

(b) The application of this section is not limited to an agreement, understanding or arrangement existing between a taxpayer and any other corporation or any person or firm for the purpose of avoiding or evading tax under the Act. It is also applicable where adjustments and redeterminations relate to transfer pricing and other transactions between related persons or entities where evasion or tax avoidance are not a consideration. The Director may initiate adjustments under this section solely in the interests of determining a fair and reasonable tax, and without respect to any benefit arising out of inter-corporate relationships or the relationships of any person holding a substantial portion of the stock of a taxpayer. The Division shall not be limited to indices, trade practices, cost sheets, Internal Revenue Reports or any other factor in determining the appropriate transfer price for goods, services, intangibles or other dispositions made to related parties. Where the Director determines that there is an adjustment to net income under this section, he or she may also make a corresponding adjustment to the allocation factor.

(c) Where any taxpayer conducts its activity or business under any agreement, arrangement or understanding in such manner as either directly or indirectly to benefit its members or stockholders, or any person or persons directly or indirectly interested in such activity or business, by entering into any transaction at more or less than a fair price which, but for such agreement, arrangement or understanding, might have been paid or received therefor, the Director may adjust and redetermine items on any affected taxpayer report or return as may be necessary properly to reflect the taxpayer's adjusted entire net income apportionable to New Jersey. The following example is an illustration only and in no way shall be interpreted as a standard for calculating wages in a particular case.

Example: Corporation D entered into an employment agreement with its sole shareholder's spouse for the performance of services as an accounting clerk. The agreement called for the shareholder's spouse to monitor 10 accounts. For the service performed, the spouse is to receive an annual salary of \$100,000 along with a substantial benefit package. The Director, upon audit, learns that the spouse works only five hours per week in completely performing the duties. The Director, based upon the going wage for such services, determines that the total compensation package would not exceed \$10,000 a year and adjusts the taxpayer's expense to determine properly the net income and the taxpayer's wage fraction of the allocation factor and to provide dividend treatment for the disallowed wage compensation.

(d) Where any taxpayer, 20 percent or more of whose capital stock is owned either directly or indirectly by or through the same interests as those of the taxpayer, conducts any activity, transaction, or business with such interests which either directly or indirectly creates an artificial loss, net income, or allocation factor, the Director may adjust and redetermine such items on any taxpayer report or

return as may be necessary properly to reflect the taxpayer's adjusted entire net income apportionable to New Jersey.

Example 1: Corporation E, the great grandparent of the taxpayer, borrows \$1 million from the taxpayer. The agreement calls for the principal and interest at the rate of two percent per annum to be paid at the end of one year. Upon audit, the Director determines that a market interest rate given the economic conditions at the time of the loan and the circumstances of the borrower is 13 percent per annum. Therefore, he adds the additional income to the taxpayer's net income as reported, and adjusts the expense on the great grandparent's return, if it files in New Jersey.

Example 2: Corporation F is the parent company of over 10 subsidiaries and provides all administrative services for the 10 subsidiaries. Corporation F receives dividend income from its subsidiaries, interest income from other investments, and service fee income from the subsidiaries for the administrative services it performs on their behalf which are an integral part of the business activity of the parent. All costs incurred by the parent are charged to the subsidiaries based solely upon the total assets of each subsidiary. Upon audit, the Director determines that the service fee includes no profit element and that the allocation of the costs of the administrative services bears no relationship to the services provided to each subsidiary. Accordingly, the Director imputes an element of profit, and assigns the charges to each subsidiary by a method reflecting the actual costs incurred in providing the services to each subsidiary.

(e) The following examples are merely illustrative and are in no way intended to limit the scope of the Director's discretion to inquire into transfer pricing or the determination of a fair and reasonable tax:

Example 1: K Corporation, the manufacturer of a proprietary product, sells goods to its distributors and wholesale customers at a 50 percent profit. It also sells goods to related foreign corporations at a 5 percent gross profit for marketing by them overseas.

On a separate entity basis, in an arm's length transaction these sales would yield a 50 percent gross profit and the price which might have been paid or received for the goods includes an amount sufficient to reflect that 50 percent gross profit.

