

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.2003 d.285, effective June 20, 2003.
See: 35 N.J.R. 1384(a), 35 N.J.R. 3386(a).

Chapter Expiration Date

Chapter 35, New Jersey Gross Income Tax, expires on June 20, 2008.

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, 1997. 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: 30 N.J.R. 612(a), 30 N.J.R. 1428(a).

Chapter 35, New Jersey Gross Income Tax, was readopted as R.2003 d.285, effective June 20, 2003. See: Source and Effective Date. See, also, section annotations.

Subchapter 2, Excludable Income, was renamed Exclusions and Deductions by R.2007 d.55, effective February 5, 2007. See: 38 N.J.R. 4658(a), 39 N.J.R. 546(a).

CHAPTER TABLE OF CONTENTS

SUBCHAPTER 1. GROSS INCOME—CATEGORIES AND CALCULATION

- 18:35-1.1 Net profits from business
- 18:35-1.2 Employee business expenses not deductible
- 18:35-1.3 Partnerships and partners
- 18:35-1.4 Clergymen; self-employed
- 18:35-1.5 S corporations and S corporation shareholders
- 18:35-1.6 Civil unions

SUBCHAPTER 2. EXCLUSIONS AND DEDUCTIONS

- 18:35-2.1 Interest and gains from certain obligations; taxable status of State and Federal securities
- 18:35-2.2 Qualified investment fund distributions
- 18:35-2.3 Employee accident or health insurance exclusion from taxable gross income

- 18:35-2.4 Election to exclude up to \$500,000 of gain on sale of principal residence
- 18:35-2.5 Pensions and annuities
- 18:35-2.6 Qualified State Tuition Program; education individual retirement account

SUBCHAPTER 3. ESTIMATED TAX

- 18:35-3.1 Estimated tax
- 18:35-3.2 Failure to file declaration or underpayment of estimated tax

SUBCHAPTER 4. CREDITS AGAINST TAX

- 18:35-4.1 Computation of credit for taxes paid to other jurisdictions
- 18:35-4.2 Credit for excess contributions
- 18:35-4.3 Earned income tax credit
- 18:35-4.4 Film tax credit

SUBCHAPTER 5. NEW JERSEY SOURCE INCOME OF NONRESIDENTS

- 18:35-5.1 Compensation received by nonresident professional athletes
- 18:35-5.2 Composite returns for nonresident partners

SUBCHAPTER 6. EXTENSION OF TIME TO FILE; RETURN REQUIREMENTS

- 18:35-6.1 Extension of time to file New Jersey gross income tax return
- 18:35-6.2 Combat zone; extension of time to file and pay
- 18:35-6.3 Signatures required on gross income tax return
- 18:35-6.4 Electronic filing methods

SUBCHAPTER 7. WITHHOLDING AND REPORTING OF TAX

- 18:35-7.1 Employee defined
- 18:35-7.2 Requirement of withholding from employees
- 18:35-7.3 Quarterly filing of withholding returns accelerated payments; exceptions
- 18:35-7.4 Summer payment plan
- 18:35-7.5 Gambling winnings subject to withholding
- 18:35-7.6 Filing of withholding returns by professional athletic teams
- 18:35-7.7 Commuter transportation benefits reporting by employer
- 18:35-7.8 Information of employer withholding from new employees
- 18:35-7.9 Treasurer's approval of a business to receive a grant from both the Business Employment Incentive Program Act and the Business Relocation Assistance Act
- 18:35-7.10 Domestic employees

SUBCHAPTER 8. INFORMATION RETURNS

- 18:35-8.1 Information furnished at source; 1977 and subsequent returns

SUBCHAPTER 9. INTEREST AND PENALTIES

- 18:35-9.1 Negligence and fraud penalties
- 18:35-9.2 Interest on overpayments

SUBCHAPTER 10. SETOFF OF INDIVIDUAL LIABILITY

- 18:35-10.1 Purpose
- 18:35-10.2 Definitions
- 18:35-10.3 Procedure for setoff
- 18:35-10.4 Matching
- 18:35-10.5 Notice to taxpayer

- 18:35-10.6 Administrative resolution; claimant agency proceedings
- 18:35-10.7 Agency procedure; hearing
- 18:35-10.8 Referral to Office of Administrative Law; hearing
- 18:35-10.9 Finalization of setoff by claimant agency; finalization by setoff
- 18:35-10.10 Notice to debtor of final setoff
- 18:35-10.11 Priorities in claims to setoff
- 18:35-10.12 Disposition of proceeds collected; collection assistance fees
- 18:35-10.13 Accounting to the claimant agency; credit to debtor's obligation

SUBCHAPTER 11. FILING FEE PAYMENTS BY PARTNERSHIPS

- 18:35-11.1 Definitions
- 18:35-11.2 Apportionment of the partnership fee
- 18:35-11.3 Annual return; payment of tax or fee due; extensions of time to file tentative return; estimated payment
- 18:35-11.4 Installment payment
- 18:35-11.5 Penalty and interest
- 18:35-11.6 Partnership examples of the imposition of the filing fee

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) For purposes of the Gross Income Tax Act, a sole proprietorship, which shall include self-employed individuals and independent contractors, is a form of business in which one taxpayer owns all the assets of a business and which is not a partnership or corporation. A single member limited liability company whose member is an individual, estate, or trust shall be treated as a sole proprietorship, unless classified otherwise for Federal tax purposes. Sole proprietors shall report their income or loss as net profits from business.

