SUPERIOR COURT OF NEW JERSEY
APPELLATE DIVISION
DOCKET NO. A-1157-16T1

KRAFT FOODS GLOBAL, INC.,
a Delaware Corporation,

Plaintiff-Appellant,

v.

DIRECTOR, DIVISION OF TAXATION,

Defendant-Respondent.

Argued May 1, 2018 – Decided May 17, 2018

Before Judges Hoffman, Gilson and Mitterhoff.

On appeal from the Tax Court of New Jersey, Docket No. 017974-2009, whose opinion is reported at 29 N.J. Tax 224 (Tax 2016).

Mitchell A. Newmark argued the cause for appellant (Morrison & Foerster LLP, attorneys; Mitchell A. Newmark, on the briefs; Craig B. Fields (Morrison & Foerster) of the New York bar, admitted pro hac vice, on the briefs).

Marlene G. Brown, Senior Deputy Attorney General, argued the cause for respondent (Gurbir S. Grewal, Attorney General, attorney; Melissa H. Raksa, Assistant Attorney General, of counsel; Marlene G. Brown, on the brief).

PER CURIAM

Kraft Foods Global, Inc. (Kraft Global or plaintiff) appeals from a Final Order and Final Judgment of the Tax Court denying its motion for summary judgment and granting summary judgment to the Director of the Division of Taxation (respectively, the Director and the Division). The Tax Court judge set forth the reasons for his decision in a published opinion. Kraft Foods Global, Inc. v. Dir., Div. of Taxation, 29 N.J. Tax 224 (Tax 2016). We affirm.

I

Plaintiff Kraft Global is a subsidiary of Kraft Foods Inc. (Kraft Foods). Between 2001 and 2004, Kraft Foods made six public bond offerings totaling $10.5 billion. Shortly after each offering, Kraft Foods loaned Kraft Global the exact same amount of money, at the same or approximately the same interest rate. Kraft Global used that money to pay off loans to Philip Morris, Kraft Foods' parent, with the intent to move away from Philip Morris. Because Kraft Foods, a publically traded company, could secure a better interest rate in the open market than Kraft Global, Kraft Foods issued the bond offerings and simply "pushed down" the loans to Kraft Global. Kraft Global signed promissory notes for each loan promising to pay interest "on the unpaid principal amount outstanding from time to time . . . ." The promissory notes neither contained a guarantee to the third-party bondholders, nor

did the notes contain payment terms or a schedule for principal payments.

In its 2005 and 2006 New Jersey corporation business tax (CBT) returns, Kraft Global deducted the Kraft Foods' interest payments from its taxable income. Kraft Global disclosed that it made interest payments to Kraft Foods in the section of the return regarding interest paid to related members. In the section regarding exceptions, Kraft Global answered "yes" to the question, "Was any interest . . . directly or indirectly paid, accrued or incurred to an independent lender?" However, Kraft Global failed to answer the next question regarding whether it guaranteed the debt and did not list the name of the "independent lender."

The Division audited Kraft Global and issued an assessment requiring Kraft Global to add back to its income the interest it paid to Kraft Foods. Kraft Global filed a complaint in the Tax Court, appealing the assessment. Both Kraft Global and the Division filed motions for summary judgment. On October 14, 2016, the Tax Court entered the Final Order and Final Judgment under review. This appeal followed.

II

Summary judgment is appropriate "if the pleadings, depositions, answers to interrogatories and admissions on file, together with the affidavits, if any, show that there is no genuine

issue as to any material fact challenged and that the moving party is entitled to a judgment or order as a matter of law." R. 4:46-2(c). Here, the material facts are undisputed, therefore summary judgment is appropriate.

New Jersey courts grant substantial deference to the decisions of an agency charged with enforcing the statute at issue. Aqua Beach Condo. Ass'n v. Dep't of Cmty. Affairs, 186 N.J. 5, 15-16 (2006). The Director's interpretation of a taxation statute will prevail "as long as it is not plainly unreasonable." Koch v. Dir., Div. of Taxation, 157 N.J. 1, 8 (1999) (quoting Metromedia, Inc. v. Dir., Div. of Taxation, 97 N.J. 313, 327 (1984)). Furthermore, "[s]ince the judges assigned to the New Jersey Tax Court have special expertise, we will not disturb their findings unless they are plainly arbitrary or there is a lack of substantial evidence to support them." NYT Cable TV v. Borough of Audubon, 230 N.J. Super. 530, 534 (App. Div. 1989) (quoting Kearny Leasing Corp. v. Town of Kearny, 7 N.J. Tax 665, 667 (App. Div. 1985)).

