

(d) A taxpayer's net profits from business shall be determined by taking into account all ordinary costs and expenses incurred in the conduct of that business. No deduction shall be allowed for taxes based on income; any civil, civil administrative or criminal penalty or fine assessed and collected for a violation of a State or Federal environmental law, or any other assessment described in N.J.S.A. 54A:5-1b(2); or any treble damages paid pursuant to N.J.S.A. 58:10-23.11fa. No deduction shall be allowed for any cost or expense which is not incurred in the conduct of the trade or business. Only ordinary business costs and expenses are deductible.

1. An ordinary business cost or expense must be:

i. Incurred primarily and directly in the pursuit of the business's income;

ii. Incurred as a common and accepted practice in that field of business;

iii. Required for and appropriate to the intended business purpose; and

iv. Reasonable in amount in relation to the intended business purpose.

2. The determination whether a business expense is ordinary shall be based upon the facts and circumstances of the expense. A taxpayer has the burden to demonstrate to the satisfaction of the Director that the cost or expense is deductible.

3. Business costs or expenses, which relate to business income exempt from tax under the Gross Income Tax Act, or which are partly or wholly nondeductible for Federal income tax purposes, may be deductible ordinary business costs or expenses under the Gross Income Tax Act. For example, meal and entertainment expenses which constitute ordinary expenses incurred in the conduct of a trade or business are fully deductible in determining a taxpayer's net profits from business.

(e) The allocation of sole proprietorship income derived from sources either within or outside of New Jersey shall be as follows:

1. Where the business activity is carried on solely within New Jersey, all items of income, gain, expense or loss of the business are deemed to have been derived from sources within New Jersey.

2. Where the business activity is carried on solely outside of New Jersey, the taxpayer must complete either New Jersey Business Allocation Schedule (Form NJ-1040-NR-A) or a schedule reflecting an approved allocation method under (e)4 below. Failure to provide such schedule may result in allocation of all sole proprietorship income to New Jersey.

Example 1:

Taxpayer is the sole proprietor of a hardware store. During the year the taxpayer receives the following income:

3. Where the business activity is carried on both within and outside of New Jersey, the portion of the business's income, gains, expenses or losses attributable to sources within New Jersey shall, except as provided in (e)4 below, be determined by use of the New Jersey Business Allocation Schedule (Form NJ-1040-NR-A). Failure to provide such schedule may result in allocation of all sole proprietorship income to New Jersey.

4. Where the business activity is carried on solely outside of New Jersey or both within and outside of New Jersey, and the taxpayer believes that the determination of business income, gains, expenses or losses attributable to sources within and outside of New Jersey by use of the New Jersey Business Allocation Schedule does not provide an equitable allocation of such items, and the books and records of the business will disclose to the Director's satisfaction a more appropriate method of allocation of such items, the taxpayer may request from the Director an exception from the use of the New Jersey Business Allocation Schedule. Such request must be made in writing and set forth the basis of the request and the substitute method of allocation requested to be used. Such request shall be mailed to the Chief of the Gross Income Tax Audit Branch, New Jersey Division of Taxation, PO Box 269, Trenton, NJ 08646-0269. The substitute method of allocation shall not be utilized prior to the written approval of such request by the Director. The business's exception request, once approved, shall not be changed without prior written approval of the Director. All exception requests must be renewed every three years.

(f) A taxpayer who is engaged in more than one trade or business as a sole proprietor must determine net profit or loss for each sole proprietorship separately. Once profit or loss from each sole proprietorship has been determined, the taxpayer must net such profits and losses and report the result in the category, "net profits from business."

(g) Sole proprietor filing requirements are as follows:

1. Resident and nonresident sole proprietorships subject to the Gross Income Tax shall attach the following for each sole proprietorship:

i. Federal Schedule C or F; and

ii. A schedule detailing changes made to each Schedule C or F in arriving at New Jersey taxable income.

2. Resident taxpayers shall report all of their business income regardless of source. Tax is imposed on all income.

3. Nonresident taxpayers shall report all business income, regardless of source. Tax is imposed only on New Jersey source income.

(h) The provisions of this section are illustrated by the following examples:

Interest from a personal savings account	\$ 300†
Interest from a business checking account	50††
Dividends from personal stock	100†
Gross receipts from hardware sales	250,000††

† Personal income
 †† Business income

Disbursements made by the taxpayer's hardware business:

<u>Ordinary expenses—deductible</u>		<u>Nondeductible expenses</u>	
Cost of goods sold	\$80,000*	Rutgers University	\$500***
Rent	20,000*		
Interest Expense (interest expense to finance inventory)	100*		
Supplies	2,000*		
Utilities	1,800*		
Insurance	1,500*		
Yellow pages (advertisement)	200*		
Local Church (advertisement church bulletin)	800**		

- * These are ordinary business expenses in the operation of a hardware store and are deductible.
- ** This expenditure is deductible since the taxpayer is advertising his business in the church bulletin in hopes of attracting new customers.
- *** This expenditure to Rutgers University, the taxpayer's alma mater, is not deductible. This expenditure is not incurred primarily and directly in the pursuit of business income, even though the taxpayer believes the university has an excellent business program which will provide possible future employees.

