NEW JERSEY CORPORATION BUSINESS TAX STUDY COMMISSION

Final Report

June 29, 2004

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New Jersey Corporation Business Tax Study Commission

Background

The Business Tax Reform Act, P.L. 2002, c. 40, ("BTRA") was approved July 2, 2002 and generally became effective for privilege periods beginning on and after January 1, 2002. Legislative Statements to Assembly Bill 2501 and Senate Bill 1556, the respective Assembly and Senate versions of the legislation, reflect the Legislature's intention to reform New Jersey's system of taxation of corporations and other business entities, through revision of the Corporation Business Tax Act and other laws.

Section 31 of the BTRA created a nine-member, bipartisan Corporation Business Tax Study Commission ("Commission"). The composition of the Commission is set forth on Appendix A. The Commission was charged with conducting a continuous study and evaluation of the corporate tax law reforms adopted pursuant to the BTRA, with reference to specific statutory questions.

The BTRA further directed the Commission to produce and provide a final report with findings and recommendations to the Governor and the Legislature, along with any legislative bills it desires to recommend for adoption by the Legislature, no later than December 30, 2003. If the Director of the Division of Taxation determines that the final report of the Commission has not been produced and provided by June 30, 2004, then the Director shall suspend the Alternate Minimum Assessment ("AMA"), which was imposed under the BTRA, for privilege periods commencing after December 31, 2004. If the Commission recommends the termination of the AMA, the AMA shall not be imposed for privilege periods beginning after December 31, 2004.

Since its appointment, the Commission has held regular meetings, including three public hearings. Public notice of its meetings was provided and its meetings were open to the members of the public. A summary of the Commission's meetings is attached as Appendix B.

On December 29, 2003, the Commission issued an interim report. That report contains transcripts of the Commission's public hearings and a statement of the principles of tax policy adopted by the Commission. The Commission's interim report is attached as Appendix C.

In addition to holding the mandated public hearings, the Commission solicited written comments from the public. A general request for comments was posted on the website of the Division of Taxation and comments were solicited from business, professional and public interest organizations. The Commission has received written comments from the New Jersey Business and Industry Association and the New Jersey Chamber of Commerce. Those comments are attached as Appendix D. The Division of Taxation provided the Commission with copies of public comments received in response to the special adoption and concurrent proposal of regulations with respect to the BTRA. See 35 N.J. Reg. 4310(a) for a summary of those comments and the Division of Taxation's responses. The Division of Taxation also provided substantive and technical comments and recommendations to the Commission for its consideration.

Scope and Limitations of the Commission's Review

The scope of the Commission, as provided by the authorizing legislation, was to study and evaluate the corporate tax law reforms adopted pursuant to the BTRA. As a result, the Commission's work should not be considered a comprehensive review of the Corporation Business Tax Act or a more general analysis of our State's business tax policy.

In the course of its deliberations, the Commission reviewed the reports of prior New Jersey tax commissions and the tax commissions of other jurisdictions.[1] Those commissions were typically tasked to review an established tax system and its performance over time rather than to assess the impact of recent statutory changes. The broader charges of those commissions permitted them the opportunity to provide more meaningful insights into appropriate reforms of state tax policy and state business tax policy.

The corporation business tax ("CBT") is not the only, nor is it necessarily the heaviest, state tax burden imposed on a corporation doing business in New Jersey. Corporations doing business in New Jersey also pay general sales and use taxes, property taxes, payroll taxes, special industry and other business activity taxes. An examination of changes to the CBT alone risks an overstatement of the volatility of business related tax receipts and an understatement of the contribution of business to total state revenues.

Given the Commission's responsibility to issue a final report by June 30, 2004, the only tax return data available was from the first year after the BTRA changes were made. Due to changing economic conditions and a host of other potential factors, it is difficult to evaluate one year's tax returns and determine trends and other information from which to draw conclusions. Moreover, the tax return data related to the BTRA changes that was available to the Commission remains incomplete. The tax return information of certain fiscal year taxpayers for the first tax period to which the BTRA applied was not reflected in the available data. The Division of Taxation estimates that the available data represents information from returns that historically reflect about 72% of annual CBT revenues for tax year 2002. Accordingly, information from returns reporting approximately 28% of CBT annual revenues for tax year 2002 was not available to the Commission.

Further, the retroactive effective date for most of the provisions of the BTRA masks any revenue effect resulting from the modification of taxpayer conduct in response to the BTRA changes. This information will only become available beginning with the processing of tax returns for years beginning on or after January 1, 2003. Thus, an ongoing evaluation of CBT revenues will be required to fairly assess the impact of the BTRA.

The Commission relied exclusively on the Division of Taxation's Office of Revenue and Economic Analysis for summary return information and analysis. The Commission did not have the resources to independently verify the accuracy of that data. It must be noted that the Commission believes that the resources of the Division of Taxation are insufficient to provide the type of data and analysis needed

[1] See the compilation of state tax study commission reports prepared by the National Conference of State Legislatures at http://www.ncsl.org/programs/fiscal/taxcomms.htm.

to adequately address the needs of the Commission. Demographic and historical tax return information reported by taxpayers is too frequently incomplete or unreliable. The State's information systems available to analyze this information are inadequate. These factors severely hampered the ability of the dedicated but over-committed professional staff of the Office of Revenue and Economic Analysis to assist the Commission.

Finally, the Commission's ability to conduct an in-depth study was severely limited by the absence of any dedicated funding. The BTRA permitted the Commission to appoint an Executive Director. However, no funds were appropriated for that purpose. Without an appropriation of funds to provide the Commission with an Executive Director or to otherwise support its work, the Commission relied exclusively on the volunteer efforts of its members and the support of the Division of Taxation.

The Commission believes that New Jersey would benefit greatly from a further analysis of its tax policies. This new study should not be limited in its focus and should examine all aspects of taxation in New Jersey. Additionally, the group performing the study should be appropriately funded and given sufficient time to allow it to do its task. This new study group should include members who understand the ramifications of potential changes to current tax laws.

The Commission's Findings and Recommendations

The BTRA directs the Commission to conduct a continuous study and evaluation of the corporate tax law reforms adopted pursuant to the BTRA. This report addresses the specific questions posed to the Commission, along with the Commission's findings and recommendations.

1. Whether the corporation business tax burden is fairly and equitably borne and distributed among corporations that are subject to the tax?

2. Whether, without reducing anticipated revenues from that tax, the tax burden could be more fairly and equitably borne and distributed?

The Commission determined that these questions are inextricably linked. Through the process of identifying areas where the CBT is not fairly and equitably borne and distributed, the Commission also identified changes that could make the CBT more fairly and equitably borne and distributed.

Based on available tax return data, the Commission was unable to evaluate the relative CBT burden borne among the various corporations subject to tax. Meaningful historical demographic taxpayer data is not available to the Division of Taxation. Such information is necessary to make a fair evaluation and comparison of the distributional characteristics of the CBT before and after enactment of the BTRA.

The revenue increases resulting from the BTRA have exceeded anticipated revenues. CBT revenues for State Fiscal Year 2003 were targeted at $1.823 billion. Actual CBT revenues for that period were $2.614 billion, $791 million more than anticipated. CBT revenue projections for subsequent fiscal years also exceed the original revenue projections for those years.

The Commission recognizes that certain provisions of the BTRA increased the fairness and equity of the CBT. However, the Commission has identified certain provisions of the BTRA that have resulted in the CBT burden being unfairly and inequitably borne by certain corporations. The Commission finds that many of those provisions can be revised to make the CBT more fairly and equitably borne and distributed without reducing actual CBT revenues below the original revenue goals set for the CBT, as modified by the BTRA.

The following is a summary of those provisions:

Suspension of Net Operating Loss Deduction

Background

The BTRA suspends the application of net operating loss deductions for tax years beginning between January 1, 2002 and December 31, 2003. The usual seven year carryforward (15 years for certain high-technology corporations) is extended for the period a loss is suspended by reason of the BTRA.

Analysis

The net operating loss suspension affected a great many companies. Of the 107,000 corporations for which the Division of Taxation has data, over 44,000 corporations reported having net operating losses available for use. Over 18,100 corporations who had a CBT liability greater than their AMA liability (and thus paid the CBT) would have been able to use their net operating loss carryforwards in 2002 were it not for the suspension. More than half the corporations paying a non-minimum CBT were unable to utilize their net operating losses. These corporations could have offset $280 million in tax liabilities with prior year operating losses if the net operating loss deduction had not been suspended.

Testimony received at the Commission's hearings and provided to the Commission in written comments was critical of the suspension of the net operating loss deduction. Further, the Commission was specifically asked by commentators to recommend corrections that would address the unintended effect of the suspension on corporations that have realized extraordinary gains, such as those resulting from the sale of substantially all of a business's assets. The deduction of net operating losses could be permanently denied to these corporations if they did not have income after 2003.

The Commission believes that the deductibility of net operating losses advances the fairness of the CBT. The allowance of net operating loss deductions also contributes to the CBT's equity and efficiency. Simply stated, the allowance of net operating loss deductions is a beneficial tax rule that allows a taxpayer to deduct losses incurred in one year against income realized by the taxpayer in subsequent years. The use of annual accounting periods to measure an entity's tax liability without the allowance of a net operating loss deduction can result in the overstatement of an entity's taxable income as compared to its economic income. To suspend, or in certain cases to effectively disallow, the deduction of net operating losses denies taxpayers the ability to smooth out annual fluctuations in earnings flow. This can adversely affect smaller firms, which are more likely to be subject to the volatility of the business cycle, and new or risky ventures which are likely to incur initial losses.

Recommendations

The Commission recommends that the net operating loss deduction be fully restored. The suspension of net operating loss deductions compromises the principles of equity and fairness and affects many corporate taxpayers having the least ability to pay. A net operating loss deduction suspension period compromises the principle of certainty, depriving taxpayers of a reasonable, predicable tax environment essential to attracting and retaining business.

Further, the Commission recommends that the CBT be amended to permit the filing of amended returns for the 2002 and 2003 tax periods to allow the deduction of net operating losses suspended by the BTRA and to permit the refund of the resulting tax overpayments.

Royalty and Interest Addback Provisions

Background

The BTRA disallows certain otherwise deductible business expenses paid to affiliates. Taxpayers are required to add back those expenses in determining their taxable income.

Specifically, the BTRA restricts the deductibility of interest expenses paid to affiliates and the deductibility of royalties, other intangible expenses and costs and related interest paid to affiliates. Exceptions to the addback provisions address certain limited "non-tax avoidance" situations. However, the exceptions contained in the interest expense and intangible expense disallowance provisions are not identical.

Approximately ten other states have enacted intangible expense disallowance provisions and approximately three other states have enacted interest expense disallowance provisions. However, none of the states with interest disallowance provisions require taxpayers to guarantee a debt to take advantage of a "conduit exemption" from the statutory addback.[2]

Analysis

The addback provisions were designed to address tax avoidance transactions that allow corporations to reduce their New Jersey taxable income by deducting expenses paid to affiliated corporations located in states that do not tax the affiliated corporation on the income generated by the payment of those expenses. However, the addback provisions go beyond merely denying expense deductions in tax avoidance situations. The addback provisions disallow expense deductions having little or nothing to do with the purported abuses that those provisions were designed to address.

In an effort to mitigate the impact of the addback provisions on legitimate expense deductions, several exceptions to the statutory addback were created. The Division of Taxation, in regulations and informal announcements, has for the most part reasonably interpreted these provisions, thus providing some relief for ordinary business transactions that were unfairly lumped together with the targeted tax avoidance transactions. Nevertheless, many transactions entered into for valid non-tax reasons still may be subject to the addback provisions.

For example, New Jersey's "conduit exception" places a "form over substance" requirement on a transaction by requiring the taxpayer to guarantee the debt owed to unrelated third parties. As a result, two economically identical transactions are treated differently based on whether a specific provision is included in a loan agreement. The exceptions to the interest expense addback provision also do not consider legitimate "cash sweep" transactions where there may be no third-party debt. Historically, the Division of Taxation has required taxpayers to impute interest expense on similar transactions, however, these otherwise arms-length interest charges would not qualify for this exception.

Regulations issued by the Division of Taxation have attempted to mitigate the potential for double taxation. For example, N.J.A.C. section 18:7-5.18(a)(2) (along with similar but not identical wording in N.J.A.C. section 18:7-5.18(b)(3)) provides relief in instances where "the taxpayer establishes that the disallowance is unreasonable by showing the extent the related party pays tax in New Jersey on the income stream." However, these provisions only consider tax paid to New Jersey and exclude taxes paid to other states. Conceivably, the taxes paid to other states could exceed the tax paid to New Jersey, dispelling the notion that the transaction was tax motivated. Yet the interest expense would not qualify for this exception, nor would it necessarily qualify for the "three percent exception" included in the BTRA, since that exception unfairly allows a taxpayer to consider only one other state in

[2] An interest addback is not required under a "conduit exemption" when the taxpayer pays interest to an affiliate who, in turn, pays interest to an unrelated third party.

determining whether tax was paid "equal to or greater than a rate three percentage points less than the rate of tax applied to interest by this State."

The "three percent exception" also contains a discrepancy with regard to the "rate of tax." The Division of Taxation's regulations require the use of an effective tax rate, that is, the statutory tax rate multiplied by the allocation factor. However, the statute uses the term "rate of tax," and does not contemplate the use of an effective tax rate.

Moreover, the statute relies unduly on the determination of the Director of the Division of Taxation as to when an addback is "unreasonable." The Commission is concerned that through its regulations, the Division of Taxation has construed this exception narrowly.

Recommendations

The Commission recommends that the intangible and related expense addback provision be amended to strike the language requiring taxpayers to prove by "clear and convincing evidence as determined by the director" that an addback of a specific expense is unreasonable. That language confuses and obfuscates the legal standard of review of a determination regarding whether an addback would be unreasonable. To the extent that such language provides a higher standard of judicial review than is provided for almost any other determination by the Director, that higher standard of judicial review is unnecessary.

The Commission recommends that the intangible and related expense addback provision be amended, either statutorily or by regulation, to provide that an addback regarding any transactions that are conducted based on arm's-length terms, at an arm's-length consideration, with a valid non-tax business purpose and with sufficient economic substance would be unreasonable. It is currently unclear whether expense addbacks related to such transactions would be unreasonable. Massachusetts has taken a position similar to what the Commission is recommending regarding its addback provisions.

The Commission recommends that the intangible and related expense addback provision be amended, either statutorily or by regulation, to clarify that a taxpayer who undertakes a transaction for a valid non-tax business purpose as well as a tax-motivated business purpose remains eligible for the "conduit exemption" that excludes from the addback requirements any payments to related parties that are in turn paid to unrelated parties.

The Commission recommends that the intangible and related expense addback provision be statutorily amended to permit taxpayers to deduct royalty payments directly or indirectly received from a related member from their entire net income unless such royalty payment would not be required to be added back under the intangible and related expense addback provision. A similar provision was enacted as part of New York State's and New York City's intangible and related expense addback provisions.

The Commission also recommends the repeal of the interest expense addback provision. The inclusion of interest expenses and costs directly or indirectly related to the acquisition, management, ownership and maintenance of intangible property as an expense that is required to be added back in the intangible and related expense addback provision sufficiently addresses any concerns regarding abusive tax avoidance transactions. However, the interest expense addback provision, although addressing the same transactions covered under the intangible and related expense addback provision, also affects a large number of legitimate intercompany transactions. New York State and New York City had enacted similar interest addback provisions last year but changed course and repealed those provisions in October 2003. Repealing the interest expense addback provision would also address the Commission's following concerns:

- The unfairness of the requirement that a taxpayer guarantee a debt with an unrelated party to take advantage of the "conduit exemption."
- The unintended consequence that the interest addback provision requires the addback of interest on intercompany cash "sweep" transactions.
- The unclear statutory language that requires a taxpayer demonstrate that the addback of a specific interest expense is unreasonable based on "clear and convincing evidence as determined by the director."
- The potential addback of otherwise valid intercompany transactions that are based on arm's-length terms, at an arm's-length consideration, with a valid non-tax business purpose and with sufficient economic substance.
- The potential unfairness resulting from the Division of Taxation's interpretation of the "three percent" exemption to require the use of an effective tax rate in place of the statutory mandated "rate of tax."

Throwout Rule

Background

Under the CBT, corporations are required to determine the portion of their taxable income that is attributable to New Jersey based on the average of each corporation's property, payroll and sales within the state divided by the corporation's property, payroll and sales everywhere. The receipts factor is double weighted.

The BTRA seeks to tax income earned outside the state of New Jersey through the adoption of a "throwout rule." Under this rule, the denominator of the receipts factor is reduced by the amount of receipts that are attributed to states where the corporation is not subject to tax. The throwout rule causes a greater percentage of a corporation's income to be assigned to states where the corporation is subject to tax.

West Virginia was the first and only state to adopt a throw-out rule by statute. In the absence of express statutory authority, Pennsylvania and Kentucky have unsuccessfully sought to administratively impose the throw-out rule in their states. No other states have enacted a throwout rule.

Analysis

Some commentators have characterized the ability of certain corporations to have less than 100% of their income taxed in the jurisdictions where they operate as a "loophole" and the enactment of the throwout rule as a "loophole closer." However, the Commission does not share this view. The portion of a corporation's income that is not taxed arises from either the decision of a jurisdiction not to exercise its full taxing authority (e.g. Nevada's decision not to impose a corporate income tax) or the decision of the Congress to limit the taxing authority of the states pursuant to the Commerce Clause of the United States Constitution. Each of those decisions is a reasoned implementation of tax policy by the respective policy maker. Apportionment modifications like the throwout rule run counter to legitimate policy decisions made by other states and by the federal government.

Some commentators have suggested that the throwout rule may violate the Commerce and Due Process Clauses of the United States Constitution. The Commission declines to consider the constitutionality of the throwout rule.

The apportionment rules of the CBT should measure the income of a corporation fairly attributable to its activities in New Jersey. The Commission finds that the CBT statute identifies the factors appropriate to that purpose. The property factor takes into account capital employed within the taxing state; the payroll factor represents the labor employed within the taxing state; and the sales factor (without the throwout rule) recognizes the market provided by the taxing state.

The use of a throwout rule does not more fairly measure a corporation's business activities in a state. Instead, it augments a state's share of a corporation's income by seeking to fully account for all of a corporation's income by dividing it among the states in which the corporation is subject to tax. The throwout rule has the effect of increasing the state's share of a corporation's income not based on the corporation's activities within the state but instead based on the corporation's activities occurring outside of the state. The throwout rule is inconsistent with the basic premise of fair apportionment which requires each factor of the apportionment formula to reflect how the income of a corporation is earned.

Recommendation

The Commission recommends the repeal of the throwout rule. The Commission does not believe that the BTRA's addition of a throwout rule to the CBT receipts factor provides a more precise or appropriate measure of a corporation's activities in this state. Instead, it increases the risk of overstating the income from those activities.

Nonoperational Income

Analysis

The BTRA changed the definition of operational income to provide that nonoperational income, which is income generated from activities outside a corporation's regular trade or business operations, is not allocated (apportioned based on the percentage of the corporation's property, payroll and sales within and outside New Jersey) but is specifically assigned. However, the method of assigning nonoperational income to New Jersey is not specified for the vast majority of corporations. The method of assignment is only specified for corporations with their principal place of business in New Jersey and, in that case, the nonoperational income is assigned to New Jersey "to the extent permitted under the Constitution and statutes of the United States."

The Commission believes that New Jersey's provisions regarding nonoperational income should be more closely aligned with other states' nonbusiness income statutes which are based on a similar but not necessarily identical concept. Those statutes provide specific rules for assigning nonbusiness income based on a model uniform act. The Uniform Division of Income for Tax Purposes Act ("UDITPA") is a model act that provides for the allocation and apportionment of income among the various states. UDITPA was drafted to provide a uniform method of determining each state's share of a multistate corporation's income. UDITPA has been adopted in whole or in part by most states.

Recommendations

The Commission recommends that New Jersey adopt the UDITPA nonbusiness income concept in place of its existing nonoperational income concept. If the State is unwilling to adopt the nonbusiness income concept in its entirety, the Commission recommends the adoption of the UDITPA sourcing rules for nonbusiness income and the application of those rules to source nonoperational income under New Jersey's existing statute.

Partnership "Withholding" Tax Payment

Background

Partnerships, including limited liability companies taxed as partnerships, generally are not subject to tax on their income. Instead, each owner of a partnership interest is required to pay tax on the owner's distributive share of the partnership's income.

Taxpayers are generally required to make periodic installment payments of estimated tax. In computing the amount required to be paid as estimated tax, a taxpayer must take into account any distributive share of partnership income includible in the income of the taxpayer.

Prior to enactment of the BTRA, reporting compliance among corporate and noncorporate nonresident taxpayers was poor and enforcement was difficult.[3] The BTRA enacted a partnership "withholding" mechanism by imposing a tax upon most partnerships that have one or more non-resident partners. Generally, partnerships must make a payment on the share of the income of each nonresident owner at a 6.37% rate for owners subject to the Gross Income Tax Act and at a 9% rate for other owners. The payment is based upon the distributive share of the partnership's income multiplied by the partnership allocation fraction determined under the corporate business tax rules.

The tax is due and payable on the fifteenth day of the fourth month following the close of the year. No provision is made for the payment by the partnership of estimated tax installments. The partnership's payment is credited to separate accounts for each owner when paid and may then be credited against the owner's New Jersey tax liability.

Analysis

Testimony received at the Commission's hearings and in written comments was critical of the failure of the BTRA to coordinate the provisions requiring partnership "withholding" payments with the estimated tax obligations of the nonresident partners. A partnership is not able to claim a credit or take into account estimated payments made by the nonresident partners. Nonresident partners are not relieved of their obligation to make periodic estimated tax payments with respect to their share of partnership income and the creditable partnership payment is made after all

[3] L.2001, c.136 attempted to resolve this issue by requiring a partnership that did not have the consent of certain partners to pay, in a manner similar to withholding, a CBT liability on behalf of the nonconsenting partners.

estimated tax payments of a partner are due. As a result, the State may be holding twice the tax liability of the nonresident partner until the partner files its New Jersey tax return. The Division of Taxation acknowledges that under the BTRA the state receives a "float" on these payments. By way of illustration, a partnership with one nonresident 50% corporate partner has income of $2,000 for the taxable year. Anticipating its distributive share of income, the corporate partner makes estimated tax payments of $90 ($2,000 x 50% x 9%) with respect to its share. With its partnership return, the partnership makes its "withholding" payment of $90 ($2,000 x 50% x 9%). At the time for filing its corporate return, the corporate partner has total credits of $180 ($90 + $90) paid with respect to a total liability of $90. A 100% overpayment will be reflected on the corporate partner's return.

The Commission believes that the extension of the partnership "withholding" requirement to all nonresident partners has significantly enhanced compliance under the Corporation Business Tax Act and the Gross Income Tax Act. However, the design of the tax payment mechanism necessarily results in tax overpayments that can be substantial as a percentage of tax actually due. The Commission does not believe this compulsory overpayment is fairly required of nonresident taxpayers.

Recommendations

The Commission recommends that the partnership "withholding" requirement be amended to require the payment of estimated tax installments by the partnership and that the installment payments be allowed as a credit against the estimated tax obligations of nonresident partners. The coordination of the tax payment obligations of the partnership and its nonresident partners will preserve the tax compliance improvements while addressing the inequity and potential economic hardship that results under the current mechanism.

Annual Per Partner Fee

Background

The BTRA imposed an annual filing fee on any partnerships, limited liability companies and limited liability partnerships having New Jersey source income. The fee is $150 per partner with a maximum fee of $250,000 per partnership. Certain investment clubs are excluded from this fee and the fee is reduced to the extent that a partnership has non-resident partners.

Analysis

Many commentators have mentioned that this fee could be significantly higher than any tax imposed on the income of the partnership. If a partnership has losses, then these annual fees are potentially even more unfair. Moreover, to impose a fee based on the number of partners rather than the partnership's activities seems potentially harsh. Two partnerships, one with three partners and another with several hundred partners, could have identical economic activities but would have a very different burden pursuant to this fee. Another problem with this fee is how it is imposed on tiered partnerships which may cause the payment of multiple fees on behalf of the same partner. Similarly, imposing the fee on family partnerships or other family businesses may subject these small businesses to significant additional taxation.

Finally, the Commission recognizes that many investment partnerships may be subject to these annual fees and that these fees may have negatively impacted their businesses. Although income from investment partnerships should generally not be considered to be New Jersey source income, this issue is not entirely clear. It has been suggested that the imposition of this fee on these investment partnerships will have significant adverse economic consequences to the state.

New York has recently enacted a similar per partner fee on limited liability companies, but with a lower maximum fee of $25,000 per partnership. If New Jersey were to lower its maximum fee to an amount similar to New York's, it may significantly reduce some of the inequities.

Recommendation

The Commission recommends that the per partner fee be reevaluated and modified to reduce the inequities and eliminate any negative economic impact to the State.

3. Whether profitable corporations doing business in New Jersey can avoid paying their fair share of taxes by using tax minimization or avoidance strategies that may include cross-border tax avoidance such as isolation of nexus-creating activities or the transfer of certain income to holding companies in low tax or tax haven jurisdictions, intragroup corporate transfer pricing techniques, use of special deductions or exclusions that manipulate income and costs between parent-subsidiary or affiliated companies that benefit large or multinational or multistate corporations over smaller businesses operating wholly within New Jersey?