The Director may include additional profits in entire net income sufficient to reflect the arm's length price which might have been paid or received.

Example 2: L Corporation is the parent corporation in a vertically integrated oil company. Its marketing subsidiary is a taxpayer. The marketing corporation reports a significantly lower gross profit than other taxpayers selling the same generic products in volume.

L Corporation has set its transfer prices to its marketing subsidiary at a price \$0.02 per gallon higher than published New York tanker port prices for its product because it deems, in good faith, that its brand name value and economies of scale are more properly attributable to the parent corporation. It also uses this transfer price to sell its product to all its independent retailers.

The fair price which might have been paid for the product sold by the marketing subsidiary would not be based upon "New York tanker prices" plus the lesser of representative contract carrier costs or the actual costs incurred for delivery. The Director would recognize the \$0.02 per gallon higher price since that is the same price used for comparable sales to all uncontrolled entities for the audit period.

(f) Whenever the Director deems it necessary, in order properly to reflect entire net income of the taxpayer, he or she may determine the year or period in which an item of income, deduction, asset or liability shall be included, without regard to the method of accounting used by the taxpayer.

(g) The Director may require any person or corporation to submit whatever information under oath or affirmation, or to permit whatever examination of its books, papers and documents, as may be necessary to enable him or her to determine the existence, nature or extent of an agreement, understanding or arrangement to which this section relates, whether or not the person or corporation is subject to the tax imposed by the Act.

Amended by R.1992 d.231, effective June 1, 1992.

See: 24 N.J.R. 1522(a), 24 N.J.R. 2074(c).

Revised section.

Amended by R.1999 d.116, effective April 5, 1999.

See: 31 N.J.R. 266(b), 31 N.J.R. 893(a).

In (a)8, added iv through vi; and in (a)9i, deleted "three" preceding "methods in" in the first sentence, and substituted "first five" for "three" preceding "methods" in the second sentence.

Statutory References

See N.J.S.A. 54:10A-4(k)(3) as to right of Director to determine the year in which an item of income or a deduction shall be included without regard to taxpayer's method of accounting, and 54:10A-10 as to Director's right to redetermine tax due when taxpayer's business records appear distorted.

Case Notes

Rule that a corporation's "net income" can be reduced by only 10 percent of the interest on indebtedness to a person or entity which owns 10 percent or more of the corporation's capital stock held applicable to corporate indebtedness owed to a corporation's parent; Division Director held without authority to recompute corporation's taxes to exclude such indebtedness from income; 10 percent rule held not violative of due process or equal protection; statutory amendments eliminating the 10 percent rule could not be applied retroactively. *GATX Terminals Corp. v. Taxation Div. Director*, 5 N.J.Tax 90 (Tax Ct.1982), affirmed in part, remanded in part per curiam 7 N.J.Tax 659 (App.Div.1985), certification denied 102 N.J. 337, 508 A.2d 213.

Example 2: The example below illustrates the net operating loss carryover for the full term of seven years and demonstrates the application of net operating loss deductions in the proper sequence.

18:7-5.11 (Reserved)

New Rule, R.1978 d.30, effective January 27, 1978.

See: 10 N.J.R. 40(b), 10 N.J.R. 128(b).

Repealed by R.1994 d.186, effective April 18, 1994.

See: 26 N.J.R. 761(a), 26 N.J.R. 1696(b).

Section was "New jobs credit; salaries deduction".

18:7-5.12 Net operating loss deduction

A taxpayer may deduct a New Jersey net operating loss carryover as defined in N.J.A.C. 18:7-5.13 in computing its entire net income before exclusions and before the net operating loss deduction.

New Rule, R.1986 d.26, effective February 3, 1986.

See: 17 N.J.R. 2096(a), 18 N.J.R. 309(a).

Amended by R.1994 d.186, effective April 18, 1994.

See: 26 N.J.R. 761(a), 26 N.J.R. 1696(b).