The CBT Act taxes corporations

> for the privilege of having or exercising its corporate franchise in this State, or for the privilege of deriving receipts from sources within this State, or for the privilege of engaging in contacts within this State, or for the privilege of doing business, employing or

> owning capital or property, or maintaining an office, in this State.
>
> [N.J.S.A. 54:10A-2.]

The amount of tax is based on the corporation's "entire net income," which is initially defined as "the taxable income, before net operating loss deduction and special deductions, which the taxpayer is required to report . . . for federal tax purposes . . . ." N.J.S.A. 54:10A-4(k).

The "entire net income" is then subject to a list of adjustments. N.J.S.A. 54:10A-4(k)(2)(A) through (J). The provision at issue here, N.J.S.A. 54:10A-4(k)(2)(I), generally prohibits the deduction of "interest paid . . . to a related member." The Legislature intended for this provision to close tax loopholes allowing corporations to "structure transactions between affiliates in various states to avoid tax." Assemb. Budget Comm. Statement to A. 2501, 1 (June 27, 2002); S. Budget & Appropriations Comm. Statement to S. 1556, 3 (June 27, 2002).

The statute lists five exceptions[1] when "a deduction shall be permitted" for interest paid to a related party. N.J.S.A. 54:10A-4(k)(2)(I). Those exceptions were intended to allow "such

[1] The five exceptions are: 1) The Three Percent Exception; 2) The Foreign Treaty Exception; 3) The Alternative Method Exception; 4) The Guarantee Exception; and 5) The Unreasonable Exception. N.J.S.A. 54:10A-4(k)(2)(I).

deductions in areas that are established as 'non-tax avoidance' situations." Assemb. Budget Comm. Statement to A. 2501, 2 (June 27, 2002); S. Budget & Appropriations Comm. Statement to S. 1556, 3 (June 27, 2002). The only exception at issue in this appeal, the Unreasonable Exception, requires the taxpayer to "establish[] by clear and convincing evidence, as determined by the [D]irector, that the disallowance of a deduction is unreasonable . . . ." N.J.S.A. 54:10A-4(k)(2)(I).

The Director issued a regulation providing the following guidance regarding the Unreasonable Exception:

> Interest paid, accrued, or incurred to a related member shall not be deducted in calculating entire net income, except that a deduction shall be permitted:
>
> . . . .
>
> If the taxpayer establishes that the disallowance of a deduction is unreasonable by showing the extent the related party pays tax in New Jersey on the income stream . . . .
>
> [N.J.A.C. 18:7-5.18(a)(2).]

However, the Tax Court has ruled that the Director cannot base a determination of whether the Unreasonable Exception has been established solely on whether the related member paid tax on the interest payments from the taxpayer. Morgan Stanley & Co. v. Dir., Div. of Taxation, 28 N.J. Tax 197, 225 (Tax 2014); see also BMC Software, Inc. v. Dir., Div. of Taxation, 30 N.J. Tax 92, 114

(2017) ("[N]on-payment of CBT upon the income subject to the addback cannot end the [Unreasonable Exception] inquiry."). In Morgan Stanley, the Director only considered whether the parent paid tax on the interest payments to the related member, and the Tax Court found that constituted an abuse of discretion. 28 N.J. Tax at 225. The Tax Court also gave examples of situations that would qualify under the Unreasonable Exception including, "a demonstration that the transaction for all intents and purposes is an unrelated loan transaction." Id. at 220.

We acknowledge the legislative history supports the contention that the Unreasonable Exception may apply to a loan pushed down, even where there is no guarantee. "If a taxpayer can demonstrate that, despite the absence of a guarantee, interest is being paid on a loan that was simply 'pushed down' from a third-party lender, then it would be unreasonable to disallow the interest deduction." Assemb. Budget Comm. Statement to A. 2501, 3 (June 27, 2002); S. Budget & Appropriations Comm. Statement to S. 1556, 3 (June 27, 2002). However, the Legislature clarified that a taxpayer is required "to secure prior approval from the [D]irector (through general regulation or case-by-case determination) before departing from the general rule of nondeductibility." Ibid. (emphasis added).

III

Plaintiff first contends the Tax Court erroneously found the Director denied the Unreasonable Exception due to the absence of a guarantee. In its Notice of Assessment, when addressing the Unreasonable Exception, the Director stated the parent did not pay tax on the interest payments from plaintiff, and the debt was not at arm's length, as reasons for not granting the Unreasonable Exception. However, the Director also found there was no guarantee from plaintiff to the bondholders when addressing the Guarantee Exception. The Tax Court was free to rely on that finding when determining the reasonableness of the Director's assessment.

Plaintiff next argues the Director required both interest paid at an arm's length rate and the parent pay tax, in order for the Unreasonable Exception to apply. While neither an arm's length interest rate nor failure of the parent to pay tax are required, they are factors to consider when deciding whether prohibiting a deduction is unreasonable. See Morgan Stanley, 28 N.J. Tax at 224 (holding payment of tax is one of the factors to consider, but not a determinative factor).

The plain language of the statute itself simply provides for an exception when "the disallowance of a deduction is unreasonable." N.J.S.A. 54:10A-4(k)(2)(I). Notably, the statute

adds, "as determined by the [D]irector," specifically giving the Director the authority to determine reasonableness. Ibid.

Here, the Director found reasonable the disallowance of a deduction. He considered both the absence of an arm's length interest rate and the failure of the parent to pay tax as factors in denying the exception. The Director also found plaintiff offered no guarantee of payment to the third party-bondholders. Therefore, the Director acted reasonably and considered various factors.

Finally plaintiff argues the Tax Court erred by finding the Unreasonable Exception did not apply solely because plaintiff did not guarantee payment to the bondholders. Although the Tax Court concentrated its reasoning on the absence of a guarantee to both the ultimate bondholders and to the parent, it also considered the parent's failure to pay tax on the interest received. Kraft Global, 29 N.J. Tax at 235-36 (citing Morgan Stanley, 28 N.J. Tax at 219-20). The Tax Court also reasoned decisions regarding the Unreasonable Exception will "be made on a case-by-case basis, based on the totality of the circumstances." Id. at 238 (quoting Technical Advisory Memorandum 2011-13(R) (N.J. Div. of Taxation, Feb. 24, 2016)).

Additionally, this case is distinguishable from Morgan Stanley because the parent's failure to pay tax is not the only

reason the Director denied the Unreasonable Exception. Here, the Director also specifically cited the absence of an arm's length interest rate as a reason for denying the exception, and found plaintiff did not guarantee any payment to the third-party bondholders. Also, the Tax Court carefully explained its reasons for rejecting Kraft Global's argument that it met its burden to establish entitlement to the claimed exception:

> With the Unreasonable Exception, the Legislature also appears to have recognized that there may be circumstances in which, even in the absence of evidence of a guarantee, the taxpayer may establish that it is ultimately responsible for paying interest to a third-party lender directly or through a related entity. The Legislature provided, however, that the taxpayer has a higher burden of proof in these circumstances. It must produce clear and convincing evidence that disallowance of the interest deduction is unreasonable. This is consistent with the general propositions that a taxpayer bears the burden of establishing its entitlement to a claimed statutory exception from a general rule of taxability, and that deductions under the CBT Act must be narrowly construed.
>
> Here, the Director acted reasonably when he determined that plaintiff did not meet its evidentiary burden. Plaintiff produced no document suggesting that it is ultimately responsible for Kraft Foods Inc.'s debts to its bondholders. Plaintiff has no obligation to Kraft Foods Inc. or to its bondholders to make interest payments on Kraft Foods Inc.'s debts. Plaintiff's only legal obligation is to make periodic interest payments to Kraft Foods Inc. on the Promissory Notes plaintiff signed in favor of Kraft Foods Inc. . . . In

> the event that plaintiff fails to make interest payments on the Promissory Notes or Kraft Foods Inc. fails to use funds paid by plaintiff on the Promissory Notes to pay its bondholders, those bondholders have no recourse against plaintiff.
>
> It was reasonable for the Director to determine that Kraft Foods Inc.'s debt was not, legally or effectively, "pushed down" to plaintiff. Although Kraft Foods Inc. may have made the business decision to incur debt through the issuance of bonds, and to thereafter lend the funds generated by those bonds to plaintiff, Kraft Foods Inc. also made the business decision not to make plaintiff a guarantor of Kraft Foods Inc.'s bonds. . . .
>
> Plaintiff does not argue that it was unable financially, legally, or technically to borrow funds on its own in the capital markets or to guarantee Kraft Foods Inc.'s bonds. . . . Of course, plaintiff and Kraft Foods Inc. are free to organize their business relationships in any way they see fit. They must, however, accept the tax consequences of those business decisions, whether those consequences were or were not anticipated.
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> [Kraft Global, 29 N.J. Tax at 242-43 (citations omitted).]

Because of the absence of a guarantee for plaintiff to make interest payments to the parent's bondholders, the fact that the parent paid no tax on the interest payments received from plaintiff, and the absence of an arm's length interest rate between plaintiff and the parent, we agree with the Tax Court's conclusion that the Director's decision to reject Kraft Global's claimed entitlement to the Unreasonable Exception was "not plainly

unreasonable." Metromedia, Inc., 97 N.J. at 327. We therefore affirm the Tax Court's Final Order and Final Judgment entered in favor of the Division.

Affirmed.