Taxpayer will calculate his net profits from business as follows:

<u>Income</u>		
Business interest	\$ 50	
Gross receipts from hardware sales	<u>250,000</u>	\$250,050
<u>Expenses</u>		
Cost of goods sold	\$ 80,000	
Rent	20,000	
Supplies	2,000	
Utilities	1,800	
Insurance	1,500	
Advertisement		
Yellow pages	200	
Local church bulletin	<u>800</u>	<u>(106,400)</u>
Net profits from business:		<u>\$143,650</u>

Taxpayer will report his income on his New Jersey gross income tax return as follows:

<u>Category</u>	<u>Amount</u>
Interest	\$ 300
Dividends	100
Net profits from business	<u>143,650</u>
New Jersey gross income:	<u>\$144,050</u>

Example 2:

Taxpayers are a married couple living in New Jersey who file a joint gross income tax return. The wife, who is an insurance agent, is an employee of a large insurance company. The husband is a self-employed trader of securities (stocks, bonds, futures). The couple has income from the following sources:

<u>Non-business income</u>		<u>Business income</u>	
Wages	\$90,000	Interest	\$4,000
(from insurance co.)		Dividends	7,000
Interest	10,000	Gains on sale of securities	400,000
(from joint savings account)		Losses on sale of securities	(100,000)
Dividends	5,000		
(non business investments held by taxpayers)		Income earned by the husband as a "trader" in securities	
Loss on sale of stock	(70,000)		
(non business investments held by taxpayers)			

Gain on sale of undeveloped land	40,000		
Disbursements made by the husband as a trader in securities:			
<u>Ordinary expenses—deductible</u>		<u>Nondeductible expenses</u>	
Investment interest expense	\$60,000*	Keogh	\$7,500**
Broker fees	5,000		
Home office expense	3,000		
Depreciation	2,000		
Meals/entertainment	500		
Journals/publications	200		
Disbursements made by the wife as an insurance agent:			
Meals/entertainment	\$ 800***		
Travel	600***		

* Investment interest expense is deductible as an ordinary business expense if it is directly related to the production of business income by the business entity incurring the cost.

** The Keogh expenditure is not deductible as an ordinary business expense. Taxpayer is not an employee of the business.

*** The wife cannot deduct any expenses incurred in the performance of her duties as an insurance agent, in that she is an employee of the insurance company and not an independent contractor. See N.J.A.C. 18:35-1.21 and 18:35-1.23 for more detail.

The husband will calculate his net profits from business as follows:

<u>Income</u>		
Interest	\$ 4,000	
Dividends	7,000	
Gains from sale of securities	400,000	
Losses from sale of securities	<u>(100,000)</u>	\$311,000
 <u>Ordinary expenses</u>		
Investment interest expense	\$ 60,000	
Broker fees	5,000	
Home office expense	3,000	
Depreciation	2,000	
Meals/entertainment	500	
Journals/publications	<u>200</u>	<u>(70,700)</u>
Net profits from business:		<u>\$240,300</u>

Taxpayers will report their income on their New Jersey gross income tax return as follows:

Wages	\$ 90,000
Interest	10,000
Dividends	5,000
Net profits from business	240,300
Net income from disposition of property	<u>0†</u>
New Jersey gross income:	<u>\$345,300</u>
† Net income from disposition of property	
Loss on sale of stock	\$(70,000)
Gain on sale of undeveloped land	<u>40,000</u>
Net income from disposition of property:	<u>\$(30,000)</u>

Taxpayers cannot apply their loss on disposition of property against their income attributable to other categories of New Jersey gross income.

Example 3:

Taxpayers are a married couple living in New Jersey who file a joint gross income tax return. The husband is employed by a large medical firm. The wife operates a rental real estate business at the Jersey shore which she personally manages and reports on her Schedule C of their Federal return. The taxpayers also own a cabin in Killington, Vermont as an investment. They report the income from the cabin as rental income on their Federal return. The property in Vermont is managed by a realty company that handles all aspects of renting and maintaining the property. The couple has income from the following sources:

<u>Rental real estate business income</u>		<u>Non business income</u>	
Rental receipts	200,000	Wages from medical firm	\$100,000
Interest	500†	Interest from investments	6,000
		Dividends from investments	5,000
		Rental receipts from VT property	12,000

† Interest earned on working capital

Disbursements made by the rental real estate business and by the taxpayers for the Vermont rental property:

<u>Rental real estate business</u>		<u>Vermont rental property</u>	
Ordinary expenses—deductible		Ordinary expenses—deductible	
Depreciation	22,000	Depreciation	\$ 4,000
Utilities	15,000	Utilities	800
Mortgage interest	13,000*	Mortgage interest	6,000*
Taxes	8,000	Taxes	5,200
Repairs	5,000	Commissions	1,000
Advertising	800		

* Interest paid to banks for the purchase of the rental properties.

Taxpayers will calculate their net profits from business and rental income as follows:

<u>Rental real estate business</u>		<u>Vermont rental property</u>	
Income		Income	
Rental receipts	200,000	Rental receipts	\$12,000 \$12,000
Interest	500		
	\$200,500		
Ordinary expenses		Ordinary expenses	
Depreciation	22,000	Depreciation	\$ 4,000
Utilities	15,000	Utilities	800
Mortgage interest	13,000	Mortgage interest	6,000
Taxes	8,000	Taxes	5,200
Repairs	5,000	Commissions	1,000
Advertising	800		
	(63,800)		
Net profits from business:	<u>\$136,700</u>	Net rental income:	<u>\$(5,000)</u>

Taxpayers will report their income on their New Jersey gross income tax return as follows:

Wages	\$100,000
Interest	6,000
Dividends	5,000
Net profits from business	136,700
Net gains or income from rents, royalties, patents and copyrights	0†
New Jersey gross income:	<u>\$247,70</u>

† Taxpayers cannot apply their rental loss of \$5,000 against income attributable to other categories of New Jersey gross income.

New Rule, R.1994 d.110, effective March 7, 1994.

See: 25 N.J.R. 677(a), 26 N.J.R. 1241(b).

