is to simply sell the activity to a third party. There is a good position under Code Section 512(b)(5) that gain on the sale of such an activity would not itself be subject to UBTI.

Contributing Activity to a Blocker Corporation

Finally, if an organization wished to control the UBTI activity without subjecting itself to UBIT, it could contribute all of the assets, liabilities, obligations, and activities with respect to the activity to a controlled for-profit C corporation (a blocker, or Newco). In this manner, the blocker would pay any federal income tax on any net income generated by the activity. Critically, the use of a blocker would protect the exempt organization from recognizing UBTI and from losing its exempt status because of operating a substantial trade or business.

Newco would have a separate board of directors to oversee its activities, as well as separate officers. The tax-exempt organization would own 100 percent of the stock of Newco, so that it would appoint all of the members of the board of Newco, who would then appoint officers.

To the extent Newco needed to at least initially use any trademarks, service marks, or other intellectual property of the tax-exempt organization, the two entities should enter into a license agreement, to allow the nonprofit organization to maintain control over the intellectual property and receive a fair market royalty.

Maintaining Separate Entity Status for a Blocker

The creation, capitalization, and strategic oversight of a taxable subsidiary are not generally considered activities regularly carried on by a parent entity, and, therefore, the subsidiary's activity is not considered to constitute an unrelated trade or business of the parent under Treasury Regulation §1.513-1(c)(1). As long as the IRS is required to respect the two entities as separate entities, the income generated by the subsidiary will not be considered to be UBTI to the parent.

Once a corporation is organized with a *bona fide* intention that it will have some real and substantial functions, its existence generally may not be disregarded for tax purposes, unless the IRS can show by clear and convincing evidence that the subsidiary is, in reality, a mere arm, agent, instrumentality, or integral part of the parent.[10] Protective steps can be used to prevent Newco from being considered a mere agent of the tax-exempt organization. Critically, not allowing the parent organization to become involved in the day-to-day management of Newco, and conducting all transactions between the entities on an arm's length basis, will go a long way toward preventing a 'mere agent' relationship.

Generally, to satisfy the IRS, Newco must be capitalized, staffed and operated in a manner that respects the separateness of the two entities. First, this requires separate books and accounts, checking accounts, and internal accounting controls. Second, while the entities may share the same office space and at least some personnel, costs must be allocated between the two organizations on a fair and reasonable basis relative to the actual use of the goods or services. Salaries of officers who are officers of both entities must also be shared on a fair and reasonable basis. The parent exempt organization should probably enter into an administrative services agreement with Newco, documenting the terms and pricing for facilities and services provided.

To the extent that more than the direct costs of the sharing mechanisms are received by the exempt organization, UBTI will be generated. Neither the investment in Newco, nor the use of the exempt organization's employees and facilities by Newco, may be substantial in comparison to the total assets of the exempt parent and the total time of employees of the exempt organization, respectively. Otherwise, the tax-exempt organization will not be considered to be operated exclusively for an exempt purpose. One IRS private letter ruling suggests that the cost-sharing revenue be less than 20 percent of an exempt organization's total income.[11]

General Counsel Memorandum (GCM) 39326 strongly implies that a for-profit subsidiary should be governed by an independent board of directors (*i.e.*, the majority of the board should be outside directors and not officers or employees of the exempt parent). GCM 39598 tempers this last requirement, however, by stating that the critical test is whether there is clear and convincing evidence the parent is so involved in, or in control of, the day-to-day activities of the subsidiary that the subsidiary becomes the agent or instrumentality of the parent. GCM 39598 states that no negative inference should be drawn from the favorable mention of a majority of outside directors in GCM 39326.[12]

In addition, consistent with the applicable corporate statutes, each transaction between the organizations (other than ordinary course of business reimbursement of expenses) involving annual payments in excess of perhaps $5,000 should be the subject of either an affirmative vote of a majority of the outside disinterested directors or the unanimous written consent of all directors, provided at least one such director is disinterested.[13]

Taxation of Transactions Between Exempt Parent and Taxable Subsidiary

While the receipt by a tax-exempt organization from third parties of rent from real property, dividends, interest, annuities, and royalties are normally excluded from UBTI under Code Section 512(b)(1) and (b)(2) (as long as the income is not financed by borrowings), interest, annuities, royalties, and rents received from a controlled organization must be included in the UBTI of an exempt parent under Code Section 512(b)(13) to the extent the payments reduce the net unrelated income of the subsidiary (or increase the net unrelated loss of the taxable subsidiary). However, dividends from a controlled entity remain excludable from UBTI under

Code Section 512(b)(1), although, of course, no corresponding deduction is allowable to the dividends-paying subsidiary.

Under Code Section 512(b)(13)(D), control is defined to mean, in the case of a corporation, "ownership (by vote or value) of more than 50 percent of the stock in such corporation." Because in most situations the tax-exempt parent will hold 100 percent of the stock of the blocker subsidiary, and it is likely that only unrelated income activities will have been transferred to the blocker, any interest, annuities, royalties, and rents received from the blocker subsidiary will constitute taxable UBTI to the exempt parent.