18:7-5.13 New Jersey net operating loss carryover

(a) A New Jersey net operating loss as defined in N.J.A.C. 18:7-5.15 for any taxable year ending after June 30, 1984 becomes a net operating loss carryover. The net operating loss carryover is carried to each of the succeeding taxable years and is reduced in each such succeeding year by the amount of entire net income before net operating loss deduction and before exclusions, and is further reduced to zero seven years following the year of the loss, taking into account the normal or extended due date for filing the return for the seventh year succeeding the year of the loss. The net operating loss carryover may not be carried back to any year preceding the year of the loss. For this purpose, taxable year shall mean the accounting period covered by the taxpayer's return. In no event may a net operating loss carryover be used for a net operating loss deduction on the eighth return succeeding the loss year.

(b) The net operating loss may only be carried over by the actual corporation that sustained the loss. The net operating loss may, however, be carried over by the corporation that sustained the loss and which is the surviving corporation of a statutory merger. The net operating loss may not be carried over by a taxpayer that changes its state of incorporation or is a part of a statutory consolidation. Section 4(k) of the Act defines entire net income in terms of a specific corporate franchise.

(c) Corporations acquired under Internal Revenue Code Section 338 do not lose their net operating loss carryover because the corporate franchise remains unchanged to the extent it does not fall within the provisions of N.J.A.C. 18:7-5.14.

Example 1: A domestic corporation dissolves pursuant to laws of the State of New Jersey and incorporates in another state. This newly formed corporation of another state is a new legal entity for corporation business tax purposes and the net operating loss carryover of the domestic corporation is not available to the new entity.

Amounts From Returns									
Return Year	1984	1985	1986	1987	1988	1989	1990	1991	1992
Fiscal Year Ended	31-Dec-84	31-Dec-85	31-Dec-86	31-Dec-87	31-Dec-88	31-Dec-89	31-Dec-90	31-Dec-91	31-Dec-92
Line 28	(\$100,000)	(6,000)	(8,000)	(10,000)	50,000	8,000	(5,000)	2,000	10,000
NJ Adjustments	5,000	5,000	5,000	5,000	5,000	5,000	5,000	5,000	5,000
ENI before NOL ded. or exclusions	(95,000)	(1,000)	(3,000)	(5,000)	55,000	13,000	0	7,000	15,000
NOL Deduction	NA	0	0	0	55,000	13,000	0	7,000	9,000
ENI before exclusions	0	0	0	0	0	0	0	0	6,000
Dividend exclusion & IBF exclusion	2,000	2,000	2,000	2,000	2,000	2,000	2,000	2,000	2,000
Entire Net Income	0	0	0	0	0	0	0	0	4,000
NOL Carryovers Applied									
1985	0								
1986	0	0							
1987	0	0	0						
1988	55,000	0	0	0					
1989	13,000	0	0	0	0				
1990	0	0	0	0	0	0			
1991	7,000	0	0	0	0	0	0		
1992		1,000	3,000	5,000	0	0	0	0	0
1993			0	0	0	0	0	0	0
1994				0	0	0	0	0	0
1995					0	0	0	0	0

Amounts From Returns									
Return Year	1984	1985	1986	1987	1988	1989	1990	1991	1992
Fiscal Year Ended	31-Dec-84	31-Dec-85	31-Dec-86	31-Dec-87	31-Dec-88	31-Dec-89	31-Dec-90	31-Dec-91	31-Dec-92
1996						0	0	0	0
1997							0	0	0
1998								0	0
1999									0
Unused	20,000	0	0	0	0	0	0	0	0
Total	95,000	1,000	3,000	5,000	0	0	0	0	0

(d) The following explain and/or define the above table: Line 28 is the amount of the taxpayer's taxable income, before net operating loss deduction and special deductions which the taxpayer is required to report to the United States Treasury Department for the purpose of computing its Federal income tax. NJ Adjustments are the statutory additions and deductions to line 28 that are peculiar to the New Jersey corporation business tax.

1. "ENI" means entire net income as defined in the Act and in these rules.

2. "NOL" means net operating loss.

i. Exclusions are the exclusions from entire net income for dividends received and the eligible net income of an international banking facility.

3. "IBF" means the eligible net income of an international banking facility.

New Rule, R.1986 d.26, effective February 3, 1986.
See: 17 N.J.R. 2096(a), 18 N.J.R. 309(a).

Administrative Correction to (c), removing Examples 1:B and 2:C from Code.