Recodified from N.J.A.C. 18:35-1.25 and amended by R.1998 d.195, effective April 20, 1998.

See: 30 N.J.R. 612(a), 30 N.J.R. 1428(a).

In (b)8, changed N.J.A.C. reference. Former N.J.A.C. 18:35-1.1, Summer payment plan, recodified as N.J.A.C. 18:35-7.4.

Repeal and New Rule, R.1999 d.95, effective March 15, 1999.

See: 30 N.J.R. 3377(b), 31 N.J.R. 779(a).

Section was "Net profits from business".

Case Notes

Proposed amendment to tax regulations governing operating loss carryovers was not long-standing practical administrative construction of Gross Income Tax Act in which Legislature had acquiesced, so as to warrant judicial deference. *Marrinan v. State*, 17 N.J.Tax 47 (N.J.Tax 1997).

Costs, expenses, or losses that are paid or incurred in ordinary course of business are deductible against business income, even if items deducted arise only infrequently. *Sabino v. Director, Division of Taxation*, 17 N.J.Tax 29 (N.J.Tax 1997).

18:35-1.2 Employee business expenses not deductible

(a) If an individual is an employee as defined in N.J.A.C. 18:35-7.1, such person shall not deduct from gross income any costs and expenses incurred in connection with such employment.

(b) If an individual is an employee as defined in N.J.A.C. 18:35-7.1, all earnings in connection with employment are deemed to be and shall be reported by the taxpayer as wages, salaries, commissions, bonuses and other remuneration received for services rendered, pursuant to N.J.S.A. 54A:5-1(a). In no case shall an employee report his or her earnings as net profits from business as defined by N.J.S.A. 54A:5-1(b).

New Rule, R.1988 d.419, effective September 6, 1988.

See: 20 N.J.R. 515(a), 20 N.J.R. 2319(c).

Recodified from N.J.A.C. 18:35-1.23 and amended by R.1998 d.195, effective April 20, 1998.

See: 30 N.J.R. 612(a), 30 N.J.R. 1428(a).

Changed N.J.A.C. references throughout. Former N.J.A.C. 18:35-1.2, Clergymen; self-employed; income; expenses, recodified as N.J.A.C. 18:35-1.4.

18:35-1.3 Partnerships and partners

(a) The following words and terms, when used in this section, shall have the following meanings:

1. "Partnership" means and shall include a syndicate, group, pool, joint venture and any other unincorporated organization through or by means of which any business, financial operation or venture is carried on and which is not a corporation, trust or estate within the meaning of the New Jersey Gross Income Tax Act. Only entities that qualify for and elect to be treated as partnerships for Federal tax purposes (for example, Limited Liability Companies and Limited Liability Partnerships) and are in business shall be treated as partnerships under the Gross Income Tax Act.

2. "Partner" means any owner of a partnership interest and shall include any taxpayer subject to the Gross Income Tax who is a member of a partnership or other unincorporated entity taxed as a partnership. A partner cannot be an employee of the partnership for purposes of determining distributive share of partnership income.

(b) Partners, not partnerships, are subject to tax. Taxpayer partners shall be subject to Gross Income Tax on their distributive share of partnership income, whether or not distributed. Such income shall be reported as distributive share of partnership income, regardless of the character or category of the income derived by the partnership.

1. Partners who are resident taxpayers of New Jersey are subject to Gross Income Tax on their entire distributive shares of partnership income, regardless of the source of the income.

2. Partners who are nonresident taxpayers of New Jersey are subject to Gross Income Tax on their distributive shares of partnership income, but only to the extent such income was derived by the partnerships from sources within New Jersey. Refer to (c)3 below for rules governing sourcing or allocating income.

(c) The partnership's determination of a partner's distributive shares of partnership income or loss shall be as follows:

1. A partnership shall determine its income or loss for purposes of this subsection in the same manner a sole proprietorship determines "net profits from business" pursuant to N.J.A.C. 18:35-1.1(c) and (d). Such income shall be taxed as distributive share of partnership income without regard to character or category of income earned by the partnership. Each partner's respective distributive share of the partnership's income shall be determined by the partnership agreement in the same manner as determined for Federal income tax purposes.

2. Guaranteed payments shall be reported as distributive share of partnership income, except guaranteed payments received by a retired partner who is receiving such payments as a result of a period of service to the partnership pursuant to a retirement agreement or pension plan. Such guaranteed payments will be treated as pension income to retired partners and should be reported by the partner as pension income, described in N.J.S.A. 54A:5-1j.

3. The allocation of partnership income derived from sources either within or outside of New Jersey shall be as follows:

i. Where a partnership's activity is carried on solely within New Jersey, all items of the income, gain, expense or loss of the partnership are deemed to have been derived from sources within New Jersey. No allocation schedule is required.

ii. Where a partnership's activity is carried on solely outside of New Jersey, the partnership shall complete either New Jersey Business Allocation Schedule (Form NJ-1040-NR-A) or a schedule reflecting an approved allocation method under (c)3iv below. Failure to provide such schedule may result in allocation of all income to New Jersey.

iii. Where a partnership's activity is carried on both within and outside of New Jersey, the portion of the partnership's income, gains, expenses or losses attributable to sources within New Jersey shall, except as provided in (c)3iv below, be determined by use of the New Jersey Business Allocation Schedule (Form NJ-1040-NR-A), as prepared by the partnership. Failure to provide such schedule may result in allocation of all income to New Jersey.

iv. Where a partnership's activity is carried on solely outside of New Jersey or both within and outside of New Jersey, and the partnership believes that the determination of partnership income, gains, expenses or losses attributable to sources within and outside of New Jersey by use of the New Jersey Business Allocation Schedule does not provide an equitable allocation of such items, and the books and records of the partnership will disclose to the Director's satisfaction a more appropriate method of allocation of such items, the partnership may request from the Director an exception from the use of the New Jersey Business Allocation Schedule. Such request shall be made in writing and set forth the basis of the request and the substitute method of allocation requested to be used. Such request shall be mailed to the Chief of the Gross Income Tax Audit Branch, New Jersey Division of Taxation, PO Box 269, Trenton, NJ 08646-0269. The substitute method of allocation shall not be utilized prior to the written approval of such request by the Director. The partnership's exception request, once approved, shall not be changed without prior written approval of the Director. All exception requests must be renewed every three years.