The Commission is unable to reach a definitive conclusion regarding whether corporations doing business in New Jersey are able to avoid paying their fair share of taxes because of the insufficiency of the data available to the Commission. The Commission finds that the provisions enacted by the BTRA curbed many abusive tax avoidance strategies that had been employed within the state. The Commission also finds that those provisions may have unfairly increased the tax for taxpayers who were not engaged in abusive tax avoidance strategies. The Commission also finds that while other tax minimization strategies may still be available, the Division of Taxation has sufficient statutory authority in existing law to address those remaining strategies.

Analysis

One of the statistics advanced to support the BTRA revisions was that 30 of the top 50 employers in the state paid no CBT tax or the minimum CBT for the 2000 tax year. Although the Commission did not have access to the historical data supporting that claim, the Commission requested the Division of Taxation's Office of Revenue and Economic Analysis to review how those 30 employers reported their taxes as a result of the changes enacted by the BTRA. Information provided to the Commission indicates that of the 30 employers, six were pass-through entities that were not required to pay the CBT (one of these six employers paid the $2,000 CBT minimum tax for reasons that are not apparent to the Commission). To date, tax returns have not been received for five of the employers. Of the remaining 19 employers, eleven paid an aggregate non-minimum CBT in 2002 of $27 million, seven paid an aggregate AMA of $26 million, and one paid the minimum tax of $2,000. The Commission was not provided sufficient data to determine the extent that specific BTRA provisions affected each of those corporations. Further, the Commission did not have sufficient data to determine whether the increase in tax for those corporations was fair and equitable.

The Commission acknowledges that only very preliminary conclusions can be drawn from the revenues generated from the BTRA provisions that were broadly characterized in the associated legislative history as "loophole closing" provisions.[4] These conclusions should be reexamined as additional details become available regarding State Fiscal Year 2003 and as revenue information for subsequent fiscal years becomes known.

The Division of Taxation has advised the Commission that the allocation of CBT collections between CBT baseline revenues and the BTRA reforms and the further allocation of receipts among the "loophole closing" provisions are subject to continuing analysis and revision. Further, there is no CBT return information available for tax years beginning in 2003, as many of the tax returns for these periods will not be filed until October 15, 2004 which is the extended return filing deadline for calendar year taxpayers. Accordingly, the Commission has less than one year's data to analyze. It is also significant that the BTRA was enacted in June of 2002 and was retroactive to the beginning of the year. It is unlikely that taxpayer conduct in response to the BTRA reforms could have changed in time to be reflected in the 2002 results. As such, it is difficult to assess the recurring impact of the "loophole closing" provisions.

The "loophole closing" provisions have reached the revenue goals projected for the 2002 tax year. However, the resulting distribution of the revenue among the various provisions differs significantly from the revenue projections.[5] Only analysis of subsequent fiscal year results will confirm that the reforms and enhanced administrative powers of the Director of the Division of Taxation will maintain the CBT base.

The Commission finds that a corporation's fair share of New Jersey taxes can only be based upon its activities conducted within this state. Consistent with the United States Constitution's limitations on a state's taxing power, New Jersey does not have the right to tax activities conducted or income truly earned outside of its borders.

The Commission recognizes that corporations have the ability to lawfully structure their operations as they wish. An intercompany transaction with a valid non-tax business purpose and sufficient economic substance that is conducted based on arm's-length terms and consideration is not an unfair avoidance of New Jersey tax merely because it reduces the corporation's CBT burden. However, the Commission also recognizes that a transaction that does not have a valid non-tax business purpose, sufficient economic substance and is not conducted based on arm's-length terms and considerations is an abusive tax avoidance transaction.

Whether a transaction represents an abusive tax avoidance transaction or a legitimate business transaction is inherently a question of fact. Attempts to address these situations with a broad legislative fix generally fail for one of two reasons. In one case, the legislative fix is overbroad, ensuring that an abusive tax avoidance transaction cannot take place. Unfortunately, such broad legislation tends to capture

[4] The Commission does not necessarily adopt this characterization with regard to each such provision.

[5] These revenues are detailed on as part of Appendix F.

and tax legitimate transactions as well as abusive tax avoidance transactions. So, in order to increase the tax paid by corporations that utilize abusive tax avoidance strategies, the state unfairly taxes legitimate business transactions. Clearly, this is an unfair result. In the second case, the legislative fix is extremely focused, strategically aimed at specific abusive tax avoidance transactions. The problem with that approach is that such a focused rule must have many exceptions to protect legitimate business transactions. Those exceptions make the rule vulnerable to additional opportunities for corporations to engage in abusive tax avoidance strategies, which ultimately result in the failure of the focused legislative fix.

Ultimately, the only way to determine if a corporation is paying its fair share of an income based tax is to examine all the relevant facts and circumstances surrounding that specific taxpayer. The Division of Taxation has many statutory tools available to address abusive tax avoidance transactions. The Commission believes that the Division of Taxation can minimize any abuse of the existing tax system if it is provided with resources sufficient to enable it to effectively utilize these statutory tools.

The CBT contains numerous provisions granting the Division of Taxation the power to discover and correct abusive tax avoidance strategies. Those provisions are over and above the specific "loophole closing" provisions adopted in the BTRA. N.J.S.A. 54:10A-10 is a broad pre-BTRA anti-abuse provision, which provides significant powers to the Director of the Division of Taxation to adjust the tax liability of a corporation if a taxpayer (i) fails to maintain adequate accounting records, (ii) conducts its business in a manner that distorts the amount of its true income (iii) maintains a place of business outside New Jersey (iv) makes agreements or other arrangements for the purpose of evading tax or (v) improperly reflects its activities, income or expenses. This provision is broad enough to deal with the vast majority of abusive tax avoidance strategies, including abusive intercompany transfer pricing transactions. N.J.S.A. 54:10A-8, also a pre-BTRA provision, gives the Director of the Division of Taxation the authority to adjust a corporation's apportionment factors in the event that those factors do not properly reflect the corporation's business activity in the state.

The BTRA amendment to N.J.S.A. 54:10A-2 expands the nexus provisions of the CBT to permit New Jersey to tax corporations to the extent permitted by the United States Constitution.

The BTRA addition of 54:10A-10(c) provides the Director of the Division of Taxation with the ability to compel the filing of a consolidated return by related parties if a taxpayer cannot demonstrate, by clear and convincing evidence, the true earnings from its business carried on in New Jersey. Under that provision, the taxpayer is responsible for showing that its intercompany transactions are at fair compensation and that its tax return reflects its true earnings. In the preamble to the regulations promulgated with regard to the BTRA, the Division of Taxation acknowledged that the BTRA provided the Director with strong statutory authority to enforce compliance with corporate tax laws by related parties that shift income to related corporations located in low tax or no tax jurisdictions. The regulations adopt the view that the BTRA has broadened the existing law to go beyond a "fair market" and "fair price" analysis alone in making a determination of "true earnings." To avoid a forced combination or consolidation, a taxpayer must now show by "clear and convincing" evidence that its tax report discloses its true earnings. The forced combination or consolidation of related corporations is counter to the CBT's general requirement of separate reporting. The Commission understands that, for this reason, it is the intention of the Director of the Division of Taxation to exercise this power sparingly. The Commission supports the Division of Taxation's intention to limit its use of the forced consolidated reporting provision.

Conclusions

The Commission concludes that for the fiscal year ending 2003, the "loophole closing" provisions yielded substantial additional revenues primarily from the interest expense and intangible expense addback provisions. The Commission cannot predict whether that objective will continue to be achieved in fiscal 2004 due to the limited data available. As discussed above, it is not possible to determine if those provisions have achieved the stated legislative objective of having each company pay its fair share of taxes as this analysis requires detailed knowledge of each taxpayer's situation and that information was not available to the Commission. That being said, it is very difficult to address abusive tax avoidance transactions with statutory "loophole closing" provisions without the risk of significantly increasing the tax of some compliant taxpayers and thereby creating an unfair situation for them.

The appropriate use of available enforcement techniques should control any abuse of the system. In order for enforcement to be effective, the Division of Taxation requires sufficient statutory authority to investigate abusive tax avoidance strategies, the audit resources necessary to identify and successfully challenge such transactions and an appropriate penalty structure that deters unacceptable taxpayer behavior. The Commission believes that the Division of Taxation has sufficient authority under the statute to successfully challenge abusive tax avoidance transactions. The Commission does not express an opinion as to whether the Division of Taxation has sufficient audit resources or whether the current penalty structure is appropriate to deter unacceptable taxpayer behavior because those issues are beyond the scope of the Commission's mandate.

4. Whether the revenue and distributional impacts of the changes to the Corporation Business Tax Act enacted pursuant to the BTRA yield the recurring revenue goals that New Jersey must achieve to bring long-term structural balance to State finances?

Frequently characterized as one of the "big three" state taxes, together with the gross income tax and the sales and use tax, the CBT has since 1991 represented, on average, only 7.2% of total state tax revenues.

The BTRA resulted in a substantial increase in the amount of CBT revenues collected during State Fiscal Year 2003. For State Fiscal Year 2003, the CBT contributed 10.5% of total state tax revenues. This increase exceeded the projections of the State Treasurer and the Office of Legislative Services made at the time of enactment. See Appendix E.

CBT collections for State Fiscal Year 2003 were $2.452 billion. CBT collections plus collections from other changes made by the BTRA that impacted the gross income tax yielded total cash collections of $2.613 billion. This total is $790 million (or 43%) more than the $1.823 billion that was forecast at the time the BTRA was adopted.

The changes made by the BTRA yielded $1.415 billion of additional revenue. This revenue is $462 million (or 48%) more than the $953 million of additional revenue that was forecast at the time the BTRA was adopted.

The remaining $328 million of collections in excess of the original BTRA forecast is apparently due to an improvement of general economic conditions in the state. The actual CBT collections without any impact of the BTRA were $1.198 billion. That amount is $328 million (or 38%) higher than the pre-enactment projection of $870 million.

It is important to note that some provisions of the BTRA have a one-time impact on collections. The recurring revenue impact of the BTRA for State Fiscal Year 2003 was $1.832 billion, which is $419 million or 30% higher than was originally projected at the time the BTRA was enacted.

A schedule setting forth the estimated receipts for each provision in the BTRA for State Fiscal Year 2003 is attached as Appendix F. That schedule is based on information provided by the Division of Taxation's Office of Revenue and Economic Analysis.

It is clear that the revenue raising provisions of the BTRA exceed all expectations and contributed substantially to the State's fiscal condition. Given that the recurring impact is also well in excess of expectations, it is likely that the CBT will continue to exceed original expectations in the coming fiscal years.

Corporation Business Tax Excess Revenue Fund

Section 32 of the BTRA created a restricted reserve fund known as the "Corporation Business Tax Excess Revenue Fund," into which amounts in excess of the annual target for CBT revenues will be deposited. A special rule applicable to State Fiscal Year 2003 provides that if the total General Fund revenue for State Fiscal Year 2003 is less than the amount certified for that year, then the amount credited to the fund shall be reduced by that difference.

Balances in the fund are to be available for appropriation in State Fiscal Year 2004 and State Fiscal Year 2005 to assist in covering shortfalls in CBT collections from the target amount for the fiscal year. If there is a balance in the fund on December 30, 2005, the Director of the Division of Taxation is required to adjust CBT rates for privilege periods beginning in calendar 2006 downward by an amount sufficient to equal the balance in the fund.

The target for State Fiscal Year 2003 was set at $1.823 billion. The targets for subsequent fiscal years are to be calculated based on the target for the prior fiscal year multiplied by the weighted average of the rate of growth of collections from the gross income tax and the sales and use tax.[6]

For State Fiscal Year 2003, General Fund revenue was less than the amount certified for that year. Accordingly, the amount credited to the fund was reduced by that difference. The reduction reduced the fund balance to zero. For State Fiscal

[6] The rate of growth is calculated for each by comparing the anticipated revenue from each source certified by the Governor upon approval of the annual appropriation act for the current year against the amount of money actually deposited from collections of each in the immediately preceding fiscal year, the deposits to be determined from the annual financial report of the State for the immediately preceding fiscal year.

Year 2004, the target is $1.913 billion. The Treasury's most recent projection of CBT revenue for State Fiscal Year 2004 is $2.5 billion. Based on these projected CBT revenues, the BTRA would require $587 million to be allocated to the fund. However, the budget for State Fiscal Year 2005 provides that no State Fiscal Year 2004 CBT revenues shall be credited to the fund but shall instead be available as undesignated funds in the General Fund.[7]

The Commission acknowledges that the State's treatment of the Excess Revenue Fund is in line with the statutory language within the BTRA creating that fund. However, the Commission recognizes that the State's treatment of the Excess Revenue Fund may not be in line with the expectations of many taxpayers who anticipated a reduction in tax based on the actual CBT revenues for State Fiscal Year 2003 and State Fiscal Year 2004 exceeding the projected CBT revenues for those fiscal years.

5. Whether New Jersey and its corporation business taxpayers would be better served by the use of a combined taxation under the unitary business concept?

The Commission recognizes that the use of a unitary combined reporting system of taxation has advantages and disadvantages for both the State and the state's corporate taxpayers. Based on the information currently available to the Division of Taxation, the Commission cannot estimate the effect of using unitary combined reporting on the state's CBT revenues. The Commission concludes that the use of unitary combined reporting requires further study and debate prior to being implemented in New Jersey.

Background

Currently, sixteen states (Alaska, Arizona, California, Colorado, Hawaii, Idaho, Illinois, Kansas, Maine, Minnesota, Montana, Nebraska, New Hampshire, North Dakota, Oregon and Utah) require unitary combined reporting. Florida enacted unitary combined reporting in 1983, only to repeal it in 1984. Connecticut adopted unitary combined reporting in 2003 and repealed it a week later. On May 21 the Vermont General Assembly approved legislation requiring mandatory unitary combined reporting for its state corporate income tax beginning January 1, 2006. That legislation was signed by Vermont Governor James Douglas on June 7, 2004.

Under the unitary combined method of taxation, each affiliated corporation that is part of the same unitary business is required to file a combined return. Although the unitary business principle is able to be simply stated, there are many different approaches adopted by states in implementing a unitary combined reporting system of taxation. Additionally, there are many issues related to unitary combined reporting that must be addressed prior to enacting a unitary combined reporting system of taxation. See the Combined Reporting Issues List for MTC Income and Franchise Tax Uniformity Subcommittee which is attached as Appendix G. The decisions

[7] Notwithstanding the provisions of section 32 of P.L. 2002, c.40 (C.52:9H--38) to the contrary, revenues derived from the CBT during fiscal year 2004 shall not be credited to the "Corporation Business Tax Excess Revenue Fund" but shall be available as undesignated funds in the General Fund except as are dedicated by Article VIII, Section II, paragraph 6 of the State Constitution. Language Provisions, General Fund Provisions, NJ State Budget FY 2004 – 2005.

regarding those issues will, in large part, determine whether unitary combined reporting is perceived as being a fair method of corporate taxation.

Analysis

Some commentators have suggested that if they were starting from scratch, they would implement a unitary combined reporting system of taxation. Unitary combined taxation remains controversial and may be perceived as being unfriendly to business. The move to unitary combined reporting would entail a substantial educational and training effort on behalf of the Division of Taxation. Every auditor within the Division of Taxation would have to be educated and trained on the theory and practice of unitary taxation. Additionally, many in-house corporate tax personnel and corporate tax professionals would also have to be educated regarding advising clients and preparing returns under unitary combined reporting.

The shift to unitary combined reporting could result in a substantial amount of litigation regarding whether certain related companies are part of a unitary group for New Jersey tax purposes. Also, there is likely to be a significant amount of controversy and litigation regarding the effect that shifting to a unitary combined reporting system has regarding the applicability and interpretation of New Jersey tax provisions that were designed under a separate-company tax regime (e.g. net operating loss deductions, various tax credits, throwout rule, intangible expense addback provisions, statutes of limitation, etc.)

It is unclear how unitary combined reporting would affect New Jersey's CBT revenues. Proponents of a unitary combined reporting system of taxation assert that there would be an increase in revenues due to the resulting closing of tax "loopholes." However, New Jersey has already realized a substantial revenue increase as a result of eliminating the benefit from abusive tax avoidance transactions. The most significant limitation to determining the revenue effect of combined reporting is that the information needed to make that determination is not currently provided on New Jersey corporate tax returns.

Recommendation

The Commission concludes that the use of unitary combined reporting requires further study and debate prior to being implemented in New Jersey.

6. Should the Commission recommend the termination of the alternative minimum assessment for privilege periods beginning on or after January 1, 2005?

Background

The BTRA requires corporations to pay the greater of their normally computed CBT liability, the increased minimum tax or the Alternative Minimum Assessment." The AMA is computed on either New Jersey gross receipts, at rates ranging from .138% to .4%, or New Jersey gross profits, at rates ranging from .277% to .8% which are twice the rates imposed under the gross receipts method. The AMA rates are not graduated but are "cliffs." That is, a taxpayer with gross profits of $9,999,999 pays tax at a rate of .25% on all of its profits for a resulting tax of $25,000 while a taxpayer with gross profits of $10,000,000 pays tax at a rate of .35% with a resulting tax of $35,000. The increase in gross profits of $1 results in an increase in tax of $10,000. As a result, the marginal tax rate for that $1 of gross profits is 1,000,000%.

Taxpayers will receive a credit for the amount by which the AMA exceeds their income tax liability in any given year. The credit may be claimed against a corporation's regular CBT liabilities in subsequent years when the taxpayer's regular CBT liability exceeds its AMA liability.

For taxpayers that are subject to the regular CBT, the AMA rates will be reduced to zero for tax periods commencing after June 30, 2006. That change effectively sunsets the AMA for those taxpayers. However, the AMA will not sunset for corporate taxpayers that are protected from the imposition of a tax based on or measured by net income under P.L. 86-272, 15 U.S.C. §381. Those taxpayers will remain subject to the AMA indefinitely, unless they waive their P.L. 86-272 protection and consent to be subject to the regular CBT.

The BTRA authorized this Commission to terminate the AMA as of January 1, 2005. This would terminate the AMA for all taxpayers, including those protected by P.L. 86-272. Additionally, the Director of the Division of Taxation was required to suspend the AMA if the Commission did not produce this final report by June 30, 2004.

Analysis

In general, small businesses were not affected by the AMA. The CBT minimum fee of $500 was paid by 75,075 "C" corporations of the 107,070 filers whose returns were examined by the Division on Taxation. Another 4,939 "C" corporations paid a minimum CBT fee of $2,000. The Commission presumes that those corporations did not have sufficient gross receipts or gross profits to be subject to the AMA and that many of those corporations may be "shell" corporations with no income generating activities. In addition 77,188 "S" corporations also paid only the minimum $500 fee based on the fact that "S" corporations are not subject to the AMA.

In general, the AMA did not affect a large percentage of corporations filing CBT returns. Only 3.27% of corporations were subject to the AMA. Most of those corporations were exempt from the AMA because they had gross receipts of less than $2 million or gross profits less than $1 million. However, 21% of all corporations with New Jersey gross receipts greater than $2 million were subject to the AMA.

Two-thirds of the corporations subject to the AMA had AMA tax liabilities of between $501 and $10,000. The total AMA generated from those 2,293 taxpayers was $8.1 million, or 3% of the total AMA collected. However, 82% of the revenue generated by the AMA came from 245 companies with 2002 NJ gross receipts of over $50 million.

The AMA requires corporations that utilize state services to pay a tax based on some measure of their activity in the state. The Commission notes that corporations with business operations in New Jersey that utilize state services do, absent the AMA, pay state and local taxes that support government services even when they are not profitable. Corporations pay various business taxes and fees, including property, payroll and sales and use taxes. Additionally, corporate employees pay gross income taxes on their wages.

The AMA serves to stabilize revenues over a period of years. The AMA will increase revenues in periods of economic downturn when corporate net income is reduced because the AMA is based on gross receipts or gross profits and not corporate net income. In favorable economic periods, CBT revenues will be reduced by AMA credits allowed to corporations (calculated as a difference between the tax paid in prior years under the AMA and the tax that would have been paid under the regular CBT). The leveling effects of the AMA should provide a disincentive to increase spending or cut taxes in better economic times and to reduce spending or increase taxes in difficult economic times.

An alternative minimum tax may provide a backstop to other "loophole closing" measures. However, the Commission finds that there is insufficient data to determine whether the AMA is necessary as a "backstop" to the other measures enacted as part of the BTRA that were intended to prevent abusive tax avoidance transactions.

The AMA has become the lightning rod of criticism regarding New Jersey's tax policy and the changes made by the BTRA. No other state imposes a tax similar to the AMA and no other state has, since the passage of the BTRA, seriously considered adopting a tax similar to the AMA.

The AMA is perceived as an unfair and burdensome tax by both in-state and out-of-state corporations. In-state corporations perceive the AMA as being unfair and burdensome because it imposes a tax regardless of whether a corporation is profitable and because the tax generated using either the receipts or gross profits bases has no relationship to the corporation's business activities in the state. Further, the AMA is perceived as being unfair and burdensome by out-of-state corporations because it imposes a tax in situations where New Jersey is prohibited under P.L. 86-272 from imposing a net income based tax.

The Commission is not persuaded that using gross receipts or gross profits is necessarily the best measure for an alternative tax. The AMA challenges a traditional principle of fairness in tax policy which looks to the ability of a taxpayer to pay tax. The alternate tax bases on which the AMA is assessed do not necessarily relate to the ability of a taxpayer to fairly bear that tax burden.

The "cliff" tax rate schedules of the AMA are patently unfair. They can result in confiscatory impositions of tax at the marginal income levels. The Commission finds that there is no rational basis for the presence of the "cliffs" and for the imposition of the AMA in that manner. The inequitable effect of the "cliffs" can be remedied by making the AMA progressive (like the gross income tax) or by simplifying the AMA by eliminating the various tax brackets and providing a single tax rate for all taxpayers.

The AMA provides that corporations engaged in the business of selling tangible personal property are able to deduct their cost of goods sold from their gross receipts in determining their gross profits. As a result, those corporations that have a cost of goods sold which represents more than 50% of the corporation's receipts pay a lower tax by electing the gross profits method. However, corporations engaged in other businesses, such as the provision of services, rentals of tangible property and financing transactions, are unable to deduct their costs of sales. The Commission finds that the disparate treatment of corporations that sell tangible personal property and corporations engaged in other businesses results in the unfair taxation of those other businesses. The disparity between corporations that sell tangible personal property and other corporations can be remedied by providing a deduction for every corporation's cost of sales, regardless of whether the corporation is in the business of selling tangible personal property. The Commission finds that such a deduction could be provided by a regulation promulgated by the Director of the Division of Taxation or by legislative amendment of the AMA.

Taxpayers are permitted to determine their New Jersey gross profits by deducting their cost of goods sold attributable to New Jersey from their New Jersey gross receipts. The AMA requires taxpayers to determine their New Jersey gross receipts based on the method used to determine the numerator of the corporation's New Jersey sales factor. However, the AMA requires taxpayers to determine the percentage of their cost of goods sold attributable to New Jersey based on their apportionment factor which includes the percentage of the taxpayer's property, payroll and sales attributable to the state. This method of computation benefits in-state corporations in comparison to out-of-state corporations.[8] The Division of Taxation attempted to ameliorate that discrimination in its regulation by permitting taxpayers to elect to use either their apportionment factor or their sales factor. However, the use of the sales factor is not provided in the statute. Additionally, that election does not entirely eliminate the discrimination faced by out-of-state taxpayers.[9]

Commentators have suggested that the AMA cost of goods sold apportionment provisions violate the Commerce Clause of the United States Constitution by discriminating against corporations with significant operations located outside the state. The Commission declines to consider the constitutionality of the AMA.

The computation of taxable receipts under the AMA includes dividends received by corporations. In comparison, the regular CBT excludes 100% of dividends received from subsidiaries owned 80% or more by the taxpayer and 50% of dividends received from subsidiaries owned 50% to 80% by the taxpayer. Thus, the inclusion of all dividends in the AMA tax base is inconsistent with the treatment of dividends for regular CBT purposes.

Dividends are only included in the AMA base if the corporation receiving the dividend is commercially domiciled or headquartered in New Jersey. That result is a clear disincentive for large corporations maintaining or locating their headquarters in New Jersey. Additionally, the amount of dividends (which represent earnings of subsidiaries that were already subject to tax in the jurisdictions where the subsidiaries operate) is completely unrelated to the extent of the recipient

[8] For example: two corporations with $20,000,000 of receipts, $10,000,000 of which are from New Jersey sources, and $16,000,000 of cost of goods sold would be treated differently depending on the extent of the corporation's activities in New Jersey. Both corporations have 50% of their sales (receipts) in New Jersey. If one corporation has its manufacturing facilities in New Jersey (and thus all its property and payroll) and the other has its manufacturing facilities (and thus all its property and payroll) in Pennsylvania, the New Jersey company would be able to deduct 75% (50% sales + 50% sales + 100% property + 100% payroll divided by 4) or $12,000,000 of its cost of goods sold (thus arriving at a negative gross profits) while the Pennsylvania company would be able to deduct 25% (50% sales + 50% sales + 0% property + 0% payroll divided by 4) or $4,000,000 of its cost of goods sold. As a result, the New Jersey company which has the same receipts as the Pennsylvania company and a greater presence in New Jersey pays no AMA based on gross profits of a negative $2,000,000 while the Pennsylvania company pays an AMA of $11,111 based on gross receipts of $10,000,000 (the tax computed using the gross profits base would have been $13,888 based on gross profits of $6,000,000).

