

CHAPTER 35**NEW JERSEY GROSS INCOME TAX****Authority**

N.J.S.A. 54:50-1, 54A:9-8.2 and 54A:9-17(a).

Source and Effective Date

R.1998 d.195, effective March 26, 1998.
See: 30 N.J.R. 612(a), 30 N.J.R. 1428(a).

Executive Order No. 66(1978) Expiration Date

Chapter 35, New Jersey Gross Income Tax, expires on March 26, 2003.

Chapter Historical Note

Chapter 35, New Jersey Gross Income Tax, was adopted prior to September 1, 1969.

Subchapter 2, Setoff of Individual Liability, was adopted as R.1982 d.161, effective May 17, 1982. See: 13 N.J.R. 940(a), 14 N.J.R. 474(b).

Pursuant to Executive Order No. 66(1978), Chapter 35, New Jersey Gross Income Tax, was readopted as R.1983 d.353, effective August 12, 1983. See: 15 N.J.R. 1091(a), 15 N.J.R. 1488(c).

Pursuant to Executive Order No. 66(1978), Chapter 35, New Jersey Gross Income Tax, was readopted as R.1988 d.299, effective June 7, 1988. See: 20 N.J.R. 514(a), 20 N.J.R. 1571(b).

Pursuant to Executive Order No. 66(1978), Chapter 35, New Jersey Gross Income Tax, was readopted as R.1993 d.315, effective June 4, 1993. See: 25 N.J.R. 1500(a), 25 N.J.R. 2906(b).

Former Subchapter 3, Information Return for Business Employment Incentive Program/Business Relocation Assistance Grant Program of the New Jersey Economic Development Authority, was adopted as R.1997 d.533, effective December 15, 1977. See: 29 N.J.R. 4076(b), 29 N.J.R. 5313(a).

Pursuant to Executive Order No. 66(1978), Chapter 35, New Jersey Gross Income Tax, was readopted as R.1998 d.195, effective March 26, 1998. See: Source and Effective Date. See, also, section annotations.

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SUBCHAPTER 1. GROSS INCOME—CATEGORIES AND CALCULATION**18:35-1.1 Net profits from business**

(a) Each taxpayer is subject to gross income tax on the taxpayer's "net profits from business" within the meaning of

N.J.S.A. 54A:5-1b, which shall be determined as provided in this subchapter.

(b) A taxpayer's net profits from business shall be determined by taking into account all income of the taxpayer derived from the conduct of a business, profession or any other income-producing activity, provided such business, profession or other income-producing activity constitutes the conduct of a trade or business. Such income shall be taken into account in determining the taxpayer's net profits from business, regardless of its source or character, provided it is directly attributable to the conduct of a trade or business by the taxpayer. All other income of the taxpayer which is subject to gross income tax, that is, that which is not directly attributable to the conduct of a trade or business, shall be included in one or more of the other categories of gross income specified in N.J.S.A. 54A:5-1 according to its character and shall not be includable in the category of income "net profits from business."

1. Income derived by a taxpayer in the taxpayer's capacity as an employee shall not be taken into account in determining the taxpayer's net profits from business, but rather shall be taxed as salary, wages, etc., described in N.J.S.A. 54A:5-1a. Income derived by a self-employed taxpayer as remuneration for services rendered in the conduct of a trade or business shall be taken into account in determining the taxpayer's net profits from business.

2. Interest and dividend income derived by a taxpayer shall not be taken into account in determining a taxpayer's net profits from business, unless:

i. The taxpayer shall annex to the taxpayer's tax return a statement which demonstrates that the interest or dividends, as the case may be, were realized in the conduct of a trade or business by the taxpayer, and not from investment activities or other income-producing activities which do not constitute the conduct of a trade or business. An adequate demonstration shall have been made where it is shown that:

(1) The interest is derived from loans made in the ordinary course of a trade or business of lending money;

(2) The interest or dividends are realized with respect to short-term liquid investments of money in an amount which does not exceed the reasonably anticipated working capital needs of the taxpayer's trade or business;

(3) The interest is derived in respect of accounts receivable or installment obligations acquired in the ordinary course of a trade or business, but only where credit is ordinarily offered to customers of the business;