4. A tiered partnership shall take into account its distributive share of partnership income from any partnership of which it is a member. Once income has been allocated by a partnership, it shall not be reallocated by the partners.

5. Partnership contributions to a qualified pension plan under the Internal Revenue Code made on behalf of

employees of the partnership and deductible as business expenses for Federal income tax purposes also are deductible under N.J.A.C. 18:35-1.1(d), consistent with (c)1 above, in determining the net income of the partnership.

(d) Partners who are taxpayers shall report their partnership income according to the following:

1. Partners who own more than one partnership interest shall determine their distributive share for each partnership interest separately. Once distributive share from each partnership interest has been determined, taxpayers shall net all distributive shares and report the total in the category, "distributive share of partnership income" under N.J.S.A. 54A:5-1k.

2. A partner may deduct unreimbursed expenses incurred in the conduct of the partnership's business if the expenses meet the deductibility standard of an ordinary business expense as described in N.J.A.C. 18:35-1.1(d).

3. In reporting partnership income, a partner may deduct payments made to a qualified Internal Revenue Code section 401(k) plan to the extent allowable for Federal income tax purposes, as provided in N.J.S.A. 54A:6-21.

4. A partner's contributions to the partnership's qualified Keogh plan under the Internal Revenue Code are not deductible business expenses under the standard provided in N.J.A.C. 18:35-1.1(d), consistent with (c)1 above. Such contributions are included in the participating partner's distributive share of partnership income reported for New Jersey gross income tax purposes. Previously taxed contributions to a Keogh Plan are not subject to tax when subsequently withdrawn by the partners.

5. Distributive share of partnership income or loss shall not be combined with other categories of income or loss. See N.J.A.C. 18:35-1.1(c)6.

6. If the partner and the partnership have different taxable years, the partner shall report his or her distributive share of partnership income for the partnership's taxable year that ended within the partner's taxable year.

7. A partner who is a resident taxpayer for part of any taxable year and a nonresident taxpayer for part of the same taxable year is required to report his or her distributive share of partnership income as follows:

i. The part-year resident return shall include the portion of the partner's distributive share of the partnership income determined by multiplying the partner's entire distributive share of partnership income as determined under (c) above by the percentage which the number of days of the partnership's fiscal year that the partner was a New Jersey resident bears to 365.

ii. The part-year nonresident return shall include the portion of the partner's distributive share of partnership income as follows:

(1) If the distributive share of partnership income was derived entirely from New Jersey sources, the portion of that distributive share of partnership income determined by multiplying the partner's entire distributive share of partnership income by the percentage which the number of days of the partnership's fiscal year that the partner was not a New Jersey resident bears to 365; or

(2) If the distributive share of partnership income was derived partly within New Jersey and partly outside New Jersey, the portion of such distributive share determined by multiplying the partner's entire distributive share of partnership income derived by the partnership from sources within New Jersey (determined as provided in (c)3ii or (c)3iii above), by the percentage which the number of days of the partnership's fiscal year that the percentage was not a New Jersey resident bears to 365.

iii. A partner who is a resident taxpayer for part of the tax year and a nonresident taxpayer for the remainder of the tax year shall attach a schedule to the partner's part year NJ-1040 and the part year NJ-1040-NR showing the calculations used to determine the amounts reported on each return with respect to income or loss of a partnership.

(e) Partnership filing requirements are as follows:

1. Partnerships having a New Jersey resident partner or having any income or loss derived from New Jersey sources shall file the following with the Division:

i. Form NJ 1065, including the partner directory;

ii. Schedule NJK-1 for every resident partner, a copy of which shall be provided to the partner;

iii. Schedule NJK-1 for every nonresident partner, but only if the partnership had income or loss from New Jersey sources, a copy of which shall be provided to the partner;

iv. Pages 1 through 4 of Federal Form 1065 and any Federal extension request forms filed; and

v. Schedule NJ-NR-A, if required under (c)3 above.

2. Information filings shall be made on or before the date of expiration of the permitted filing period for the partnership's Federal Form 1065, including any extensions of such period allowed for Federal income tax purposes.

3. Partnerships with partners subject to the Gross Income Tax shall make available and submit the following items at the Division's request:

i. Schedule NJK-1 for nonresident partners;

ii. A complete Federal Form 1065, including all schedules and supporting attachments; and

iii. Any other documentation or information the Division deems necessary.

(f) Partner filing requirements are as follows:

1. Resident and nonresident partners subject to the Gross Income Tax shall attach the following for each partnership:

i. The partner's New Jersey Schedule NJK-1, if received; or

ii. If no Schedule NJK-1 was received, Federal Schedule K-1, along with a schedule showing the calculation of New Jersey distributive share of partnership income.

2. Resident partners shall include with their New Jersey resident tax return a copy of the items specified in (f)1 above for each partnership in which the taxpayer is a partner, regardless of the source of the partnership's income or loss.

3. Nonresident partners in a partnership having income or loss from New Jersey sources shall, for each partnership, include a copy of the items specified in (f)1 above with the partner's New Jersey nonresident tax return.

