

Appellate Court Upholds Penalties on IHC; Non-Filers Should Consider VDA—New Policy Reduces Cost of Coming Forward

Author: [David J. Gutowski](#), Partner, Philadelphia

Author: [Kyle O. Sollie](#), Partner, Philadelphia

Publication Date: September 03, 2010

Yesterday, the New Jersey Superior Court, Appellate Division, issued its decision in *Praxair Technology, Inc.*,¹ upholding the application of New Jersey's 25 percent late-filing penalty and 5 percent amnesty non-participation penalty to an intangible holding company. Although the decision is disappointing, other taxpayers facing assessments of the amnesty non-participation penalty may still have strong cases to avoid application of the penalty. In addition, non-filers may be able to obtain penalty relief (as well as a limited lookback period) by taking advantage of New Jersey's newly revised voluntary disclosure policy.

Penalties Upheld

Praxair Technology, Inc. ("PTI") is an intangible holding company that licensed patents and trade secrets to affiliates, which used the technologies to conduct manufacturing activities in New Jersey. It had no physical presence in New Jersey, but the New Jersey Division of Taxation asserted nexus and issued a \$2.2 million assessment in 2002. The Division's assessment went back to 1994, which was two years before New Jersey codified its economic nexus policy in a regulation.² The assessment included New Jersey's 25 percent late-filing penalty and a 5 percent penalty for failing to participate in New Jersey's 2002 amnesty program.

The Division's economic nexus policy was upheld, of course, in *Lanco*.³ But PTI argued that the Division's policy didn't apply to periods before the Division's 1996 regulation. PTI also challenged the imposition of the late-filing and amnesty non-participation penalties. In 2007, the New Jersey Tax Court issued an unpublished letter of opinion rejecting PTI's arguments.⁴ Remarkably, the Tax Court concluded that PTI had "no reasonable cause" not to file returns beginning in 1994^{3/4} despite the uncertainty at the time surrounding the economic nexus issue. PTI appealed and got a brief respite when, in 2008, the Appellate Division reversed the Tax Court's decision.⁵ But the New Jersey Supreme Court sided with the Division on appeal and reinstated the Tax Court's decision upholding the tax assessment. The Supreme Court remanded the case to the Appellate Division to consider whether imposing the 25 percent late-filing penalty and 5 percent amnesty penalty was appropriate.

In yesterday's decision, the Appellate Division upheld the imposition of the penalties. Although the Appellate Division had been sympathetic when it originally ruled in favor of PTI back in 2008, it showed no sympathy now. The Appellate Division acknowledged that PTI "may have had some basis in an arguably unsettled state of law," the court nonetheless concluded PTI "was obliged to accord greater respect than it did to the position of the Division in this regard." As for the amnesty penalty, the court noted that PTI had received its assessment prior to the start of the 2002 amnesty program. Because PTI chose not to participate, the Appellate Division saw no problem with imposing the 5 percent non-participation penalty.

Abatement of the Amnesty Non-Participation Penalty is Still Possible for Some Taxpayers

The *Praxair* case involved a taxpayer that received its assessment prior to the start of amnesty. If you receive an assessment after amnesty ends, the non-participation penalty may not apply. This follows from *United Parcel Service General Services Co.*,⁶ which involved a taxpayer that was issued an assessment after amnesty had already closed.⁷

In *UPS*, the Tax Court concluded that the Division had properly imputed interest on certain intercompany transactions. As in *Praxair*, the Division assessed a 5 percent non-participation penalty on the tax deficiency. Unlike *Praxair*, however, the Tax Court concluded that the non-participation penalty was inappropriate. Under the statute,⁸ the non-participation penalty applies only to "tax liabilities eligible to be satisfied [but] . . . that were not satisfied during the amnesty period." And the court interpreted this to mean "liabilities which, during the applicable amnesty period, were known to the taxpayer or which, by reasonable inquiry, could have been known." Because UPS acted in good faith and did not know (and, by reasonable inquiry, could not have known) that additional taxes were due, the court struck the penalty.