(4) The interest or dividends are realized with respect to investments held to meet requirements imposed by law with respect to the conduct of a trade or business (for example, minimum capital requirements imposed by regulatory agencies), or with respect to deposits made in the ordinary course of business (for example, security deposits pertaining to leases by the taxpayer of property used by the taxpayer in a trade or business, or deposits pledged by the taxpayer to secure loans incurred by the taxpayer in the conduct of a trade or business), or with respect to other interest or dividend-bearing contracts or instruments held in the ordinary course of business (for example, interest received on life insurance policies owned by a taxpayer insuring the lives of key employees of the taxpayer's trade or business);

(5) The interest or dividends are derived in the ordinary course of an activity of trading or dealing in any property which generates such income, if such activity constitutes the conduct of a trade or business; or

(6) The interest or dividends are otherwise realized directly in the conduct of a trade or business, as demonstrated to the satisfaction of the Director.

3. Where no statement is attached to the taxpayer's return, or where such statement fails to demonstrate that the interest or dividends in question have been realized in the conduct of a trade or business, such items of income shall be separately stated on the taxpayer's return and taxed either as interest described in N.J.S.A. 54A:5-1e or dividends described in N.J.S.A. 54A:5-1f, as the case may be.

4. Rental income shall not be taken into account in determining a taxpayer's net profits from business, unless the rentals are received by a taxpayer in the ordinary course of the conduct of a trade or business of dealing in or leasing property of a character in respect of which the rentals are received. A taxpayer shall not be deemed to be engaged in the conduct of a trade or business of leasing property unless substantial services are rendered in connection with the leasing activities. The activity of net leasing property shall not constitute the conduct of a trade or business, unless the taxpayer shall be in the trade or business of dealing in such property and such property shall constitute inventory or stock-in-trade of the taxpayer. Rental income of a taxpayer which is not received in the ordinary course of the conduct of a trade or business shall be taken into account in determining the taxpayer's net gains or net income from or in the form of rents, royalties, patents and copyrights described in N.J.S.A. 54A:5-1d.

5. Royalty income and income derived from patents or copyrights of a taxpayer shall not be taken into account in determining the taxpayer's net profits from business, unless the royalties or the income derived from patents or copyrights are derived by the taxpayer in the ordinary course of a trade or business of licensing intangible property. A taxpayer shall be considered to be engaged in a trade or business of licensing intangible property only if the taxpayer created the property or performed substantial services or incurred substantial costs with respect to the development or marketing of such property. Royalty income or income derived from patents or copyrights of a taxpayer which is not derived in the ordinary course of a trade or business of licensing intangible property shall be taken into account in determining the taxpayer's net gains or net income from or in the form of rents, royalties, patents and copyrights described in N.J.S.A. 54A:5-1d.

6. Gains, profits and losses from the sale, exchange or disposition of property shall not be taken into account in determining a taxpayer's net profits from business, unless:

- i. The gain, profit or loss is realized by the taxpayer in the ordinary course of the conduct of an activity of trading or dealing in such property and such activity constitutes the conduct of a trade or business; or
- ii. The gain, profit or loss is realized by the taxpayer on the sale, exchange or other disposition of property which, in the hands of the taxpayer, constitutes property which is stock-in-trade, inventory or property held primarily for sale to customers in the ordinary course of a trade or business.

7. Gains, or profits and losses from the sale, exchange or disposition of property described in I.R.C. § 1231 shall not be taken into account in determining a taxpayer's net profits from business. Gains, or profits and losses not taken into account in determining a taxpayer's net profits from business shall be taken into account in determining a taxpayer's net gains or income from the disposition of property described in N.J.S.A. 54A:5-1c.

8. A taxpayer's distributive share of partnership income or loss shall not be taken into account in determining a taxpayer's net profits from business, regardless of the character of the partnership's activities. For rules governing the taxation of income derived by a taxpayer from a partnership, see N.J.A.C. 18:35-1.3.

(c) A taxpayer's net profits from business shall be determined by taking into account all costs and expenses incurred in the conduct thereof, except 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 expense or loss which is not incurred in the ordinary course of the conduct of the taxpayer's trade or business.

(d) A taxpayer's net profits from business shall be determined in accordance with the method of accounting utilized in reporting the taxpayer's business income or loss for Federal income tax purposes.