(g) The provisions of this rule are illustrated by the following examples:

Example 1:

A partnership reported the following income on its Federal Schedule K (Form 1065):

Ordinary income	197,000
Interest income	1,000
1231 gain	2,000

The partnership in completing its NJ-1065 will determine partnership income as follows:

Ordinary income	197,000
Interest income	1,000
1231 gain	2,000
Partnership income:	<u>200,00</u>

The partnership has two full year resident partners who are not members of any other partnerships. Partner A has a 60% interest and partner B has a 40% interest. They will report their distributive shares of partnership income on their NJ-1040s as follows:

	Partner A	Partner B
	(60%)	(40%)
Distributive share of partnership income:	120,000	80,000

Example 2:

A partnership reported the following income on its Federal Schedule K (Form 1065):

Ordinary income	\$75,000
1231 gain	6,000

The partnership also incurred the following expenses as reported for Federal income tax purposes:

Section 179 expense	\$15,000
Meal and entertainment expenses (50% disallowed for Federal)	3,000

The partnership in completing its NJ-1065 will determine partnership income as follows:

Income		
Ordinary income:	\$ 75,000	
1231 gain	6,000	\$ 81,00
Expenses		
Section 179	\$(15,000)	
Meal and entertainment	<u>(3,000)</u>	<u>(18,000)</u>
Partnership income:		<u>\$ 63,000</u>

The partnership has two full year resident partners who are not members of any other partnerships. Partner A has a 2/3 interest and partner B has a 1/3 interest. Partner A also has the following unreimbursed business expenses: automobile \$800 and telephone \$200. These ordinary business expenses were incurred in the conduct of the partnership's business and are deductible. The partners will report their distributive shares of partnership income on their NJ-1040s as follows:

	Partner A	Partner B
	(2/3)	(1/3)
Distributive share of partnership income:	\$42,000	\$21,000
Unreimbursed business expenses		
Auto	(800)	
Telephone	<u>(200)</u>	
Distributive share of partnership income:	<u>\$41,000</u>	<u>\$21,00</u>

Example 3:

A partnership reported the following income on its Federal Schedule K (Form 1065):

Ordinary income	200,000
Interest income	1,000
Guaranteed payments	30,000*

* Partner A received guaranteed payments of \$20,000 for special services rendered.

Partner B received no guaranteed payments.

Partner C is retired and received guaranteed payments of \$10,000 pursuant to the partnership's pension plan.

The partnership in completing its NJ-1065 will determine partnership income as follows:

Ordinary income	200,000
Interest income	1,000
Guaranteed payments	<u>20,000**</u>
Partnership income:	<u>221,000</u>

Guaranteed payments classified as pension income:

10,000

** Guaranteed payments are allocated to partners according to the partnership agreement.

Partners A and B are full year residents who each have a 50% interest in the profit and loss of the partnership. Partners A and B will each report 50% of the partnership income (excluding guaranteed payments) on their NJ-1040s as follows:

	Partner A (50%)	Partner B (50%)	Retired Partner C (00%)
Distributive share of partnership income: (excluding guaranteed payments)	100,500	100,500	0
Guaranteed payments:	<u>20,000</u>		
Distributive share of partnership income:	<u>\$120,50</u>	<u>100,500</u>	<u>0</u>

Retired partner C has no distributive share of partnership income to report on his NJ-1040; however, he must report pension income in the amount of \$10,000.

Example 4a:

A partnership makes contributions to a qualified pension plan under the Internal Revenue Code on behalf of its employees for \$4,500. The partnership may deduct the \$4,500 as a business expense.

Example 4b:

Partner X elects to contribute \$3,000 to her account in the qualified Keogh plan established by the partnership. Partner Y elects not to make a contribution to the plan. The partnership must include the \$3,000 contribution made by partner X in her distributive share of partnership income in the taxable year the contribution was made. Partner X may not deduct her \$3,000 contribution as an ordinary business expense. When subsequently withdrawn, partner X's previously taxed contribution will not be subject to tax.

Partners X and Y each elect to make a contribution of \$5,000 to the partnership's 401(k) plan. They may deduct their contributions to the extent allowed under the Internal Revenue Code in determining their distributive share of partnership income.

The partnership reported the following income on its Federal Schedule K (Form 1065):

Ordinary income	98,000*
Interest income	2,000

* The ordinary income is net of a \$15,000 contribution made by the partnership to a qualified pension plan on behalf of its employees.

The partnership in completing its NJ-1065 will determine partnership income as follows:

Ordinary income	98,000
Interest income	<u>2,000</u>
Partnership income:	<u>100,000</u>

The partnership has two full year resident partners who are not members of any other partnerships. They each have an equal interest in the sharing of profit or loss. They will report their distributive shares of partnership income on their NJ-1040s as follows:

	Partner A (50%)	Partner B (50%)
Distributive share of partnership income:	50,000	50,000
401(K) contribution	<u>(5,000)</u>	<u>(5,000)</u>
Distributive share of partnership income:	<u>45,000</u>	<u>45,000</u>

401(K) contributions made by the partners are deductible. Keogh plan contributions made by the partners are not deductible.