[9] In the above example, the Pennsylvania taxpayer would be able to deduct 50% of its cost of goods sold (based on its sales factor), resulting in an AMA of $2,777 based on gross profits of $2,000,000. Thus, the Pennsylvania corporation continues to be treated unfairly in comparison to the New Jersey corporation which does not pay the AMA.

corporation's New Jersey operations and the services provided by the state to that corporation.

The Commission is concerned that many taxpayers could become systemic AMA payers, paying the AMA on a consistent basis because their AMA liability is, as a result of the particular operations of their business, always greater than their regular CBT liability. The Commission is concerned that approximately 21% of taxpayers potentially eligible to pay the AMA (e.g. taxpayers with gross receipts in excess of $2,000,000) are paying the AMA. This percentage is significantly higher than the Commission would have expected for an alternative minimum tax. The Commission is unable to determine whether there are any specific groups of taxpayers that will be paying the AMA on a consistent basis from the information available to the Commission. The remedy for the AMA creating a class of systemic AMA payers or for the AMA affecting too large a percentage of corporations is to reduce the AMA tax rates. Certain other changes such as eliminating the "cliffs", and adopting a fairer measure of cost of sales for companies that do not sell tangible property would reduce the possibility that certain taxpayers would become systemic AMA payers.

As discussed above, the AMA rates will be reduced to zero for in-state taxpayers for tax years beginning on or after July 1, 2006. As a result, the AMA will only be imposed on out-of-state corporations that are protected by P.L. 86-272. The Commission finds that subjecting only those out-of-state corporations to the AMA is unfair.

Finally, commentators have argued that the sunsetting of the AMA only for regular CBT taxpayers and not for taxpayers that are protected from a net income based tax by P.L. 86-272 violates the Commerce Clause of the United States Constitution. The Commission declines to consider the constitutionality of the AMA.

Recommendations

There is little New Jersey can do to alleviate the perceived and actual unfairness that resulted from the imposition of the AMA short of repealing the AMA for both in-state and out-of-state taxpayers or repealing the AMA for out-of-state taxpayers after the AMA rates have been set at zero for in-state taxpayers.

However, the Commission, by a majority vote, declines to recommend the termination of the AMA as of January 1, 2005. The Commission is concerned that the early termination of the AMA will adversely affect CBT revenues included in the budget for State Fiscal Year 2005.

The Commission, by a majority vote, recommends that the AMA rate remain at zero for tax years beginning on or after July 1, 2006. That is, the Commission recommends that the legislature not reimpose or extend the AMA.

The Commission, by a majority vote, further recommends that the AMA rates, as applied to companies that are protected from a tax based on or measured by income under P.L. 86-272, be set at zero for tax years beginning on or after July 1, 2006.

The Commission recognizes that making significant changes to the AMA to reflect the Commission's concerns regarding the fairness of the AMA will address many of the specific criticisms directed at the AMA. The Commission recommends that the following changes be made to the AMA for tax years beginning on or after January 1, 2004 to correct the Commission's above-discussed concerns regarding the fairness of the AMA:

- The Commission recommends that the AMA rate schedules be modified to eliminate the "cliffs" in rates.
- The Commission recommends that all dividends be excluded from the AMA base.
- The Commission recommends that taxable gross profits be determined after allowance of deductions for all costs of sales, not only costs associates with the sale of tangible personal property. The existing provisions of the AMA authorize the Director of the Division of Taxation to determine other input or expenditure necessary to equitably measure the business activity of a taxpayer. The Commission believes that the liberal exercise of that discretion is warranted in the case of finance, insurance, real estate, personal services and other similarly situated businesses.
- The Commission recommends that the CBT statute be amended to permit corporations to determine the New Jersey Cost of Goods Sold using either the corporation's New Jersey apportionment factor or the corporation's New Jersey sales factor. That change will bring the statutory language in line with the Division of Taxation's regulation.

Summary of the Commission's Recommendations

1. The Commission believes that New Jersey would benefit greatly from a further analysis of its tax policies.
2. The Commission recommends that the net operating loss deduction be fully restored.
3. The Commission recommends that the CBT be amended to permit the filing of amended returns for the 2002 and 2003 tax periods to allow the deduction of net operating losses suspended by the BTRA and to permit the refund of the resulting tax overpayments.
4. The Commission recommends that the intangible and related expense addback provision be amended to strike the language requiring taxpayers to prove by "clear and convincing evidence as determined by the director" that an addback of a specific expense is unreasonable.
5. The Commission recommends that the intangible and related expense addback provision be amended, either statutorily or by regulation, to provide that an addback regarding any transactions that are conducted based on arm's-length terms, at an arm's-length consideration, with a valid non-tax business purpose and with sufficient economic substance would be unreasonable.
6. The Commission recommends that the intangible and related expense addback provision be amended, either statutorily or by regulation, to clarify that a taxpayer who undertakes a transaction for a valid non-tax business purpose as well as a tax-motivated business purpose remains eligible for the "conduit exemption" that excludes from the addback requirements any payments to related parties that are in turn paid to unrelated parties.
7. The Commission recommends that the intangible and related expense addback provision be statutorily amended to permit taxpayers to deduct royalty payments directly or indirectly received from a related member from their entire net income unless such royalty payment would not be required to be added back under the intangible and related expense addback provision.
8. The Commission recommends the repeal of the interest expense addback provision.
9. The Commission recommends the repeal of the throwout rule.
10. The Commission recommends that New Jersey adopt the UDITPA nonbusiness income concept in place of its existing nonoperational income concept. If the State is unwilling to adopt the nonbusiness income concept in its entirety, the Commission recommends the adoption of the UDITPA sourcing rules for nonbusiness income and the application of those rules to source nonoperational income under New Jersey's existing statute.

11. The Commission recommends that the partnership "withholding" requirement be amended to require the payment of estimated tax installments by the partnership and that the installment payments be allowed as a credit against the estimated tax obligations of nonresident partners.

12. The Commission recommends that the per partner fee be reevaluated and modified to reduce the inequities and eliminate any negative economic impact to the State.

13. The Commission concludes that the use of unitary combined reporting requires further study and debate prior to being implemented in New Jersey

14. The Commission, by a majority vote, declines to recommend the termination of the AMA as of January 1, 2005.

15. The Commission, by a majority vote, recommends that the AMA rate remain at zero for tax years beginning on or after July 1, 2006. That is, the Commission recommends that the legislature not reimpose or extend the AMA.

16. The Commission, by a majority vote, further recommends that the AMA rates, as applied to companies that are protected from a tax based on or measured by income under P.L. 86-272, be set at zero for tax years beginning on or after July 1, 2006.

17. The Commission recommends that the following changes be made to the AMA for tax years beginning on or after January 1, 2004 to correct the Commission's above-discussed concerns regarding the fairness of the AMA:

    - The Commission recommends that the AMA rate schedules be modified to eliminate the "cliffs" in rates.
    - The Commission recommends that all dividends be excluded from the AMA base.
    - The Commission recommends that taxable gross profits be determined after allowance of deductions for all costs of sales, not only costs associates with the sale of tangible personal property.
    - The Commission recommends that the CBT statute be amended to permit corporations to determine the New Jersey Cost of Goods Sold using either the corporation's New Jersey apportionment factor or the corporation's New Jersey sales factor.

Acknowledgements

The Commission acknowledges the assistance of the Office of the Treasurer, the Division of Taxation and the Office of Legislative Services providing technical and logistical support to the Commission. The Commission would like to thank Assistant State Treasurer Daniel H. Levine and the Director of the Division of Taxation, Robert K. Thompson as well as the staff of the Division of Taxation who assisted the Commission.

Also gratefully acknowledged is Rutgers University for making its facilities available for the Commission's public hearings and other meetings.

APPENDICES

Appendix A:	Composition of Corporation Business Tax Study Commission
Appendix B:	Summary of the Corporation Business Tax Study Commission's Meetings
Appendix C:	Interim Report of the Corporation Business Tax Study Commission
Appendix D:	Written Comments Provided to the Corporation Business Tax Study Commission
Appendix E:	Business Tax Reform Act Revenue Estimates
Appendix F:	Estimated State Fiscal Year 2002 Business Tax Reform Act Related Collections
Appendix G:	Combined Reporting Issues List

APPENDIX A

Composition of the Corporation Business Tax Study Commission

The New Jersey Corporation Business Tax Study Commission is composed of nine members. Two members were appointed by the Presidents of the Senate. Two members were appointed by the Speaker of the General Assembly; and five members were appointed by the Governor.

The BTRA requires that each member be a resident of the State having knowledge and expertise in the area of corporation income tax. Further, of the members appointed by the Governor, the BTRA requires that one be a member of the academic community, one be a certified public accountant, one be a member of the State tax bar, one represent large businesses, and one represent small businesses. The members appointed by the Speaker of the General Assembly shall not be members of the same political party, the members appointed by the Presidents of the Senate shall not be members of the same political party, and no more than three of the members appointed by the Governor shall be of the same political party.

Commissioners Appointed by the Governor

Eileen Appelbaum, PhD

Center for Women and Work
Rutgers University
New Brunswick, New Jersey

James B. Evans, Jr., J.D., L.L.M, CPA

Kulzer & DiPadova, PA
Haddonfield, New Jersey

Tami Gaines

G2 Consulting, Inc.
Montclair, New Jersey

Robert Krueger, CPA

Public Service Enterprise Group
Newark, New Jersey

John J. Pydyszewski

Johnson & Johnson
New Brunswick, New Jersey

Commissioners Appointed by the Senate Presidents

Michael Kasparian

S. Hekemian Kasparian Troast, LLC
Paramus, New Jersey

David J. Shipley, J.D.

McCarter & English
Philadelphia, Pennsylvania

Commissioners Appointed by the Speaker of the General Assembly

Kenneth Gershenfeld, J.D

Goldman Sachs
New York, New York

Frank Huttel, III, JD, LLM, CPA

DeCotiis FitzPatrick Cole & Wisler, L.L.C.
Teaneck, New Jersey

APPENDIX B

Summary of the Corporation Business Tax Study Commission's Meetings

The following is a summary of the conduct of the Commission's meetings, excluding public work sessions at which no guest presentations were made, since the convening of the Commission on December 11, 2002.

July 2, 2002	A-2501/S-1556 is enacted as the Business Tax Reform Act P.L. 2003 c. 40 reforming New Jersey's system of taxation of corporations and other business entities, through revision of the corporation business tax and other changes of law.
December 11, 2002	Organizational meeting
January 8, 2003	Overview of Business Tax Reform Act P.L. 2002, c 40 (Part 1 of 2) Division of Taxation
January 28, 2003	Overview of Business Tax Reform Act P.L. 2002, c 40 (Part 2 of 2) CBT Revenue Presentation Division of Taxation
March 12, 2003	A Review of New Jersey's Prior Tax Review Commissions Henry Coleman, Executive Director New Jersey State and Local Expenditure and Revenue Policy Commission State Business Tax Reform - A Business Perspective Doug Lindholm, Executive Director Council on State Taxation State Business Tax Reform - A Tax Administrator's Perspective Dan Bucks, Executive Director Multistate Tax Commission
April 9, 2003	Ethical Standards – Special State Officers Rita L. Strmensky, Esq., Executive Director Executive Commission on Ethical Standards

May 13, 2003	Public hearing held in Newark Campus of Rutgers the State University of New Jersey Testimony provided by: Arthur J. Maurice, New Jersey Business & Industry Association Stephen C. Fox, CPA
May 15, 2003	Public hearing held in New Brunswick Campus of Rutgers the State University of New Jersey Testimony provided by: E. Martin Davidoff, CPA, Esq. Frank Nardi, CPA, Esq.
May 28, 2003	Public hearing held in Camden Campus of Rutgers the State University of New Jersey Testimony provided by: Mary Forsberg, Senior Policy Analyst New Jersey Policy Perspective Joseph R. Crosby, Legislative Director, Council on State Taxation Kathleen Davis, Executive Vice President Chamber of Commerce Southern New Jersey
August 13, 2003	BTRA Regulations Division of Taxation
February 11, 2004	BTRA Revenue and Tax Return Analysis Division of Taxation
March 10, 2004	Commission working session
April 14, 2004	Commission working session
May 12, 2004	Commission working session
June 9, 2004	Commission working session

APPENDIX C

Interim Report of the Corporation Business Tax Study Commission

STATE OF NEW JERSEY
CORPORATION BUSINESS TAX STUDY COMMISSION
PO Box 002
Trenton, NJ 08625-0002

December 29, 2003

To: The Honorable James E. McGreevey, Governor
The Honorable John O. Bennett, Republican Senate President
The Honorable Richard J. Codey, Democratic Senate President
The Honorable Albio Sires, General Assembly Speaker
State Treasurer, John E. McCormac

The New Jersey Corporation Business Tax Study Commission is pleased to deliver to you its Interim Report.

The New Jersey Corporation Business Tax Study Commission was established by Section 31 of P.L. 2002, c. 40, approved July 2, 2002 (the "Act") to evaluate the changes made by the Act and to address specific statutory questions. The Commission is directed to report its findings by December 30, 2003. If the report is not produced by June 30, 2004, then the Director of the Division of Taxation must suspend for tax periods beginning after December 31, 2004 the Alternate Minimum Assessment which was imposed as a part of the Act.

The Commission is unable to issue a final report by December 30, 2003. The Commission issues this Interim Report in lieu of such final report with the present intention to issue a final report before June 30, 2004.

The Commission has issued an Interim Report because it does not yet have available to it the tax return information necessary for a fair and thorough evaluation of the provisions of the Act and the statutory questions presented to the Commission. As of the date of this Interim Report, the processing, compilation and analysis of tax return information reflecting the impact of the Act have not been completed by the Divisions of Revenue and Taxation.

As directed by the Act, the Commission held three public hearings. The testimony provided to the Commission is made a part of the Interim Report.

The Commission has reaffirmed and adopted the revenue evaluation criteria adopted by the New Jersey State and Land Expenditure Revenue Policy Commission having determined the continuing vitality of those principles.

We offer our thanks to those who have contributed to our efforts to date. This Interim Report was approved and is respectfully submitted by the members of the New Jersey Corporation Business Tax Study Commission.

James B. Evans, Jr.
Chairman

cc: Commissioners

New Jersey Corporation Business Tax Study Commission

Interim Report – December 29, 2003

Summary of Interim Report

The Business Tax Reform Act, P.L. 2002, c. 40, (the "BTRA") was approved July 2, 2002 and became effective for privilege periods beginning on or after January 1, 2002. Legislative Statements to Assembly Bill 2501 and Senate Bill 1556, the respective Assembly and Senate versions of the legislation, reflect the Legislature's intention to reform New Jersey's system of taxation of corporations and other business entities, through revision of the Corporation Business Tax Act (the "CBT") and other changes of law.

Among the many changes enacted, the BTRA introduced an Alternative Minimum Assessment which imposes an alternative method for computing a taxpayer's CBT liability. The alternative tax is based on either reported gross receipts or gross profits as its tax base. Corporations are required to pay the alternative assessment if it is greater than their regular CBT liability.

Other changes were designed to overhaul the CBT to close perceived loopholes and to defer or eliminate other corporate deductions. The BTRA also imposes new taxes on partnerships and professional corporations and increased the statutory minimum tax. Small business relief provisions were also enacted.

The Corporation Business Tax Study Commission was established by Section 31 of the BTRA (the "Commission") to evaluate the changes made by the new law and to address specific statutory questions. The Commission is to report its findings by December 30, 2003. If the report is not produced by June 30, 2004, then the Director of the Division of Taxation must suspend the AMA for tax periods beginning after December 31, 2004.

The BTRA has resulted in substantial increases in the amount of tax revenues collected. These increases exceed the projections of the State Treasurer and the Office of Legislative Services made about the time of enactment. An analysis of CBT tax return information is expected to identify which provisions of the BTRA are contributing to the increased revenue and the reasons for the BTRA outperforming all estimates.

The Commission does not yet have available to it the tax return information necessary for a fair and thorough evaluation of the provisions of the BTRA and the statutory questions presented to the Commission. As of the date of this Interim Report, the processing, compilation and analysis of tax return information reflecting the impact of the BTRA changes have not been completed by the Divisions of Revenue and Taxation.

The Commissioners presently believe that sufficient information will be made available to the Commission to allow the issuance of its final report before June 30, 2004.

The Commission

The Business Tax Reform Act, P.L. 2002, c.40 was approved July 2, 2002. Assembly Bill 2501 and Senate Bill 1556, the respective Assembly and Senate versions of the legislation, include statements that reflect the legislature's general and specific intention in passing the bills. Generally effective for taxable years beginning on or after January 1, 2002, the BTRA is intended to reform New Jersey's system of taxation of corporations and other business entities, through revision of the Corporation Business Tax Act, N.J.S.A. 54:10A-1 *et seq*., and other changes of law.

Section 31 of the BTRA created a nine-member, bipartisan Corporation Business Tax Study Commission. The Commission is to conduct a continuous study and evaluation of the corporate tax law reforms adopted pursuant to the BTRA, with specific reference to:

(1) Whether the CBT burden is fairly and equitably borne and distributed among corporations that are subject to the tax;

(2) Whether profitable corporations doing business in New Jersey can avoid paying their fair share of taxes by using tax minimization or avoidance strategies that may include cross-border tax avoidance such as isolation of nexus-creating activities or the transfer of certain income to holding companies in low tax or tax haven jurisdictions, intragroup corporate transfer pricing techniques, use of special deductions or exclusions that manipulate income and costs between parent-subsidiary or affiliated companies that benefit large or multinational or multistate corporations over smaller businesses operating wholly within New Jersey;

(3) Whether, without reducing anticipated revenues from that tax, the tax burden could be more fairly and equitably borne and distributed;

(4) Whether the revenue and distributional impacts of the changes to the Corporation Business Tax Act enacted pursuant to the BTRA yield the recurring revenue goals that New Jersey must achieve to bring long-term structural balance to State finances; and

(5) Whether New Jersey and its corporation business taxpayers would be better served by the use of a combined taxation under the unitary business concept.

The BTRA directs the Commission to produce and provide a final report with findings and recommendations to the Governor and the Legislature, along with any legislative bills it desires to recommend for adoption by the Legislature, no later than December 30, 2003. The Commission is authorized to issue interim reports. If the Director of the Division of Taxation determines that the final report of the Commission has not been produced and provided by June 30, 2004, then the Director shall suspend the Alternate Minimum Assessment (AMA), which was imposed under the BTRA, for privilege periods commencing after December 31, 2004. If the Commission recommends the termination of the AMA, the AMA shall not be imposed for privilege periods beginning after December 31, 2004.

For the reasons detailed below, the Commission is unable to issue a final report by December 30, 2003. The Commission issues this Interim Report in lieu of such final report with the present intention to issue a final report before June 30, 2004.

Composition of Commission

The New Jersey Corporation Business Tax Commission is composed of nine members; two members were appointed by the Presidents of the Senate; two members were appointed by the Speaker of the General Assembly; and five members were appointed by the Governor.

The BTRA requires that each member be a resident of the State having knowledge and expertise in the area of corporation income tax. Further, of the members appointed by the Governor, the BTRA requires that one be a member of the academic community, one be a certified public accountant, one be a member of the State tax bar, one represent large businesses, and one represent small businesses. The members appointed by the Speaker of the General Assembly shall not be members of the same political party, the members appointed by the Presidents of the Senate shall not be members of the same political party, and no more than three of the members appointed by the Governor shall be of the same political party.

Commissioners Appointed by the Governor

Eileen Appelbaum, PhD
Center for Women and Work
Rutgers University
New Brunswick, New Jersey

Robert Krueger, CPA
Public Service Enterprise Group
Newark, New Jersey

James B. Evans, Jr., J.D., L.L.M, CPA
Kulzer & DiPadova, PA
Haddonfield, New Jersey

John J. Pydyszewski
Johnson & Johnson
New Brunswick, New Jersey

Tami Gaines
G2 Consulting, Inc.
Montclair, New Jersey

Commissioners Appointed by the Senate Presidents

Michael Kasparian
S. Hekemian Kasparian Troast, LLC
Paramus, New Jersey

David J. Shipley, Esq.
McCarter & English, LLP
Philadelphia, Pennsylvania

Commissioners Appointed by the Speaker of the General Assembly

Kenneth K. Gershenfeld, J.D.
Managing Director
Goldman Sachs & Co.
New York, NewYork

Frank Huttle, III, JD, LLM, CPA
DeCotiis FitzPatrick Cole & Wisler, L.L.C.
Teaneck, New Jersey

Commission Activities

Since its appointment, the Commission has held thirteen meetings, including three public hearings. Public notice of its meetings is provided and its meetings are open to the members of the public.

The following is a summary of the conduct of the Commission's meetings since the convening of the Commission on December 11, 2002:

December 11, 2002	Organizational meeting
January 8, 2003	Overview of Business Tax Reform Act P.L. 2002, c 40 (Part 1 of 2) *Division of Taxation*
January 28, 2003	Overview of Business Tax Reform Act P.L. 2002, c 40 (Part 2 of 2) CBT Revenue Presentation *Division of Taxation*
March 12, 2003	A Review of New Jersey's Prior Tax Review Commissions *Henry Coleman, Executive Director* *New Jersey State and Local Expenditure and Revenue Policy Commission* State Business Tax Reform - A Business Perspective *Doug Lindholm, Executive Director* *Council on State Taxation* State Business Tax Reform - A Tax Administrator's Perspective *Dan Bucks,* *Executive Director Multistate Tax Commission*
April 9, 2003	Ethical Standards – Special State Officers *Rita L. Strmensky, Esq., Executive Director* *Executive Commission on Ethical Standards*

May 13, 2003	Public hearing held in Newark Campus of Rutgers the State University of New Jersey <u>Testimony provided by</u>: *Arthur J. Maurice,* *New Jersey Business & Industry Association* *Stephen C. Fox, CPA*
May 15, 2003	Public hearing held in New Brunswick Campus of Rutgers the State University of New Jersey <u>Testimony provided by</u>: *E. Martin Davidoff, CPA, Esq.* *Frank Nardi, CPA, Esq.*
May 28, 2003	Public hearing held in Camden Campus of Rutgers the State University of New Jersey <u>Testimony provided by</u>: *Mary Forsberg, Senior Policy Analyst* *New Jersey Policy Perspective* *Joseph R. Crosby, Legislative Director,* *Council on State Taxation* *Kathleen Davis, Executive Vice President* *Chamber of Commerce Southern New Jersey*
June 11, 2003	Commission Working Session
August 13, 2003	BTRA Regulations *Division of Taxation*
September 10, 2003	Commission Working Session
November 12, 2003	Commission Working Session
December 10, 2003	Commission Working Session

Governing Principles Adopted

The Commission sought to identify principles of tax policy to guide its consideration of the CBT. Examinations of appropriate tax principles have been undertaken by numerous other commissions, public interest groups and professional organizations. The Commission was aided by these prior efforts.

The New Jersey State and Land Expenditure Revenue Policy (SLERP) Commission adopted revenue evaluation criteria that this Commission has determined to have continuing vitality. The Commission reaffirms those criteria and adopts the following as its governing principles:

- ADEQUACY refers to the ability of state and local revenue systems to provide revenues sufficient to meet current and anticipated state and local expenditure needs based on existing policies and programs.
- CERTAINTY relates to the extent to which individual taxpayers can predict future tax liabilities or recipient units of government can predict the level of aid receipts. Certainty regarding the intricacies of the tax or aid system may facilitate financial planning and decision making by businesses, households and units of government alike.
- COMPETITIVENESS refers to the advantages or disadvantages in attracting or retaining desired firms and households, which a state and local tax system has relative to tax systems in other comparable or neighboring states.
- COMPLIANCE/SIMPLICITY indicates the ease with which individual taxpayer liability can be determined, by both the taxpayer and the collection agency, and provisions of the tax code can be enforced.
- DIVERSITY measures the extent to which the base of the individual tax or the whole of the tax system is broadly defined so that it can withstand long-run declines in importance of some components while reflecting the importance of long-run growth in other components.
- ELASTICITY measures the relationship between changes in measures of economic activity or population characteristics and changes in the revenue Yield of the state and local tax system or selected taxes.
- EQUITY/FAIRNESS refers to the extent to which the revenue burdens of the state and local revenue system are distributed fairly based upon either the individual's or firm's ability to pay the tax or upon the benefits it receives from services financed by the tax.
- NEUTRALITY/EFFICIENCY indicates the extent to which government financing influences private economic decision making and behavior. In general, the less the influence, the more neutral the individual tax or tax system. However, neutrality may not always be preferable, as government may decide to encourage some activities while discouraging others. Neutrality also refers to the extent to which local jurisdictions have their priorities distorted or restructured by the imposition of limits and by the form in which aid is received.

Public Hearings

The BTRA directs the Commission to hold at least three public hearings and to solicit testimony from the public. Pursuant to that directive, the Commission held the following three public hearings:

Hearing Date	Hearing Location
May 13, 2003	Rutgers University - Newark
May 15, 2003	Rutgers University – New Brunswick
May 28, 2003	Rutgers University - Camden

Transcripts of the testimony offered to the Commission are attached as the Appendix of this Interim report.

In addition to holding the mandated public hearings, the Commission has solicited written comments from the public. A general request for comments was posted on the website of the Division of Taxation and business, professional and public interest organizations were solicited for comments. The Commission has received no written comments to date.

The Director of the Division of Taxation provided to the Commission written public comments received by the Division of Taxation in response to the special adoption and concurrent proposal of rules with respect to the BTRA.

