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3rd Circ. Questions Tax Exemption In NJ Biz Grant Dispute

By **Jeannie O'Sullivan**

Law360 (April 23, 2020, 7:35 PM EDT) -- The Third Circuit on Thursday questioned the U.S. Tax Court's determination that portions of New Jersey business relocation grants awarded to BrokerTec Holdings Inc. affiliates were tax-exempt capital contributions, reasoning that the unrestricted funds came absent any requirement to use them for capital investment.

During an oral argument, a three-judge panel considered the Internal Revenue Service's bid to overturn the tax court's finding that the financial services company properly excluded $55.7 million of the grants from their taxable income because it was considered nontaxable, nonshareholder contributions to capital. The IRS contends the grants are premised on generating payroll tax revenue for the state, not building corporate capital.

The panel appeared unswayed by BrokerTec's reliance on case law — such as the U.S. Supreme Court's 1950 decision in Brown Shoe Co. v. Commissioner and the Third Circuit's 1949 ruling in Commissioner v. McKay Products Corp. — involving money directly intended for the recipients' working capital.

"But when you look at the facts in this case, the grant itself didn't provide as a condition, that the monies be used to acquire a capital asset," U.S. Circuit Judge Thomas L. Ambro told BrokerTec attorney David B. Blair of Crowell & Moring LLP.

"And it doesn't look as if the grant required the monies to be placed into a capital account, and so that would seem to suggest an intent to provide additional income to BrokerTec, rather than contribute to its permanent working structure. That's the concern you're hearing from us," Judge Ambro continued.

However, Blair argued, the definition of capital isn't limited to hard assets. Rather, it's any money deployed by a business to generate more income.

"In our modern economy, many businesses have working capital that isn't tied up in hard assets," Blair told the court.

Referring to the tax court's reasoning, Blair said the IRS, in its bid to levy taxes on the $55.7 million, conflated capital assets with the working capital of the corporation. But the court saw the money as a contribution to working capital.

The tax court "looked at all the facts and inferred a purpose, that was not to make a payment in the context of a commercial relationship, but rather to add to the working capital of the company," Blair told the court.

The grants at the heart of the case came from the New Jersey Economic Development Authority's Business Employment Incentive Program and are based on a percentage of payroll tax generated by employees of the recipient, according to court records. BrokerTec was the recipient of grants totaling $170 million, of which $55.7 million was deemed exempt by the tax court.

"New Jersey could have set up its program the same way, but it didn't," U.S. Circuit Judge Stephanos Bibas said at one point to Blair, referring to case law involving grants that were specifically earmarked for business capital.

The BEIP grants were conditioned on New Jersey receiving a benefit in the form of payroll tax revenue, according to IRS attorney Judith A. Hagley of the U.S. Department of Justice's Tax Division.

Further, the grants were "completely unrestricted" and could have been used for any purpose, such as paying off dividends or covering operating expenses, Hagley argued.

"New Jersey did not intend the grants to become a permanent part of the recipient's working capital structure," Hagley told the court.

Emphasizing the notion that grants weren't based on capital, U.S. Circuit Judge Patty Shwartz asked Blair at one point how the panel could ignore that the grant was measured on payroll tax, an operating expense.

BrokerTec affiliates Garban Intercapital North America Inc. and First Brokers Securities Inc. sought the grant with plans to relocate after the World Trade Center attacks on Sept. 11, 2001, destroyed the former's offices and rendered the latter's nearby offices uninhabitable.

In exchange for the incentives, each BrokerTec affiliate agreed to move into the Harborside Financial Center in Jersey City and maintain a minimum number of jobs there for 15 years, according to court records.

In its income tax returns for 2010 through 2013, BrokerTec excluded roughly $55.7 million in grants the affiliates received as nontaxable, nonshareholder contributions to capital.

The IRS disagreed and filed an action in U.S. Tax Court. In April 2019, Tax Court Judge Julian Jacobs sided with BrokerTec and ruled that the grants were capital contributions that could be excluded from taxable gross income.

U.S. Circuit Judges Thomas L. Ambro, Patty Shwartz and Stephanos Bibas sat on the panel for the Third Circuit.

BrokerTec is represented by David B. Blair, Robert L. Willmore and Teresa M. Abney of Crowell & Moring LLP.

The IRS is represented by Teresa E. McLaughlin and Judith A. Hagley of the U.S. Department of Justice's Tax Division.

The case is BrokerTec Holdings Inc. et al. v. Commissioner of Internal Revenue, case number 19-2603, in the U.S. Court of Appeals for the Third Circuit.

--Editing by John Campbell.