Example 5:

A group of four friends form an investment club, structured as a partnership. Their partnership, in which they agree to share profit and loss equally, is in business. The partnership reported the following income on its Federal Schedule K (Form 1065):

Interest	300
Dividends	600
Short term capital loss	(400)
Long term capital gains	500

The partnership incurred the following expenses:

Brokerage fees	400
Accounting fees	500
Software	300
Rent	1,200

The partnership in completing its NJ-1065 will determine partnership income as follows:

Income		
Interest	\$ 300	
Dividends	600	
Short term capital loss	(400)	
Long term capital gains	<u>500</u>	1,000
Expenses		
Brokerage fees	\$ (400)	
Accounting fees	(500)	
Software	(300)	
Rent	<u>(1,200)</u>	<u>(2,400)</u>
Partnership income:		<u>(1,400)</u>

Each full year resident partner will have a \$350 distributive share of partnership loss to net against any distributive share of partnership income they may have from another partnership. Their resulting distributive share of partnership income will be reported on their individual NJ-1040s.

Example 6a:

A partnership that is in the business of manufacturing consumer products reported the following on its Federal Schedule K (Form 1065):

Ordinary income	100,000
Investment interest expense	(10,000)
179 expense	(8,000)

The investment interest expense resulted from a loan to finance improvement of machinery and equipment used in the business and meets the ordinary business expense standard.

The partnership in completing its NJ-1065 will determine partnership income as follows:

Ordinary income	200,000
Investment interest expense	(10,000)
179 expense	(8,000)
Partnership income:	<u>182,000</u>

The partnership has two full year resident partners. Partner A and Partner B have equal shares. The partners will report their distributive share of partnership income on their NJ-1040s as follows:

	Partner A (50%)	Partner B (50%)
Distributive share of partnership income:	<u>91,000</u>	<u>91,000</u>

Example 6b:

A law firm partnership earned \$600,000 of ordinary income during the calendar year. Partner A is financing 50% of his capital contribution to the partnership with a loan from the partnership. The interest on this loan is \$4,000. Partner B's capital contribution came entirely from his own funds. The partnership in completing its NJ-1065 will determine partnership income as follows:

Ordinary income	600,000
Interest income	4,000
Partnership income:	<u>604,000</u>

Partners A and B share equally in profit and loss of the partnership. Partners A and B each will report \$302,000 as distributive share of partnership income on their NJ-1040s. Partner A cannot deduct the \$4,000 interest expense since the interest resulted from a loan used to buy equity in the partnership. Partner A is in the business of practicing law and investing in the partnership is his personal expense.

Example 6c:

A rental real estate partnership reported the following on its Federal Schedule K (Form 1065):

Rental income	21,000
Interest income	3,000
Investment interest expense	(20,000)

The investment interest expense of \$20,000 resulted from the partnership financing a \$300,000 distribution to the partners with a bank loan that required the partnership to pledge one of its buildings as collateral.

The partnership in completing its NJ-1065 will determine partnership income as follows:

Rental income	21,000
Interest income	3,000
Investment interest expense	<u>0</u>
Partnership income:	<u>24,000</u>

The investment interest expense cannot be deducted for New Jersey Gross Income Tax purposes since the transaction does not meet the ordinary business expense standard. Investment interest expense that flows out of the partnership to a partner may never be deducted by the individual partner as an ordinary business expense for New Jersey Gross Income Tax purposes.

The partnership has two full year resident partners. Partner A has a 2/3 interest and Partner B has a 1/3 interest. The partners will report their distributive shares of partnership income on their NJ-1040s as follows:

	Partner A (2/3)	Partner B (1/3)
Distributive share of partnership income:	16,000	8,000

Example 7:

An individual taxpayer was a partner in three partnerships. Her distributive share of partnership income or loss from each of the partnerships was as follows:

Partnership K	20,000
Partnership L	(8,000)
Partnership M	<u>4,000</u>
Total	<u>16,000</u>

The taxpayer must net all her distributive shares of partnership income and report the total in the category distributive share of partnership income.

In addition to being a partner in these partnerships, the taxpayer was also a shareholder in an S corporation and a proprietor of a small business. Her other business activities resulted in the following:

Pro rata share of S corporation income	3,000
Net profits from business	(2,000)

The taxpayer cannot combine her net pro rata share of S corporation income of \$3,000 with her gain from her total distributive share of partnership income of \$16,000 or her loan from her sole proprietorship of \$2,000. Each category of income must be reported separately.

The taxpayer will report the following income on her NJ-1040:

Distributive share of partnership income	16,000
Net pro rata share of S corporation income	3,000
Net profits from business	0

The taxpayer must report a zero in the category net profits from business on her NJ-1040. Under the Gross Income Tax Act, a taxpayer may not offset losses in one category of income against income or gain in another category.

Example 8:

Partnership DEF is a partner in Partnership XYZ. As a partner, Partnership DEF received a schedule NJK-1 from Partnership XYZ that reported the following income:

	<u>Total Distribution</u>	<u>NJ Source Amounts</u>
Distributive share of partnership income:	12,000	6,000

In addition to its income from XYZ, Partnership DEF generated the following income during the calendar year:

Ordinary income	46,000
Interest income	4,000

Partnership DEF completed the New Jersey Business Allocation Schedule (Form NJ-NR-A) and determined its percentage of partnership income allocated to New Jersey to be 10%. In determining its income allocation percentage, Partnership DEF includes neither the distributive share of partnership income nor the allocation factors of Partnership XYZ.

Partnership DEF will report its distributive share of partnership income as follows:

	<u>Total Distribution</u>	<u>NJ Source Amounts</u>
Ordinary income	46,000	
Interest income	4,000	
Distributive share of partnership income:	50,000	
Business Allocation Percentage = 10%		5,000
Distributive share of XYZ partnership income (Per schedule NJK-1 from Partnership XYZ)	<u>12,000</u>	<u>6,000</u>
Distributive share of partnership income:	<u>62,000</u>	<u>11,000</u>

Partnership DEF cannot reallocate the income it received from Partnership XYZ.

