

New Jersey Tax Court Decides in Favor of Taxpayer in First Interest Addback Case

by Jeffrey M. Vesely and Annie H. Huang

On August 31, 2010, the New Jersey Tax Court issued a memorandum decision in Beneficial New Jersey, Inc. v. Director, Division of Taxation,¹ concluding that the taxpayer satisfied one of the enumerated exceptions to the interest addback statute under N.J.S.A. 54:10A-4(k)(2)(I), and was thus entitled to its interest expense deductions.

The case, which was handled by the authors, involved the interest addback provisions of N.J.S.A. 54:10A-4(k)(2)(I), which were enacted as part of the Business Tax Reform Act of 2002. The statute provides that the determination of a taxpayer's "entire net income" shall be made without the exclusion, deduction or credit of "interest paid, accrued or incurred...to a related member." However, the Legislature also provided several exceptions whereby such interest expense deductions would be permitted.

During the tax years at issue, Beneficial New Jersey ("BNJ") offered consumer finance products to customers at its retail branch lending operations located in New Jersey. The fundamental business practice of BNJ was to make loans to its customers. In order to finance those loans, BNJ itself would need to borrow money, which it did from its parent, HSBC Finance Corporation ("HSBC"). HSBC borrowed funds from unrelated third parties at a more favorable rate than any of its subsidiaries, including BNJ, could do on its own. HSBC then loaned those funds to the subsidiaries at the maximum Applicable Federal Rate.

For the tax years at issue, BNJ deducted the interest payments paid on its loans from HSBC in arriving at its taxable income. Upon audit, the Director disallowed the interest expense deductions pursuant to the interest addback statute and refused to apply any of the enumerated exceptions in N.J.S.A. 54:10A-4(k)(2)(I).

In its Tax Court complaint, BNJ alleged that it was entitled to the interest expense deductions because it satisfied three of the exceptions in N.J.S.A. 54:10A-4(k)(2)(I). Specifically, BNJ alleged that it satisfied the "three percent" exception, the "guarantee/conduit" exception, and the "unreasonable" exception.²



¹ N.J. Tax Court, Docket No. 009886-2007 (Aug. 31, 2010).

² N.J.S.A. 54:10A-4(k)(2)(I) gives the Director discretion in determining when the disallowance of a deduction is unreasonable.

In its memorandum decision, the Tax Court concluded that BNJ did not satisfy the “three percent” and “guarantee/conduit” exceptions. However, the court held that “the totality of these circumstances present the kind of situation contemplated by the drafters of the ‘unreasonable’ exception.”

The court found that BNJ’s loans from HSBC had economic substance, and that the reason for the practice whereby HSBC borrowed funds to lend to its subsidiaries was credible because HSBC could receive more favorable rates than its subsidiaries could on their own. The court also noted that HSBC paid taxes in other jurisdictions on the interest income it earned from BNJ.

Although the Director argued that BNJ was not entitled to the “unreasonable” exception because the statute was not enacted solely to address tax avoidance, the court disagreed. The court noted that the Director offered only two scenarios where the “unreasonable” exception would apply, and while those situations are perhaps unreasonable, “they are not the ‘alpha and omega’ of unreasonable situations.” Moreover, despite the Director’s concession that the “unreasonable” exception applies to more than the two specifically named situations, the Director could not sufficiently explain its approach to the “unreasonable” exception.

The court concluded that

[I]f the Director’s overly strict interpretation of the statute were to prevail, he would not be exercising any discretion himself but only that confined to specific pre-determined situations. Had the Legislature intended for such strict circumstances, it would not have drafted the statute as it did.... The Director’s overly narrow interpretation of the statute, in this matter, at least, goes beyond reasonable limits, calling into question the reasonableness of the methodology.

The court then held that the “unreasonable” exception operates to permit BNJ’s interest expense deductions.

What is the significance of the Tax Court decision in *Beneficial New Jersey, Inc. v. Director, Division of Taxation*? It confirms that even without the “three percent” or the “guarantee/conduit” exception, the addback of interest expense is not automatic or purely mechanical, and that the “unreasonable” exception is a viable one for taxpayers despite the Director’s attempts to limit its applicability to “pre-determined situations.” As the court held, the applicability of the “unreasonable” exception shall be determined on a case-by-case basis dependent on the totality of the taxpayer’s facts and circumstances.

If you have questions regarding the content of this client alert, please contact the Pillsbury attorney with whom you regularly work or the authors below.

Jeffrey M. Vesely (bio)
San Francisco
+1.415.983.1075
jeffrey.vesely@pillsburylaw.com

Annie H. Huang (bio)
San Francisco
+1.415.983.1979
annie.huang@pillsburylaw.com

This publication is issued periodically to keep Pillsbury Winthrop Shaw Pittman LLP clients and other interested parties informed of current legal developments that may affect or otherwise be of interest to them. The information contained herein does not constitute legal opinion and should not be regarded as a substitute for legal advice.

© 2010 Pillsbury Winthrop Shaw Pittman LLP. All Rights Reserved.