See: 23 N.J.R. 1024(a).

Amended by R.1994 d.186, effective April 18, 1994.
See: 26 N.J.R. 761(a), 26 N.J.R. 1696(b).

Law Review and Journal Commentaries

Tax Law. Robert J. Alter, Jay A. Soled, 138 N.J.L.J. No. 1, S64 (1994).

Taxes. Steven P. Bann, 136 N.J.L.J. No. 8, 53 (1994).

Case Notes

Successor corporation; net operating losses of merged corporation. *Richard's Auto City, Inc. v. Director, Div. of Taxation*, 270 N.J. Super. 92, 636 A.2d 572 (A.D.1994), also published at 14 N.J. Tax 436, certification granted 137 N.J. 167, 644 A.2d 614, reversed 140 N.J. 523, 659 A.2d 1360.

Regulation governing net operating loss carryovers was not authorized. *Richard's Auto City, Inc. v. Director, Div. of Taxation*, 270 N.J. Super. 92, 636 A.2d 572 (A.D.1994), also published at 14 N.J. Tax 436, certification granted 137 N.J. 167, 644 A.2d 614, reversed 140 N.J. 523, 659 A.2d 1360.

Surviving corporation could not carryover loss of a merged corporation. *Richard's Auto City, Inc. v. Director, Div. of Taxation*, 12 N.J. Tax 619 (1992), reversed, 14 N.J. Tax 436, certification granted 137 N.J. 167, 644 A.2d 614, reversed, reinstated 140 N.J. 523, 659 A.2d 1360.

Change in 50% or more of ownership of corporation may remove corporation's right to carryover net operating losses. *Richard's Auto City, Inc. v. Director, Div. of Taxation*, 12 N.J. Tax 619 (1992), reversed, 14 N.J. Tax 436, certification granted 137 N.J. 167, 644 A.2d 614, reversed, reinstated 140 N.J. 523, 659 A.2d 1360.

18:7-5.14 Limitations to the right of a net operating loss carryover

(a) The net operating loss carryover automatically becomes zero when the cumulative effect of all its capital stock redemptions and sales after June 30, 1984 is a 50 percentage point change in the ownership of its voting stock and the corporation changes from the business giving rise to the loss. For this purpose the exchange of stock is a sale. Further, solely for this purpose and no other purpose in the Act, a business is defined in terms of the economic factors of production. The sequence in change of ownership and change in the business and the taxability of an exchange for Federal income tax purposes are irrelevant. The economic substance of the transaction is, however, paramount and may indicate forfeiture of a net operating loss carryover.

(b) The Director may disallow the carryover in those instances where the facts support the premise that a corporation was acquired for the primary purpose of the use of its net operating loss carryovers. In this context, to prevent the trafficking in loss corporations, the Director will consider the following facts:

1. Whether the physical location or other fixed assets of the loss corporation were used in a new business;
2. The extent of the termination of the existing work force of the loss corporation;
3. A price paid for the loss corporation in excess of the market value of the assets; and
4. Any other material deemed appropriate to the determination.

(c) No single factor shall be deemed on its own to be dispositive of the issue.

Example 1: B Corporation was wholly owned by a single stockholder. It operated a notably unsuccessful restaurant and built up significant net operating loss carryovers. The stockholder transferred 49 percent of his stock to an investor who has access to a recognized and uniformly profitable fast food franchise. B Corporation releases substantially all of its existing employees, disposes of its equipment and undertakes the fast food franchise business at a new location. Notwithstanding that B Corporation's sole stockholder sold less than 50 percent of his stock and the corporation still sells food in a heated state, the net operating loss carryovers to B Corporation become zero. The disposition of land, labor and capital until nothing remains except an empty corporate shell whose principal attributes are the apparent existence of an unused net operating loss carryover and some liquid capital in quest of an entirely new business is deemed to support the premise that the corporation was acquired for the primary purpose of the use of its net operating loss carryover. The economic substance of the transaction would have been to transfer the loss carryovers to a new business which is precluded by the rule.