1. A taxpayer's net profits from business shall be determined by including any income which is subject to tax under the Gross Income Tax Act but which is exempt from Federal income taxation (for example, interest on non-New Jersey municipal obligations) and by excluding any income which is exempt from tax under the Gross Income Tax Act but which is subject to Federal income taxation (for example, interest or gains attributable to obligations described in N.J.S.A. 54A:6-14).

2. A taxpayer's net profits from business shall be determined by taking into account expenses or losses incurred in the conduct of the taxpayer's trade or business which are properly deductible in accordance with the taxpayer's method of accounting, even if such deductions relate to expenses incurred in earning business income exempt from taxation under the Gross Income Tax Act, or expenses which are partly or wholly nondeductible for Federal income tax purposes under rules which limit the deductibility of particular business expenses under the Internal Revenue Code. For example, meal and entertainment expenses which constitute ordinary and necessary expenses incurred in the conduct of a trade or business are fully deductible in determining a taxpayer's net profits from business for Gross Income Tax purposes.

(e) In the case of a taxpayer who is engaged in more than one trade or business, the taxpayer's net profits from business shall be determined by taking into account the income, profits, expenses and losses of all such activities on a net consolidated basis.

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.

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 Distributive share of partnership income

(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. "Partnership" shall not include:

- i. A publicly traded partnership;
- ii. A limited partnership association;
- iii. An unincorporated organization whose members properly elect to exclude such organization from the application of Subchapter K of Subtitle A of the Internal Revenue Code; or
- iv. Any other entity which is not taxed as a partnership for Federal income tax purposes.

2. "Partner" means and shall include any person or entity subject to the Gross Income Tax who shall be a member of a partnership, whether as a general partner or a limited partner.

(b) Partners, not partnerships shall be subject to tax and resident and non-resident partners treated as follows:

1. A partnership as such is not subject to the Gross Income Tax. However, each partner of a partnership shall be subject to Gross Income Tax on his or her distributive shares of the categories of New Jersey gross income, whether or not distributed, realized by the partnership for its taxable year ending within or with such partner's taxable year. Each partner shall account for and report his or her distributive shares of the partnership's categories of New Jersey gross income in the manner provided in (c) below.

2. A partner who is a resident taxpayer of New Jersey shall report and be subject to Gross Income Tax upon such partner's full distributive shares of the categories of New Jersey gross income of each partnership in which such partner is a member, regardless of the sources from which such income was derived by each such partnership.

3. A partner who is a nonresident taxpayer of New Jersey shall report and be subject to tax upon the distributive shares of the categories of New Jersey gross income of each partnership in which such partner is a member, but only to the extent such income was derived by the partnerships from sources within New Jersey.

i. Where a partnership's business is carried on solely within New Jersey, all items of the income, gain, expenses or losses of the partnership are deemed to have been derived from sources within New Jersey.

ii. Where a partnership's business 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 (b)3iii below, be determined by use of the New Jersey Business Allocation Schedule (Form NJ-1040-NR-A), as prepared by the partnership.

iii. Where a partnership's business is carried on both within and outside of New Jersey, and the partnership believes that the determination of the portion of the partnership's income, gains, expenses or losses attributable to sources within New Jersey by use of the New Jersey Business Allocation Schedule does not provide an equitable allocation of such items to sources within and outside of New Jersey, 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. Any such request shall be made in writing and shall set forth the basis of the request and the substitute method of allocation requested to be used in lieu of use of the New Jersey Business Allocation Schedule. The substitute method of allocation may not be utilized prior to the submission of the partnership's exception request and the approval of such request by the Director. The partnership's exception request, once approved, shall be made every three years, unless the Director or the partnership requests a change sooner.

(c) The determination of a partner's distributive shares of the partnership's items of gross income shall be as follows:

1. Each partnership which has one or more New Jersey resident partners, or which derives any item of gross income from sources within New Jersey, shall compute its New Jersey gross income in the same manner as would an individual taxpayer. Such gross income shall be allocated according to its character among the categories of gross income specified in N.J.S.A. 54A:5-1. Each partner's respective distributive shares of the partnership's various categories of gross income shall be determined by the partnership agreement of the partnership in the same manner the partner's distributive share of partnership income is determined for Federal income tax purposes.

