AVOIDING CORPORATE TAX MISTAKES

LESSONS LEARNED FROM BRACHA EXPORT CORPORATION V. DIVISION OF TAXATION

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On March 20, 2012, in Bracha Export Corporation v. Director, Division of Taxation (Docket No. A-1638-10T1)[1] the New Jersey Appellate Division reminded taxpayers and tax practitioners of the importance of following the rules when it comes to corporate tax practice in the state. In upholding a New Jersey Tax Court's grant of summary judgment in favor of the New Jersey Division of Taxation (the Division), the Appellate Division ruled against a corporation's election to be taxed as a New Jersey S-Corporation for three (3) consecutive years. The Appellate Division also disallowed the company's attempt to then allocate a percentage of its net income out of state. The resulting tax liability, with interest and penalties amounted to more than $220,000.

I. New Jersey S-Corporations

A. In General

A corporation taxed under subchapter "S" of the internal revenue code is termed an S-Corporation or S-Corp.[2] While an S-Corp is still responsible for certain taxes such as FICA payroll taxes, income earned by an S-Corp is not taxed at the corporate level but flows to the shareholders for reporting on their individual income tax returns. This avoids the system of double taxation whereby corporation profits get taxed both at the

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[1] Unpublished Opinion Found at http://njlaw.rutgers.edu/collections/courts/appellate/a1638-10.opn.html. Last Accessed January 20, 2013.

[2] IRC § 1361 *et. seq*. All IRC references are to the Internal Revenue Code of 1986, as amended.

corporation level and at the shareholder level. Avoiding the layer of corporate taxation can often serve as a strong incentive for management to structure their business accordingly.

Importantly, a federal election under IRC § 1362 to be taxed as an S-Corp does not automatically apply to New Jersey's corporate tax system. New Jersey requires a separate election to be made, and has its own requirements for what constitutes a valid S-Corp for state purposes. Under this system, a federally recognized S-Corporation doing business in New Jersey will still be liable for the state corporate income tax unless a separate election is also made and accepted by state authorities. Note that the reverse is not possible. It is not possible for a corporation to elect S-Corporation status for New Jersey purposes only without also being recognized as an S-Corporation for federal purposes.

The rules for making a New Jersey S-Corp election are governed by N.J.S.A. 54:10A-5.22 and require that the corporation and each shareholder consent to the election and the jurisdictional requirements of becoming a New Jersey S-Corporation. This means that New Jersey is granted the ability to tax the shareholder no matter where that shareholder resides. Obviously, if the corporation could elect S status and flow New Jersey source income to a non-resident shareholder, New Jersey would lose the tax revenue if it could not also compel that non-resident shareholder to pay tax to New Jersey on his or her *pro rata* share of the corporation's income.

Notably, the statute requires that all initial shareholders consent to the election. If shareholders are later added who do not consent, New Jersey is authorized to tax the corporation on that shareholder's pro rata share of income at the highest marginal rate.[3] This means also that by consenting, shareholders, wherever located, must file New Jersey resident or non-resident income tax returns.

The election is made on form CBT-2553 which can be downloaded off the state's website.[4] Taxpayers have until the 15th day of the fourth month of the tax year (generally April 15 for calendar year taxpayers) to file for S-Corporation status.

[3] N.J.S.A. 54:10A-5.22(b)(3).
[4] http://www.state.nj.us/treasury/revenue/sub-s.pdf.

B. As Applied to Bracha

In Bracha, the taxpayer tried to elect New Jersey S-Corporation status for tax years 1998, 1999, and 2000. The election was denied because one of the three initial consenting shareholders failed to file New Jersey personal income tax returns for those years. By not filing income tax returns, the jurisdictional requirements of N.J.S.A. 54:10A-5.22 were not met. Interestingly, because the shareholder in question was one of the initial shareholders, his failure to file caused the election to be disallowed for the corporation as a whole. If on the other hand, the shareholder had been added later, failure to file income tax returns would only have meant New Jersey corporate taxation on his *pro rata* share of income. The other shareholders would still have received the benefit of a New Jersey S election.

Practice Point: Consider language in the shareholder agreement that imposes penalties on any shareholder who fails to follow the requirements for maintaining an S election. In the event such failure adversely affects the other shareholders, the non-compliant shareholder would then be responsible for any loss suffered.

The Division issued its final determination on April 2, 2003 giving the taxpayer ninety (90) days to appeal.[5] Under New Jersey law, the formal protest is the only method open to a taxpayer wishing to appeal a determination issued by the Division.[6] By law, the Tax Court is without jurisdiction to consider the merits of an untimely protest.[7] The court in Bracha upheld the ninety (90) period and ruled that the taxpayer's challenge to the 2003 determination was time barred.

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[5] N.J.S.A. 54:51A-14.
[6] N.J.S.A. 54:51A-16.
[7] See generally Harry's Lobster House Corp. v. Director, Division of Taxation, 23 N.J. Tax 149 (Tax Ct. 2006).