BTRA Revenue Estimates

The BTRA established a CBT revenue target amount of $1,823,000,000 for fiscal year 2003.[1] In establishing this target amount, baseline CBT revenues for 2002, before the changes made by the BTRA, were projected to total $900 million. The BTRA target amount assumed additional revenue as a result of the BTRA changes of $923 million.

No formal fiscal analysis for the BTRA was published by the Executive branch; however, the State Treasurer did provide to the Legislature revenue estimates for components of the BTRA for fiscal year 2003.

A legislative fiscal estimate was produced by the Office of Legislative Services ("OLS") pursuant to P.L.1980, c.67.[2] The OLS noted that the CBT is the most difficult State revenue source to estimate and projecting the impact of the far reaching changes of the BTRA was even more challenging. The Treasurer provided to the OLS some of the aggregate data used in the formulation of his estimates. The OLS did not have access to tax return information from specific returns.

The OLS estimates did not account for behavioral changes that may occur as a result of the enactment of the BTRA. Possible behavioral changes identified by the OLS that would likely reduce the revenues estimated were:

- Some inactive corporations and partnerships may be dissolved.
- Some corporations may change their status or relocate.
- Some corporations may alter their business or accounting practices.

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[1] Section 32 of the BTRA created a restricted reserve fund known as the "Corporation Business Tax Excess Revenue Fund." The State Treasurer is to credit to the fund, on or before December 31 annually in 2003, 2004 and 2005 with the amounts, if any, by which the State revenues derived from the corporation business tax in the prior fiscal year exceeded the target amount for that fiscal year, subject to reduction if General Fund revenue for State Fiscal Year 2003 is less than the amount certified for that year.

[2] Legislative Fiscal Estimate, First Reprint, Assembly No. 2501, 210th Legislature - Dated: September 13, 2002

The OLS prepared its fiscal estimates for the first three fiscal years for which the BTRA changes would be effective. The Treasurer's fiscal estimates were for the first fiscal year. The estimates are as follows:

	Projected CBT Revenue Increase in $Millions							
	Treasurer		OLS					
	FY03		FY03		FY04		FY05	
	Low	High	Low	High	Low	High	Low	High
"Loophole Closers"[3]	157	220	157	220	122	172	122	172
Net Operating Loss Disallowance	180	200	234	260	126	140	0	0
Alternative Minimum Assessment	260	300	260	300	203	234	203	234
Partnership Processing Fee	50	80	40	60	28	40	28	40
Minimum Tax Increase	45	45	45	45	45	45	45	45
3Q Speed Up	100	140	100	140	0	0	0	0
TOTAL	**792**	**985**	**836**	**1025**	**524**	**631**	**398**	**491**

Preliminary BTRA Revenue Information

Fiscal Year 2003 Cash Collections

At the Commission's December 10, 2003 meeting, the Office of Revenue and Economic Analysis of the Division of Taxation presented its most recent estimates of reported CBT cash collections for fiscal year 2003. These estimates are based on preliminary analysis of 100,464 returns filed for tax years starting after December 31, 2001. These estimates reveal that the BTRA generated more additional first year revenue than was projected.

The fiscal year 2003 total CBT collections as preliminarily reported break down into the following components:

[3] This category includes changes to the treatment of certain interest and royalty expenses, the exclusion of deductions for certain dividends, the "throw out rule" which changes the calculation of sales attributable to New Jersey, and rate changes for investment companies and savings and loan associations.

CBT Collections in $Millions[4]	
Partnership Processing Fee	51
Professional Corporation Fee	4
Nonresident Tax – Individuals	110
Nonresident Tax – Corporations	126
Minimum Tax	22
Savings Institution Conversion	15
3Q Speed Up	120
December 2002 Overpayment	75
Net Operating Loss Disallowance	185
Alternative Minimum Assessment	209
Remaining CBT Collections [5]	1697
TOTAL	**2614**

Fiscal year 2003 CBT cash collections totaled $2.614 billion. Of this, $51 million represents collections from the $150 partnership fees plus 50% prepayment for fiscal year 2004 and $110 million represents withholding on non-resident non-corporate owners by New Jersey tax partnerships and S corporations. These two amounts, totaling $161 million, were initially deposited in the CBT revenue account but ultimately will be reflected as fiscal year 2003 Gross Income Tax (GIT) revenue. The CBT collections, net of the transferred GIT revenue, are $2.453 billion.

Fiscal Year 2004 Cash Collections

On December 11, 2003, the State Treasurer announced that the CBT has generated $594.3 million in revenue through the first five months of fiscal year 2004. This was reported to be approximately 50 percent ahead of targets for the period. The reasons for the higher than anticipated revenues are unclear. The announced CBT collection numbers do not reflect an anticipated increase in CBT refunds for businesses that may have overpaid corporate tax liabilities. The amount of anticipated refunds was not estimated.

Availability of Tax Return Information

Information necessary for the Commission to evaluate the effects of the BTRA is reflected in the CBT returns filed with the Division of Revenue for taxable periods

[4] The fiscal year 2003 cash collections and allocations among the various BTRA revenue categories as reported by Office of Revenue and Economic Analysis are preliminary and subject to change.
[5] This amount includes base CBT revenues before amendments made by the BTRA plus the BTRA changes not specifically identified in the table. For the reasons discussed below, information necessary to identify the contributions made to fiscal year 2003 revenue from these other BTRA changes is not yet available.

beginning after December 31, 2001.[6] In addition to the return information routinely required of taxpayers, the Division of Taxation required the reporting of supplemental statistical information on the returns first affected by the BTRA. This additional information will assist the Commission in completing its evaluation. The Division of Taxation has announced that the failure to provide the additional statistical information may subject taxpayers to penalties.

Return information sufficient to identify and quantify the effects of the changes made by the BTRA is not presently available to the Commission. Calendar year taxpayers, the largest group of CBT return filers, are the first taxpayers to be subject to the provisions of the BTRA. While final CBT tax payments by calendar 2002 taxpayers were required to be made on or before April 15, 2003, taxpayers were allowed an extension of time for the filing of the related CBT tax returns until October 15, 2003.

A large number of CBT returns, including those of many of the State's largest corporate taxpayers, were filed under extension and were not available for processing until after October 15, 2003. The 2002 tax return information for many fiscal year taxpayers will be filed in the months following October, 2002 and may not become available in time for use by the Commission.

As of this report date, the processing, compilation and analysis of calendar year tax return information, including the additional statistical information, has not been completed by the Division of Revenue and the Division of Taxation. Accordingly, the Commission does not yet have available to it the information necessary for a fair and thorough evaluation of the provisions of the BTRA and the statutory questions presented to the Commission.

The Commissioners presently believe that sufficient information will be made available to the Commission to produce and provide a final report before June 30, 2004.

ACKNOWLEDGEMENTS

The Commission's effort in advance of this report has been primarily dedicated to the education of Commission members and the solicitation of public commentary. The Commission acknowledges the assistance of the Office of the Treasurer, the Division of Taxation, the Office of Legislative Services and the Office of Governor's Counsel for providing technical and logistical support to the Commission.

The process of data compilation and analysis and the Commissioners' deliberations leading to the recommendations in a final report is dependent upon the continued support of these offices in the absence of any appropriation to acquire these services and to provide for administrative staff support.

Also gratefully acknowledged is Rutgers University for making its facilities available for the Commission's public hearings and other meetings.

[6] Only aggregate return information will be made available to the Commission. Return information of specific taxpayers is confidential and privileged and will not be provided to the Commission.

APPENDIX

Tab 1	May 13, 2003	Public hearing held in Newark Campus of Rutgers the State University of New Jersey Testimony provided by: *Arthur J. Maurice,* *New Jersey Business & Industry Association* *Stephen C. Fox, CPA*
Tab 2	May 15, 2003	Public hearing held in New Brunswick Campus of Rutgers the State University of New Jersey Testimony provided by: *E. Martin Davidoff, CPA, Esq.* *Frank Nardi, CPA, Esq.*
Tab 3	May 28, 2003	Public hearing held in Camden Campus of Rutgers the State University of New Jersey Testimony provided by: *Mary Forsberg, Senior Policy Analyst* *New Jersey Policy Perspective* *Joseph R. Crosby, Legislative Director,* *Council on State Taxation* *Kathleen Davis, Executive Vice President* *Chamber of Commerce Southern New Jersey*

STATE OF NEW JERSEY

DEPARTMENT OF THE TREASURY

CORPORATION BUSINESS TAX STUDY Commission

IN RE: :

BUSINESS REFORM TAX ACT :

OF 2002 :

PUBLIC HEARING :

- - - - - - - - - -

P R E S E N T:

JAMES B. EVANS, JR., CHAIRMAN

FRANK HUTTLE, III

MICHAEL N. KASPARIAN

JOHN J. PYDYSZEWSKI

DAVID SHIPLEY

EILEEN APPELBAUM

ROBERT C. KRUEGER, JR.

KENNETH K. GERSHENFELD

ESSEX-UNION REPORTING SERVICE

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Transcript of Proceedings, taken in the above-entitled matter before JOANNE M. OPPERMANN, a Certified Shorthand Reporter (License No. 1435) and Notary Public of the State of New Jersey, taken at Rutgers University, Paul Robeson Campus Center, 350 Martin Luther King Boulevard, Newark, New Jersey on May 13, 2003, commencing at 1:00 in the afternoon.

THE CHAIRMAN: Good afternoon. My name is Jim Evans, I'm serving as the initial chair to the Corporation Business Tax Study Commission. I'd like to ask each of the members of the Commission to introduce themselves, beginning to my left.

MR. HUTTLE: My name is Frank Huttle.

MR. KASPARIAN: Michael Kasparian.

MR. SHIPLEY: David Shipley.

MR. KRUEGER: Bob Krueger.

MR. GERSHENFELD: Ken Gershenfeld.

MR. PYDYSZEWSKI: John Pydyszewski.

THE CHAIRMAN: Eileen Appelbaum is also a member of the Commission. And Tammy Gaines is unable to attend this afternoon's session.

The Commission was established pursuant to Section 31 of Public Law 2002, Chapter 40. The Commission is to study and evaluate Corporate Tax Reform adopted pursuant to the Business Tax Reform Act. This Commission is to issue a report, with findings and recommendations, to the governor and legislature, along with any legislative bills it desires, for adoption no later than December 30, 2003. If the Director of Division of Taxation determines that the final report of this Commission has not been released by June 30, 2004, the director shall suspend the minimum assessment imposed by the act for all privileged periods commencing after December 31, 2004. If the Commission recommends the termination of the assessment, it shall not be imposed for privileged periods beginning on or after January 31, 2005.

The Act directs this Commission to hold three public hearings. This hearing is the first of three. They have been scheduled.

On behalf of the Commission, I'd like to thank Rutgers University for making available its facilities on the Newark, New Brunswick, and Rutgers campuses. The Commission Office of the Treasurer provided notice of these schedules of hearings to the Secretary of State. All major newspapers in the state. The Commission, through the Office of the Treasurer, has also notified various business, tax and professional associations of the schedule of these hearings.

There is a speaker list provided. We ask each speaker to provide their name, address and telephone number. Commissioners, after testimony, will be afforded an opportunity to question the speakers. If you have written comments, you can submit them to the Commission or written comments can be submitted, preferably, before June 30, 2003.

Any comments from any of the Commissioners?

If not, Arthur.

MR. ARTHUR J. MAURICE: Thank you. My name is Arthur Maurice and I am First Vice President with the New Jersey Business & Industry Association. I have copies of the written comments. I will not read the comments, since I know so many of you, but I'll summarize them.

But first I'd like to say that on behalf of our 20,000 member employers, we lobbied this legislation pretty hard last spring. And we didn't have very high expectations for the Commission, to be perfectly honest. But I've got to say that each of you is just phenomenally qualified, and much better, in terms of appointments, than we have thought we would see, so I want to congratulate you.

We did oppose the law last spring, just so you know that, and felt that enactment of the BTRA was a mistake.

We oppose it basically because we thought the legislation went well beyond the stated intention closing abusive corporate tax loopholes. If that was purely what this legislation was about, shutting down loopholes, we and other business associations would have supported the legislation because, after all, no business person wants to be economically at a competitive disadvantage because a competitor is using loopholes.

However, as you know, in this legislation loophole closing is only a small part. We argued last spring that the law would raise taxes on hundreds of thousands of small and medium size firms that have nothing to do with loopholes, including raising taxes on many small and midsize corporations that are legitimately losing money. All in order to reach an arbitrary revenue collection figure of

$1.8 billion this fiscal year. The number that was referred to countless times by the administration, is a business' "fair share".

We estimated instead that the tax increase would generate far more revenues this year precisely because the money net was cast so far and wide.

Just to quickly summarize where the revenue are now, with less than two months left, it looks like this tax will bring in a lot more. In February the administration acknowledged the CBT would generate $2 billion, not 1.8. And then, last month, the nonpartisan office of our legislative services raised that number from 2 billion to 2.2 billion. We wouldn't be surprised, frankly, if we saw the CBT bringing in 2.4 billion, a staggering 33 percent increase over the original BTRA-driven projection.

Now, how is this affecting the businesses of the state? Well, an early indication came from our annual business outlook survey. We have 20,000 employers, we do a survey every winter, and this year's results, we had about 1,600 responses. The third worst problem facing businesses in this state, the third worst, were high state business taxes. Only behind health care costs, which was number one, and property taxes which were number two. To put this into context, business taxes have never exceeded the ranking of seventh in the history of the survey. And when respondents were asked to rank policy initiatives that the Mc Greevey administration should pursue, the reduction of business taxes was the first priority of 16 percent of all respondents.

Second, only behind health care costs, interestingly listed by 44 percent of respondents. You may see some of that in your own work, I guess, with the clients you have.

So, we feel that this is an excellent barometer of how business in general feels. Of the 1,600 responses we think it's a pretty good cross-section, about a fifth of them are manufacturers, a third of them are service firms, 71 percent of those respondents employed less than 25 employees, seven percent employed more than a hundred employees. They clearly felt the BTRA was onerous and unfair.

Why they should see it as unfair is

not shocking. If you look at the fiscal note that accompanied the legislation, published in September, only a fifth of new tax revenues, 20 percent would be coming from "loophole closers", things like chambers and the treatment of interest, royalty expenses, dividend deductions, the throw-out rule and rate changes for investment companies and savings and loan associations.

The vast majority of the BTRA increases were to come from either fiscal gimmicks with no policy basis, such as spending and operating losses, and accelerating estimated tax payments, and from the single most unfair aspect of the BTRA, which I want to focus the rest of my discussions on, and the revenue raising champion of the law, the misnamed Alternative Minimum Assessment, the new gross receipts and gross profits tax.

The Treasurer has indicated in the past that approximately a hundred thousand New Jersey firms will be taxed under this new gross receipt and gross profits tax.

Estimates of revenues range from 260 to $300 million the first year. Both the

Legislature and Treasury agreed that the tax would generate over a third of all new BTRA revenues. Given the higher anticipated tax revenues. We wouldn't be shocked if the AMA approached $400 million.

We feel the AMA terrible tax policy nebulizes low-profit margin firms, service companies, start-ups, firms with extraordinary and unexpected expenses, doing all this by taxing gross revenues without allowance for customary cost of doing business. It is unfair and confiscatory, but unfortunately, it is the backbone of the BTRA. By FY 2005, it will consist of 50 percent of all BTRA-generated revenues.

All that New Jersey employers ask is that state business tax policy be predictable, applied fairly across all firms and encourage business growth and expansion by taxing profits in good years and understanding that employers' business taxes should be reduced.

The AMA failed on all counts. We urge you to recommend its immediate repeal.

Thank you.

THE CHAIRMAN: Questions of Arthur?
Any questions?

MR. SHIPLEY: One question. In terms of the AMA, your objection is not necessarily to having some sort of minimum tax, but it's more so the method that is used to compute the tax and the magnitude of the so-called minimum tax.

MR. MAURICE: Right. We understood that the $200 minimum hasn't been changed in several years, although I guess it was indexed with inflation. And if something was done there, we wouldn't have complained. We looked at New York State, which I guess goes up to several thousand dollars. While we were never happy with tax increases, I think that would have met the goal of fairness and something that was predictable and understandable.

MS. APPELBAUM: Can I ask a question? We read in the newspaper of the ability that companies have, I mean after Enron we have all read about the ability that companies have to match their profit and their net, after taking ordinary business expenses. How do you deal with the fairness issue in a situation like that? You have large companies which have access to the best advice possible and we have understood now that tax planning has become a profit center for some companies.

So, how do you address that question without an alternative minimum tax?

MR. MAURICE: Well, I think that the legislation did a couple of things. One, it made it much more difficult to utilize some of the revenue-shifting techniques. But it also gave the Division of Taxation the ability to go in, and in cases where they felt that money was being shifted despite the new law, they could call for an audit, I guess, within 60 to 90 days, and then even require filing consolidated returns. We would have much rather have gone to the loophole closing aspects of the law. Which again I think most business associations would not have opposed. Seeing what the result is, looked and see how taxation used their new enforcement techniques, and then revisited this.

We just think that the costs that we're seeing, in terms of the image of New Jersey as being a place to expand a business and relocate, the damage that's been done by this law has been terrible, in this particular aspect.

We follow all the states. One of the things that was said last spring was, you watch, every other state in the nation will be following us. That's nonsense, absolute nonsense. In California, $35 billion deficit, bigger than our entire state budget. We didn't see them rushing out.

You know, I think that most states would -- I think most governors and most policymakers would acknowledge that the best way to grow revenue is to have a thriving economy, not raise taxes.

MR. KASPARIAN: Would you venture to say what the estimate for revenue generation would be, had it just been loopholes?

MR. MAURICE: Well, I can't say all we have is that fiscal note. And it looked as though -- I think I have it here. Have you seen that fiscal note? Date of September 13th, both the Executive Treasury and Office of Legislative Service, given yearly as I've described, they were looking at a low of 175 million to a high of 220 million. I dare say those numbers are probably low. But that gives you the range of the ballpark. The partnership processing fee was 50 to 80 million. Actually, our legislative was 50 to 80 million, excuse me.

I can leave this with you if you would like.

MR. KASPARIAN: Thank you.

THE CHAIRMAN: Thank you.

MS. APPELBAUM: Do you take any position or think at all about the -- we have all seen Mc Greevey's budget and we know the cuts are coming, right here at Rutgers University, which is facing a cut steeper than what it faced during the depression. From the point of view of your members, when you think about location decision, what attracts business, especially the high wage businesses that New Jersey has been so successful in attracting, what attracts them to this state is the high quality of education in the state university system, you know, the high quality of public education in many of the school districts. How do we balance these things?

MR. MAURICE: Well, I think that you're right, that is important, and the governor is doing an excellent job on that. But we're in a regional, if not a national and a global economy, and businesses can really move different places. You can be across the river in New York and across the river in Pennsylvania and still get that fine work force.

In terms of growing the budget, I think what I'm hearing most from my members is that, look, when we have a hard time, we've got to tighten our belts. And the state's got to have priorities and they should do that as well.

That may be very simplistic, but that's really how they think, it gets down out of matching your own costs and setting priorities.

I think the governor is right, he certainly has made education a priority. I wish -- expressing our members' view, I wish he had looked at other areas to cut.

MR. GERSHENFLED: You mentioned that you thought that New Jersey was now a business-unfriendly place or something like that. Do you have any statistic data to back that up, companies that moved out of New Jersey, companies that were going to move in that didn't move out? More objective and subjective information. That would be very helpful.

MR. MAURICE: We can give you that, sure. Actually, I'll get very specific. I didn't say it's a business-unfriendly state, I said --

MR. GERSHENFELD: I'm sorry.

MR. MAURICE: I said it's a place where many businesses are wondering whether they would want to expand and relocate here. And it's not just this BTRA. We could talk about the BTRA, I won't, but it would go into that as well.

We have been surveying our members for probably about 15 years. And one question we ask them: Is New Jersey a good place to expand your business? Would you recommend expanding your business in New Jersey?

And this number has been just dropping every year. And I can actually send you a copy of the survey, but I believe right now we're up to -- we're down to 27 percent of the members who are here now, business people who are here now saying this is a good place to expand.

MS. APPELBAUM: Are these companies that were planning to expand? We're three years into a business downturn in this country.

MR. MAURICE: Right. What we asked them is: Is New Jersey a good place to expand a business?

MS. APPELBAUM: Is anyplace a good place to expand a business right now?

MR. MAURICE: I can tell you that when we do time surveys on this, the numbers are bad. Look, I can agree with you that this economy has many more issues than just issues government can effect, but we would argue strongly that where government can't effect, it shouldn't do things to the detriment of the economy, it should be looking to foster it.

But I'll get you the economic position.

MR. GERSHENFELD: Give us a comparison, if it was 70 percent three years ago, now 27 percent, that would be relevant. If it's been 30 percent the last three years and now dropped to 27 percent, that doesn't mean a whole lot.

MR. MAURICE: It was up a whole 66 percent. Again, part of that was the expansion, people felt better. Think people felt better about the state's economy and the state as a place to do business.

MS. APPELBAUM: The question was a comparison between last year and this year.

MR. MAURICE: There's a timeline in there. Sure.

Anything else?

THE CHAIRMAN: Any other questions?

Arthur, thank you.

MR. MAURICE: Good luck.

MR. STEPHEN C. FOX: I've given you copies of my written comments. And like Arthur, I won't just read the comments to you, but I would like to summarize them a bit and elaborate on one or two points.

I'm not here to lobby for massive overhaul in the tax code, more for pointing out some areas of technical correction that we think, as a firm, are hitting our clients and not hitting some of the people that were targeted at.

The key areas of our concern are first the alternative minimum assessment. Secondly, the throw-out rule. And third, the partnership withholding per partner fee provisions.

The AMA seems to have been designed to hit larger companies with operations in New Jersey and elsewhere. And, in particular, multinationals. In the press there was mention of companies like Lucent and Pfizer paying not a penny of New Jersey tax, despite earning millions of dollars in New Jersey.

So, it strikes us as, I would like to say, humorous, but maybe not quite so humorous, that these multinationals will almost all not pay a penny of alternative minimum tax simply because of the way it works.

The AMA's a tax either on gross receipts or gross income at the election of the taxpayer. Gross income is not quite how we accountants would define it, it is total New Jersey gross receipts less apportioned cost of goods sold. And it's that apportionment of the cost of goods sold that results in distortions.

Let's take an example, and I'll use this for a couple of other things too. Let's assume we have "Big Co." that distributes goods, has operations in Texas, Nevada and New Jersey, with equal property payroll and sales in those states and nothing anyplace else.

Before the BTRA changes this summer, "Big Co's", New Jersey apportionment factor, was one-third. After the changes it will be either 50 percent or two-thirds under the throw-out rule. I'll talk about that in a moment.

If "Big Co." has anything but obscene gross margins on the products, it's not going to have any gross income in New Jersey because one-third of the income will be reduced by two-thirds of the cost of sales. The gross income goes away, so does the AMA.

This is going to happen for any taxpayer who has sales scattered around big operations in New Jersey. This distorted effect will happen for all of them.

Now, where is the AMA going to hit? It's going to hit our client base. Our clients are entirely closely-held companies, or individuals, with revenues from around a million to nearly a hundred million, the mid market. A lot of our clients are service businesses that have no cost of goods sold.

The AMA has a tax on gross receipts for them.

At a fairly low level of sales, under 20 million, the AMA starts kicking in if their profitability is less than 1.54 percent. For a larger service business, it kicks in at profitability of 4.4 percent. We have some clients that were profitable this year, whose AMA exceeded their profits.

In fact, we have quite a few of those. The Division of Taxation incorporated a rule very recently in the regulations, that carved out one piece of those clients, the professional employer organizations, and others with similar accounting possibilities from the application of the AMA. The PEO's would have structurally paid more AMA on a permanent basis than their profits every year, because their margins, by the nature of their business, have to be very small.

I was speaking with the New Jersey director of one of the largest PEO's a while back, and he said, before those regulations came out, they were considering simply withdrawing from New Jersey all together, stopping doing business because the state was going to tax them at more than a hundred percent of their profits.

So that's a problem with the AMA, hitting service businesses. And it's an area that I would like your committee to give consideration to as to how we can go about mitigating that for low profit service businesses.

Another problem with AMA is the rate. At some points it's more than a one million percent tax rate. The gross income tax works as a marginal rate, kind of like the AMA, but the marginal -- the next marginal rate is not applied to the entire tax base but only the revenues above the point that it kicks in. Where you apply any sort of a rate to everything that came before, and the rate increases, you get extreme distortions at little points.

Eileen's point about tax planning earlier is particularly relevant here. Clients of ours will be -- if they are sufficiently aware of it will be very sensitive about being just a couple of dollars over that kick-in point for the next rate. Certainly would make our fees worthwhile for doing some fancy accounting trades for those cases.

So I think changing the rate to something that looks like the way the gross income tax works, would be a very good thing.

While we're still close to the AMA discussion, the throw-out rule that was enacted as part of BTRA had the laudable goal of making New Jersey businesses really pay their fair share of tax based on where they were getting taxed not just where they had sales.

A lot of states have a throw-back rule that seeks to accomplish the same sort of thing. Sometimes in a less equitable manner.

Let's go back to my case of "Big Co.", that has operations in New Jersey, Texas and Nevada. Since Nevada imposes no income tax, Nevada sales are thrown out even though they have big operations there.

Texas is a problematic matter. Texas doesn't have an income tax, but it has a franchise tax, it has an income component. So it's not clear yet, and I'm sure the division is going to come up with some regs to talk about that, it's not clear yet whether Texas gets thrown out or not.

