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Client Alert

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Corporations Should Review Intercompany Debt Structures After The Recent New Jersey Tax Court Decision In *Kraft*

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The New Jersey Tax Court recently held that the New Jersey Corporate Business Tax (CBT) statute required the add-back into income of interest paid from a subsidiary to its parent corporation, concluding that the interest paid did not qualify for one of the five exceptions to the add-back requirement. *Kraft Foods Global, Inc. v. Director, Division of Taxation*, (Docket No. 017974-2009) (April 26, 2016). The Tax Court reached this conclusion even though (1) the subsidiary had received proceeds, from the parent, of public bonds issued by the parent soon after the bonds were issued, (2) the subsidiary issued promissory notes to the parent shortly after each time funds were transferred from the parent, and (3) the interest paid on the promissory notes was used by the parent to pay the interest on the public debt.

Companies doing business in New Jersey that make interest payments to related parties should review the structure of those interest payments to see whether the add-back of interest can be avoided. Properly structured, interest payments should be able to qualify for one of the five statutory exceptions to the add back requirement, which could greatly reduce the New Jersey CBT obligation (in the case of *Kraft* the total CBT obligation, with interest and penalties, for the two years at issue was over $14.5 million). Of course, in many cases the structural requirements will be at odds with the business needs; however, knowing the alternatives will allow business owners to make an informed decision about the proper structure.[1]

The Facts in *Kraft*

Kraft Foods Global, Inc. (KFG) is a Delaware corporation with its principal office in Illinois. KFG is a direct subsidiary of its parent corporation, Kraft Foods Inc (KFI), which itself is a direct subsidiary of Philip Morris Companies Inc ("Philip Morris"). KFG was engaged in business in New Jersey.

Beginning in 2001, KFI from time to time issued public debt in the form of bonds. Shortly after issuance of the bonds, KFI would transfer amounts equal to the proceeds of the bonds to KFG. Shortly after the transfer of funds, KFG would execute a promissory note in favor of KFI in an amount equal to the funds transferred. KFG agreed to pay interest to KFI equal to the interest on the bonds, and it was undisputed that the interest rate was lower than KFG would have had to pay independently to a third party.

Importantly, KFG did not guarantee the public bonds, nor did the promissory notes contain payment terms or a payment schedule for principal repayment. KFI had no recourse if KFG failed to make the interest payments, and the promissory notes made no reference to the public bonds. The KFI bondholders were not third party beneficiaries of the notes and had no recourse against KFG if KFG did not make payments on the notes or if KFI did not use the payments from KFG to make the interest payments on the notes.

The Division of Taxation audited KFG's CBT returns for 2005 and 2006. The Notice of Assessment made several adjustments to KFG's returns, including the adding back of $472,787,500 in interest paid to KFI in 2005 and $462,062,500 in interest payments made in 2006. The stated reason was "The debt between Kraft Foods Global, Inc. and Kraft Foods Inc is not at arm's length as Kraft Foods Inc. is charging the same interest as it is paying. Also, Kraft Foods Global, Inc. is not a legal guarantor of the debt." (Opinion at page 5).

New Jersey Law on the Interest Add-Back

The CBT, N.J.S.A. 54:10A-1 et.seq., is the governing corporate tax statute at issue in the case. The tax is imposed on a corporation's "entire net income," which starts with the taxable income, before net operating losses and special deductions, which the taxpayer reports on its Federal return. N.J.S.A. 54:10A-4(k).

The CBT then adjusts entire net income for certain items. One of those items is the add-back of interest paid to related parties. N.J.S.A. 54:10A-4(k)(2)(I). The statute then provides five exceptions to the add-back requirement. One of those, the "Unreasonable Exception," was at issue in the *Kraft* case.

The "Unreasonable Exception" provides that the

1 Any such review should also take into account the proposed regulations under Section 385 and their potential impact on State taxes.

add back will not apply if the taxpayer "establishes by clear and convincing evidence, as determined by the director, that the disallowance of a deduction is unreasonable." *Id.* In the Kraft case, and relevant to most analyses, the "Unreasonable Exception" was viewed in connection with a second exception, the "Guarantee Exception."[2] The Guarantee Exception provides an exception to the add-back where the taxpayer "establishes by a preponderance of the evidence, as determined by the director, that the interest is directly or indirectly paid, accrued or incurred to…an independent lender and the taxpayer guarantees the debt on which the interest is required." *Id.*

As is apparent, in a situation where the parent company accesses funding from the public, or a specific third party, and loans those funds on to its subsidiary, that subsidiary will not be required to add back the interest if the subsidiary is a guarantor of the loan. In *Kraft*, KFG did not guarantee the public bonds, and thus it did not qualify for the Guarantee Exception.