Example 2: C Corporation was a manufacturer of buggy whips and button hooks. Due to a declining demand for its products it has built up significant net operating loss carryovers. C Corporation has only one stockholder who sells 50 percent of his capital stock to a woman who has invented a cheap and well-styled perpetual motion machine for which there is a clamorous demand. C Corporation changes its name to D Corporation, retools and hires additional employees. It expands its plants, closes out its old product lines and realizes huge profits in its rejuvenation. D Corporation's net operating loss carryovers from its buggy whip days are unaffected by any of the above circumstances and may be claimed as a net operating loss deduction. The economic substance of the transaction is a mere restructuring of its manufacturing product line. It did not change its business where it only reallocated its economic factors of production.

Administrative Correction to (c), added Examples to section. See: 23 N.J.R. 1024(a).

Case Notes

Surviving corporation could not carryover loss of a merged corporation. *Richard's Auto City, Inc. v. Director, Div. of Taxation*, 12 N.J. Tax 619 (1992), reversed, 14 N.J. Tax 436, certification granted 137 N.J. 167, 644 A.2d 614, reversed, reinstated 140 N.J. 523, 659 A.2d 1360.

Change in 50% or more of ownership of corporation may remove corporation's right to carryover net operating losses. *Richard's Auto City, Inc. v. Director, Div. of Taxation*, 12 N.J. Tax 619 (1992), reversed, 14 N.J. Tax 436, certification granted 137 N.J. 167, 644 A.2d 614, reversed, reinstated 140 N.J. 523, 659 A.2d 1360.

18:7-5.15 Net operating loss

(a) A net operating loss is the excess of allowable deductions over gross income used in computing entire net income.

(b) Neither a net operating loss deduction nor any exclusions from entire net income are allowable deductions in computing a net operating loss.

(c) There is no net operating loss for any year that a Corporation Business Tax Return (CBT-100) is not filed or if filed does not report entire net income as a negative amount.

New Rule, R.1986 d.26, effective February 3, 1986. See: 17 N.J.R. 2096(a), 18 N.J.R. 309(a).

18:7-5.16 Effect of audit adjustments

An audit adjustment to entire net income shall serve to revise the amount of any net operating loss for the year of the change and the net operating loss carryover to which it relates.

New Rule, R.1986 d.26, effective February 3, 1986. See: 17 N.J.R. 2096(a), 18 N.J.R. 309(a).

SUBCHAPTER 6. (RESERVED)

SUBCHAPTER 7. ALLOCATION

18:7-7.1 General instructions regarding allocation of net income

(a) No corporation, foreign or domestic (other than a corporation entitled and electing to report as an investment company, regulated investment company or real estate investment trust) is entitled to allocate any part of its entire net income outside New Jersey unless during the period covered by the return it maintained a regular place of business outside the State.

(b) In the absence of a regular place of business, 100 percent of its entire net income must be allocated to New Jersey.

(c) The mere ownership of assets outside New Jersey does not constitute a basis for allocating less than 100 percent of the taxpayer's net income to New Jersey.

(d) Where the taxpayer does not maintain a regular place of business outside New Jersey and its allocation factor is 100 percent and the taxpayer in fact pays a tax based on or measured by income to another state, see N.J.A.C. 18:7-8.3 which provides for the eligibility and method in computing a reduction in the tax for such taxpayer.

Amended by R.1985 d.54, effective February 19, 1985.
See: 16 N.J.R. 2999(b), 17 N.J.R. 476(b).

"Corporation" substituted for "taxpayer" and added "or real estate investment trust."

Amended by R.1994 d.186, effective April 18, 1994.
See: 26 N.J.R. 761(a), 26 N.J.R. 1696(b).

Statutory References

See N.J.S.A. 54:10A-6 as to how to determine allocation factor for taxpayer maintaining regular place of business outside New Jersey.

Case Notes

Failure to permit allocation to New Jersey corporation which owned rental property in Connecticut but had no regular employees working outside New Jersey held neither contrary to the scheme of the Business Tax Act, a burden on interstate commerce nor double taxation. *S.M.Z. Corp. v. Director, Div. of Taxation*, 5 N.J.Tax 232 (Tax Ct.1982), reversed and remanded 193 N.J.Super. 305, 473 A.2d 982 (App.Div. 1984).