Tax Treatment of Intercompany Service Income

The foregoing discussion regarding taxation of payments to an exempt parent by a taxable blocker has relevance only to applicable payments (*i.e.*, interest, annuities, royalties, or rent). To the extent the exempt parent is paid amounts for management or administrative services, or other services or goods it provides to a taxable subsidiary not within the purview of its exempt purpose activities, the income also will be taxable as UBTI. As described as follows, depending on the amount charged for these items, no net taxable UBTI may be generated because the tax-exempt organization is still entitled to deduct costs and expenses directly incurred in providing the goods and services.

Keep in mind that, to protect its exempt status, the tax-exempt organization cannot provide goods and services to the blocker on a *gratis* basis. The exempt parent must charge a reasonable fee.

In addition, some care must be taken in how the exempt parent characterizes the services it provides to a taxable subsidiary to minimize any applicable sales taxes. Some states apply sales tax to maintenance services or certain types of administrative services (*e.g.*, delivery charges, information services, or equipment rentals).

Limited Possibility of Debt-Financed Income; No Double Taxation of Exempt Parent

To the extent the exempt parent leases or rents office space or equipment to the taxable subsidiary, and to the extent that the property is debt-financed, the rental income would normally constitute UBTI by being characterized as debt-financed income under Code Section 514. Property is debt-financed to the extent of the amount of indebtedness used to finance the property relative to the adjusted tax basis of the property.

Critically, however, Code Section 512(b)(13), described above, supersedes Code Section 514 to avoid double counting.[14] Only to the extent that Section 512(b)(13) does not apply to the tax-exempt organization, and so, therefore, does not characterize rent earned by the tax-exempt organization from the taxable subsidiary as taxable UBTI, would Section 514 apply to characterize that amount as UBTI.

Deduction of Direct Costs Against UBTI

As alluded to above, even if a tax-exempt organization is taxable on certain payments from its controlled taxable subsidiary pursuant to Code Section 512(b)(13), Code Section 514, or on its provision of services, the exempt parent is entitled to deduct all of its deductions "directly connected with amounts treated as derived from an unrelated trade or business...."[15]

Obviously, a tax-exempt organization will need to determine which of its expenses incurred are directly connected with any UBTI. The applicable regulations provide some guidance. Treasury Regulation §1.512(a)-1(a) states that to be deductible, an item of deduction "must have proximate and primary relationship to the carrying on of that business." Of some more practical assistance, Treasury Regulation §1.512(a)-1(c) states, in part:

> Where facilities are used both to carry on exempt activities and to conduct unrelated trade or business activities, expenses, depreciation and similar items attributable to such facilities (as, for example, items of overhead) shall be allocated between the two uses on a reasonable basis. Similarly, where personnel are used both to carry on exempt activities and to conduct unrelated trade or business activities, expenses and similar items attributable to such personnel (as, for example, items of salary) shall be allocated between the two uses on a reasonable basis.

One example used by the IRS allocates a president's salary between exempt activities and a UBTI activity based on the relative time spent by the president.

In *Rensselaer Polytechnic Institute v. Commissioner*,[16] the court held that apportioning fixed expenses such as salaries, fringe benefits, depreciation, etc. on the basis of the actual hours a field facility with an ice rink was used for related and unrelated activities, was a proper method of allocation. The court rejected the IRS's argument that the allocation should be made on the basis of total annual time available for use. The IRS argued that the denominator of the allocating fraction should be the total number of hours in a tax year, rather than the total number of hours used for both related and unrelated activities.

It is understood that the IRS still does not follow *Rensselaer Polytechnic Institute*.

Distributions by Taxable Subsidiary Do Not Constitute Charitable Contributions

One question that might arise is whether a taxable subsidiary could obtain a tax-deductible charitable contribution deduction for any gifts or grants made to the tax-exempt parent.

First, Code Section 170(b) limits a corporation's charitable contribution deduction to 10 percent of the corporation's taxable income.

More critically, a number of federal income tax cases have held that, when a controlled taxable subsidiary makes a grant or gift to its exempt parent, the payment will be treated as a non-deductible distribution and not a deductible charitable contribution.