2. Each partner shall report as such partner's "distributive share of partnership income" described in N.J.S.A. 54A:5-1k the net aggregate amount of:

i. The partner's distributive shares of the net profits (or loss) from each partnership of which such partner is a member derived from the conduct by such partnership of a business, profession or other income-producing activity, provided such business, profession or income-producing activity constitutes the conduct of a trade or business, plus

ii. The amount of the partner's guaranteed payments, as determined for Federal income tax purposes, from each partnership of which such partner is a member.

3. A partnership shall determine its net profits (or loss) from the conduct of a business, profession or other income-producing activity for purposes of this subsection in the same manner an individual taxpayer determines his or her "net profits from business" pursuant to N.J.A.C. 18:35-1.1, provided, however, in the case of tiered partnerships, a partnership shall take into account its distributive share of partnership income from any partnership of which it is a member.

4. Each partner shall report such partner's distributive shares of each category of New Jersey gross income of the partnership, other than the partnership's net profits (or loss) from the conduct of a business, profession or other income-producing activity described in (c)2 and 3 above, as an item of income attributable to such category of gross income in the same manner as if the partner had derived such item of gross income directly from sources other than a partnership. Each such item of gross income attributable to any category of gross income shall be reported on a consolidated basis with the partner's other items of gross income which are attributable to such category and which are derived from sources other than a partnership.

5. In the case of any category of gross income which pursuant to the Gross Income Tax Act is to be determined on a net income basis, a partner's distributive share of partnership income, gain, loss or expense attributable to such category shall be reported on a net consolidated basis with the partner's items of income, gain, loss or expenses derived from sources other than a partnership which also are attributable to the same category of gross income.

6. A partner may not report a distributive share of partnership income or loss on a consolidated basis with the partner's net income or loss from business derived from sources other than a partnership.

7. In determining a partner's distributive share of partnership income or loss, no deduction is allowed for expenses which are not incurred by the partnership.

8. The provisions of this section are illustrated by the following examples:

Example 1: A partnership shows the following income on its Federal Partnership Return of Income (Form 1065):

Partnership ordinary income (derived from the conduct of a trade or business):	\$25,000
Included in the partnership's ordinary income is interest income of \$500 derived from U.S. Treasury bills and excluded from the partnership's ordinary income is interest income of \$300 derived from State of New York bonds	
Dividend income (non-business source):	1,200
Long term capital gain on sale of partnership capital assets:	1,000
Total	<u>\$27,200</u>

Partner A has a 50 percent interest in the partnership and is entitled to a 50 percent share of partnership profits or losses. How does partner A report his share of the partnership income or gain on his New Jersey Form NJ-1040?

Partner A reports this income for New Jersey Gross Income Tax purposes as follows:

Distributive share of federal partnership ordinary income	\$12,500
Adjustments for New Jersey Gross Income Tax purposes:	
Add: Interest on New York State bonds	150
	<u>\$12,650</u>
Deduct: Interest on U.S. Treasury bills	(250)
Partner A's distributive share of partnership income:	\$12,400
Dividends:	600
Net gains from disposition of property:	500
Total New Jersey Gross Income:	<u>\$13,500</u>

Example 2: A taxpayer has the following income:

Distributive share of partnership income, including \$5,000 of guaranteed payments:	\$12,000
Distributive share of partnership capital gain (non-business):	2,000
Salary and wages from employment:	15,000
Capital loss on sale of individually owned stock:	(4,000)

How is this reportable for New Jersey gross income tax purposes on taxpayer's Form NJ-1040?

The taxpayer will report this income for New Jersey Gross Income Tax purposes as follows:

Salary and wages from employment:	\$15,000
Distributive share of partnership income:	12,000
Capital loss on sale of individually owned stock:	(\$4,000)
Plus: Distributive share of partnership gain:	<u>2,000</u>
Net gain from disposition of property:	0 †
Total New Jersey gross income	<u>\$27,000</u>

† Note: The taxpayer may offset the capital loss on the sale of individually owned stock against his distributive share of the partnership's capital gain,

but may not apply the resulting net loss from the disposition of property against income attributable to other categories of New Jersey gross income.

Example 3: A taxpayer has the following income:

Salary and wages from employment:	\$10,000
Distributive share of partnership loss:	(3,000)
Distributive share of partnership capital loss (non-business):	(2,000)
Capital gain on sale of individually owned stock:	5,000

How is this income reportable for New Jersey Gross Income Tax purposes on Form NJ-1040?