But in "Big Co's" case, if Texas were to be thrown out, they would go from paying tax on a third of their income to New Jersey, where a third of their operations are, to paying tax on two-thirds of their income.

I'm not certain how well that would survive a constitutional challenge. It won't be our clients that pay for that. None of them can afford the hundred thousand dollars-plus set of legal fees that it takes to get to the Supreme Court, and that's probably where it would have to end up. It's only going to be the big guys that fight that battle.

So, once again, the mid market companies are getting slammed for something that was designed to hit the big multinationals and the big multinationals are escaping completely free of tax.

One thing that was also aimed at the multinationals, we think, is the disallowance of deductions for interest and royalties or other intangible costs. It was fairly popular for years, still is, among large companies, to have a Delaware finance subsidiary. And you put all your finance operations in Delaware, charge interest to all your subs that are paying state tax, strip out interest into Delaware where there is no state tax. That still works, by the way, not with Delaware but with offshore companies, for the big multinational companies. They won't pay a penny more in state tax because of either of those provisions.

All of the national firms are marketing structures that will almost guarantee to get them out of paying additional tax due to this provision. Who it hits is our client base, the mid market companies. And we suspect this wasn't considered when the law was drafted, that it could hit shareholder loans, from individuals to the shareholder, or to the companies they own.

Quite a number of our clients are

directly impacted by this. Let's take two different possibilities. S Corporation and C Corporation are owned by the same person, they are related parties. S Corporation loans money to the C corporation. C corporation will not get a deduction for that interest. And S Corp. and the shareholder will pick it up as income. That one is guaranteed regardless of tax rates of the individual.

The S Corp. and individual tax rates could be as little as one percentage point less than the corporate tax rate. There's no tax avoidance motive here because there's almost no tax avoidance. This type of arrangement is almost always done because the money is in one place and it's needed someplace else.

Situation number two: Individual loans money to the C Corp. that he owns. He's got savings, they need the money, he makes the loan, they pay him interest. If he is not in the top individual tax rate, the corporation doesn't get a deduction for the interest, he picks up the income. That's clear from the regulations.

MR. SHIPLEY: That's because of the differential between the corporate tax rate and highest individual rate, if you are below that, you don't have the three percent differ --

MR. FOX: That's right. Do all of you understand the mechanism on that?

Okay.

We think this area, that just wasn't considered, really needs to be reconsidered. What we would recommend is that a deduction be allowed if the payment is to persons that are wholly taxable in New Jersey, which is most of our client base.

There are two other partnership areas related to BTRA that I'd also like to discuss, and I'm not sure if those are within the purview of this Commission, but perhaps you can give some feedback to those that are involved in it. Both of them relate to a definition that just isn't in the law. The partnership withholding provision and the partnership $150 fee provision both apply where a partnership earns income from New Jersey sources.

That term isn't defined in the law

and it wasn't terribly relevant before the changes to the partnership rules.

Now it's very relevant.

Let me illustrate the problem with an example. One way to try to figure out what income from New Jersey sources means is to look to what kind of income it is and what kind of property it is. Rental real estate in New Jersey obviously generates income from New Jersey sources. But how about stocks and bonds? General Motors stock or Citicorp CDs, what's the source of that income, is it from New York sources? Well both Citicorp and GM have operations here, but a nonresident person, receiving interest from Citicorp or dividends from General Motors, doesn't pay New Jersey tax as a matter of law under the gross income tax.

But if the partnership earns that income, and the partnership has income from New Jersey sources, they have to withhold on that.

Now, how do we figure out if the partnership has nothing but those two items of income? How do we figure out where the source is? We don't have a rule for that.

If we look to whether the partners

get taxed on that income, you might say, okay, well, that's well and good. If they're resident partners, they will get taxed, if they are nonresidence they don't. Does that mean if a partnership had -- a non New Jersey partnership has New Jersey resident partners and all the income it gets is interest and dividend, it has to withhold tax on the nonresident partners who then will get it all back?

So we have a bit of a definitional problem that needs to be cleared up. And that will hit both under the withholding provisions and under the per partner fee provisions.

There's another aspect of the per partner fee that we consider inevitable. A lot of our -- and it relates to investment partnerships. A lot of our clients have family limited partnerships set up as a way of matching their stock and bond portfolios. Now they have to pay $150 per partner fee because they have that partnership set up to match their stocks and bonds. Where partnerships do business in New Jersey, maybe the $150 is fair. Where it is nothing but an investment holding vehicle, is that fair? We think not.

That pretty much concludes what I want to talk about.

To summarize, let me suggest the areas of change that we would recommend.

First, reduce the impact of the alternative minimum assessment on service businesses. They are the ones that will pay the bulk of the AMA.

Second, change the AMA from a cliff rate to a real graduated rate.

Third, allow deductions for all interest and royalties paid to related taxpayers that are wholly taxable in New Jersey.

Next, reconsider the trigger mechanism and the mechanics of the throw-out rule.

Next, eliminate withholding on nonresident partners and purely investment partnerships.

And finally, reduce or eliminate the $150 per partner fee, especially for family-owned partnerships.

That pretty much concludes my remarks. And thank you for letting me appear.

THE CHAIRMAN: Thank you.

Questions by the Commission?

MS. APPELBAUM: It's probably in your written testimony, but could you just explain the way in which you had the one-third, one-third, one-third, in a huge multinational, an apportionment could be as much as a half or a third -- or two-thirds?

MR. FOX: This will hit a New Jersey only company. The way an apportionment fraction works in New Jersey is a four-factor formula; sales, sales, property and payroll. So sales is double-weighted.

Under the throw-out rule, sales are removed from the denominator of the sales fraction if the company does not pay income tax in the state to which those sales are made.

So, for our "Big Co." example, we had one-third of our sales made in Nevada. Nevada doesn't have an income tax, so Nevada sales come out of the denominator.

If Texas income tax is not considered -- or if Texas franchise tax isn't considered an income tax, it comes out of the denominator for the sales fraction only. So our sales fraction will go from one-third to a hundred percent. And with double-weighting, then we have a hundred, a hundred, a third and a third, which put together equals -- and divided by four equals two-thirds.

MR. SHIPLEY: Could you go into a little more depth? You had said that in that example you ended up with it becoming unconstitutional. I wanted to follow through that analysis.

MR. FOX: This is a CPA way of talking. The courts have generally held that apportionment is permissible, though not as good as really determining what income really happened in each state. The reason they have allowed apportionment is to prevent things like Eileen suggested, manipulation as to where your earnings are and realizing that the courts felt that apportionment tends to end up with a fair result most of the time, if you do it certain ways, and will allow it.

Where that apportionment completely falls down, as in this case, where it changes -- you know, it's clear that one-third of your income is really New Jersey, and suddenly the apportionment is causing two-thirds to be taxed, it's our feeling that the courts will really have some difficulty with that. Whether it will meet the complete auto four-factor test, I think is really open to question.

MR. SHIPLEY: Thus that it would be taxing income out of all proportion to the activities conducted in New Jersey.

MR. FOX: Yes. I think the out of all proportion would be the least of my worries in that it would be clearly unfair and fairness is one of the prongs of complete auto test. Clearly, taxing you on two-thirds of your income, when you obviously earn only one-third there, is unfair and is not fairly apportioned.

You know, I think it's back to the drawing board time.

MS. APPELBAUM: I thought the problem, as you described it, was the multinationals, this "Big Co.", would not have to pay any tax.

MR. FOX: Right. What's going to happen with the throw-out rule if you leave it alone? Well, the multinationals won't have to worry about it. Our clients will. They will suddenly be taxed under the throw-out rule, even with the throw-out rule will face some AMA, especially the service businesses. The throw-out rule will tend to impact them on the regular tax in profitable years. The multinationals will take you to court, may end up winning, but it won't do our clients any good until eight to 10 years from now when they finally do win.

So the time to get from filing a tax return, to Supreme Court ruling, is a lot of years.

MR. SHIPLEY: One other follow-up. You had talked about the lack of a definition of income from New Jersey sources. Do you feel that the definition, which is contained in the gross income tax, to the extent the application was expanded beyond merely nonresidents, would that be a suitable definition to apply across-the-board?

MR. FOX: Probably so, yeah. The problem with the gross income tax definition, and that's why I pointed out that quite a few has one resident partner and everybody else is nonresident, doesn't suddenly make the nonresident subject to withholding. I think you need to figure out how to apply that at the partnership level rather than the partner level attributing back to the partnership.

Perhaps a good way to do it, since investment income in the way of dividends and interest, regular dividends, is not taxable to nonresident partners, might simply be to define income from New Jersey sources for that purpose, to exclude dividends and interest. That would go a long way toward clarifying things. Perhaps that could be done in regs.

MR. GERSHENFELD: Have you thought about a method or a way to reduce the impact of the AMA on service businesses other than just reducing the rate? I mean is that just --

MR. FOX: Some foreign jurisdictions have come up with alternative tax bases for some kinds of businesses. I used to be in the oil patch many years ago and Singapore and Indonesia both came up with an alternative tax base on a deemed profit on revenues for service businesses. So mainly from a simplicity standpoint.

And perhaps for a service business allowing some sort of deemed cost of sales or allowing recharacterizing certain operating costs, as deductible against gross receipts, would be a way to go. I'm afraid I don't have a good solution for that.

MR. GERSHENFELD: Let me ask the question a different way, which is basically most of your suggestions seem to reduce -- we can argue significantly, very significant, if the revenue of the state were reduced. What would you recommend how to make that up? In other words, a certain amount of revenue, what's the other side of this to sort of -- a $100 million, making up a number, how would you recommend that the state increase a $100 million?

MR. FOX: There are a lot of politically unpopular ways to do that. Taxing one segment of the population and not another, though, strikes me as inherently unfair.

I think some of the provisions here, especially of the AMA, are tending to tax the mid market company, and the mid market company that is owned by people who vote, and not taxing the big, evil multinationals who don't vote. And I suspect some of these provisions were designed to do exactly the opposite. It just didn't quite work right.

THE CHAIRMAN: Any other questions?

MS. APPELBAUM: How do you define mid market when you talk about it? Is this a company with just one location or is it less than a certain number of employees?

MR. FOX: Generally, most definitions look to revenues. And it depends on who you ask, what mid market is. Clearly a company with $25 million in revenues is a mid market company, same with one with 50. When you hit a hundred, is it still mid market? Yeah, probably. At 300 million, probably not.

MS. APPELBAUM: A hundred five million?

MR. FOX: At a million, no, it's still mom-and-pop.

MS. APPELBAUM: Between a hundred and 300 million?

MR. FOX: Generally tend to be 125 to 200 is what most people tend to look at. In other words, the typical prosperous, growing, not-yet-public company.

MS. APPELBAUM: So not-yet-public would be another --

MR. FOX: Yes, none of our clients are publicly traded.

THE CHAIRMAN: Questions of anyone else?

Thank you.

MR. FOX: Thank you for the opportunity.

THE CHAIRMAN: Thank you. I appreciate your help.

Are there any other witnesses or speakers at this point? If not, I would suggest that, it's about 2:00, we'll adjourn for a few moments.

(45-minute adjournment.)

45 minutes elapsed since our last speaker. No other notices or intent to speak were received, so we'll adjourn this initial meeting at approximately 3 PM. The Commission will meet again on Thursday, May 15th, at 1:00, on the campus of Rutgers University New

Brunswick.

(Whereupon, the proceedings concluded at 3:00 PM.)

C E R T I F I C A T E

I, JOANNE M. OPPERMANN, a Certified Shorthand Reporter and Notary Public of the State of New Jersey, do hereby state that the foregoing is a true and accurate transcript of my stenographic notes of the within proceedings, to the best of my ability.

/s/ JOANNE M. OPPERMANN

JOANNE M. OPPERMANN, C.S.R.
License No. XI01435

NEW JERSEY CORPORATION BUSINESS
TAX COMMISSION
PUBLIC HEARING

:
IN RE: :
CORPORATION BUSINESS TAX STUDY :
:

TAKEN: THURSDAY, MAY 15, 2003
BEFORE: CORPORATE BUSINESS TAX COMMISSION

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I N D E X

E X H I B I T S

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MR. EVANS: Good afternoon. My name is Jim Evans. I serve as the initial chair of the "Corporation Business Tax Study Commission. " I'm an attorney in Haddonfield, New Jersey.

Before we begin, I'd ask the members of the commission to introduce themselves. We'll start on my left.

MR. KASPARIAN: Michael Kasparian.

MR. PYDYSZEWSKI: John Pydyszewski.

MR. SHIPLEY: David Shipley.

MR. KRUEGER: Bob Krueger.

MR. HUTTLE: Frank Huttle.

MS. GAINES: Tami Gaines.

MR. GERSHENFELD: Ken Gershenfeld.

MR. EVANS: Eileen Applebaum is also a member of the commission, and is unable to attend the hearing.

This commission is established pursuant to Section 31 of Public Law 2002, Chapter 40, designated to Business Tax Reformat. This commission is the study and evaluate the corporate tax law reforms adopted pursuant to the act.

The commission is to issue a report with findings and recommendations to the governor and the legislature, along with any legislative bills it desires to recommend for adoption by the legislature, no later than December 30, 2003.

If the director of the Division of Taxation determines that a final report has not been issued by the commission by June 30, 2004, the director shall suspend the alternate minimum assessment imposed by the act for all privilege periods commencing after December 31, 2004.

If this commission recommends the termination after alternate minimum assessment, the assessment shall not be imposed for privileged periods beginning on or after January 1, 2005.

The Business Tax Reform Act directs this commission to hold at least three public hearings. This public hearing is this second of three scheduled public hearings.

On behalf of each member of the commission, I thank Rutgers University for making available to the commission its facilities on the Newark, New Brunswick, and Camden campuses.

The commission, through the Office of the Treasurer, provided notice of these hearings of the commission to the Secretary of

State, and to all major newspapers. The commissions through the Office of Treasurer has notified various business tax and professional associations of these public hearings.

The commission will accept written copies of testimony, in addition to an oral presentation. Members unable to -- or persons unable to attend the hearings can submit written testimony to the commission through the Office of the Treasurer until June 30, 2003.

At this point, I'd ask Mr. Davidoff, our first speaker, to begin his testimony.

Thank you.

MR. DAVIDOFF: Thank you very much Mr. Evans, and thank you very much, commission members.

My name is E. Martin Davidoff. I'm a CPA, and a tax attorney, practicing out of Dayton, New Jersey.

In your folders, you have three documents. One is a copy of today's testimony, the one that starts out, "Scope of Commission's Responsibilities." The others are an article from Business News New Jersey that really was also incorporated to my testimony last year before the Assembly Budget Committee. And I've given that to you by, more as means of background, but I do ask that it be incorporated into the record.

As you very well know, the statute under which you have been formed asks that you evaluate --

By the way, I'm not going to read all of my testimony. I'm going to read certain parts.

MR. EVANS: Thank you.

MR. DAVIDOFF: As all of you well know, the statute under which you've formed asks that you evaluate the corporate law tax reforms adopted by Public Law 2002, Chapter 40.

The statute goes on to present five specific questions to you. However, I ask you to consider the initial wording in the statute, wherein you were asked to evaluate the corporate tax law reforms.

To that end, I ask you to interpret that phrase, in broad terms, to include all of the taxes imposed by Chapter 40, under what I would call the guise of making companies pay their fair share.

Specifically, I'm asking to include in your report, a position $150 processing fees imposed on many partnerships. Although this is not technically a corporate tax, it is certainly one of the major revenue raises last year on business, and it's really one of the most devastating to our state citizens.

Basically, my testimony is going to cover three areas. Two of which I'm sure you're very familiar with; the third, you may not be, and, hopefully, I will be bringing to your attention.

The ones that are familiar to you are the $150 processing fee on partnerships, advocating that that be repealed.

And the other item that I think you're familiar is to reduce the corporate minimum tax back from the 500 to the $210 that it was scheduled to be.

The third area is requesting you to add relief provisions on the suspension of net operating losses for those companies selling the bulk of their assets as part of a plan of liquidation.

In essence, what's happening is,

companies are selling their assets, getting a big gain, going out of business, and never getting to use those carry forward losses. And that's causing them an undue hardship. They're basically losing it forever.

Repeal of the new processing fee on partnerships. Basically, this is neither a tax on income, nor is it one on wealth. It was nothing more than a tax in the vein of, "if it moves, let's tax it."

I was actually involved in some of the preliminary discussions with the treasurer's office. And then, one day, when they cut off involving business groups, I was there on behalf of the N.F.I.B. Today I'm here on behalf of myself.

But, you know, I got a call from Mitchell Loster (Ph.) one day, and Michelle said, What do you think of this $150 per partner charge? And I said, I think it's a terrible idea. You're going to have a lot of small investment clubs, and you're going to have a lot of people.

And, frankly, when Jim Evans and I -- I didn't use that name at the time. But Jim and I were on the ADHOC tax force to put together the S Corporation law, back in 1993. And one of the things we added to that, as a fund-raiser, was the filing of partnership returns. Up until then, there were no partnerships returns.

And we added a requirement that partnership returns be filed, and with the purpose that you would then fine people, and get money from them.

So, here, the absurdity of requesting a $150 fee for the processing, quote, unquote, of returns, is absurd. It doesn't cost the state to process insurance. What's happening is, they're making money because of the returns that are required, and this is nothing more than a grab for money.

I'm turning now -- if you're following along a little bit. I'm now page two. I'm going to talk about the suspension of net operating losses.

These provisions need some tweaking. You know, for the most part, for most companies, these are not going to hurt people, two-year suspensions, it's just going to defer their ability to use it.

However, what happens in the case of an enterprise which terminates its operations? This has happened at least to one of my clients, who had it -- who had suspended its operations prior to the passage of the legislation. And, in February of 2002, sold its real estate and inventory at a substantial gain.

They had a about a $600,000 net operating loss carried forward, and as a result of sales, they had about a $300,000 gain. They ended up having to fork over $27,000.

Under the new law, it was unable to carry forward its net operating losses. The loss is simply suspended and lost for -- it's not simply suspended, it's lost forever.

What could be more unfair?

At the time of the transaction, their loss could be utilized. I mean, it's even more unfair, in this particular case, because the transaction was done before the law was even passed. However, the retroactivity of the law has unfairly cost them substantial dollars.

And I'm not looking for you just to correct this in the case of a retroactive instance. Which, clearly, is one that should be remedied. But also, if somebody's going to terminate their company in this two-year period because they have a good offer --

I mean, we should not -- the tax law should not be affecting economic decisions too much. You know, it's always going to have some affect, but it shouldn't affect it too much.

So, basically, I put here, the two-year suspension of net operating losses should not apply to years in which the companies sell substantially all of their assets as part of a plan of liquidation. Instead of a deferral of operating losses, these companies would suffer the total elimination of their net operating losses.

And the two-year suspension, if you try and look for even a clearer rule, should not apply to the last or next to last year of the corporation's operation.

And you might ask, How do we know when the next to last year is? Well, you know because the guys amend the returns, and say, here was my last year, and now I'm asking the law to be used the year before.

MR. SHIPLEY: What's the theory for

applying it to the next to last year?

MR. DAVIDOFF: Often, what happens is, it's in the next to last year that they actually do the sale. And by the time they formally liquidate, the Secretary of State, you've drooped over into another year.

I've had many cases where I'll adopt a plan of liquidation in January, I'll liquidate the last asset in November, I don't get the final return in until January, and then the secretary -- the Secretary of State, or Division of Taxation says, We want a next year's return. So, technically, there would be another year's return.

MR. SHIPLEY: So it would merely be the year in which the gain and liquidation were recognized?

MR. DAVIDOFF: That's where I'm looking.

MR. SHIPLEY: It technically could. Even be depending on how long it takes to liquidate, you could have three tax years or it could be one.

MR. DAVIDOFF: Sometimes, yes.

MR. SHIPLEY: So it just would be

targeted to the year in which the gain was recognized?

MR. DAVIDOFF: That would be certainly appropriate. Yes. Yes. That could work.

MR. SHIPLEY: Is there a reason that this should only apply to just total liquidation, or would partial liquidation be covered, also?

MR. DAVIDOFF: I'm with you. The only reason that -- why it's more urgent for a total liquidation, at least, if you have a partial liquidation, presumably, you have an operating business going forward that could use up the losses. But, certainly, in a total liquidation there's a more compelling argument.

In this particular case, with this particular company -- sometimes it just pulls at your heart strings. It tugs a little bit.

You had a company that was in business for 75 years here, in New Jersey, and -- you know, three generations. And here, right at the end --

They did everything exactly the way they were supposed to, and then, you know, when we're preparing the tax returns, Oh, you owe

$27,000.

The corporate minimum tax, you'll see in my testimony, it's too high, it's too high, it's too high. Even California, which charges $800, at least gives the first two years. They give you a break. They don't charge you the minimum tax. New York, in certain circumstances -- and probably, some of you know this better than I -- charges $100, in many cases.

And basically, what's happening is -- and I've listed in my testimony how people are reacting. You know, the merging into limited liability companies, they've decided to actually do business in other states.

Sometimes -- I've had this happen a couple times -- they incorporate out of state thinking that they're going -- even they're doing business here in New Jersey, thinking that they're going to avoid the tax.

And you may be losing some ground where people like me tell them, no, no, no, that's not going to work. They may actually just not file in New Jersey, thinking they're okay, and do business in New Jersey.

They've abandoned their corporations. Some have, you know, just walked away, and said, I'm not paying it. You had a lot of inactive corporations. And they point it out as one of the reasons to increase the minimum tax. We have all these inactive corporations, you know.

I was part of the group, in 1993, again, that, you know, as part of the negotiations between the governor, which, at the time, was a democratic governor, and the legislature which was predominantly republican, there was discussion about, Let's increase the minimum tax from $25. And we phased it into $200.

And we actually put an automatic provision, that every five years, take 75 percent of the cost of living, and let's increase it automatically so that the legislature would never again have to vote an increase in the minimum tax. Because they thought it was going to be a -- to vote an increase in taxes would be very difficult for the legislature to ever do. We found differently in the last year.

MR. SHIPLEY: And have you found

that there's a significant number of fines paying the $500 minimum tax as opposed to AMA?

MR. DAVIDOFF: Oh, yeah. Absolutely. You had an overwhelming number of companies paying the minimum tax before.

MR. SHIPLEY: Basically, the companies you're referring to are ones that fall below the AMA's minimum?

MR. DAVIDOFF: Absolutely. Yes. I'm talking about companies like --

I had one that had three transactions a year, buying office supplies. I had a company that was an office supply company, that bought office supplies, and sold it to me and a couple of other CPA firms, and, you know, it was -- and now, the $500, you know, puts me into a $300 deficit each year. So we ended up merging that company into an LLC.

I have a lot of very small corporations. Some that are just there to hold the name, some that are just there awaiting for something. And I have the same problem with limited liability companies.

I had -- one of my clients had a three-person LLC, and got hit by the $450 assessment. And they had tried something, and they said, Well, should I stay here or should I go? And they said, This is just pushing me over the line. Why do I need to be paying this? I might as well just give up on the business. I don't want to pay this money.

Now, it's not a lot of money. It may not be a lot of money to me, it may not be a lot of money to you. But, basically, when you're looking at where you allocate resource. If it's $200, people could accept that. $500, that becomes significant money.

And, you know, certainly, a lot of people were surprised, as much publicity with the law. A lot of people didn't know, until March 15th or April 15th, that the LLC taxes. Particularly, the withholding on out-of-state people. A lot of people got surprised by that.

And the corporate tax, it's just -- you know, for the small ones is where I'm seeing it. The relatively inactive ma and pa little businesses, doing anywhere from zero to a couple hundred thousand dollars a year. If you're doing a couple hundred thousand dollars a year, you're not going to squawk a lot about $500 tax.

But a lot of these companies were inactive, had very little activity. And, you know, for those, it just doesn't make sense.

Now, you know, you might -- I haven't even thought of it. But thinking out loud with you today, and with the questions raised, you might think about, well, we could have a minimum tax grant, you know, to be $200 if you have less than 200,000 of gross revenue, or less than this, and less than that. And much like New York had something where their minimum tax racks up based upon activity. And that -- you know, that may be something you may want to consider as a recommendation.

Here's the tough part. Okay. Most people come in here, and say, Let's reduce the taxes. I'm going to come up here, and give you a couple ideas on how to raise the revenue to offset those reductions.

Obviously, we know, one way is, you've gotten more money than you expected. Not you, but in the State Treasury. From the corporate taxes.

And that's a good thing because it may allow you to give some relief in some of these areas. And, again, I put all these in writing in my testimony.

But basically, you know -- and I encourage you to continue to close loopholes that still may be available to multi-national corporations, and specifically ask you to consider a unitary business concept.

This is fair, in light of the fact that 2002 legislation placed an unfair burden on small businesses. Due, in large part, to organizations lobbying heavily on behalf of the largest corporations doing business in New Jersey.

MR. SHIPLEY: What loopholes would you be referring to?

Because we have been trying to determine if there are any other loopholes out there.

Is there anything specific you had in mind?

MR. DAVIDOFF: No. I really don't. I don't work enough in that area, that I -- you know --

I think, when the debate was going through, there were certain things that were backed off on from bigger corporations. I think, if you look to the legislative history, and see what things were proposed, and backed off on, you might want to take another look at some of those items. And I don't remember them, offhand, right now.

But I will tell you this, with the New Jersey Chamber of Commerce that recommended the increase from -- to $500 in the minimum tax because of, they wanted relief in other areas for the larger corporations.

