Uneasy Link Between Federal Income Tax And NJ Gross Income Tax

by James F. McDonough, Jr. on September 6, 2013

There is a difficult and uneasy relationship between the Federal Income Tax (FIT) and the New Jersey Gross Income Tax (NJGIT). Despite the fact that the income for FIT purposes is the starting point for NJGIT purposes, there are significant differences. One observation is that NJGIT is unfriendly when it comes to the types of deductions allowed, the ability to carry losses to other years, and offsetting income and losses from different categories.

In Warsal v. Director, the differences between a FIT non-business bad-debt loss and NJGIT treatment is readily apparent. Although NJGIT permits some losses to be recognized, it does not provide for federal treatment to carryover to New Jersey in every case. The issue was whether the bad debt owed by a family member was a sale or disposition for NJGIT purposes. The court held that it was not and therefore was not deductible. Although the debt was deductible for federal purposes as a non-business bad debt that theory was not recognized for NJGIT. The taxpayer advanced the theory that the debtor's non-payment constituted a "disposition" under state law which permitted the taxpayer to recognize gain or loss.

A second issue was whether the federal treatment of the bad debt constituted a "method of accounting" that the state must follow for NJGIT purposes. The court stated that it was not a method of accounting to be imported into state law.

A second issue involves losses from S corporations. State Tax Bulletin GIT – 9S provides that:
In no case can you adjust your New Jersey adjusted basis in the stock below zero. S corporation losses which you are unable to use for New Jersey gross income tax purposes to offset income from another S corporation in the year the losses are incurred may not be used to offset S corporation income in any other taxable year. However, such unused losses will be used to adjust your New Jersey adjusted basis when calculating your gain/loss from the disposition of your shares of the S corporation

N.J.S.A.54A:5-2 only permits losses to offset income of the same class incurred in the same year. The state required taxpayers to reduce their state basis even when they were unable to use the losses and such a view prevailed until the a defeat in court.

In the aftermath of 2008, many businesses generated losses. Unfortunately, the losses from prior years were of no help for NJGIT purposes when the major asset was sold. One taxpayer recognized gain for NJGIT paid state income tax but did not for FIT. In net economic terms, the taxpayer lost money even with the proceeds of sale. Planning is imperative.

New Jersey and taxpayers are not perfect together.