Partnership DEF has two partners who share equally in profits and losses. Partner L is a full year resident of New Jersey and Partner M is a full year resident of Pennsylvania. Partnership DEF will report the following distributive share of partnership income on each of its partner's schedules NJK-1:

	<u>Total Distribution</u>	<u>NJ Source Amounts</u>
Distributive share of partnership income:	31,000	5,500

The partners will report their distributive share of partnership income on their individual returns as follows:

	<u>Partner L (50%)</u>	<u>Partner M (50%)</u>
NJ-1040	31,000	
NJ-1040NR		5,500

As a resident, Partner L is subject to tax on her entire distributive share of partnership income, regardless of where it is sourced. Partner M, as a nonresident, is only subject to tax on his distributive share of partnership income that is sourced to New Jersey.

Example 9a:

A partner's taxable year ends on December 31, 1998, while the partnership's fiscal year ends on June 30, 1998. The partner is to report the partner's distributive share of partnership income from the partnership's taxable year ended June 30, 1998 on the partner's 1998-NJ-1040.

Example 9b:

A partner's taxable year ends on December 31, 1998, while the partnership's fiscal year ended on August 31, 1998. The partnership changed to a calendar year partnership in 1998. In addition to the partnership filing a fiscal year return covering the period from September 1, 1997 to August 31, 1998, the partnership must also file a short year return covering the period from September 1, 1998 to December 31, 1998.

The partnership reported the following distributive share of partnership income on the partner's schedules NJK-1:

NJK-1 (09/01/97—08/31/98)	100,000
NJK-1 (09/01/98)—12/31/98)	30,000

The partner, who is not a member of any other partnership and who is a full year resident of New Jersey, is to report \$130,000 as distributive share of partnership income on his 1998 NJ-1040. The partner has to report the total from both NJK-1s on his 1998 NJ-1040 since both taxable years of the partnership ended within the partner's taxable year.

Example 10:

Partnership ABC carried on business both within and outside of New Jersey. By completing the New Jersey Business Allocation Schedule (Form NJ-1040-NR-A), Partnership ABC determined that 60% of its partnership income is sourced to New Jersey.

Partnership ABC reported the following income on its Federal Schedule K (Form 1065):

Ordinary income	63,000
Dividend income	1,000
Net long-term capital loss	(4,000)

The partnership in completing its NJ-1065 will determine partnership income as follows:

Ordinary income	63,000
Dividend income	1,000
Net long-term capital loss	(4,000)
Partnership income:	<u>60,000</u>

Partnership ABC has partnership income from all sources of \$60,000 and partnership income from New Jersey sources of \$36,000 (\$60,000 x 60%).

Partnership ABC has three partners who share equally in profits and losses. They are not members of any other partnerships. Partners A and B are each full year resident partners and Partner C is a full year resident of New York. Partnership ABC will report the following distributive shares of partnership income on its partner's schedules NJK-1.

	Total Distribution	NJ Source Amounts
Distributive share of partnership income:	20,000	12,000

The partners will report their distributive share of partnership income on their individual returns as follows:

	Partner A (1/3)	Partner B (1/3)	Partner C (1/3)
NJ-1040	\$20,000		
NJ-1040		20,000	
NJ-1040NR			12,000

Partners A and B, as residents, are subject to tax on their entire distributive shares of partnership income, regardless of where it is sourced. Partner C, as a nonresident, is only subject to tax on his distributive share of partnership income that is sourced to New Jersey.

Example 11a:

Partnership ABC is a calendar year partnership that reported a distributive share of partnership income to Partner A of \$12,000. Partnership ABC's income is all sourced to New Jersey.

Partner A was a resident of New Jersey through September 30, 1998 and became a nonresident of New Jersey on October 1, 1998.

Partner A is required to file a part-year New Jersey resident return for the period from January 1, 1998 through September 30, 1998 and a part-year New Jersey nonresident return for the remaining three months of the calendar year.

Partner A will report a distributive share of ABC's partnership income in the amount of \$8,975 on her part-year New Jersey resident return.

$$\$12,000 \times \frac{273}{365} = \$8,975$$

Partner A will report a distributive share of ABC's partnership income in the amount of \$3,025 on her part-year New Jersey nonresident return.

$$\$12,000 \times \frac{92}{365} = \$3,025$$

Partner A must attach a schedule to both her part-year NJ-1040 and part-year NJ-1040-NR showing the calculations used to determine the amounts reported on each return.

Example 11b:

Partnership ABC is a fiscal year partnership that has a year end of November 30, 1998. Partnership ABC reported a distributive share of partnership income to Partner A of \$12,000. Partnership ABC's income is all sourced to New Jersey.

Partner A was a resident of New Jersey through September 30, 1998 and became a nonresident of New Jersey on October 1, 1998.

Partner A is required to file a part-year New Jersey resident return for the period from January 1, 1998 through September 30, 1998 and a part-year New Jersey nonresident return for the remaining three months of the calendar year.

Partner A will report a distributive share of ABC's partnership income in the amount of \$9,995 on her part-year New Jersey resident return. Partner A must multiply her entire distributive share of partnership income by the percentage which the number of days of the partnership's fiscal year that Partner A was a New Jersey resident bears to 365. Partnership ABC's fiscal year began on December 1, 1997 and Partner A was a resident of New Jersey from December 1, 1997 through September 30, 1998.

$$\$12,000 \times \frac{304}{365} = \$9,995$$

Partner A will report a distributive share of ABC's partnership income in the amount of \$2,005 on her part-year New

Jersey nonresident return. Partner A must multiply her entire distributive share of partnership income (all sourced to New Jersey) by the percentage which the number of days of the partnership's fiscal year that she was not a New Jersey resident bears to 365. Partner A was not a resident of New Jersey as of October 1, 1998 and Partnership's ABC fiscal year ended on November 30, 1998.

$$\$12,000 \times \frac{61}{365} = \$2,005$$

Partner A must attach a schedule to both her part-year NJ-1040 and part-year NJ-1040-NR showing the calculations used to determine the amounts reported on each return.