II. Allocating Non-New Jersey Source Income

A. Issue Presented

The second issue presented in Bracha concerns the out-of-state allocation of corporate income. After the Division denied the corporation's S-Corp election for 1998, 1999, and 2000, the corporation filed amended corporate tax returns for those years (Form CBT-100 returns). In those returns, the corporation allocated a percent of its income to New York claiming in part that it maintained a regular place of business in that state. Under New Jersey law, a corporation can allocate income away from New Jersey if it maintains a regular place of business outside of New Jersey.

B. Power of Allocation as a Method to Avoid State Income Taxes

Allocation of out-of-state income is governed by N.J.S.A. 54:10A-6 which provides for a weighted average that considers a corporation's **property**, **sales**, and **payroll** (giving added weight to sales) and then computes the percentage that can be allocated out of state. It is important to note that the weighted average is scheduled to change over the next few years resulting in a complete phase-out in 2014. The power of allocation can be seen in the following examples.

Example 1: XYZ Corp is a calendar-year taxpayer. In **2011**, XYZ Corp. maintained a regular place of business in Seattle, Washington and posted a net income of $5,000,000.

In 2011 XYZ Corp. had property in New Jersey worth $1,000,000 (and worldwide of $2,000,000); posted sales receipts in New Jersey worth $1,000,000 (and worldwide of $4,000,000); and paid wages in New Jersey of $200,000 (and worldwide of $2,000,000). On these facts:

The **percent** of the company's **property** located in New Jersey is **50%**

- ($1,000,000 / $2,000,000).

The **percent** of the company's **sales receipts** in New Jersey is **25%**

- ($1,000,000 / $4,000,000).

The **percent** of the company's **wages** paid in New Jersey is **10%**

- ($200,000 / $2,000,000).

For tax year 2011, XYZ Corp. was able to allocate $3,625,000 (or 72.5% of its $5,000,000 net income) out of New Jersey.[8] As a result, the company was forced to pay New Jersey corporate taxes on just $1,375,000 (or 27.5% of its net income). At the 9% state tax rate, taxes for the year to New Jersey amounted to just $123,750. If on the other hand, a regular place of business was not maintained out of state, the tax due to New Jersey would have been $450,000. Therefore, maintaining a regular place of business in a state with no state income tax (such as Washington) saved XYZ Corp. $326,250 in state income taxes.

Example 2: How to calculate the allocation factor in *Example 1*. In *Example 1*, XYZ Corp. was able to multiply its net income by the fraction of that income allocable to New Jersey. The fraction is blended from the separate fractions associated with the company's property, receipts, and wages attributed to New Jersey as calculated above.

For 2011, the allocation factor was computed by giving double weight to the percentage of sales receipts attributed to New Jersey as follows:

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[8] See *Example 2* for calculation.

Numerator	– (0.50 * 1) + (0.25 * 2) + (0.10 * 1)	= 1.100
Denominator	– (1 + 2 + 1) multiplier; by statute	= 4
Allocation Factor	– 0.275	

Therefore, the net income of $5,000,000 multiplied by the allocation factor 0.275 (27.5%) yields the $1,375,000 of income allocable to New Jersey. The remaining $3,625,000 of net income (72.5%) gets allocated out of state.

Example 3: Allocation Factor in **2012**. Computation of the allocation factor changes for tax years beginning on or after **January 1, 2012** with receipts accounting for 70% of the fraction, and with property and payroll accounting each for 15%.

Applied to the facts above, the allocation factor for 2012 would have been:

Numerator	– (0.50 * 1.5) + (0.25 * 7) + (0.10 * 1.5)	= 2.65
Denominator	– (1.5 + 7 + 1.5)	= 10
Allocation Factor	– 0.265	

Example 4: Allocation Factor in **2013**. Computation of the allocation factor changes again for tax years beginning on or after **January 1, 2013** with receipts accounting for 90% of the fraction, and with property and payroll accounting each for 5%.

Applied to the facts above, the allocation factor for 2013 would have been:

Numerator	– (0.50 *0.5) + (0.25 * 9) + (0.10 *0.5)	= 2.55
Denominator	– (0.5 + 9 + 0.5)	= 10
Allocation Factor	– 0.255	

Example 5: Allocation Factor in **2014**. Computation of the allocation factor changes yet again for tax years beginning on or after **January 1, 2014** with receipts accounting for 100% of the fraction, and with property and payroll no longer being considered.

Applied to the facts above, the allocation factor for 2014 would have been the percent of the company's sales receipts in New Jersey for that year, 0.250 or 25%.

C. Regular Place of Business

Whether or not a company maintains a "regular place of business" in another jurisdiction is a fact sensitive question. The regulations define a regular place of business "as any bona fide office (other than a statutory office), factory, warehouse, or other space of the taxpayer which is regularly maintained, occupied and used by the taxpayer in carrying on its business and in which one or more regular employees are in attendance".[9]

The regulations go on to provide additional factors:

1. Bona fide office: An office in which an employee in attendance performs significant duties related to the business of the taxpayer. A token office, space of the taxpayer or any place where an employee does not actually perform significant duties constituting part of taxpayer's business does not constitute a regular place of business.