I'd also -- you know. Again, if you're taking a look at -- you know, how do we substitute? I'm not suggesting you do this alone. But if you say, How do we give the relief to the smaller, and, yet, collect the same revenue?

New York has a tax on capital. All right. Which is a very low tax if you're a very small business. And you might want to consider, you know, at a very minimal level, thinking of that to replace it. Again, I think you have better alternatives, but, you know, there are a lot of things.

One of the items is, as you well

know, the federal tax rules allow only 50 percent of your meals and entertainment.

New Jersey has, what I would call, a complicating factor. In that, anything different from the federal laws is a complication. They actually give additional benefit by saying, We'll give you a hundred percent.

Well, take that money, link up to the federal law in there, and take that money and provide it for relief on the minimum tax, provide it for relief on the $150 processing fee. Maybe even formalize the exemption on investment clubs. Right now, it is an informal $60,000 a year.

So, you know, that's one area that you can provide simplification. And most -- I don't think you'll get a lot of squawks about that because, you know, you're following the federal law.

Much has been said, particularly this year, more than last year, about all of us joining in and sharing the burden of New Jersey's budget deficits. However, that has not been the reality at all.

Instead, at every turn, businesses of every type have been attacked and burdened by additional tax. Since taxes have been assessed through an unfair amalgamation of new taxes.

Ideally, what should have taken place as an across-the-board increase to everyone, coupled with an couple true loopholes. That's what should have happened.

Now, last year, I proposed that we all share the burden. To that end, I proposed a surtax as a fair, simplest solution to our budget deficit.

We had an $8 billion, approximately, individual gross income tax. Many of the people who pay the minimum tax and the $150 processing fee are in this category. And those specific proposals are outlined in last year's testimony.

In this manner, everyone would be coming together to close our budget deficit. Those who paid very little would have very little increase. What's a 5 percent increase if you're only paying $200 in tax. It's $10. But if you're paying 6,000 in tax, it's $300.

Everybody's coming together to close our budget deficit. The most burden falls equitably on everyone across the board, and a proportion to their current tax burdens.

You have unique opportunities over the coming months to provide your expertise and knowledge of the tax laws and tax policy to recommend gutsy legislation, to eliminate the three problems I have discussed today.

Quite simply: The $150 tax processing fee in a wholly inappropriate tax and should be repealed; the suspension of net operating loss has unintended effects which needs to be corrected; and the minimum tax of $500 per year is too high.

Correct these inequities, and you will have done New Jersey a huge service.

I would like to thank Dan Levine for the support that he provides you today, and the leadership he provided ten years when we worked together, along with Jim, on the S Corporation tax legislation.

I'd also like to thank each of you for your time that you have committed to this process. You should be congratulated for your zest for public service and your commitment to the integrity of the process.

I'm open to any other questions, comments.

MR. EVANS: Questions of the commission?

(No Response.)

MR. EVANS: Thank you very much. We appreciate your time and your thoughts.

MR. DAVIDOFF: There's an extra blue folder for the person who didn't show up.

MR. EVANS: Are there any other persons that wish to speak at this time?

MR. NARDI: I'd just like to make a few comments.

MR. EVANS: Why don't you come to the table, give your name and spelling to assist the reporter.

MR. NARDI: Frank Nardi, N-A-R-D-I. I don't have anything formally prepared. I'll just give you a little background of myself; I'm a CPA, I'm also an attorney; I run a solo practice in Newark, New Jersey.

Currently, I'm the vice-president of the New Jersey Association of Public Accountants. They asked me to come down here today and just listen to the testimony. But as I listened to Mr. Davidoff, I just wanted to say a few comments, and discuss something that's been going on with our organization.

When we found out that the minimum tax was going to be increased to $500, a lot of us deal with small mom and pop organizations, sole proprietors, with a corporate structure.

In speaking with the state of New Jersey, I found that the state feels as though maybe those people shouldn't be corporations.

And I'm getting a sense, from my small corporations, which I have about a hundred different corporations, small clients, that this $500 increase has really hurt them in the pocketbook, and they're not willing to continue as a corporation.

As Mr. Davidoff has said, that a lot of the clients didn't realize that the fee would be $500 until March. And they were willing to make it their final years corporate business tax returns, and switch back to a sole proprietor, provided that they didn't have to pay another $500 fee.

And I know this is going outside the CB tax structure a little bit, and going into the division of commercial reporting. Dissolution process in New Jersey, right now, to get these corporations back to sole proprietors is very, very difficult and costly for these people.

This year my CBT clients looked a $750 tax liability as opposed to a $200 tax liability. The reason being, it was 500, plus an additional 250 as the estimated tax for next year. My clients are asking me, How would I go about dissolving?

I inform them that they would additionally have to pay another $500 for 2003 because their corporation wouldn't be dissolved in that year, of 2002; I told them that the requirement to dissolve the corporation, through New Jersey, takes over 90 days; and that the attorney's fee for something like that is typically somewhere between 750 to $1,500 on the low end.

So these people are faced with $750 in 2002, an additional 250 for 2003, and another $1,500 in attorneys fees. Costing them $2,500 to dissolve their corporation.

And the reason why I bring it to your that attention is, I understand a lot of you don't deal with small companies. But in the past, attorneys, not myself, but others attorneys have told people, don't pay your annual report fee, and the corporation will dissolve itself, by statute.

And I understand, that if you didn't have the annual report filed for three years, the corporation will dissolve, under state statute.

The Division of Taxation doesn't recognize that dissolution. They require a tax clearance certificate, and a formal dissolution process.

As I said, there's a lot of corporations sitting on the state records right now. It's a waste of time, from the State of New Jersey's viewpoint, resources and correspondence.

I always get delinquency notices from corporations that haven't been in business for years, and they're looking for that $200 a year CBT tax. That's accumulated up to a large amount of money if they haven't dissolved.

I'd like the commission, here, to pretty much, try and find a simplified way to dissolve corporations for inactive companies that have been around for years.

And the reason why this has become larger concern is, there was mention that I found that the CBT franchise tax may become a personal tax liability.

In the past, they could not go after the corporate officers for the CBT tax. The corporate officers would only be responsible for sales and use tax, and GIT tax. The trust fund monies.

Now, with this law coming into place, the State of New Jersey would be basically chasing companies that haven't been in business for years for thousands of dollars.

I'd like the commission to possibly take a look at states like New York and Florida. I understand New York basically dissolves a corporation with a phone call. We don't have that luxury in New Jersey. And, in fact, the process extends beyond 90 days sometimes. And I just want to go into that process for one second.

If a client wanted to dissolve in 2002, you had to have your application in to the State of New Jersey by September 30. If you tried to dissolve in October, November, or December, for the most part, your dissolution would not be effective for 2002, and you have to go back to your client, and tell them that they would have to file a CBT tax return for 2003. Clients don't want to hear that.

There's a very negative stance towards the state, at that point. Why do they have to have the state take 90 days to dissolve their corporation?

The state did accept a few dissolutions after October, and gave you an opportunity to have it resolved in 2002. But those were few and far in between.

The other problem that I've come across is reinstatements of corporations that have lost their corporate charter. Reasons why companies have lost their corporate charter is failure to file a CBT return or an annual report.

In the past, a corporation was not advised that their annual report was not received and filed. Sometimes the attorneys would receive that annual report, and not forward it to the client.

I had one client that was inactive -- or lost their corporate charter back in '84, and didn't find out about it until a year ago.

In trying to dissolve that

corporation, formally, I was faced with the fact that I had to reinstate the company, which costs over $375, bring that past due CBT tax and annual report fees back into existence, and then take the time to dissolve the corporation.

You're going to -- the state is going to be basically wasting a lot of time and effort and money trying to track down these small corporations that shouldn't have been corporations, possibly. And all I'm asking is, if there's a possibility of streamlining the process, making some type of amnesty provisions to dissolve old corporations so that they're not affected by the penalty periods and interest. Maybe just a one flat sum. To try and get some of these corporations that the state is wasting their time trying to track down.

I appreciate your time on that. Thank you very much. I'm sorry I didn't have anything formal. But I wish that you would consider the small taxpayer out there, and try and make some type of provision to reduce the amount of tax and costs in dissolving the corporation in order to bring him back to a place where he could be sole proprietor, and not incur this additional tax.

Thank you.

MR. EVANS: Thank you, Mr. Nardi. Are there any questions of the commission?

(No Response.)

MR. EVANS: Thank you. Any other persons wish speak with the commission this morning?

(No response.)

MR. EVANS: If not, the next scheduled public hearing of the commission is May 29, on the Rutgers campus in Camden, New Jersey. It's scheduled to begin at 1 p.m.

With no other comments from the commission, or any commissioner, we'll conclude this hearing.

Thank you.

(HEARING ADJOURNED AT 2:18 P.M.)

C E R T I F I C A T E

I, MIRIAM RIOS (License No. XIO2031), a Certified Shorthand Reporter and Notary Public of the State of New Jersey, do hereby certify the foregoing to be a true and accurate transcript of my original stenographic notes taken at the time and place hereinbefore set forth.

/s/ MIRIAM RIOS

MIRIAM RIOS, CSR

(XIO0203100)

Dated: June 18, 2003

STATE OF NEW JERSEY

DEPARTMENT OF TREASURY

CORPORATION BUSINESS TAX STUDY COMMISSION

PUBLIC HEARING

AT: RUTGERS UNIVERSITY
Student Center
311 North 5th Street
Camden, New Jersey

DATE: THURSDAY, MAY 29, 2003

TIME: 1:21 P.M. TO 2:38 P.M.

ESSEX-UNION REPORTING SERVICE
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Roseland, New Jersey 0768
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P A N E L   M E M B E R S:

JAMES B. EVANS, Jr., Esq., Chairman

TAMI C. GAINES

KEN GERSHENFELD

JOHN J. PYDYSZEWSKI, State Tax Manager

DAVID J. SHIPLEY

I N D E X

E X H I B I T S

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(NO EXHIBITS WERE MARKED.)

R E Q U E S T S

(NO REQUESTS WERE MADE.)

CHAIRMAN EVANS: Good afternoon, my name is Jim Evans. I serve as the current chair of the Corporation Business Study Tax Commission. Today we have Ken Gershenfeld and John Pydyszewski of the Commission attending this hearing as well.

The Commission was established pursuant to Section 31 of Public Law 2002 Chapter 40 designated to the Business Tax Reform Act. This advisory commission is to study and evaluate the corporate tax law reforms adopted pursuant to the act. This Commission is to issue a report with findings and recommendation to the governor and legislature along with any legislative bills and desires to recommend for adoption by the legislature no later than December 3, 2003.

If the director of the Division of Taxation determines that the final report of this Commission has not been released by June 30, 2004, the director shall suspend the alternate minimum assessment imposed by the act for all privilege periods commencing after December 31, 2004. If this Commission recommends the termination of the alternate minimum assessment, the assessment shall not be imposed for privilege periods beginning on or after January 1, 2005.

The Business Tax Reform Act directs this Commission to hold at least three public hearings. This hearing is the last of three scheduled public hearings. On behalf of each member of the Commission, I thank Rutgers University for making available to the Commission its facilities in the Newark, New Brunswick, and Camden Campuses.

The Commission through the office of the Treasurer provided notice of these scheduled hearings of the Commission to the Secretary of State, all major papers throughout the state. The Commission through the Office of the Treasurer also notified various business, tax, and professional associations of these public hearings.

With that, we'll have the first speaker, Mary Forsberg.

Thank you, Mary.

MS. FORSBERG: Mary Forsberg.

(David Shipley, Commission member, arrives.)

CHAIRMAN EVANS: Before you start, I guess David Shipley has also joined the

Commission, a Commission member who joined us today.

Mary, thank you. Go ahead.

MS. FORSBERG: Thank you for the opportunity to testify before you today. My name is Mary Forsberg. I am a senior policy analyst at New Jersey Policy Perspective. New Jersey Policy Perspective is a nonpartisan and nonprofit research and educational organization established in 1997 with the mission of promoting broad debate about the important issues facing the people of New Jersey.

Before talking a job with New Jersey Policy Perspective, I was an analyst at the nonpartisan Office of Legislative Services. I have spent more than 20 years analyzing taxes, budgets and public sector programs.

Earlier this year, I wrote a report, A Question of Balance, which attempted to explain the New Jersey business tax and the reforms that took place last year. My purpose in writing this report was to increase awareness about the corporate business tax so that people who are not CEOs, lawyers, CPAs, lobbyists or employees at the New Jersey Division of Taxation can have an informed opinions about the way we tax corporations.

Information that came out last year prior to the CBT reforms showed that the corporate business tax in New Jersey was not working.

Although corporate profits doubled from 15.6 billion in 1990 to 31.2 billion in 2000, corporate tax revenues were stagnant.

Seventy-seven percent of New Jersey's 262,000 corporations paid only $200 in corporate business taxes and 30 of the 50 largest employers in New Jersey were among these corporations.

The 50 largest employers in New Jersey combined to pay $345 million in corporate business taxes in 1999 but 10 of these companies paid $314 million or 91 percent of the revenue, while 30 collectively paid a total of $6,000 -- only $200 per company.

A simple comparison of three grocers at a legislative hearing last June showed how inequitable the New Jersey corporate business tax was. The giant multi-state A&P chain, one of New Jersey's 50 largest employers pay, paid $200 in corporate business taxes while a smaller New Jersey-based QuickChek paid $210,000; and the smallest of all, a single store, Pagano's paid $3,000.

Prior to the reform, certain corporations were not subject to the New Jersey franchise tax if they solicited orders and delivered goods in New Jersey but did not have an office or employees in the state. This put New Jersey-based businesses subject to the franchise tax at a comparative disadvantage to other corporations if they were not subject to the New Jersey franchise tax.

Some of the changes made to the corporate business tax in 200032 were an effort to address a projected shortfall in the fiscal year 2003 budget and were expected to provide a one time, one fiscal year benefit. I know you know all of this but I would like to highlight three key changes that I think may have a longer term impact.

The first is the Alternative Minimum Assessment and Loophole Closing Proposals. The AMA was designed to measure a company's economic activity in New Jersey in situations where the traditional corporate business tax is not a fair measure. It is levied on either gross receipts or gross profits at graduated rates and allows no deductions or exemptions. Every corporation with gross receipts above $2 million or gross profits above $1 million must calculate its liability under the revised old system and under the AMA and pay whichever is highest.

Two types of income are expected to be captured by the AMA.

The first is the situation where a large New Jersey corporation is able to use loopholes in the tax code to transfer valuable assets to another state in order to reduce its taxable liability in New Jersey. The tax reform has made it more difficult to transfer these assets. Absent mandatory combined reporting for all multi-state corporations, the AMA is expected to improve the distribution of the tax burden between multi-state corporations and New Jesery-only corporations.

The AMA also applies to out-of-state companies that sell products in New Jersey but have no office or employees. Because it is a tax on gross receipts or gross profits not income, New Jersey expects it will be able to collect taxes from every corporation that earns money in the state. It is expected that this will level the playing field between New Jersey companies and untaxed out-of-state companies.

Tax Rates. All corporations with incomes over $100,000 and over 50,000 continue to be taxed at the respective rates of 9 percent and 7.5 percent. Beginning in 2002, a new reduced rate of 6.5 percent is applied to corporations with net incomes of $50,000 or less. The obvious impact of this is to tax smaller corporations less heavily.

The minimum corporate business tax. The new law increase the minimum corporate business tax from $210 to $500 annually. According to the Division of Taxation, two types of corporations are likely to pay this tax. One group is the 60,000 or so mostly inactive corporations that had no economic activity but remain incorporated for a variety of legal and business reasons; the other are the 100,000 New Jersey corporations that will not be subject to the AMA either because their gross receipts or their gross profits are below the 2 million and

1 million.

This past Tuesday Treasurer McCormac told the Assembly Budget Committee that in FY 2003 the state expects to collect over $2.4 billion in taxes from corporations who do business in this state. He acknowledged that approximately $500 million of these revenues are due to one time speed up provisions. Even discounting the $500 million, this is significantly more than what would have been collected without the reforms.

Although it is obvious that corporations are paying more tax, the underlying source of the new revenue is not yet understood -- and won't be understood for months -- obviously, as you know, because many corporations file preliminary returns and pay their tax in April but do not file a final return until October.

As someone interested in taxes and equity I would like to analyze and be able to understand who pays the state corporate business tax. Because of privacy issues, however, anecdotal information is all that is available -- interesting for the story but is not necessarily the most accurate or appropriate basis for public policy.

Sixteen years ago was the last time that the New Jersey Division of Taxation published information on corporate tax returns. This information actually shows the overall structure of the corporate business tax has change little. In 1987, 69 percent of New Jersey's 216,572 corporations paid $200 or less in corporate taxes and 1467 paid more than $100,000. This is not unlike the information Governor McGreevey released in his budget last year.

But neither then nor now do we have information on the companies who are paying that tax. What we have are anecdotal stories like the story I told earlier about the three grocers. In New Jersey it is possible to have open discussions about property taxes, income taxes and sales taxes because we have information available to us. Property tax records are publicly available to everyone. Substantial information about the income tax data is also available to the public because the state publishes that data annually. No where is corporate income tax data made available and this is bad public policy.

I would like to close with a selection of the recommendations I made in A Questions of Balance, which I assume some of you had read, which I believe would improve public awareness and accountability.

The first is I believe the state should mandate combined reporting. I am not an expert on this but tax practitioners who represent the public not corporations agree that mandatory combined reporting is perhaps the single most important measure any state can act to simplify corporate tax administration and limit the tax strategies that companies use to minimize their tax liabilities in individual states. Mandatory combined reporting is considered one of the best ways to minimize corporations' ability to shift income to lower tax jurisdictions. This leads me to my second recommendation.

The state should consider making the Alternative Minimum Assessment permanent. As you know, the AMA is scheduled to expire in 2006 form most companies. The state believes the measures it has taken to limit loophole abuses will reduce the need for this alternative tax.

It is very important for the state to do a very thorough job of analyzing who is paying the AMA; how much they are paying; and what they would pay under the corporate business tax. The state should not allow the AMA to sunset until it is absolutely certain tax shifting strategies have been eliminated.

The state should also require corporations to make public the amount of tax they pay in each state just as they disclose the amount of federal tax they pay. Since corporations are creatures of the law and it is in the public interest for citizens to know whether the standards of law are being met, New Jersey should require corporations to provide the public with clear detailed information on their taxes. This should include a straightforward statement of what they paid in state taxes and the reasons why those taxes differ from the statutory 9 percent, 7.5 percent or 6.5 percent corporate rates now in effect in New Jersey. Without information there can be no accountability.

New Jersey officials should also support the creation of a nationwide accounting database which would show how corporate taxable income gets divided across state lines and to which states corporations pay taxes.

The state should also report how much tax revenue is given up by providing incentives to businesses and should establish rigorous criteria for the future use of such credits. A number of states, including Maine, Minnesota, Texas, Connecticut and West Virginia, have enacted disclosure laws that require companies to make public the value of subsidies they receive each year. Some states also have started to respond to subsidy abuse through "clawback" laws that reclaim taxes and subsidies if a company does not fulfill all aspects of the incentives provided.

Tuesday at the Assembly Budget hearing, legislators wanted to know whether this commission had met and whether you had prepared any reports yet. There is obviously great interest in the impact of these reforms.

I, for one, am very interested in your analysis and recommendations and look forward to learning more about the corporate tax burden in New Jersey.

Thank you for your time and consideration.

CHAIRMAN EVANS: Thank you, Mary.

Questions of Mary?

MR. GERSHENFELD: I have lots.

Well, Mary, first of all, I went to your presentation you made on A Question of Balance. I thought it was great. I think you really -- your report was very interesting reading and it gave me a very good springboard to start understanding, so we appreciate that.

MS. FORSBERG: Thank you.

MR. GERSHENFELD: A couple of interesting things, which I don't know and I'm going to sort of -- you talk about -- on one hand, you say that, for example, let's talk about combined reporting which you know it's single. Personally, I think the combined reporting may be something which we would consider as one of the questions.

The question that we heard from a lot of people is there's a real question with combined reporting as to you may agree that theoretically it works, but what you do after the first three or four years? The state has no idea how much revenue it will bring in or not bring in and it could be a lot more, a lot less. And the major threshold is one from a practicality which is as far as the state knows, it might just be a billion dollars less in the first year.

And maybe the answer is in good years it could have switched very easily and no one would have worried. But in years where it's financially troubling, they can't take any risk of not having the revenue or predict what the revenue will be without any good estimate.

What do you think about that?

MS. FORSBERG: I'm not an expert on this, I have to admit. But I talked to someone at the Division of Taxation about this, and I note that, I was told that the administration considered combined reporting and backed off because they thought they might lose money. And the person I talked to at the Division of Taxation said, "Well, you know, who knows." But he actually didn't really feel that the state would lose money.

MR. GERSHENFELD: But it's not even

losing money, they just have no idea how to project what the number's going to be.

MS. FORSBERG: Oh.

MR. GERSHENFELD: In other words, it's got no -- it's not -- if they knew it was going to cost them $500 million, they'd say "Fine, we could budget that. We'll do it." The real question is they just don't have a clue as to what the number will be.

MS. FORSBERG: Interests of doing revenue checks.

MR. GERSHENFELD: That's exactly right.

MS. FORSBERG: Oh, okay.

MR. GERSHENFELD: But two or three years they're just sort of in the dark. If you could tell them exactly what the number would be, we could then say "Here is the number, let's work on it. Here's close to the number." But they just don't have a clue. They're smart guys. They've been working on it. They've been thinking about it. It's not like they're --

MR. SHIPLEY: I don't think it's a matter that they don't have the information to upon which to actually to come up with a projection.

MS. FORSBERG: Right.

MR. SHIPLEY: That may be a more accurate statement.

MS. FORSBERG: Well, you know, when I worked at the Office of Legislative Services, for a couple of years I was part of the group that did revenue estimating. And there were all sorts of -- I mean, we always worked in the dark because we didn't have as much information as anybody else had. And I so, you know, part of it is a guess. But I know with a lot of those tax assignments we really didn't have much of a clue and had to go along with what the administration believed the estimate was going to be, and I believe they were guessing a lot of the time, too.

MR. GERSHENFELD: It's also interesting to me that you -- you know, we had some people from the state tax and they both thought that sort of you look around the state and you don't find gross receipts anywhere. And that really if you had your intertidal (ph) reporting or combined reporting, that would sort of put everyone on an equal footing and then there was really no purpose for the AMA other than to raise revenue.

It's interesting that you connect the two and you think that even if you have combined reporting, the AMA is still something that should be permanent. It seems to me that if the AMA would sort of tax people fairly, you go to combined reporting, then the AMA is not really needed unless you need to raise revenue. I mean, that should be a revenue question not a fairness question.

MS. FORSBERG: Right. Right.

MR. GERSHENFELD: Unless you believe that --

MS. FORSBERG: Well, I think it doesn't have to be the two together. I think what I was saying was that unless the state feels really strongly that -- what is it -- that it's not mandatory combined reporting, it's suggested mandatory reporting in New Jersey now -- unless the state feels that they are capturing all of the income. That's what's I think the AMA should continue.

MR. GERSHENFELD: But doesn't it combine with what they automatically do? I mean, basically there's nowhere else to hide anything, if you know what I mean.

MS. FORSBERG: It does. But if the state enacts combined reporting, which I don't think there's any evidence the state is necessarily going to do --

MR. GERSHENFELD: That's one of the questions before them.

MS. FORSBERG: Right, yeah, I know that. I know that. Then I think that the AMA should stay.

But the other thing is that nobody knows what the impact of the AMA is going to be. And you obviously are going to be doing an analysis of that. And it seems to me that if the AMA turns out to be a good source of revenue and not draconian to small business and to businesses that would be subject to it, I don't see any reason to get rid of it. I mean, I think corporations should pay more than $200 and more than $500 a year if they are making money.

MR. SHIPLEY: But doesn't the AMA apply even if you're not making money? I mean corporations can have receipts but not have income. And therefore, start-up companies like biotechnology companies, companies which have fallen on hard times are going to be technically losing money but still paying a substantial tax based on their receipts.

MS. FORSBERG: I mean, technically that's true, but I don't know that that -- you know, I don't know how this is going to work out. I don't know exactly how the AMA will be, how much corporations will end up paying as a result of the AMA.

MR. PYDYSZEWSKI: I think that's a good point you make. I mean, you stated in your testimony that you would like to be able to analyze and understand who pays the CBT. And I think all of us on the Commission would like to do that as well. I mean, that's part of our problem here. But to say that the state should make the AMA permanent when we don't know what the impact of it is, seems to me to be somewhat of a contradiction.

MS. FORSBERG: Well, I think maybe I didn't make myself clear. I think what I meant to say was that if the AMA is a good source of revenue and is not -- is not a burdensome tax for business in New Jersey, I think it should be permanent. If it is a problem then -- I think you need more information. But I think you have to make sure to do the analysis, to know exactly who's paying the AMA.

MR. GERSHENFELD: I have a question which is -- maybe this is one of the problems I have with the Commission in general, so it's not, you know -- in that you were looking at the tip of the iceberg. Which when you look at a corporation, you shouldn't just be looking at the CBT it pays. You should be looking at the property tax that it pays, the sales tax it pays, the personal income tax that employees pay.