(c) 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 activity intended to produce income, provided such activity qualifies for and reports as a trade or business for Federal income tax purposes. All income attributable to the taxpayer's conduct of a trade or business, reduced by costs and expenses as provided in (d) below, shall be taken into account in determining the taxpayer's net profits from business. All other income of the taxpayer subject to gross income tax that is not 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." The determination of whether income is derived from the conduct of a trade, business or profession shall be based upon an examination of facts and circumstances of the taxpayer's activities.

1. Income derived as remuneration for services rendered in the sole proprietorship's conduct of a trade or business shall be taken into account in determining a self-employed taxpayer's net profits from business. Income derived by a taxpayer in the taxpayer's capacity as an employee, as defined in N.J.A.C. 18:35-7.1, shall not be taken into account in determining the taxpayer's net profits from business, but rather shall be taxed under N.J.S.A. 54A:5-1a (salaries, wages, etc.).

2. Interest and dividend income derived by a taxpayer in the conduct of a trade or business shall be taken into account in determining a taxpayer's net profits from business. The taxpayer shall annex to the taxpayer's return a statement demonstrating that the interest or dividends were realized in the conduct of the trade or business. Interest and dividends from investment activities or other income-producing activities which do not constitute the conduct of a trade or business 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.

3. Rental income derived by a taxpayer in the conduct of a trade or business shall be taken into account in determining a taxpayer's net profits from business. Rental income of a taxpayer which is not received in the conduct of a trade or business shall be taken into account in determining the taxpayer's net gains or net income from rents, royalties, patents and copyrights described in N.J.S.A. 54A:5-1d.

4. Royalty, patent, or copyright income derived by a taxpayer in the conduct of a trade or business that licenses intangible property shall be taken into account in determining the taxpayer's net profits from business. Income derived from royalties, patents or copyrights of a taxpayer which is not derived from 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. Gains from the sale, exchange or other disposition of trade or business property shall be taken into account in determining a taxpayer's net profits from business. The taxpayer shall annex to the taxpayer's return a statement which demonstrates that gains and losses from the sale, exchange, or other disposition of property were realized in the conduct of a trade or business. The sale, exchange or other disposition of property which is not directly related to or employed in the conduct of a trade or business must be reported as described in N.J.S.A. 54A:5-1c, net gains or income from the disposition of property. Gain or loss from the sale or disposition of assets employed in a trade or business as a result of a complete liquidation of the business must be reported as described in N.J.S.A. 54A:5-1c, net gains or income from the disposition of property.

i. A complete liquidation of a business is deemed to occur in the tax year when the business discontinues

- 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, 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 (d)4 above; and
- vi. Form PART-100 if the partnership is subject to the per partner filing fee; tax on nonresident partners; or has filed a PART-200-T.

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.

- i. All Form NJ-1065 filers with 10 or more partners or members must file the return electronically.

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

- i. A complete Federal Form 1065, including all schedules and supporting attachments; and
- ii. Any other documentation or information the Division deems necessary.

(g) 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 (g)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 (g)1 above with the partner's New Jersey nonresident tax return.

(h) 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	<u>\$2,000</u>
Partnership income:	<u>\$200,000</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 (60%)	Partner B (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)	<u>\$3,000</u>

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

Income		
Ordinary income:	\$75,000	
1231 gain	\$6,000	\$81,000
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 (2/3)	Partner B (1/3)
Distributive share of partnership income:	\$42,000	\$21,000
Unreimbursed business expenses		
Auto	(\$800)	
Telephone	(\$200)	
Distributive share of partnership income:	<u>\$41,000</u>	<u>\$21,000</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:	<u>\$10,000</u>

** 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>\$120,500</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 X (50%)	Partner Y (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 to the extent allowed under the Internal Revenue Code. Keogh plan contributions made by the partners are not deductible.

Additionally, Partner X had a gain of \$5,000 on the disposition of his partnership interest and Partner Y had a loss of \$2,000 on the disposition of her partnership interest.

The partners will report the following on their individual returns:

Partner X			
NJ-1040			
Net gains or income from disposition of property:			
Gain/loss from complete liquidation	\$7,500		
Gain/loss sale of partnership interest	\$5,000	\$12,500	
Distributive share of partnership income		\$2,000	

Partner Y			
		Everywhere	New Jersey
NJ-1040NR			
Net gains or income from disposition of property:			
Gain/loss from complete liquidation	\$7,500	\$4,800	
Gain/loss sale of partnership interest	(\$2,000)	\$0	\$5,500
Distributive share of partnership income		\$2,000	\$1,500

Since the partnership had a complete liquidation, Partner X will report \$2,000 in the distributive share of partnership income category and \$12,500 in the net gains from disposition of property category.