2. Space of the taxpayer: The taxpayer must be directly responsible for the expenses incurred in maintaining the regular place of business and must either own or rent the facility in its own name and not through a related person or entity. The regular place of business should be identifiable as belonging to the taxpayer by, for example, reflecting the taxpayer's name on the exterior and interior of the building and being listed in the taxpayer's name in a telephone book.

3. Regularly maintained, occupied and used by the taxpayer in carrying on its business: The taxpayer must regularly maintain, occupy and use the premises by employing one or more regular employees who are in attendance during normal working hours. Premises are not regularly maintained, occupied and used in the event employees are in attendance only on a part time basis and, in their absence, telephone messages are received by an answering service or recording device.

[9] N.J.A.C. 18:7-7.2(a).

4. Regular employee: A regular employee must be under the control and direction of the taxpayer in transacting the taxpayer's business and/or performing work on behalf of the taxpayer. The officers of the taxpayer are generally deemed to be regular employees of the taxpayer while independent contractors and members of the taxpayer's board of directors are not regular employees of the taxpayer. The method or procedure by which a taxpayer reports the compensation paid to an individual (such as a W-2 form) shall not be conclusive as to whether the individual is a regular employee (See N.J.A.C. 18:7-8.14):

i. The facilities of a public warehouse located outside New Jersey and utilized to store property of the taxpayer prior to shipment to customers shall not constitute a regular place of business of the taxpayer where the warehouse is not the space of the taxpayer.

ii. The facilities of an independent contractor located outside of New Jersey and used to store, convert, process, finish and/or improve the goods of the taxpayer prior to shipment to customers shall not constitute a regular place of business of the taxpayer.

iii. A job site, field office or other facility which is not regularly maintained, occupied and used in taxpayer's business or where administrative duties, such as performing payroll functions, telephoning, recordkeeping, banking, accounting, the hiring and firing of employees and similar functions are not performed, is not a regular place of business.

iv. The location of inventories outside of New Jersey in the possession of employees in their homes, or in trucks, or in coin-operated machines do not represent space regularly maintained, occupied and used by the taxpayer in carrying on its business.

v. In the event the taxpayer's business is conducted by an independent agent or independent contractor, the place of business of the independent agent or independent contractor shall not be considered a regular place of business of the taxpayer. In addition, any employee of such independent agent or independent contractor shall not be considered a regular employee of the taxpayer.

(b) A taxpayer does not have a regular place of business outside New Jersey solely by consigning goods to an independent factor outside New Jersey for sale at the direction of either the consignor or consignee.

(c) The mere fact that a taxpayer is subject to an income or franchise tax in other jurisdictions shall not be determinative as to whether the taxpayer maintains a regular place of business outside of New Jersey where taxable status in that jurisdiction is based on criteria other than a regular place of business.[10]

[10] N.J.A.C. 18:7-7.2(a)-(c).

D. As Applied to Bracha

In Bracha, the taxpayer tried to allocate net income to a warehouse located in New York City. The warehouse allegedly served as a shipping hub for local customers, and two (2) workers were employed at that facility. In denying the allocation, the Division noted the taxpayer's failure to provide evidence that the warehouse was a regular place of business. The Division requested proofs such as New York income tax returns, payroll returns, employment agreements, and a statement showing the number of hours worked by the employees at the facility. The taxpayer could not provide such documentation and the tax court also noted that the W-2s that were provided showed those two (2) employees as being employed in New Jersey.

The Appellate Division, in reviewing the tax court's determination *de novo*, held as the tax court did that the warehouse did not meet the definition of a regular place of business as provided in the statutes and regulations. Furthermore, the proofs that were submitted did not even raise a material issue of fact that could survive a motion for summary judgment.

Practice Point: The taxpayer's attempt to allocate income was done after the taxpayer lost its bid for S election status. In this situation, the taxpayer clearly did not engage in planning with the statutory requisites for allocation in mind. If allocation is considered as either a primary or contingent tax planning strategy, proper steps should be taken from the outset to maintain and manage the out-of-state office. For example, keep detailed employment records and employment agreements, hire a local accountant and file returns reflecting the permanency of the office, and shift actual corporate function to that office and be prepared to show its general non-tax business purpose.

III. Conclusion

For out-of-state companies choosing to conduct business in this state, strict adherence to the requirements for recognition as a New Jersey S-Corporation must be followed. Furthermore, determinations issued by the Division of Taxation must be acted upon to preserve the rights of any taxpayer affected by the judgment of the Division. Once the ninety (90) day window passes to protest the Division, the taxpayer is no longer able to petition tax court to review the matter.

Furthermore, for those companies regularly conducting business outside of New Jersey, maintaining a "regular place of business" in such other jurisdiction, and meeting the statutory and regulatory requirements, is essential to recognize the state tax avoidance of non-New Jersey source income. Without adequate records to substantiate the other office, the Division will continue to disallow any claim for allocation.

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