Example 11c:

Partnership ABC is a fiscal year partnership that has a year end of November 30, 1998. Partnership ABC reported a distributive share of partnership income to Partner A of \$12,000. Partnership ABC determined that 20% of its income is sourced to New Jersey.

Partner A was a resident of New Jersey through September 30, 1998 and became a nonresident on October 1, 1998.

Partner A is required to file a part-year New Jersey resident return for the period from January 1, 1998 through September 30, 1998 and a part-year New Jersey nonresident return for the remaining three months of the calendar year.

Partner A will report a distributive share of ABC's partnership income in the amount of \$9,995 on her part-year New Jersey resident return. Partner A must multiply her entire distributive share of partnership income by the percentage which the number of days of the partnership's fiscal year that Partner A was a New Jersey resident bears to 365. Partnership ABC's fiscal year began on December 1, 1997 and Partner A was a resident of New Jersey from December 1, 1997 through September 30, 1998.

$$\$12,000 \times \frac{304}{365} = \$9,995$$

Partner A will report a distributive share of ABC's partnership income in the amount of \$401 on her part-year New Jersey nonresident return. Partner A must multiply her distributive share of partnership income that is sourced to New Jersey by the percentage which the number of days of the partnership's fiscal year that she was not a New Jersey resident bears to 365. Partner A was not a resident of New Jersey as of October 1, 1998 and Partnership's ABC fiscal year ended on November 30, 1998.

$$\begin{aligned} \$12,000 \times 20\% &= \$2,400 \\ \$2,400 \times \frac{61}{365} &= \$401 \end{aligned}$$

Partner A must attach a schedule to both her part-year NJ-1040 and part-year NJ-1040-NR showing the calculations used to determine the amounts reported on each return.

Amended by R.1981 d.6, effective January 8, 1981.

See: 12 N.J.R. 676(a), 13 N.J.R. 111(d).

Repeal and New Rule, R.1994 d.110, effective March 7, 1994.

See: 25 N.J.R. 677(a), 26 N.J.R. 1241(b).

Section was "Partnerships".

Recodified from N.J.A.C. 18:35-1.14 and amended by R.1998 d.195, effective April 20, 1998.

See: 30 N.J.R. 612(a), 30 N.J.R. 1428(a).

Changed N.J.A.C. references throughout. Former N.J.A.C. 18:35-1.3, Declaration of estimated tax; 1976, repealed.

Repeal and New Rule, R.1999 d.95, effective March 15, 1999.

See: 30 N.J.R. 3377(b), 31 N.J.R. 779(a).

Section was "Distributive share of partnership income".

Case Notes

Statute permitting taxpayer to deduct from partnership business income all costs and expenses incurred in conduct of business authorizes deduction of only ordinary business expenses, not all expenses. *Sabino v. Director, Div. of Taxation*, 296 N.J.Super. 269, 686 A.2d 1197 (A.D.1996).

Regulation could not exclude from partnership net income dividends and capital gains. *Smith v. Director, Div. of Taxation*, 108 N.J. 19, 527 A.2d 843 (1987).

Partnership business expenses could be deducted from partnership income when determining taxpayers' distributive share. *Smith v. Director, Div. of Taxation*, 108 N.J. 19, 527 A.2d 843 (1987).

Regulation relating to deductibility of reimbursed expenses of individual partner for purposes of computing partner's distributive share of partnership income; void. *Sabino v. Director, Div. of Taxation*, 14 N.J.Tax 501 (1995).

Paragraph (c)4 held inconsistent with statute: in determining liability for partner's distributive share of partnership income, partnership expenses incurred in connection with tax exempt income were deductible; expense incurred by securities partnership in the conduct of its business may be deductible against all other forms of partnership income, including dividends and capital gains, in determining partner's distributive shares of partnership income. *Smith v. Director, Div. of Taxation*, 7 N.J.Tax 187 (Tax Ct.1984), affirmed per curiam 8 N.J.Tax 319, affirmed 108 N.J. 19, 527 A.2d 843 (App.Div.1986).

Depletion expenses of partnership engaged in oil and gas production are properly deductible by a partner subject to New Jersey gross income tax; since percentage depletion, to the extent it exceeds cost depletion, is not attributable to production of income for the purpose of New Jersey gross income tax, it is not deductible in computing New Jersey taxable income. *Lee v. Director, Div. of Taxation*, 6 N.J.Tax 385 (Tax Ct.1984).

18:35-1.4 Clergymen; self-employed

Duly ordained clergymen are considered to be self-employed individuals for the purposes of the New Jersey Gross Income Tax Act. Accordingly, salaries, fees, honorariums, allowances and other remuneration paid to clergymen for services rendered are not subject to withholding. Therefore, income does not include the rental value of a residence provided for a clergyman by his church or congregation.

R.1976 d.424, effective December 17, 1976.

See: 9 N.J.R. 52(b).

Recodified from N.J.A.C. 18:35-1.2 by R.1998 d.195, effective April 20, 1998.

See: 30 N.J.R. 612(a), 30 N.J.R. 1428(a).

Former N.J.A.C. 18:35-1.4, Information furnished at source, repealed.

SUBCHAPTER 2. EXCLUDABLE INCOME

**18:35-2.1 Interest and gains from certain obligations;
taxable status of State and Federal securities**

(a) Gross income shall not include interest on obligations: