

Notice
Corporation Business Tax
Add Back of Interest Expense

N.J.S.A. 54:10A-4(k)(2)(l) requires taxpayers to add back interest expense paid to a related member. The law establishes exceptions to this general rule. One of the exceptions states:

“A deduction shall also be permitted if the taxpayer establishes by clear and convincing evidence as determined by the Director, that the disallowance is unreasonable.”

This “unreasonable” exception has created some confusion. The following are common unreasonable situations that are recognized by the Director.

The first recognized unreasonable situation is detailed in N.J.A.C. 18:7-5.18(a)(2). The purpose of this exception is to avoid double taxation by the state taxing the interest income of the related party and also not permitting the payor a deduction. This exception is claimed by completing Schedule G-2.

A second situation recognized by the Director is where a taxpayer has both a receivable and a payable from the exact same entity which results in both interest income and interest expense. The Director will permit the interest income and interest expense to be netted so only the excess of interest expense over interest income will be subject to the general add back rule. This exception **only** applies to interest income and expense related to the same entity. Interest income from one related member will not be permitted to offset interest expense to another.

The third unreasonable situation is where a taxpayer is involved in a “cash sweep” cash management system with its related members. For purposes of this exception, a cash sweep cash management system is defined as an agreement between related parties wherein one affiliate is responsible for handling all of the cash activities of the group. All cash is automatically “swept” into the bank account of the cash manager. The cash manager pays all of the expenses of the related parties and the cash balances are accounted for by intercompany accounts receivables and payables.

If both parties to this cash sweep arrangement conduct business at arm’s length, then the interest expense generated would not be subject to the general add back rule. In order to qualify, all cash must be handled through the cash sweep structure and the cash manager must charge arm’s length interest rates and make a profit on its cash sweep activities.