That led the Tax Court to evaluate the interplay between the Guarantee Exception and the Unreasonable Exception. Specifically the question was whether the existence of a guarantee was the only way the subsidiary can avoid the add back requirement. The Tax Court, after reviewing the legislative history of the statute, concluded that even in the absence of a guarantee a taxpayer may establish that it is ultimately responsible for paying interest to a third party lender directly or through a related entity. There is a higher burden of proof on the taxpayer, however, in that case: the taxpayer must prove its case by "clear and convincing evidence."[3]

The bottom line in the *Kraft* case was that, according to the Tax Court, the taxpayer fell short of proving that the Director acted unreasonably in concluding the taxpayer did not meet the burden of proof. The key factors, according to the Tax Court, were:

1. There was no document stating that KFG was ultimately responsible to the bondholders;
2. KFG had no obligation to KFI or the bondholders to make interest payments on KFI's debts;
3. The only obligation KFG had was to make interest payments on the promissory notes, which promissory notes make no reference to the bonds;
4. There is no obligation that the interest payments be forwarded to the bondholders; and
5. The bondholders have no recourse against KFG in the event of a default.

Thus KFG was required to add back the interest paid to KFI.

Kraft is the most recent of a series of cases involving the interpretation of the exceptions to the add-back of interest requirement. Two others, *Beneficial New Jersey v. Director, Div. of Taxation*, No 009886-2007 (Tax Aug 31, 2010), which is an unpublished New Jersey Tax Court case, and *Morgan Stanley Co., Inc. v. Director, Div. of Taxation*, 28 N.J. Tax 197 (2014), provided favorable results for the taxpayers. In Beneficial, while the taxpayer was unable to show that it satisfied the "rate of tax" exception, the Court did find that the taxpayer was entitled to the "Unreasonable Exception" under the totality of the circumstances. In that case the totality of the circumstances included the parent corporation's practice of obtaining funds to loan to the subsidiary because it had a favorable credit rating and thus borrowed at lower rates than the subsidiary could, and that the parent did in fact pay tax on the interest income.

In *Morgan Stanley*, the taxpayer again won, this time based on a conclusion that the Director acted unreasonably when it failed to consider other facts once it was clear that the parent did not meet the "subject to tax" exception. While Morgan Stanley won the case, the Tax Court made it perfectly clear that was because of the Director's actions (actually its inactions) in that case. In fact, Morgan Stanley had argued that add-back should not apply to any transaction that has a valid non-tax business motive and economic purpose. The Tax Court explicitly rejected that argument, notwithstanding the taxpayer's win.

The holding in *Kraft* removes any false sense of security taxpayers might have believed they gained from the *Beneficial* and *Morgan Stanley* decisions. Corporate taxpayers should scrutinize their structures based on the *Kraft* holding.

New Jersey Tax Planning in the Wake of *Kraft*

After *Kraft*, corporate taxpayers doing business in New Jersey and paying interest to related parties really have two avenues. First, the subsidiary can guarantee the third-party debt issued by the parent. That is the cleanest alternative, but of course could very well be at odds with the business needs and constraints.

If the guarantee alternative is chosen, the taxpayer needs to be aware that the Division of Taxation takes the position that the guarantee must arise at the time the debt is issued. New Jersey Technical Advisory Memorandum 2011-13(R). On the positive side, to the extent that the business factors are driven by a hesitancy to interfere with senior debt at the subsidiary company level, while not free from doubt it would appear that a subordinated guarantee issued by the subsidiary should be equally effective, given that the

2 The other three exceptions are (1) the Three Percent Exception, which requires that the recipient of the interest is subject to a "rate of tax" within 3 percentage points of the taxpayer's New Jersey tax rate ("rate of tax" has been interpreted to mean the effective tax rate taking into account the allocation factor, and is thus not just a test focused on the New Jersey tax rate; this is a mathematical test that is difficult to satisfy given the variation in state tax rules and rates); (2) the Foreign Treaty Exception; to qualify the related member has to be in a foreign jurisdiction which has in place a comprehensive income tax treaty with the U.S.; and (3) by agreement with the Director.

3 For the Guarantee Exception, the taxpayer must prove its case by a "preponderance of evidence;" with a written guarantee the evidence will be clear.

subordinated guarantee still puts the subsidiary on the hook for the debt.

The second road would be factually based to meet the Unreasonable Exception. Certainty in this regard becomes difficult, given that at least some of the determining factors in *Beneficial* – for example, loans from the parent to the subsidiary were funded by public borrowings at favorable rates – were present in *Kraft* as well.

On the other hand, taxpayers might be able to use the shortfalls listed by the Court in *Kraft* as a checklist of steps to take. In this manner, the taxpayer could try to make the facts better than the *Kraft* facts but still short of a guarantee. That could include, for example, default language that would give the bondholders (or the indenture trustee) the right to pursue the subsidiary in the event of a default, as well as explicit obligations on the parent to pass through the interest payments. Also, lacking in the *Kraft* case, according to the Tax Court, were payment terms and a payment schedule. Adding these features should also increase the ability to fall under this exception. Also, a trustee could be established to hold the promissory note from the subsidiary and make the payments on the bonds, taking the parent out of the equation. See, *Rollins Leasing Corp. v. Director, Division of Taxation*, 14 N.J. Tax. 289 (1994). Finally, certain "cash sweep" structures have been conceded by the Division to work. New Jersey Technical Advisory Memorandum 2011-13(R).

In all cases, however, the tax requirements need to be weighed against the business needs. The bottom line is that by reviewing the alternatives taxpayers can balance their business goals with their New Jersey tax exposure.

If you have any questions about this alert, please do not hesitate to contact the authors.

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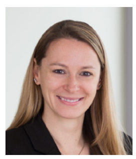

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