The amnesty statute at issue in *UPS* is nearly identical to the 2009 amnesty statute.⁹ This is important for a taxpayer that gets assessed a penalty for failing to participate in the 2009 amnesty program. If the assessment is issued after June 15, 2009 (when the 2009 amnesty program ended), and the taxpayer reasonably did not know that additional taxes were due, the non-participation penalty should be abated based on *UPS*.

Non-Filers Can Benefit from New Voluntary Disclosure Policy

New Jersey has become more aggressive in its nexus policies. For example, even though the Division ruled less than two years ago that it would not be following West Virginia's lead in *MBNA*,¹⁰ audit officials have recently stated that they would be asserting nexus over out-of-state credit card companies. Further, New Jersey's audit officials have stated that they would be extending *Lanco's* economic nexus rule to other situations, including licensing intangibles to unrelated licensees; selling tangible products with an embedded royalty; franchising activities; and receiving interest from related or unrelated borrowers who are located in (or simply use the funds in) New Jersey. The audit group apparently intends to apply these expanded nexus rules, regardless of whether the taxpayer is located in the United States or overseas.

These expanded nexus rules have yet to be tested in the courts and, in some cases, contradict the Division's prior policy. But non-filers with significant exposure may want to consider coming forward under the Division's voluntary disclosure program.

After New Jersey's 2009 amnesty program ended, the Division made some taxpayer-unfriendly changes to its voluntary disclosure policy. For example, the lookback period for the voluntary disclosure program was extended from four to seven years. Also, taxpayers looking for special terms involving apportionment, throwout, or addback were no longer able to negotiate terms on an anonymous basis. Because of this more stringent voluntary disclosure policy, many taxpayers who might have otherwise conceded nexus decided not to come forward.

Fortunately, the Division has revisited its voluntary disclosure policy. Late last month, the Division announced a number of changes that make voluntary disclosure much more attractive.¹¹ The key aspects of the revised voluntary disclosure policy are as follows:

- The lookback period is now only four years (current year plus three prior years). For intangible holding companies, however, the Division will generally require returns back to 1996.
- Tax returns covering the lookback period and any tax due must be paid within a reasonable period (typically 30-60 days).
- The Division will assess statutory interest and a 5 percent amnesty penalty for liabilities prior to June 15, 2009, but will waive the 25 percent late-filing penalty and 5 percent late-payment penalty. (A 5 percent penalty will be assessed on any trust fund taxes that were collected and not remitted.)
- To be eligible, a taxpayer cannot be registered for the taxes it seeks to come forward on, and there can be no previous contract between the taxpayer and the Division.



By approaching the Division under voluntary disclosure, a company may be able to negotiate more favorable apportionment terms or resolve its exposure under the throwout rule, which is in effect for tax years beginning before July 1, 2010. Importantly, a non-filer can approach the Division and begin negotiating terms on an anonymous basis. In particular, intangible holding companies that receive royalties from New Jersey sources should consider coming forward. As *Praxair* makes clear, if the Division discovers you, it can assert nexus back to when your company first began receiving royalties and impose a 25 percent late-filing penalty.

By coming forward under voluntary disclosure, an intangible holding company can obtain relief from full throwout, and can potentially limit its lookback period and avoid the full 25 percent late-filing penalty.

About Reed Smith

Reed Smith is a global relationship law firm with more than 1,600 lawyers in 23 offices throughout the United States, Europe, Asia and the Middle East.

The information contained herein is intended to be a general guide only and not to be comprehensive, nor to provide legal advice. You should not rely on the information contained herein as if it were legal or other professional advice.

The business carried on from offices in the United States and Germany is carried on by Reed Smith LLP of Delaware, USA; from the other offices is carried on by Reed Smith LLP of England; but in Hong Kong, the business is carried on by Reed Smith Richards Butler. A list of all Partners and employed attorneys as well as their court admissions can be inspected at the website <http://www.reedsmith.com/>.

© Reed Smith LLP 2011. All rights reserved.