Partner Y will report \$2,000 in the distributive share of partnership income category and \$5,500 in the net gains from disposition of property category in the everywhere column and \$1,500 in the distributive share of partnership income category and \$4,800 in the net gains from disposition of property category in the New Jersey source column. The gain or loss from the sale of a partnership interest is from an intangible not employed in a trade or business therefore, not subject to tax for a nonresident.

Example 12:

Partners A and B who are both residents of New Jersey share profit and loss equally. On August 31, 2005, Partners A and B sold their rental building located in New Jersey at a gain of \$16,000. The partnership continued operating their other business activity, which generated ordinary income of \$20,000.

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

Ordinary income	\$20,000
Gain from disposition	<u>\$16,000</u>
Partnership income	\$36,000

Since the partnership did not have a complete liquidation, the partnership will include the gain from the sale of its rental property in with partnership income.

The partners will report the following on their individual tax returns:

	Partner A (1/2)	Partner B (1/2)
NJ-1040		
Partnership income	\$18,000	\$18,000

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".

Amended by R.2007 d.14, effective January 16, 2007.

See: 38 N.J.R. 3502(a), 39 N.J.R. 238(b).

Rewrote the section.

Amended by R.2008 d.42, effective March 3, 2008.

See: 39 N.J.R. 4559(a), 40 N.J.R. 1373(b).

Deleted former (a)1; recodified former (a)2 as (a)1; in (a)1, added the last sentence; added new (a)2; and in (d)1iii(3), deleted the second sentence.

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).

An individual partner in a law firm that required capital for the running of the operation was permitted to deduct from gross income subject to tax interest on money borrowed to meet his required investment in the partnership. *Dantzler v. Director, Division of Taxation*, 18 N.J.Tax 507 (1999).

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.

18:35-1.5 S corporations and S corporation shareholders

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

"Hybrid" means a Federal S corporation that has not made the New Jersey S corporation election, and the corporation conducts business both within and outside of New Jersey.

"Pro rata share" means the portion of any items attributable to an S corporation shareholder determined in accordance with I.R.C. sections 1377 and 1362.

"S corporation" means a corporation that meets the Federal definition under I.R.C. Section 1361, regardless of whether a New Jersey S corporation election was made.

"S corporation income" means the net of an S corporation's items of income, loss or deduction, and determined without exclusion of items of income properly taxable or deduction of expenses or losses prohibited for Gross Income Tax purposes.

(b) Determining S corporation's income. S corporation income is properly determined by netting together all items of income, gain, loss or expense reported on the S corporation's Federal form 1120S, Schedule K, and making modifications required under the Gross Income Tax Act for expenses and losses which were deducted for Federal purposes, but are not permitted to be deducted for State purposes, Federally exempt income which is taxable to New Jersey, Federally taxable income which was included for Federal purposes, but is exempt for New Jersey purposes, and expenses not deducted Federally, which are allowable for New Jersey.

1. Additions are required for:

i. Taxes based on or measured by profits, income, business presence or business activity, which were paid or accrued to the United States, any state, including New Jersey, a political subdivision of any state, or the District of Columbia. Such taxes include, but are not limited to, corporate franchise or income taxes, unincorporated business taxes, net worth taxes, gross receipts taxes, local and city income taxes, business occupancy taxes;

ii. Income taxes paid or accrued by the S corporation on behalf of, or in satisfaction of the liability of, shareholders of the S corporation;

iii. Expenses incurred to earn or collect income or gains that are exempt from New Jersey tax;

iv. Losses attributable to the disposition of obligations of the Federal government, any of its territories or instrumentalities, the State of New Jersey or its political subdivisions; and

v. Interest income derived from the obligations of states other than New Jersey, their municipalities and political subdivisions.

2. Subtractions are required for:

i. Gains attributable to the disposition of obligations of the Federal government, any of its territories or instrumentalities, the State of New Jersey or its political subdivisions;

ii. Interest income derived from the obligations of the Federal government, any of its territories or instrumentalities, the State of New Jersey or its political subdivisions;

iii. Expenses incurred to generate Federally excludable income which is taxable to New Jersey; and

iv. Expenses which Federally flow to the shareholder as itemized deductions (for example, I.R.C. section 179 expense, charitable contributions) or which are limited for Federal tax purposes (for example, meals and entertainment) unless specifically restricted or prohibited under the Gross Income Tax Act.

(c) A shareholder's pro rata share is determined by the following:

1. A New Jersey electing S corporation must determine S corporation income and provide each shareholder with a NJ K-1 reporting the shareholder's pro rata share based on ownership percentage, the New Jersey allocation factor, or deemed allocation factor, and all other information required for the proper filing of a New Jersey Gross Income Tax return.

2. The shareholder of a Federal S corporation that has not made the New Jersey S corporation election must compute the pro rata share on a New Jersey Worksheet, Reconciliation Schedule K-1, Federal Form 1120S using the information from the Federal Schedule K-1, Form 1120S, and in accordance with (b) above.

3. A Federal S corporation's income or loss is allocated inside or outside of New Jersey based on the percentages determined by the S corporation in accordance with N.J.S.A. 54A:5-10.

4. A Federal S corporation that does not have a New Jersey filing requirement and does not file a New Jersey