Salary and wages from employment:	\$10,000
Gain on sale of stock:	\$5,000
Less: Share of partnership capital loss	(2,000)
Net gains or income from disposition of property:	3,000
Distributive share of partnership income:	0†
Total New Jersey gross income	<u>\$13,000</u>

† Note: The taxpayer cannot apply his distributive share of partnership loss against his income attributable to other categories of New Jersey gross income. The taxpayer may only net a distributive share of a partnership loss against a distributive share of partnership income derived from another partnership.

Example 4: The Federal form Schedule K-1 (Form 1065) issued to a partner of a partnership activity engaged in the practice of medicine contained the following information:

Partnership net ordinary income (all of which is derived from business activities):	\$25,000
Interest income realized on money market accounts holding required working capital	300

† Note: Interest income realized by the partnership with respect to its working capital and security deposits may be taken into account in determining the partnership's net income or loss from trade or business only if the partnership annexes to its tax return the statement described in N.J.A.C. 18:35-1.3(f)4. Absent such statement, the interest income must be separately reported as "interest" by the partnership and will be taxable to the partners as "interest."

Example 5: The Federal form Schedule K-1 (Form 1065) issued to a partner of a partnership actively engaged in a trade or business of dealing in and trading securities contained the following information:

Partnership net ordinary income (all of which is derived from business activities):	\$25,000
Other classes of partnership income:	
Interest (Includes \$500 from U.S. Treasury bills and does not include \$300 from New York State bonds) (realized in the ordinary course of business):	1,800
Dividends (realized in the ordinary course of business):	1,200
Trading gains treated as capital gain (realized in the ordinary course of business):	600
Net gain under I.R.C. § 1231:	400
Royalties (non-business):	500

The taxpayer will report this income on his NJ-1040 as follows:

Partnership items of income derived from the conduct of a trade or business:	
Partnership net ordinary income:	\$25,000

Interest income realized on security deposits held by lessors pertaining to medical equipment leased by the partnership and used in its trade or business	100
Portfolio (that is, non-business) income:	
Interest (Includes \$500 from U.S. Treasury bills and does not include \$300 from New York State bonds held by the partnership):	1,800
Dividends:	1,200
Royalties:	500
Net long term capital gain:	600
Gain on the sale of property described in I.R.C. § 1231	400

The taxpayer will report this information on his NJ-1040 as follows:

Distributive share of partnership income:		
Business ordinary income	\$25,000	
Interest on working capital	300†	
Interest on security deposits	100	
Net distributive share of partnership income reportable on NJ-1040:		25,400
Interest:	1,800	
Adjustments:		
Less interest income from U.S. Treasury bills	(500)	
Plus interest income from New York State bonds	300	
Interest income reportable on NJ-1040:		1,600
Dividends:	1,200	
Net income from rents, royalties, etc.:	500	
Gains from disposition of property:		
Long term capital gain	600	
§ 1231 gain	400	
Net gains from disposition of property:		1,000

Interest:	1,800
Dividends:	1,200
Net trading gains treated as capital gain:	<u>600</u>
	\$28,600

Adjustments:	
Interest income from U.S. Treasury bills	(500)
Interest income from New York State bonds	<u>300</u>
	(200)

Distributive share of partnership income:		\$28,400
Net Gains from the disposition of property: § 1231 Gain	400	
Net income from rents, royalties, etc.:	500	
Partnership net ordinary income (all of which is derived from business activities):		\$25,000
Other classes of partnership income:		
Interest (Includes \$500 from U.S. Treasury bills and does not include \$300 from New York State bonds) (realized in the ordinary course of business):	1,800	
Dividends (realized in the ordinary course of business):	1,200	
Trading gains treated as capital gain (realized in the ordinary course of business):	600	

Net gain under I.R.C. § 1231:	400
Royalties (non-business):	500

The taxpayer will report this income on his NJ-1040 as follows:

Partnership items of income derived from the conduct of a trade or business:	
Partnership net ordinary income:	\$25,000
Interest:	1,800
Dividends:	1,200
Net trading gains treated as capital gain:	<u>600</u>
	\$28,600
Adjustments:	
Interest income from U.S. Treasury bills	(500)
Interest income from New York State bonds	<u>300</u>
	(200)
Distributive share of partnership income:	\$28,400
Net Gains from the disposition of property:	
§ 1231 Gain	400
Net income from rents, royalties, etc.:	500