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Endnotes

1. Code Sections 511 and 11.
2. Code Section 6104(d).
3. With respect to a (c)(3) organization, *see Orange County Agricultural Society v. Comm.*, 893 F.2d 529 (2nd Cir. 1990). With respect to a (c)(6) organization, *see Retailers Credit Assn v. Commissioner*, 90 F. 2d 47, (C.A. 9, 1937); *Associated Industries of Cleveland v. Commissioner*, 7 T.C. 1449, 1467 (1946); *cf Trinidad v. Sagrada Orden de Predicadores*, 263 U.S. 578 (1924).
4. *Id.*
5. *See Orange County Agricultural Society v. Comm.*, 893 F.2d at 533-534.
6. Revenue Ruling 80-106, 1980-1 C.B. 113.
7. Treas. Reg. §1.501(c)(6)-1.
8. *Evanston-North Shore Board of Realtors v. United States*, 320 F.2d 375 (Ct. Claims 1963), *cert. denied*, 376 U.S. 931 (1964).
9. Treas. Reg. §1.513-1(a).
10. *Moline Properties, Inc. v. Commissioner*, 319 U.S. 436, 438 (1943).
11. Priv. Ltr Rul. 8423083 (March 12, 1984). Providing some additional guidance, General Counsel Memoranda 39326 (Jan. 17, 1985) and 39598 (Feb. 4, 1987) describe the foregoing requirements and certain others that need to be met so that a taxable subsidiary will be respected as a separate taxable entity from its parent.
12. *Id.*
13. *See* N.J.S.A. 15A:6-8 with respect to New Jersey nonprofit corporations and N.J.S.A. 14A:6-8 with respect to for profit corporations.
14. Treas. Reg. §1.512(b)-1(l)(5)(ii); Treas. Reg. §1.514(b)-1(b)(3), Ex. (3).
15. Code Section 512(b)(13)(A).
16. 732 F.2d 1958 (2d Cir. 1984), *aff'g* 79 T.C. 967 (1982).

Taxpayers and Municipalities: Caution Called for Following Court's Revised Interpretation of Municipal Filing Fees in State Tax Court

by David B. Wolfe and Christopher Kozik

In 2014, the Supreme Court adopted several revisions to filing fees under Rule 1:43, the most notable of these to real property tax practitioners were the changes to filing fees paid by taxing districts. Prior to this, taxing districts were exempt from any filing fees for counterclaims; however, the change required districts to pay the same filing fees as taxpayers.

The Supreme Court has now concluded that the adoption of those filing fees was not consistent with existing statutes (N.J.S.A. 22A:5-1 and 54:51A-10) and has restored the taxing district's exemption to filing fees for counterclaims. This change should bring caution to both taxpayer's filing affirmative claims, as well as municipalities seeking to file counterclaims.

Taxpayer's counsel should always exercise caution in screening cases, both to avoid the filing of meritless appeals and to avoid the risk of a counterclaim and a potential increase. With the taxing districts once again exempt from the cost of filing a counterclaim, many will begin scrutinizing appeals filed against them, and look for opportunities to file counterclaims seeking increases in assessments. It has always been good practice to advise that all taxpayers carefully screen their cases prior to filing, but now it is once again imperative that counsel review all properties prior to filing, and effectively communicate the risk of a municipal counterclaim, and the potential for an increase, to their clients.

Taxing districts should, however, not view their exemption from filing fees as tacit authorization to file counterclaims in all actions. To the contrary, municipal counsel must be cognizant of their responsibility to 'turn square corners' when dealing with taxpayers. In *F.M.C. Stores Co., v. Borough of Morris Plains,*[1] the Supreme Court set the standard to which taxing districts must comport. The Court noted that "a municipality should undertake to appeal its own assessment only when it has good cause to believe the assessment does not reflect true value, and not simply to achieve a tactical advantage over, *or even strategic parity* with, a taxpayer that has independently appealed the assessment."[2] The taxing district is expected to "comport itself with compunction and integrity, and in doing so government may have to forego the freedom of action that private citizens may employ in dealing with one another."[3] A "municipality should not be influenced or swayed simply by the pendency of a taxpayer's appeal as a reason for filing its own appeal, absent independent grounds for believing in good faith that its assessment is erroneous."[4]

It may be tempting for municipal counsel to automatically file counterclaims as a means of protecting the municipality's ability to seek an increase if it discovers the property is under-assessed. However, much like taxpayer's counsel, the municipality has a duty to screen its cases and only file counterclaims where there is a good faith belief an increase in the assessment is warranted. Municipalities must also remain mindful that the obligation to 'turn square corners' extends beyond the determination of whether to pursue either a counterclaim or an affirmative appeal, but throughout all parts of the litigation process.[5]

In *Beach Creek*, the Appellate Division cautioned that the city's motion to dismiss when it had "no basis for believing that the…assessments were anything but grossly erroneous" "raise[d] a serious question about the City's performance of its obligation to 'turn square corners' in litigation."

The Supreme Court's elimination of municipal filing fees in property tax matters should benefit the taxpayers of New Jersey by reducing the cost of public litigation, and is consistent with existing statutes. However, parties to tax appeals must recognize the potential impact of this revision, and practitioners must counsel their clients accordingly. ■

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Endnotes

1. 100 N.J. 418 (1985).
2. *F.M.C.*, *supra*, 427.
3. *Id.*
4. *Id.*
5. *See Beach Creek Marina v. N. Wildwood City*, No. A-3081-11T1, 2013 WL 1908030, at *6 (N.J. Super. Ct. App. Div. May 9, 2013).