New Jersey – No deduction relating to CODI attribute reduction without statutory authority

August 3, 2015

Update. On June 15, 2018, the Superior Court, Appellate Division, affirmed "substantially for the reasons expressed" in the Tax Court's 2015 opinion. See, No. A-5735-14T3 (6/15/18)

In brief

The New Jersey Tax Court concluded the federal consolidated tax return regulatory requirement to 'push down' cancellation of indebtedness income (CODI) and attribute reduction to subsidiaries applies in determining New Jersey's Entire Net Income. [*MCI Communication Services, Inc. v. Director, Division of Taxation*, N.J. Tax Court, No. 013905-2010 (7/20/15)]

In detail

Facts

During the 2005 tax year at issue, MCI Communication Services, Inc. (MCICS) and its parent, WorldcomMCI, (Worldcom) received income from the cancellation of indebtedness (CODI). Pursuant to the IRC, such CODI was excluded from the federal taxable income of MCICS's federal affiliated group.

MCICS and Worldcom were members of the same federal affiliated group. For federal tax purposes, MCICS was required to reduce certain of its tax attributes with respect to its CODI. Because Worldcom had limited tax attributes, the federal consolidated return regulations mandated that it 'push down' CODI that exceeded its tax attributes to its subsidiaries, including MCICS. As a result of the 'pushed down' CODI (which resulted in an asset basis reduction), MCICS recognized $271,144,051 of federal taxable income.

On its 2005 separate company New Jersey corporation business tax (CBT) return, MCICS reported a deduction of $271,144,051 labeled "Reversal of Federal Attribute Reduction Turn" (i.e., the amount of income recognized solely as a result of the reduction of tax attributes attributed to the 'pushed down' CODI). The Division of Taxation disallowed the deduction. Following an appeal that upheld the disallowance, MCICS appealed to the New Jersey Tax Court.

New Jersey net income 'inextricably linked' to federal taxable income

Citing the 2011 *IBM* decision, the Tax Court acknowledged that there can be 'no argument' that the Entire Net Income for New Jersey CBT purposes is inextricably linked to federal taxable income: "The court is not permitted to ignore the unequivocal provisions of [New Jersey law] linking Entire Net Income to federal taxable income with limited, express exceptions, or the established legal precedents recognizing that the Legislature coupled Entire Net Income under the CBT to federal taxable income."

Taxpayers must accept tax consequences of filing federal consolidated returns

MCICS argued that recognition of 'pushed down' CODI occurred only because it filed a federal consolidated return. If MCICS reported CBT Entire Net Income as if it filed a federal return on a separate company basis it would not have recognized the 'pushed down' CODI and therefore such income should not be included in its CBT income.

The Tax Court disagreed and concluded that the definition of Entire Net Income under the CBT includes the effect of the reduction in tax attributes required to be made by MCICS as a result of the application of IRC § 108. Furthermore, since MCICS consented to file federal income tax returns on a consolidated basis, it must accept the tax consequences of those business decisions, including the federal tax consequences of the reduction of the tax attributes caused by the push down of CODI as required by the federal consolidated return regulations.

MCICS's argument, that the reduction of tax attributes in connection with 'pushed down' CODI is not required under the CBT, was found to be 'unavailing.' "It is precisely the absence of any provision in the CBT to reverse the IRC §108(b) adjustments in determining taxable income that requires they be taken into account in determining Entire Net Income under the NJ CBT."

Absence of CODI modification supports following federal taxable income

MCICS argued that it should not be required to reduce its attributes for CBT purposes because there is no New Jersey code provisions requiring the reduction of tax attributes in connection with 'pushed down' CODI. MCICS cited a 1996 Director position statement providing that a taxpayer does not reduce its net operating loss due to CODI because New Jersey's net operating loss deduction is calculated independently of federal tax attributes.

The Tax Court disagreed, noting that the difference between net operating losses and the attribute at issue in *MCICS* (basis) is important. Entire net income for purposes of the CBT is defined as federal "taxable income, before net operating loss deduction." Accordingly, the conclusion that New Jersey does not require the reduction of NOLs relating to CODI "has no bearing" on the effect of federal requirements to reduce other tax attributes.

The Tax Court indicated that the absence of an express provision in the CBT supports the conclusion that federal adjustments to tax attributes due to CODI should be taken into account for New Jersey purposes, "regardless of whether [CODI] is pushed down from an upper tier member, or is occasioned by the taxpayer's own CODI."

Phantom income argument rejected

MCICS asserted that disallowing the deduction "creates and taxes phantom income," which the Tax Court rejected in the 2014 *Toyota* decision. In that decision, the court provided that state tax policy "prohibits the assessment of tax on 'phantom income' resulting from depreciation deductions used by the taxpayer for federal purposes but which resulted in no New Jersey tax benefit."

The Tax Court disagreed, noting that in *Toyota* there was an inequality of treatment between federal and New Jersey law. However, in this case, the state is according MCICS the very same treatment as under federal law. Accordingly, the court rejected an extension of *Toyota* to "all cases involving so-called 'phantom income.'"

The takeaway

This decision is contrary to many tax practitioners' view that in separate filing states the starting point should be federal taxable income, assuming that the federal tax return also was filed separately. The decision is also contrary to New Jersey's regulation, which states that "entire net income shall be determined on a separate entity basis as if the contemporaneous Federal return had not been a consolidated return." Finally, it is also contrary to New Jersey's long standing policy that the appropriate starting point for entire net income is the federal pro forma separate company tax return, not the federal consolidated return.

In this case, if MCICS filed a separate federal tax return in 2005, it would not have been required to report lower depreciation expense in 2005 for federal income tax purposes. If this decision is upheld, it will create many uncertainties regarding what types of income and expenses should be included in Entire Net Income. For example, if a taxpayer recognizes an excess loss account (ELA) on its federal consolidated return, should that ELA be taxable in New Jersey? Similarly, in computing gain or loss on the sale of a subsidiary for New Jersey CBT purposes, should the stock basis be computed under the federal consolidated return regulations? The decision also creates the potential for double taxation, as referenced by taxpayer's phantom income argument. For example, if the debtor (Worldcom) is required to reduce its assets under IRC 108(b), including the stock basis in MCICS, then Worldcom will have a lower stock basis in MCICS and thus a higher gain upon sale. This seems to be exactly the situation the *Toyota* decision was meant to rectify.

Finally, the Court relied on *IBM* and *General Building Products* in reaching its decision. However, the issue in *MCICS* is distinguishable from the issues in those cases. In fact, the *General Building Products* case could be read to support MCICS's arguments.

Let's talk

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