And, you know, to a certain degree, if you're attracting -- this has influenced me -- if you're attracting corporations from New York City, and even if it pays no corporate tax even though property tax but it's paying $50 million sales tax and $25 million in property tax, and you've got a thousand employees that are making a $100 million paying personal income tax, that's a net, huge positive for the state of New Jersey. And I feel like it's not just the CBT but don't you have to look in sort of the entire view of what's coming -- is that a right analysis or is that something -- I mean, you thought about this a lot.

I just feel like looking at the CBT by itself, all you know A&P is paying -- you know, in your example, A&P is paying $50 million in property taxes, it's hiring 20,000 employees and paying taxes -- you know, withholding taxes and everything else, that the A&P food chain is in effect having -- I don't know, I'm making up a number -- $200 million of taxes paid to the State of New Jersey, while QuickCheck may pay 210, but they pay another $5 million. And in reality A&P is paying 200 million versus QuickCheck which is 5.2, and Pagano's is paying -- see, I mean, is that the wrong analysis? I don't know.

MS. FORSBERG: I mean, I've seen those analyses.

MR. GERSHENFELD: Oh, you have.

MS. FORSBERG: Yeah. I looked at one not too long ago that was making the case that corporations do pay all sorts of taxes. When they pay property taxes, they are responsible for collecting sales tax and employee taxes. But, you know, that's true of everybody. I mean, everybody pays property tax in New Jersey whether you own property or not. You live in an apartment, you pay property taxes through your rent. And we all pay withholding tax.

So I think that -- I'm not sure that it's fair to -- it's fair to include all of the different taxes that corporations pay unless you do the same thing with individuals. And -- I mean, I know a lot of people that do analyses that talk about the tax burden and whether corporations are moving to or leaving New Jersey and New Jersey Policy Perspective is one of the organizations involved in a thing called the Fairness Alliance, which I don't know if you know what it is, but it's a group of I think 110 organizations now that want to raise the income tax, personal income tax, on people earning $400,000 or more.

And people make the argument that if you do that, all the rich people will leave the state. They'll move someplace where it's cheaper to live. We looked at IRS data of where people moved based -- it was based on income and all these other things. And there was no correlation between -- in fact, when the property -- when the income tax was raised in New Jersey, more people moved to New Jersey than before. So there doesn't seem to be a correlation between raising income taxes and where people live and where they move. I don't think you can make the argument that corporations only move to a state because of the taxes that they pay there.

MR. SHIPLEY: That clearly would be a factor in their analysis.

MS. FORSBERG: It would be a factor, yeah, but I don't think it's the absolute most important factor. I think the services that are supplied in a state by the taxes that people pay are the things that make a place desirable, I think, for corporations. And if you have a well-educated workforce, and that comes from the taxes that individuals and corporations pay, and you have a good transportation system, I don't think that raising the income tax on corporations a little bit is going to make that much difference.

CHAIRMAN EVANS: Mary, on your AMA proposal, just to be clear, are you proposing that it remain as it is inactive or that it not sunset with respect to certain New Jersey taxpayers?

MS. FORSBERG: I am recommending that it remain as inactive.

CHAIRMAN EVANS: So that it sunsets with respect to companies that are inside New Jersey but only --

MS. FORSBERG: Oh, no, no.

CHAIRMAN EVANS: I'm sorry.

MS. FORSBERG: Depending on what the analysis shows that it not sunset for New Jersey corporations.

CHAIRMAN EVANS: As it's presently proposed to sunset in any event.

MS. FORSBERG: But it depends on what the analysis of it shows.

CHAIRMAN EVANS: What would you be looking to make that kind of determination?

MS. FORSBERG: I'm not sure what is draconian about the tax is for a corporation. I mean, at the last hearing, Martin Davidson was talking about $500 as being an outrageous amount for people to be paying. I mean, I don't think that's an outrageous amount.

So I guess, you know, somebody has to make a determination -- and I guess it would be you -- what is a reasonable amount of tax for people to pay. I mean, I wouldn't have a problem with the rates changing, you know, going up, going down. But, you know, New Jersey has taxed utilities as a gross receipts tax for years and years and years. And it's a tax that works okay.

MR. SHIPLEY: But isn't there a difference in taxing utilities on a gross receipts tax where each utility has a specific rate tailored to that utility, as opposed to taking a broad swap of all the corporations and taxing them on one or two bases regardless of whether a corporation is a high-margin or a low-margin corporation, which means that some corporations are going to fair better on a gross receipts method or on a gross profits methods, other corporations are going to fair worse. And we've heard a lot of issues arising from certain corporations that are very high volume. And a large amount of receipts do not have significant cost of goods sold and therefore are paying a substantially higher tax than a corporation that's similarly situated in another industry. So...

MS. FORSBERG: You know, that's information I don't have. That's the kind of information I'd really like to see. I think that that's a kind of analysis not anecdotal analysis, but I think that's the kind of analysis that needs to be done and I haven't seen that and --

MR. GERSHENFELD: The only information we have is in the Treasury. The Department of Taxation has said that at least 35 or 50 different industries have come in and said to them "We need to be taxed differently than the AMA." Because we -- you know, every group in New Jersey has come in to them and said "We're special because..."

MS. FORSBERG: We're special, yeah.

MR. GERSHENFELD: So that's the only anecdotal in effect that we have.

MR. PYDYSZEWSKI: One, I think that's how the Washington business and occupation tax has evolved over time as well is that they have different rates for different industries specifically because you have different margins and different industries.

But I just wanted to touch back on one thing you said, I don't want to take that out of context or anything, but you said if the state you were talking about if the state -- you were talking about whether taxes are a decision-maker in where a company locates, you said that you don't think that raising taxes a little bit would have that effect. And I think that if the state had just raised taxes a little bit, this Commission would not have been put in place, no one would have objected to taxes being raised a little bit. I think the problem is that that they were raised a lot and, you know, we need to understand why. And I think we need to understand better if the fact they were raised a lot is effecting where companies locate, and I don't think we can know that at this point.

MS. FORSBERG: Right, yeah. No, I agree with that, and I don't think anybody knows that. And I know that when the Treasurer came in to talk about the revenues that are coming in, everybody's been surprised that they're coming in faster than anyone expected. But $500 million of that is the acceleration part of it and so I think you're talking about basically a doubling in taxes. But the department doesn't know, the state doesn't know whether there's going to be a lot of refunds are going to be paid out from that.

So, you know, if it turns out that instead of collecting $700 million, which was the initial amount that the state was going to collect, if the state's collecting $1.4 million, I guess it depends who's paying that tax whether it really got raised a lot.

MR. GERSHENFELD: You're talking about other states -- just to follow up on John's question -- I sort of -- maybe because I'm a New Jerseyan, I think of New Jersey as being a unique state and it's got sort of a border with New York and a border with Pennsylvania. And there seems to be lots, I wouldn't say fighting, or attempt to get businesses to move from New York to New Jersey or from Pennsylvania to New Jersey. And therefore in my mind, you know, maybe in other states, I don't know, Kansas or whatever, it doesn't make a big difference because the state's got to move 500 miles, but here it's a move of five miles across the river or whatever it is and there maybe things make a bigger difference.

I just think of New Jersey as being a unique state where every little bit makes a difference, if you know what I'm saying. I don't know if other states are like that, if that's common in other states. Do you have any sense of that?

MS. FORSBERG: I lived in Minnesota for five years and Minnesota was always talking about how everybody was moving to Iowa and everybody was moving to Wisconsin because Minnesota was too expensive to live in. So, you know -- and I went to Connecticut to talk to the legislature up there because there was a group that was pushing for some of these reforms in Connecticut. And one of the legislators up there said Well, you know, now New Jersey has priced itself out of the business market, what do you think we should do in order to lure all the business up to Connecticut. And, you know, I don't think that all the businesses are going to leave New Jersey as a result of this.

A friend of mine who has a small business, it's an S corporation just outside of Chicago was looking at expanding his business, and I think they have two locations in New Jersey, Edison, and I think Piscataway, and they were looking at a third, and they looked in Trenton, Hamilton, and a couple of other places, and they ended up in Allentown. And I asked him if it had anything to do with the taxes in New Jersey, and he said it actually didn't, but New Jersey was a difficult place to do business in. Now, I don't know exactly what that means, he's from New Jersey. But he said it really didn't, the income tax situation was not something that concerned him.

So I know it's like I'm hoping that you can inform me about all of this because I'm curious, I'm interested. I think with the AMA I think it's an interesting new development in taxes. And if it turns out that New Jersey is able to collect taxes from, you know, businesses that don't have physical presence in the state, other states will look to do this, I think.

MR. PYDYSZEWSKI: They haven't yet.

MS. FORSBERG: Well, it hasn't been very long. I mean, there's been talk of other states doing what New Jersey has done. I mean, Missouri and Michigan and Massachusetts and Connecticut. And a lot of things have been enacted, but that doesn't necessarily -- you know legislatures don't move really fast on things. And when other states see that New Jersey's making so much money off the taxes, the alternative to not raising the corporate business tax was to cut another billion or more out of the state budget. And, you know, where are you going to cut that? You're going to cut it out of the schools? You're going to cut it out of the -- it's a decision. Somebody has to pay the bill.

CHAIRMAN EVANS: Any other questions from the Commission?

Mary, thank you very much for your time and I appreciate the presentation you gave earlier in the year and your presentation here today before the Commission. Thank you.

MS. FORSBERG: And as you know more I'd love to know more on what you're learning.

CHAIRMAN EVANS: Thank you.

The next speaker will be Joseph Crosby.

MR. CROSBY: Thank you, Mr. Chairman, and members of the Committee. I appreciate the opportunity to address you today on COST views on the changes that were made last year in the corporation business tax. I know that the COST president and executive director Doug Lindholm appeared before you earlier this year. And actually, I've limited my comments. I feel like you've already got a good discussion going. You've already touched on a number of the issues that I intended to address. I'm going to go through them briefly, but I encourage questions as we go along.

For those who aren't aware COST is nonprofit trade association based in Washington D.C. We were formed in 1969. We have approximately 550 members who are all businesses that do business in multiple states. The overwhelming majority of these businesses do conduct business here in New Jersey employing its citizens and paying a large percentage of the tax that come from multi-jurisdictional business entities.

The CBT Study Commission was created in part -- and Mary addressed this in her comments -- from the fact there wasn't a lot of data last year. There was really a legislative rush to fill a budget shortfall and very little to no consideration of the longer term economic policy objectives of the state and how the changes that were brought through the legislation would effect those policies. It was called the

"Business Tax Reform Act."

But one of questions that was already raised alluded to the fact that it only really touched one aspect of business taxation, the corporate business tax. It didn't effect any of the other taxes that businesses pay. There were many accusations levied last year about businesses and whether or not they're paying their fair share. There was a lot of discussion about the fact -- and Mary just raised this again -- that 30 of the 50 largest employers in the state pay the minimum tax of $200. I'm not sure that data tells us anything.

It reflects a complete misunderstanding of taxation and a separate return environment, the fact that the business trade name that's reported in the press in terms of how many employees they have many have no relevance whatsoever to the legal entity that's actually paying tax in the state. It doesn't tell you anything about all the taxes the businesses are paying. In fact, it provides almost no information that one would hope to base a reasonable policy discussion on before reaching tax reform conclusions.

I would hope that the Committee takes a broader and more empirical approach and looks at all the tax the business pays. If we're looking at business tax reform and we're trying to help policy-makers determine whether or not businesses pay their fair share, it seems that at a minimum you'd want to know how much business pays right now.

Mary indicated that it might not be relevant to look at property taxes and sales taxes and those sorts of things. I think policy-makers when they're asking if business pays a fair share are taking a relatively simple look at things, much like any of us would do.

How much revenue does the state collect right now? What is it -- let's say it's $10 billion. Of that $10 billion, how much comes from business? That was not discussed at all last year. COST does not have state specific data, however, I think you've been provided with the study we did at the national level which demonstrated that businesses pay on average nationally 46 percent of all state and local taxes, property taxes, sales taxes, excise taxes, worker's compensation, unemployment insurance, et cetera.

This doesn't include any tax that businesses collect from someone else like an employee or a patron of a retail establishment and then pass on to the state or the local government. This just taxes that they pay themselves. I think that sort of data is critical for policy-makers to determine whether or not someone is paying a fair share. I can't tell you what a fair share is. It's something that only the political process, our legislators and ultimately their constituents can decide, but clearly that information is necessary.

Unfortunately, John Pydyszewski just before the hearing today you weren't appropriated any funds. So now I understand my request might be a bit unreasonable to expect you to develope this data. But clearly, you know, I think that one of the Commissions recommendations might be that the state endeavor to develope such data and provide that to the legislature if it is interested in continuing a discussion of business tax reforms.

And then the second thing I wanted to talk about is, What are other states doing?

Mary's correct that it's been only a little less than a year since New Jersey enacted its statute and other legislatures may not have had a lot of time to respond. However, operating in this environment for a long time, I know that especially in fiscal crisis like we are now, legislators are more than willing to listen to any potential solution any other state might have.

Just four weeks ago I was in Boston for a meeting of the National Conference of State Legislators. Senator Wayne Bryant was there at a meeting, a roundtable discussion much like this one, with the fiscal chairs from 35 other state legislators. The chairs are the folks that sit on the tax writing committees and the revenue committees. And they went around the room, talked about the problems their states were having, budget deficits much like they're occurring here in New Jersey and what their solutions were, and not one of them talked about business tax increases.

At the end of the meeting Senator Bryant finally chimed up and said, "You know, I've got to share with you, we did this thing last year. We were projected to raise $1 billion in corporate business tax. The changes that we enacted raised that projection to 1.8 billion. And I'm here to tell you today it looks like we're going to get 2.6. billion."

Now, whether that number is accurate or not, that's what he reported at the meeting. And we do follow what goes on in other states. They are talking about what's happening in New Jersey. In fact, going into this year, we expected the changes that were made here in New Jersey would be substantially discussed in a lot of other states. For whatever reason that really hasn't happened.

I think the most unusual part of the taxes changes that were made here were the alternative minimum tax. Only one other state discussed that last year and that was Indiana. And Indiana discussed it in the context it had a gross receipts tax and it repealed it because they thought it was bad for business and economic development.

MR. SHIPLEY: At the same time they increased their corporate taxes. In other words, they had both a income tax and a gross receipts tax. They repealed the gross receipts and increase the rate of the income tax.

MR. CROSBY: And the total net change was a business tax reduction. If you look at the whole package, that was part of a much broader reform package. You're correct. The net was a business tax reduction.

MR. SHIPLEY: But your point is they moved away from --

MR. CROSBY: They moved away from gross receipts type tax. They also had a supplementary income tax and they kind of consolidated all these taxes into just a plain income tax statute, correct.

MR. SHIPLEY: In other words, getting rid of three taxes, having one tax where the net effect is actually a reduction in tax and you have tax (unintelligible) and a reduction in tax.

MR. CROSBY: Correct.

Kentucky Governor Patton called for a new "Business Activity Tax." Lots of states come up with different names, but it was essentially a gross receipts tax. Fortunately or unfortunately for him, the press began to report on his extra-marital affairs and that quickly died and did not get any consideration of the legislature.

Governor Tap (ph) in Ohio proposed a very broad tax reform package. It was 80 different points. Twenty points dealt with the corporate tax. That package is foundering. But sort of in its place, the chairwoman of the House Ways and Means Committee proposed a factorial base tax. Which, again, similar to a gross receipts tax, that proposal has died, and I have not heard of any other state considering or enacting anything of the like.

Accelerated tax payments, I'm not aware of any other states doing that for corporate taxes. There have been some states that have done that for sales taxes.

"Throwout" rule. Maryland Governor Erlik (ph) just last week vetoed legislation which would have done that. North Carolina rejected it last year, although they're considering it again. And I can't really hazard to guess at this point what its legislative chances are.

These are just a few. I'm not going

to go through everything that's in the bill. But a couple of them that are more salient, limitations on dividends received deduction. No other state has proposed or enacted such a change.

I'm going to skip over the related part expense because I want to say a little bit more about that.

Forced combined reporting at the Division of Taxation's discretion. No other state has done that. Maryland discussed combined reporting, rejected it before it got to the governor's desk. Massachusetts has a combined reporting proposal. But I think that the chances of it being enacted are highly unlikely at best.

New partnership fees. I'm not aware of any state doing that right now.

So a lot of the things that were done in last year's bill not only have not been enacted on other states but have not been considered in other states for whatever reason. I can draw some conclusions if you like --

MR. SHIPLEY: In fairness to the Division of Taxation, the throwout rule I think also existed previously in, I believe, in one state, West Virginia.

MR. CROSBY: West Virginia. I did not attempt to do analysis of what existed prior, but I am happy to talk about that.

MR. SHIPLEY: But some of these due to related party expense limitations, Ohio, Connecticut had similar provisions. The forced combined reporting, New York had a similar provision.

MR. CROSBY: Right.

MR. SHIPLEY: For related party expenses, Connecticut and Ohio previously had provisions. And for forced combined reporting, New York previously had a similar provision to what was enacted in New Jersey.

MR. CROSBY: I'm going to talk about the related party expense. I would say under forced combined reporting, the New York statute is much narrower than the statute here in New Jersey and requires a substantial inquiry into facts and circumstances as to whether or not it's appropriate to combine. It also allows companies to combine if they believe that this is the right result, which I don't believe the New Jersey legislation -- I know what's introduced to talk about having that. But as enacted it's a one-way street. Whether that stands up under litigation is something that remains to be seen over the next, I don't know, probably decade or two depending on how things go.

Related party --

MR. GERSHENFELD: Before you do, if you could wait one second.

MR. CROSBY: Sure.

MR. GERSHENFELD: Our 16 states now have it?

MR. CROSBY: That's my next comment. I think that fits into related party expense.

MR. GERSHENFELD: You're saying those states have recently changed combined reporting and two states have recently rejected it?

MR. SHIPLEY: Force combined.

MR. GERSHENFELD: Do we know why those states have rejected it could we get --

MR. CROSBY: Yes. I mean, the last state to enact combined reporting was Florida 1983 and they repealed it six months later. Since then it's been considered in Tennessee, Wisconsin, Alabama, Louisiana, Massachusetts, Maryland; New Jersey, which rejected it in terms of having it mandatory for everyone. In most cases, the state legislatures have looked at it and said this is different from what our other sister states do. We don't think it's going to be an economic development incentive. We think it's going to brand us as unfavorable to business.

And it's complicated. I think you brought it up earlier. We don't really know what it's going to do for us. And it's one of those things that comes up more frequently when the fiscal condition is pretty bad. And many states have feared that they were going to actually lose revenue by doing it. So --

MR. GERSHENFELD: I'm going to segue into your next --

MR. CROSBY: Sure.

MR. GERSHENFELD: Given where states are with this, with the related party expense, would these states or corporations look upon combined reporting more friendly now? In other words, maybe in the old world, but if you have all these dates and have all these related party expense wars, which are let's say whatever, maybe combined reporting would be viewed as a blessing not a detriment.

MR. SHIPLEY: Or even more specifically, in terms of New Jersey, would combined reporting be a step in for the better considering all of the other changes that were there if we were to replace that with combined reporting.

MR. CROSBY: COST has no position on combined reporting and never has. Part of that is because it helps some people and hurts others. My own personal view based on what New Jersey has done, I'm sure if you eliminated all those and went to combined reporting, which we can say these changes were all made because there's loopholes and the loopholes need to be brought out of the system. We know that's not true. The changes were made. The rationale for them was the loopholes, but the reality was that we needed money in New Jersey.

And if you went to combined reporting, which Rick Palm (ph), Michael Masura (ph), you know bring in the tax policy expert to tell you that this doesn't get the loopholes out of the system. You can get the loopholes out of the system. We all know it's complicated to administer. It will lead to the Division of Taxation requiring a sort of to educate its employees in a different way to audit differently. It will create a whole new host of litigation.

If you replace what you have now with just combined reporting, I'm sure the state will lose a significant amount of money over what it's collecting this year.

So if that's the litmus test for corporations, how much actually comes out of their bottom line, I'm sure for most corporations under the new system, combined reporting would be viewed as a favorable change. But that's just my own sort of personal guess. I haven't had that on any authority.

But really, you know, when we look at the loop hole closing, it's the related party expense issue that is the only example that's brought out as a loop hole and then all of these changes follow behind that. So 16 states have addressed the related party expense issue through combined reporting. Ohio in 1992; Connecticut in 1997 and 1999; Mississippi, Alabama, North Carolina in 2001; New Jersey in 2002; Massachusetts and New York this year. And the separate return environments have addressed it with specific legislation.

Here, however, New Jersey's legislation here in this area is among the most restrictive in that it captures lots of transactions at least on the face value of the statute that have nothing to do with tax avoidance.

For example, Ordinary Treasury Management System. Every large corporation, every large organization, even the State of New Jersey centralizes cash management functions. Each executive branch department doesn't get to keep its money overnight. So the State of New Jersey sweeps it up to get the best rates of interest it can on the market. Those things aren't tax motivated necessarily. There are a number of states which have recognized that. New York in the legislation they just passed specifically includes a safe harbor for transactions where the taxpayer can establish they were created for business purpose and they have economic substance. Those sorts of things don't exist in the New Jersey statute.

So even in the area of related party transactions, which is one area where New Jersey made a change, where other states really are looking hard at this at enacting legislation, the legislation in New Jersey stands out at one end of the spectrum in terms of it's punitive effect on taxpayers. It happened to engage in business in multiple states. It happened to be large enough to have multiple entities.

COST recognizes this is one of the most challenging fiscal environments the states have ever gone through. I talk frequently on just how bad it is out there right now. We recognize that business has a role to play in it. I encourage you to look at the entire spectrum of business taxes in projecting information to legislature on what business tax reform ought to mean and what a fair share might be.

We'd happy to assist you as you go forward in anyway we can, and I'll answer more questions if you have them.

MR. GERSHENFELD: Can I ask say a miraculous disaster, McGreevey retires or resigns and you become the governor. You're faced with a

$5 billion fiscal crisis in the tax system, which clearly, you know, there are much huge loopholes that corporations are taking advantage of whether they're loopholes or not. There's some gray areas for people, clearly, what do you do?

MR. CROSBY: It's a good question. The loopholes, I tend to consider them a consequence of the Federal system. We all know it's not so much a hole in the New Jersey's Tax Code as it is the fact we have a quilt of 50 different states who happen to have very different tax policies.

MR. GERSHENFELD: There was some aspects of New Jersey that were pretty -- I mean, they limit -- I work for a major corporation. We all pitched out, if we found too aggressive, we didn't do them.

MR. CROSBY: Right. They were there.

MR. GERSHENFELD: They were there, yeah, and they were New Jersey specific. They weren't in any state.

MR. CROSBY: I stayed out of elective politics my entire life and elected to do so. But, you know, it's a difficult question.

A lot of states have addressed it simply with budget cuts. They've just cut recognizing that voters went the poles in Missouri and Virginia and other states and projected it. In Missouri, they went to the pole and rejected a cigarette tax increase. Now, that's the easiest tax increase in the world. The voter sentiment out there does not appear to be in favor of tax increase.

On the other hand, if I was elected by a party that expect services not to be cut significantly, I'd be in a bit of a bind. I can't say exactly what I would have done in Mr. McGreevey's place because I don't think I would have been in his place.

As Henry Kissinger would say "I don't deal with hypotheticals."

It doesn't really answer the question, but I can't in my professional capacity give an answer.

MR. GERSHENFELD: You want to give us your personal capacity?

MR. CROSBY: I think dealing with related party transactions, that specific one makes a lot of sense. COST has developed some model language that we've worked with other folks on. If the problem is Toys R Us setting up a Delaware holding company, shifting it's trademarks claiming that the New Jersey company makes no profit and the Delaware company makes all the money, that's a sort of narrow issue that I think can be solved with fairly crafted legislation.

In New Jersey that was used as the political front for a major tax increase. Again, COST has no position on the level of business taxes. The tax changes that were made here in certain areas seem to be particularly egregious in their violation of any economist's standard for fair and equitable taxation. I mean, a gross receipts tax is never at the top of any economist's list. Michigan, Mary mentioned, was looking at changes. They have a single business tax. I mean, it's a completely different system. The loopholes that they've talked about there are loopholes like were originally talked about here such as the net operating loss is a loophole. I mean, those things, no economist would ever say that. That's a political question.

And so I probably would have looked

at where the real abuse is taking place. Those are easy to do. And the others are broader policy questions of what services the state wants, the people want in New Jersey.

MR. SHIPLEY: To the extent you're dealing with whether real abuse is taking place. You feel that there should have been more clear safe harbors for the related party transactions where there were certain types of transactions as to the treasury management function. And that additionally there should have been additional protection where if a taxpayer could prove that there was a legitimate business purpose and adequate substance that these transactions should not be taken in with a broad sweep of the related party provisions.

MR. CROSBY: I think so. We can also look at certain transactions that are entered into arguably for business purposes, but those arguments might not hold up.

There are clearly other transactions that related parties enter into everyday which are for legitimate business purposes. And it may be you may have a regulated entity and a nonregulated entity. By law they have to deal with arm's length and they have to enter certain transactions because the unregulated entity can't do certain things. Does it make sense that that regulated entity which has cash and wants to set up an unregulated subsidiary should have to go out to the market to borrow money when it can finance it internally at a much lower rate?

I mean, that's not tax motivated. There may or may not be tax benefit to it and I don't know. Again, it's facts and circumstances. And that's really the problem.

Corporate taxes are extraordinarily complex. Oddity corporations is extremely difficult because corporations are complex and corporate income taxes are complex. This basically says, "We know everyone's cheating. We don't know exactly how. So we're going to institute an alternative minimum tax and tax everybody based on their gross receipts and we'll let the market sort it out. Some will fail, some will not. Some will move, some will not." As Mary says it's all anecdotal.