Example 6: Taxpayer is a partner in two partnerships. Partnership A is a medical partnership and Partnership B is a securities partnership. Each partnership's activities constitute an active trade or business. The Federal Schedules K-1 (Form 1065) issued to the taxpayer by the partnerships contained the following information:

	Partnership A	Partnership B
Partnership net ordinary income	\$100,000†	(\$240,000) †
Other income:		
Interest:	5,000 ††	1,000 †
Dividends:	—	25,000 †
Capital gain:	12,000 ††	20,000 †
Net gain or loss under I.R.C. § 1231		(5,000) ††
The taxpayer also incurred with respect to his partnerships the following unreimbursed business expenses:	15,000	8,000

† Business income.
†† Non-business income.

The Taxpayer will report this income on his NJ-1040 as follows:

Partnership A	
Partnership Ordinary Income	\$100,000
Partnership B	
Partnership net ordinary income	(\$240,000)
Interest	1,000
Dividends	25,000
Capital gain	<u>20,000</u>
	(194,000)
	(94,000)
Distributive share of partnership income:	0†
Interest income (Partnership A):	5,000
Gains from disposition of property:	

Capital gain (Partnership A)	12,000
§ 1231 loss (Partnership B)	(5,000)
Net gain from disposition of property:	<u>7,000</u>

† Note: Taxpayer would report "0" on the line of his NJ-1040 calling for the taxpayer's distributive share of partnership income. However, if the taxpayer had been a partner of a third partnership, up to \$94,000 of the taxpayer's distributive share of income realized by the third partnership from the conduct of a trade or business could be offset by the net \$94,000 loss from Partnerships A and B.

Example 7: The Federal form Schedule K-1 (Form 1065) issued to a New Jersey resident partner of a partnership actively engaged in the practice of law in New York contained the following information:

Partnership net ordinary income:	\$10,000
Guaranteed payments:	5,000
Interest (Includes \$2,000 from U.S. Treasury bills and does not include \$2,000 from New York State bonds) (non-business):	5,000
Net gain under I.R.C. § 1231:	4,000
I.R.C. § 179 deduction:	1,000
Taxes based on income (UBT):	2,000
Expense incurred to carry New York State bonds:	1,000
Keogh deduction:	2,000
Charitable contributions (non-business):	3,000
The taxpayer also incurred unreimbursed business expenses with respect to his partnership in the amount of \$3,000.	

The taxpayer will report this information on his NJ-1040 as follows:

Partnership net ordinary income	\$10,000
Guaranteed payments	<u>5,000</u>
	\$15,000
Adjustments	
Taxes Based on Income	2,000
§ 179 Deduction	<u>(1,000)</u>
	1,000
Distributive share of partnership income:	16,000 †
Interest income	
Adjustments:	5,000
Interest income from U.S. Treasury bills	(2,000)
Interest income from New York State bonds	2,000
Net Adjustments:	<u>-0-</u>
Interest:	5,000 ††
Net Gains from the disposition of property:	
§ 1231 Gain	4,000

† Note: Keogh Plan contributions for partners, charitable contributions not deducted under I.R.C. § 162 and unreimbursed business expenses are not deductible for Gross Income Tax purposes.

†† Note: The cost to carry the New York State bonds cannot be deducted because the expense was not incurred in the ordinary course of a trade or business conducted by the partnership.

Example 8: The taxpayer is a New Jersey resident who is a partner in two partnerships. Partnership A is a New York based securities partnership and Partnership B is a New Jersey based accounting partnership. Each partnership's activities constitute an active trade or business. The Federal forms Schedule K-1 (Form 1065) issued to the taxpayer by the partnerships contained the following information:

	Partnership A	Partnership B
Partnership Ordinary Income:	(\$10,000) †	(\$15,000) †
Guaranteed payments:	2,000	
Interest:	8,000 †	3,000 ††
Interest from U.S. Treasury Bills included in the interest above	7,000 †	
Interest from Pennsylvania State bonds not included in interest above	5,000 †	
Dividends:	5,000 †	
Net short term capital gains or losses:	(2,000) †	
Net long term capital gains or losses:	18,000 †	(1,000) ††
Net Gain under § 1231:	1,500 ††	
Taxes based on income (UBT):	2,500 †	
Cost to carry Pennsylvania bonds:	1,000 †	
Keogh deductions:	2,000	
Charitable contribution incurred as a business expense:		3,000

† Business income.