I think many corporations after the very public spat federated department stores had with Governor McGreevey will not be forthcoming in terms of the moves that they're making in response to the corporate business tax changes. I know that some are, but I don't think they're willing to share that information because it didn't prove forth while the first time around.

CHAIRMAN EVANS: Other questions of the speaker?

(Tami Gaines, Commission member, arrives.)

Tami Gaines of the Commission has joined us now.

Thank you, Tami.

MR. CROSBY: Thank you, Mr. Chairman.

MR. GERSHENFELD: Can I ask a question?

MR. CROSBY: Sure.

MR. GERSHENFELD: Everyone's got their view and it's totally subjective. How much do you think the taxation of the changes of the New Jersey tax will effect economical development in New Jersey?

MR. CROSBY: It's a marginal issue. I mean marginal sort of in an academic sense. I think as you mentioned it does effect things substantially at the margins. If you have an opportunity to locate in Pennsylvania or New Jersey because you're right at the border, you know, there those decisions have a marginal difference.

I represent the very largest corporations in the world. They generally have facilities all across the countries and in many different countries. So when their divisions compete internally for capital, these costs get factored in. So it's not a question of does the building you drive by every day now with the big corporate logo on there, is that going to go away? It's a question of where the next investment is going to be.

Unfortunately, I can't give names because these were given to me in confidence. One corporation that had planned to create 600 new jobs in New Jersey, shortly after the changes last year, created those jobs in Florida instead. One company had moved 400 very well compensated white-collar jobs in New Jersey in 2000 and moved them late last year back to Massachusetts.

You know, these sorts of things are going to be anecdotal. They don't jive with the political sector. The changes are rot over ten years or 20 years. It's a marginal issue, but it matters at the margins. And I don't think any economist unfortunately can say with any precision what it's going to do.

New Jersey is different now. The tax community all across the country is talking more about New Jersey than about all the other states combined. Whether that's a good or bad thing I leave to you to decide. When I go places, people want to know about New Jersey.

MR. PYDYSZEWSKI: Do you think, Joe -- and I guess just for full disclosure I should point out that I'm a member of the Board of Directors of COST.

But my question is, do you think that right now there is a credibility issue with the State of New Jersey in terms of the changes that were made last year, the discussions about the beef this year that -- you do think there's an attitude that will achieve -- you know, we can look at the way New Jersey is today, but is that the way it's going to be tomorrow? Can we rely on what's here?

MR. CROSBY: I think the Division of

Taxation is well respected by the national tax community and has been for some time. And I think their representation has been really unscathed from this entire process. So in terms of the fairness of the administrative process in New Jersey, I think there's still high confidence that the Division of Taxation tends to deal with taxpayers in a fair and evenhanded manner.

MR. PYDYSZEWSKI: I would agree with that.

MR. CROSBY: In terms of the political process, I think there is a clear -- it's clear that corporations were made the scapegoat for the fiscal crisis. At least that's the perception in the business community. Whether that's accurate or not, that's how folks think about it. And there was a provision placed in the law which would have access funds reverted to a special account to be distributed back to taxpayers. And I know there was discussion this year of removing that. Clearly, no business that I've spoken with has any trust in the political process except for trust perhaps that they will be made scapegoat again before this is all said and done. And I hope that answers the question.

I think the Division of Taxation is still highly regarded, but the state as a whole has taken a turn that most business would view as anti-business.

CHAIRMAN EVANS: Any questions?

Thank you. We appreciate your comments.

MR. CROSBY: Thank you very much.

MS. DAVIS: I do have a request if it would be okay. Would it be all right if we took a photo of while I'm testifying so we can include it in our newsletter as evidence that we were here? I have to show this to my boss when we get back.

CHAIRMAN EVANS: Perhaps you ought to take a picture of us so we have evidence we were here.

MS. DAVIS: You need a map of South Jersey behind you, though.

MR. GERSHENFELD: Do you want him to give you a note?

MR. SHIPLEY: See what you need to get is one of those blue screens there where you can have massive people listening to you.

MS. DAVIS: Well, good afternoon.

My name is Kathleen Davis and I'm Executive Vice President of the Chamber of Commerce Southern New Jersey. Thank you for the opportunity to present information on the impacts of the corporation Business Tax increase on businesses including our members. The Chamber represents approximately 2,000 member companies from the seven southern counties, as well as Greater Philadelphia and Northern Delaware.

Now, after hearing the preceding people that testified, I am not a tax expert, but what I would like to do instead is to offer you general comments and to convey the information that we have received from our members as to the impacts on the tax changes.

Just by way of background our Chamber was intimately involved in the debate and shaping this legislation that made such major changes to the structure of the CBT. We are not the Chamber nor are we related to the Chamber that ran the Save Sally's Job ads. We work directly with Assemblyman Louis Greenwald, chairman of the assembly budget committee, who met several times with a number of our board members. We formed a special ad hoc committee of our board of directors who were specifically charged with analyzing the impacts of the corporation business tax. And also to come up with less onerous ways to make this tax increase happen, I guess, as painlessly as possible. And I will tell you that the discussion started with we are getting $1.8 billion dollars from the business community. The question is how are we going to do it. So that was our starting point. At the time they were getting about 900,000 so we're talking about doubling with the business tax.

And while we recognize the fiscal crisis in the state and while we recognize that the role that the business community could play in helping to reduce that reduce that crisis somewhat, we did not support the CBT increase then and we don't support it now. What we try to do is offer meaningful amendments to the legislation, politically recognizing that something was going to happen so let's at the very least make it something that we could live with.

But we commend the Commission for starting this process now when so many companies have become aware of how they're going to be impacted by the tax changes. And we also thank you for holding the hearing here in Southern New Jersey. We -- the Chamber strongly recommended the formation of this Commission, and we were certainly pleased when the language was included in the bill to create the Commission because your work is very important and we offer our support and assistance and the expertise of our staff and the members of your work.

The concerns that we had a year ago are the same ones that we have today. Of course, we're very concerned about the impact of the CBT increase on our members and it certainly is having an impact on the business community.

I'm sure you're all familiar with the Rutgers University Bloustein School of Planning & Public Policy's study on the impact of the Corporation Business Tax changes on New Jersey's economy. The study concluded that the increased CBT will reduce anticipated job growth, increase unemployment, depress growth in personal income and diminish growth in the gross State product. And I hope that Rutgers shared that report with you.

During the debate last year on the CBT increase, the Chamber sampled our members as to its impacts. And at that time, we found that the taxes were increased for companies anywhere from 75 percent to several hundred to several thousand times. Small and large companies were impacted, and were challenged to find the revenue to pay the taxes that were imposed retroactively, and were, therefore, unobligated.

And what we protected to occur in fact did. We know that the casinos saw their CBT liability quadruple, from $5.4 million to $21 million.

And I'd like to give you a sampling of the CBT impacts on some of our member companies. One company and manufacture in Southern New Jersey that employs a thousand people, saw its tax liability more than double under the new CBT formulas from $400,000 to $900,000. That's a 125 percent increase.

A high-tech company in our region that had paid the minimum tax because of net operating losses as a start-up company, saw their tax bill increase to $80,000 this year. That's a 400-fold increase. Turning the corner to profitability is even farther away for this company, that has recently laid off a number of its workers to make ends meet.

Yet another manufacture that employs about 500 people so their tax liability increased from the minimum, which they paid because they operated at a loss to $1.9 million under the AMA, that's a 9,125 percent increase.

A service business in Southern New Jersey that employs about 1,700 people saw its tax liability nearly double from about $270,000 in 2001 to about $500,000 under the new tax act, an increase of 85 percent.

Another major manufacturer in Souther New Jersey that employs close to 5,000 people saw its taxes increase five-fold from $836,000 to $4.2 million.

A sampling of smaller companies serviced by a member tax accounting firm shows the impacts of the CBT on LLCs, S Corporations and small C Corporations. The total taxes paid by this sampling of companies increased by two and one-half times this year. And For these companies, the partner tax and the tax on licensed professionals were the main drivers of the increases.

And the increased taxes paid by these companies weren't because so-called "loopholes" were eliminated. They're due to a total recreation of the tax, primarily the Alternate Minimum Tax, which you all have been speaking about for some time now, and also the professional fees and partner taxes, and among other changes as well.

How these increased tax liabilities impact our State? Well, our members tell us that there is less money for capital investment in their companies, less money to invest in the community, including our chamber, and the impact on their workforce is inevitable, including reduced benefits, postponing or not providing salary increases, and cutting the workforce.

And there were unforeseen consequences to the CBT increase, as well.

The first is the increased compliance costs for businesses. Companies have had to pay dearly to tax planners to analyze whether their AMA should be based on gross receipts or gross profits. This requires careful planning, as a company is locked into its choice for five years. Further, many companies have paid accounting firms simply to analyze the impacts on their company so that they could figure out how to absorb these unplanned tax increases. Companies have spent up to $10,000 on these analyses. One accounting firm estimates that clients have spent three times more on tax services simply to comply with the new, complicated, and at times unclear tax act.

And smaller companies are unfairly impacted because they don't have the resources to pay for the valuable advice that tax firms can provide. So, while accounting companies are the winners here, it's not a win that is sweet for them. Clients have reacted with anger and frustration over their unexpectedly high tax bills, and accountants have found themselves on the losing end of a "shoot the messenger" response by clients.

Another unforeseen consequence is the complicated nature of implementing the new Corporation Business Tax Act. There's still a good deal of confusion when attempting to interpret the statute. For example, the add-back provision -- and again, I don't know the intricacies of this. From what I'm hearing from our tax accountants, it's very complex.

Discussions during the debate over the bill raised the North Carolina model for add-backs, which is much simpler to implement. But this was rejected and we're faced again with a very complicated model. Passing such sweeping changes in the tax act have resulted in language that is sometimes circuitous, but almost always with the State ensuring that it receives the most amount of revenue possible from companies, with "fairness" taking a back seat to the dire need of the State for more money.

The Alternate Minimum Assessment has had the most dire impacts on companies, the most serious of which is on service companies. And, it's doubtful that some companies will ever be able to use the 50 percent credit in future tax years. Companies that will have enough income to generate enough tax in the future will be able to take advantage of that tax credit. However, companies that don't generate income, and therefore, not much in taxes, may not ever be able to fully use their tax credit.

MR. SHIPLEY: So what you're saying

is that some companies could be paying the AMA year after year after year regardless of the economic change just because of the way the AMA's structure?

MS. DAVIS: Well, I believe in future years there's a tax credit back.

MR. SHIPLEY: You told me that it is not profitable.

MS. DAVIS: Exactly.

MR. SHIPLEY: If it becomes profitable in the future year, they can use the AMA as credit. But, however, there are some companies that due to their circumstances are going to continually be paying this AMA and they won't get any credit.

MS. DAVIS: Correct, correct.

And finally, perhaps the most unfair part of this law, after all is said and done, according to our experts, is the suspension of Net Operating Losses carry-forward. The NOL carry -forward was not a "loophole"; it was a way to ensure that companies on the verge of making a profit had an even greater chance for survival. NOLs are real economic losses to companies. The suspension of NOLs has driven the effective tax rate for these companies "through the roof," as described by one accountant.

So how are companies dealing with the increased tax liability brought about by last year's CBT increase? Many companies simply cannot afford to move out of the State. The cost of moving would outweigh the benefits for several years. The strategy now is for companies simply to shift operations out of the state to decrease their apportionment. One New Jersey company is shifting operations to Mexico and North Carolina, and is not producing its product in New Jersey anymore or plans not to. Another company is changing the nature of its operations in the State, and shifting more operations abroad. And this, of course, means fewer jobs in our State.

Accounting firms with national clients looking to expand operations somewhere in the U.S. are being steered away from New Jersey because of its unfavorable tax climate, not to mention what is being perceived as a business unfriendly State.

I know you've heard from our good friends at New Jersey Business & Industry on their 2003 Business Outlook Survey, but these results bear repeating. Forty-two percent of businesses responding to the survey ranked New Jersey fair or poor as a site for business expansion. Further, 70 percent of respondents said that New Jersey's attitude toward business was worse than other states; 68 percent said we're worse than other states in attracting business; and nearly 60 percent said we're worse at promoting economic development than other states. Certainly, the impact of last year's tax increase is turning the business community sour.

My final point is on the CBT numbers released on Tuesday by the Treasurer and OLS. As we expected, the State collected significantly more than the so-called "fair share" business tax, which was determined to be $1.823 billion. OLS says the state will collect 2.5 billion, the Treasurer says 2.4 billion. So, as it turns out, it's not just a doubling of the tax on business, it's a 170 percent increase over the 2001 tax liability. And we don't know how much that collection figure is going to go up because a lot of business have postponed their filing and won't pay until September.

Those figures demonstrated why our

Chamber insisted last year on an amendment that was ultimately included in the bill. And I sure hope that it's not true that it's going to be -- looking to be taken out. That the over-collections over that target amount of $1.823 billion be returned to the business tax payers starting in 2006.

We recommend to the Commission eliminating the AMA, fixing the NOL provision to ensure that companies can continue to carry forward their losses in the next and future tax years, and joining us in ensuring that the tax over-collections from this and future years be returned to business taxpayers.

And I thank you for the opportunity to offer our perspective on the impacts of the CBT increase on our members.

CHAIRMAN EVANS: Thank you, Kathleen.

Any questions?

Thank you very much.

MS. DAVIS: Thank.

CHAIRMAN EVANS: Are there any other persons who wishes to speak to the Commission?

If not, then we will close this

session of the hearings. This is the last of the scheduled and required public hearings. The Commission will end the meeting.

Do I have any other comments from Commission members?

The meeting is adjourned.

Thank you.

(HEARING CONCLUDED AT 2:38 P.M.)

C E R T I F I C A T E

I, LINDA P. CALAMARI, a Notary Public of the State of New Jersey, do hereby certify the foregoing to be a true and accurate transcript of my original stenographic notes taken at the time and place hereinbefore set forth.

/s/ LINDA P. CALAMARI

LINDA P. CALAMARI

Dated: JULY 1, 2003.

Appendix D

Written Comments Provided to Corporation Business Tax Study Commission

1. Letter dated February 3, 2004 from Art Maurice, First Vice President, New Jersey Business & Industry Association
2. Letter dated March 31, 2004 from Jim Leonard, Vice President, Government Relations and Cherie Marce, Manager, Government Relations, New Jersey Chamber of Commerce

Appendix E

Business Tax Reform Act Revenue Estimates

No formal fiscal analysis for the BTRA was published by the Executive branch; however, the State Treasurer did provide to the Legislature revenue estimates for components of the BTRA for fiscal year 2003. The Treasurer's fiscal estimates were for the first fiscal year.

A legislative fiscal estimate was produced by the Office of Legislative Services ("OLS") pursuant to P.L.1980, c.67.[1] The OLS prepared its fiscal estimates for the first three fiscal years for which the BTRA changes would be effective.

The respective estimates are as follows:

	Revenue Increase in $Millions							
	Treasurer		OLS					
	FY03		FY03		FY04		FY05	
	Low	High	Low	High	Low	High	Low	High
"Loophole Closers"[2]	157	220	157	220	122	172	122	172
Net Operating Loss Disallowance	180	200	234	260	126	140	0	0
Alternative Minimum Assessment	260	300	260	300	203	234	203	234
Partnership Processing Fee	50	80	40	60	28	40	28	40
Minimum Tax Increase	45	45	45	45	45	45	45	45
3Q Speed Up[3]	100	140	100	140	0	0	0	0
TOTAL	**792**	**985**	**836**	**1025**	**524**	**631**	**398**	**491**

[1] Legislative Fiscal Estimate, First Reprint, Assembly No. 2501, 210th Legislature - Dated: September 13, 2002

[2] This category includes changes to the treatment of certain interest and royalty expenses, the exclusion of deductions for certain dividends, the "throw out rule" which changes the calculation of sales attributable to New Jersey, and rate changes for investment companies and savings and loan associations. The Commission does not necessarily adopt this characterization with regard to each such provision.

[3] This item is the shift of the third quarterly tax payment to the second quarter for certain large CBT taxpayers.

Appendix F

Estimated State Fiscal Year 2002 Business Tax Reform Act Related Collections

(in millions)	Projected Revenues	Estimated Collections[4]	Variance
BTRA Provisions Impacting the GIT:			
Partner $150 fee (partnerships)	60.0	51.0	-9.0
Non-resident Partner Withholding (Individuals)	20.0	110.0	90.0
Sub-total Gross Income Tax	80.0	161.0	81.0
BTRA Provisions Impacting the CBT			
Non-recurring:			
Accelerate Sept. Est. tax payment to June	150.0	82.0	-68.0
December 2002 Overpayment	0.0	110.0	110.0
Suspension of NOL deduction	180.0	280.0	100.0
Impact of BTRA changes Jan-Jun 2002		146.0	146.0
Professional Corp. fee Pre-payment		2.0	2.0
Sub-total Non-recurring	330.0	620.0	290.0
Recurring:			
Partner $150 fee (professional Corps)	5.0	4.0	-1.0
Non-resident Partner Withholding (Corps)	30.0	126.0	96.0
Increase Minimum CBT to $500	50.0	58.3	8.3
Increase Minimum CBT to $2000	0.0	9.3	9.3
Eliminate Savings Institution Tax	15.0	15.0	0.0
Alternative Minimum Assessment	240.0	213.0	-27.0
"Loophole Closing" Provisions:			
Intangible Expense Disallowance	30.0	73.0	43.0
Interest Expense Disallowance	25.0	67.0	42.0
Dividend Exclusion (50-80%)	0.0	8.0	8.0
Dividend Exclusion (less than 50%)	55.0	26.0	-29.0
Throw-out Rule	50.0	31.0	-19.0
Investment Company Changes	20.0	3.0	-17.0
Miscellaneous	23.0		-23.0
Sub-total Recurring	543.0	633.6	90.6
Total CBT Impact of BTRA	953.0	1414.6	461.6
Pre-enactment Baseline Revenues	870.0	1198.4	328.4
Total CBT Revenue post BTRA	1743.0	2452.0	709.0
Total CBT Revenue post BTRA and Change in GIT due to BTRA	1823.0	2613.0	790.0

[4] The Commission relied exclusively on the Division of Taxation's Office of Revenue and Economic Analysis for summary return information and analysis. The Commission did not have the resources to independently verify the accuracy of that data.

Appendix G

Combined Reporting Issues List[5]

1. Should a combined report be mandatory, or an anti-abuse tool? Discretionary with the taxing agency? "Permit or require?" Or "necessary to reflect income?"

2. Should the combined reporting group be treated as a single taxpayer for purposes of liability for tax, or should each specific entity doing business in a state be a taxpayer, with its own liability independently determined?

3. If the combined reporting group is a single liability taxpayer:

a. How is nonbusiness income to be treated?

i. Does the unitary group have a "group" domicile for purposes of nonbusiness intangible income?

ii. Is it constitutionally appropriate under Allied Signal to make all members of the group jointly and severally liable for the nonbusiness income of another one of its members?

b. What happens if a group of affiliated corporations are engaged in two separate nonunitary businesses?

i. Is there a constitutional problem treating all members as a single taxpayer?

ii. If there is, what are the mechanics of apportioning nonunitary businesses, if one entity has two divisions, and each of the divisions are unitary with the separate businesses, and the divisions are not unitary with each other?

4. If each member of the combined reporting group has its own liability based on its "share" of the unitary group's business income:

a. How is the income assigned to the respective members for purposes of taxation? (E.g., intrastate apportionment?)

i. Should each member be responsible for payment of tax on income measured by that member's share of group income determined by an apportionment percentage composed of payroll, property and sales factors. For example, each member's sales factor is that member's instate sales divided by the total sales of the group. (*Joyce* Method)

1. Pros: Consistent with the theory of taxation that each member is responsible for payment of tax attributable to its own numerator activity.

[5] Text of the Discussion Draft considered by the Income and Franchise Tax Uniformity Subcommittee of the Multistate Tax Commission on March 15, 2004.
(http://www.mtc.gov/UNIFORM/Combined%20reporting%20issues%20list%203-15-04.pdf)

2. Cons: May not prevent "nexus carve-ups" where the group separately incorporates the taxable activity in the state and then alleges P.L. 86-272 protections with respect to the other inbound sales.

ii. Should there be two stages of apportionment:

1. The first stage multiplies the business income of the group by an apportionment percentage determined by reference to the payroll, property and sales factors of the group as a whole (without regard to exempt status any of the members), and

2. The second stage then takes the state source income in the first stage and then "intrastate apportions" that income between the taxable members, based on the taxpayer's respective numerator activity in the state. (*Finnigan* Method)

3. Pros: Avoids potential for "nexus carve-ups"

4. Cons: Arguably inconsistent with the theory of intrastate apportionment; some potential P.L. 86-272 issues about indirect taxation of exempt income.

b. If each taxpayer member is independently liable, should there be a means for simplifying the tax returns so that a "key" corporation can file a "group" return on behalf of all members, to avoid having to have all of the taxpayer members file individual returns and duplicating data by multiple combined reporting schedules?

5. How is total income subject to apportionment computed?

a. Does each member determine income under the Code as if it were unconnected to the other members, or is there a computation of income and expense as if all members of the group were a single taxpayer?

b. Does the group as a whole have to make the same accounting elections (e.g., R&D, IDCs, etc.)?

c. How are expenses allocated to business and nonbusiness income, particularly when several members of the group have nonbusiness income? Is there a problem assigning expense incurred by one member to the nonbusiness income of another member?

6. How are intercompany transactions (see Treas. Reg. §1.1502-13) handled?

a. Should intercompany income be currently taxed?

b. Should the income be "eliminated" and the basis in the asset transferred to the purchaser? Would this create too many federal/state differences?

c. What happens if an asset is sold between affiliates that are not unitary, but the income is deferred for federal purposes?

d. Should intercompany income be deferred for state purposes as in the federal system?

e. What is a restoration event for state purposes? Does conversion of an asset to nonbusiness use constitute a restoration event?

f. What apportionment percentage should be used when income is restored?

g. What happens if a corporation receives a distribution with respect to stock in excess of tax basis (IRC §301(c)(3))?

h. What is to prevent an entity with deferred income from simply leaving the state and not restoring income?

i. Can income previously deferred before the taxpayer entered the state be taxed by the state when it is restored for federal purposes?

7. How should dividends paid between unitary members be treated?

a. Like any other dividend?

b. Eliminated?

c. Eliminated to the extent paid from unitary income (but not from nonbusiness or separate trade or business income)?

8. How do you deal with taxpayers on different fiscal years?

9. How does combination work if a member enters the group or leaves the group at midyear?

10. Special Rules, Limitations and Carryovers.

a. How are net operating loss carryovers determined?

i. Is there a unitary group carryover, or a post-apportioned carryover specific to each member?

ii. If the group method is used, what happens to the carryover if some of the members leave the group? Is the loss allocated based on the separate accounting contribution of the member creating the loss, or is there some other allocation of loss?

iii. What happens if a member joins the group with an NOL? Is the NOL limited to that member or can it be shared with other new members?

b. How are charitable expenses treated: as business, or proportionately business and nonbusiness, etc.?

i. How is the charitable expense carried forward—specific to the entity that incurs the cost, or some kind of group carryover?

ii. What happens if the members of the group disaffiliate when a charitable carryover remains unused?

c. How do you deal with business and nonbusiness capital gains and losses (including section 1231 assets, involuntary conversion income)? Is it appropriate for one member's nonbusiness capital gain to "free up" the business capital losses of the group?

11. How are tax credits to be handled?

 a. Is the credit available only to the specific legal entity that incurred a creditable cost, or all of to the taxpayer members of the group? If the latter, how is the credit allocated?

 b. How are credits to be carried forward if members leave or enter the group?

 c. Is appropriate that tax attributable the nonbusiness income of one of the members to be available to apply a credit attributable to the business income of the group?

12. How is partnership income treated in the context of a unitary group?

 a. What happens if the partnership is itself an apportioning entity?

 b. What if the partnership is unitary with a member of the group?

 c. What if the partnership itself has both business and nonbusiness income?

 d. What if a partner is unitary with a second tier partnership but not the first tier partnership?

13. How is income of unitary financial institutions or insurance companies treated where those entities are not subject to the corporate income or franchise tax?

14. How should holding companies be treated?

 a. What is a holding company?

  i. A company that holds stock in another member(s), but has no operations?

  ii. A company that holds stock in another member(s), but has central management activity (i.e., a management holding company)

  iii. A company that holds intangibles and derives income therefrom, but has no other active operations (intangible holding companies)?

 b. How should intermediate holding companies be treated (i.e., a holding company between two unitary members).

 c. How should a parent holding company that holds only members of a single unitary group be treated?

 d. How should a parent holding company be treated if it holds corporations that represent two distinct unitary businesses?

 e. How should acquisition debt of a holding company be treated (e.g., leveraged buy-out)?

 f. How are dividends that pass to or from or through a holding company treated?

15. Should combination be worldwide, water's edge or something in between?

 a. How does combination work under a water's-edge system?

i. Should U.S. source income (under federal tax law) of an otherwise excluded foreign entity be included in a combined report?

ii. How does combined reporting work if a foreign entity has two divisions: a U.S. trade or business and a foreign trade or business.

b. How does combination work under a worldwide system?

i. What can be done to have constitutionally acceptable "rough approximations" of income and factors?

ii. How can a foreign entity take advantage of tax laws that are preferential compared to book income?