†† Non-business income.

The taxpayer is also a shareholder in a New York S corporation. The Schedule K-1 issued by the S corporation showed an ordinary loss of (\$5,000)†.

The taxpayer will report this information on his NJ-1040 as follows:

<u>Partnership A</u>		
Partnership ordinary income	(10,000)	
Guaranteed payments	2,000	
Interest	8,000	
Dividends	5,000	
Net short term capital loss	(2,000)	
Net long term capital gain	18,000	
		\$21,000
Adjustments:		
Interest income from U.S. Treasury Bills	(7,000)	
Interest income from Penn- sylvania State Bonds	5,000	
Taxes based on income	2,500	
Cost to carry Pennsylvania bonds	(1,000)	
		(500)
Distributive share of partnership income from Partnership A:		20,500
<u>Partnership B</u>		
Partnership ordinary income	(15,000)	
Charitable contribution incurred as a business expense:	(3,000)	
Adjustments:	-0-	
Distributive share of partnership loss from Partnership B		(18,000)
Distributive share of partnership income:		2,500
Interest (Partnership B):		3,000
Gains from disposition of proper- ty:		
Net gain under § 1231 (Partnership A)	1,500	
Net long term capital loss (Partnership B)	(1,000)	
Net gains from the disposition of property:		500

† Note: S Corporation status is not recognized for New Jersey Gross Income Tax purposes. An S Corporation shareholder's share of the corporation's loss is not deductible for New Jersey Gross Income Tax purposes.

(d) If a partner's taxable year differs from that of the partnership, the partner is to report the partner's distributive share of income, gain or loss for the taxable year of the partnership which ends with or within his or her taxable year.

Example 1: A partner's taxable year ends on December 31, 1979, while the partnership's fiscal year ends on June 30, 1979. The partner is to report the partner's entire distributive share of the income, gain or loss from the partnership's taxable year ended June 30, 1979 on the partner's 1979 NJ-1040.

(e) The following apply to partners who are part-year residents:

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

i. The part-year resident return shall include:

(1) The portion of the partner's distributive share of partnership income determined by multiplying the partner's entire distributive share of partnership income (including guaranteed payments) 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; plus

(2) The partner's distributive share of each other category of New Jersey gross income (or loss) realized by the partnership during the period covered by the return.

ii. The part-year nonresident return shall include:

(1) The portion of the partner's distributive share of partnership income as follows:

(A) If the distributive share of partnership income was derived entirely from New Jersey sources, the portion of that distributive share of partnership income (including guaranteed payments) 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

(B) 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 (b)3ii or (b)3iii above), 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; and

(2) The partner's distributive share of each other category of New Jersey gross income (or loss) realized by the partnership and derived from New Jersey sources during that period covered by the return.

2. If the partner can demonstrate to the Director's satisfaction that the above reporting method does not properly reflect the partner's reportable income, gains and losses incurred during the partner's periods of residency and nonresidency, then the partner may allocate to the part year resident and part year nonresident returns the portions of the partner's distributive share of partnership income realized by the partnership during each such period.

3. In all cases, a partner who is a resident taxpayer for part of the tax year and a nonresident taxpayer for the remainder of the tax year must 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, gains, or losses of a partnership.

(f) Partnership filing requirements are as follows:

1. Partnerships having a New Jersey resident partner or having any income derived from New Jersey sources shall file with the Division a complete copy of the Federal Form 1065, U.S. Partnership Return of Income, required to be filed with the Internal Revenue Service, along with the requisite schedules and attachments. Such information filing must 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.

2. Except as may be authorized by the Director pursuant to (b)3iii above, every partnership which derives income both from sources within and outside of New Jersey and which has one or more nonresident partners shall complete a New Jersey Business Allocation Schedule (NJ-1040-NR-A). The partnership shall attach a copy of the Schedule to the Federal Form 1065 which it files with the Division, and must also provide a copy of the Allocation Schedule to each nonresident partner.

3. Each partnership shall distribute to each of its partners their respective Schedule K-1 of the partnership's Federal Form 1065. Each partnership also shall distribute to any partner requesting same any materials required to be filed by the partner with the partner's return pursuant to (g) below.

4. Any partnership which for Federal income tax purposes includes interest or dividends in the ordinary income or loss of the partnership, shall annex to its tax return which it files with the Division a statement such as that described in N.J.A.C. 18:35-1.1(b)2 which justifies the inclusion of such income items in the partnership's ordinary income or loss for New Jersey Gross Income Tax purposes. Any partnership which fails to annex such a

statement to its return shall separately state on its return the full amounts of its dividend and interest income.

(g) Partner filing requirements are as follows:

1. Each nonresident taxpayer who is a partner in a partnership having income, gains or losses derived from New Jersey sources shall, for each such partnership, include a copy of each of the following with the partner's New Jersey non-resident tax return:

i. The partner's Federal Schedule K-1;

ii. Reconciliation of his or her share of partnership income as determined for Federal income tax purposes, in accordance with (c) above; and

iii. The partnership's New Jersey Business Allocation Schedule (NJ-1040-NR-A), as provided by the partnership.

2. Each resident taxpayer shall include with the New Jersey resident tax return a copy of each of the items specified in (g)1i through ii above, for each partnership in which the taxpayer is a partner, regardless of the source from which the partnership's income, gains, or losses are derived.

(h) The following apply to Keogh Plans:

1. Partnership contributions to a Keogh Plan made on behalf of employees of the partnership and which are deductible as ordinary and necessary business expenses for Federal income tax purposes also shall be deductible for New Jersey Gross Income tax purposes in determining the net income of the partnership. The employees on whose behalf such contributions were made are not subject to gross income tax on the amounts contributed in the taxable year in which they are contributed to the Keogh Plan, unless withdrawn in such taxable year by the employees from the Plan. The employees are not considered to have actually or constructively received the contributions at the time they were made to the Keogh Plan. When an employee makes a withdrawal from the Keogh Plan, both the untaxed employer contribution and accumulated interest earned thereon are taxable to the employee.

2. Partnership contributions to a Keogh Plan made on behalf of a partner are not deductible business expenses. Such contributions are to be taken into account in determining the distributive shares of partnership income of the individual partners for New Jersey gross income tax purposes in the taxable years in which they are contributed to the Keogh Plan. Previously taxed employer contributions to a Keogh Plan are not subject to tax when subsequently withdrawn by the partners.

3. The interest income accumulated on the Keogh Plan contributions made by the partnership on behalf of the partners is not subject to tax during the period of a partner's participation. Such interest shall become tax-

able when the partner withdraws it from the Keogh Plan. When a partner makes periodic withdrawals, the accumulated interest in the Keogh Plan is subject to tax in the ratio that the interest bears to the total amount in the partner's account.

Example 1: A partner's accumulated Keogh contributions held in his account:	
Accumulated interest in partner's Keogh account:	\$7,500
Total amount in partner's Keogh account:	500
	\$8,000

Assume periodic payments to the partner from the account during the taxable year of \$1,600.

The amount of interest withdrawn would be calculated as follows:

$$\frac{\$ 500}{\$8,000} \times \$1,600 = \$100$$

Note: Under the above facts, if a periodic withdrawal of \$1,600 were made by an employee (rather than by a partner) during the taxable year, the full amount of \$1,600 is subject to tax since the employer contribution component of the amount withdrawn was not includable in the employee's income at the time the partnership made the contribution on his behalf.

Example 2: A partnership makes a contribution to a Keogh Plan on behalf of the partners for \$3,000 and on behalf of the employees for \$4,500. The partnership may deduct the \$4,500 contribution on behalf of the employees as a business expense for the taxable year and the employees will not include the \$4,500 as income until withdrawal is made from the Keogh Plan. The partnership cannot deduct the \$3,000 contribution made on behalf of the partners as a business expense for the taxable year. Each partner must include the portion of the \$3,000 contribution made on his behalf in his computation of his distributive share of partnership income in the taxable year the contribution was made. The amount of the contribution thus taxed to the partner will not again be taxable to the partner when such moneys are withdrawn by the partner from the Keogh Plan.

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.

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).

4. The provisions of this subsection are illustrated by the following examples:

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: