**Title:** No Bad Debt Deduction for NJ Taxpayers on Non-Business Debt

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Unlike the Federal Tax Treatment of Bad Debts,
New Jersey Taxpayers Are Not Entitled to a Bad Debt Deduction

The New Jersey Appellate Division in Waksal v. Director, Division Of Taxation determined that a New Jersey couple could not report losses to offset capital gains on their New Jersey income tax return.

In January 2002, Harlan W. Waksal loaned $14,769,320 to his brother, who signed a promissory note and agreed to repay the loan on or before January 31, 2004. His brother then defaulted on the loan. Subsequently, plaintiffs filed a 2004 Federal Individual Income Tax Return and reported a short term capital loss of $14,769,320. They also filed a 2004 New Jersey Gross Income Tax Return and reported the same amount as a loss from the "sale, exchange or other disposition of property," pursuant to N.J.S.A. 54A:5-1(c). After using the loss to offset capital gains, they reported $6,644,022 as a net gain in their New Jersey tax return.

The New Jersey Appellate Court affirmed the summary judgment granted to the Director, Division of Taxation. The Waksals argue primarily that their nonbusiness bad debt was "a sale, exchange or other disposition of property" under N.J.S.A. 54A:5-1(c), and, as a result, they are allowed to report the loss on their New Jersey Gross Income Tax Return and offset capital gains. Because the New Jersey Gross Income Tax Act (the Act), N.J.S.A. 54A:1-1 to -10, does not permit such a deduction, the trial court’s decision was affirmed.

The trial court relied in part on Walsh v. Director, Division of Taxation, 15 N.J. Tax 180 (App. Div. 1995), and King v. Director, Division of Taxation, 22 N.J. Tax 627 (App. Div. 2005), which held that a loss from a nonbusiness bad debt could not be used to offset gains "derived from the sale, exchange, or other disposition of property" under N.J.S.A. 54A:5-1(c). The trial judge indicated that "net gains or income from disposition of property" is considered taxable income under N.J.S.A. 54A:5-1(c), which provides in part that New Jersey gross income consists of certain categories, including:

Net gains or net income, less net losses, derived from the sale, exchange or other disposition of property, including real or personal, whether tangible or intangible as determined in accordance with the method of accounting allowed for federal income tax purposes.

The judge reasoned that the Act "does not mirror federal taxing statutes" and observed that the Supreme Court explained in Smith v. Director, Division of Taxation, 108 N.J. 19, 32 (1987), that:

Even a cursory comparison of the New Jersey Gross Income Tax and the Internal Revenue Code indicate [sic] that they are fundamentally disparate statutes. The federal income tax model was rejected by the Legislature in favor of a gross income tax to avoid the loopholes available under the Code.

The court recognized that in Walsh the Legislature determined that the New Jersey Gross Income Tax should contain fewer deductions from income than the federal income tax. This was seen as a way of making the Gross Income Tax fairer. The Legislature did not explicitly provide for a deduction of a nonbusiness bad debt. Thus, in view of the legislative history, it would appear that the Legislature did not intend for N.J.S.A. 54A:5-1c to be read broadly to include a deduction for nonbusiness bad debts.

On appeal, plaintiffs contend that the decision of the judge conflicts with N.J.S.A. 54A:5-1(c) and the Supreme Court's clear direction to apply substantive federal tax rules to determine net gains and loses.

In Walsh, the taxpayers sought to deduct a nonbusiness bad debt following a personal loan to a corporation in which they were also shareholders. The corporation then transferred its assets to a second corporation, "but [the taxpayers] remained liable as . . . guarantor[s] on the bank loans." After the second corporation defaulted on the bank loans that the taxpayers guaranteed, the taxpayers paid off the debt and deducted the losses on their New Jersey Gross Income Tax return.

Quoting the Tax Court, the Appellate Court held that the worthless debt, although treated as a loss from the sale or exchange of a capital asset held for not more than one year . . . under the Internal Revenue Code, does not fit the statutory rubric of sale, exchange or other disposition of property" found in N.J.S.A. 54A:5-1(c).

Because Waksal's loss from their nonbusiness bad debt cannot be used to offset gains derived from the "sale, exchange or other disposition of property" under N.J.S.A. 54A:5-1(c), the judge  concluded that plaintiffs could not report the loss to offset capital gains on their New Jersey income tax return.

**Raw Content:** <p style="text-align: center;"><strong>Unlike the Federal Tax Treatment of Bad Debts,
New Jersey Taxpayers Are Not Entitled to a Bad Debt Deduction</strong></p>
<p style="text-align: left;">The New Jersey Appellate Division in <em>Waksal v. Director, Division Of Taxation</em> determined that a New Jersey couple<em> </em>could not report losses to offset capital gains on their New Jersey income tax return.</p>
<p style="text-align: left;">In January 2002, Harlan W. Waksal loaned $14,769,320 to his brother, who signed a promissory note and agreed to repay the loan on or before January 31, 2004. His brother then defaulted on the loan. Subsequently, plaintiffs filed a 2004 Federal Individual Income Tax Return and reported a short term capital loss of $14,769,320. They also filed a 2004 New Jersey Gross Income Tax Return and reported the same amount as a loss from the "sale, exchange or other disposition of property," pursuant to <span style="text-decoration: underline;">N.J.S.A.</span> 54A:5-1(c). After using the loss to offset capital gains, they reported $6,644,022 as a net gain in their New Jersey tax return.</p>
<p style="text-align: left;">The New Jersey Appellate Court affirmed the summary judgment granted to the Director, Division of Taxation. The Waksals argue primarily that their nonbusiness bad debt was "a sale, exchange or other disposition of property" under N.J.S.A. 54A:5-1(c), and, as a result, they are allowed to report the loss on their New Jersey Gross Income Tax Return and offset capital gains. Because the <a title="New Jersey Gross Income Tax" href="http://www.state.nj.us/treasury/taxation/git.shtml" target="\_blank" rel="noopener noreferrer">New Jersey Gross Income Tax Act </a>(the Act), N.J.S.A. 54A:1-1 to -10, does not permit such a deduction, the trial court’s decision was affirmed.</p>
<p style="text-align: left;">The trial court relied in part on <span style="text-decoration: underline;"><a title="Walsh v. Director, Division of Taxation" href="http://caselaw.findlaw.com/nj-supreme-court/1385952.html" target="\_blank" rel="noopener noreferrer">Walsh v. Director, Division of Taxation</a></span>, 15 <span style="text-decoration: underline;">N.J. Tax</span> 180 (App. Div. 1995), and <span style="text-decoration: underline;"><a title="King v. Director, Division of Taxation" href="http://caselaw.findlaw.com/nj-superior-court-appellate-division/1296123.html" target="\_blank" rel="noopener noreferrer">King v. Director, Division of Taxation</a></span>, 22 <span style="text-decoration: underline;">N.J.</span> Tax 627 (App. Div. 2005), which held that a loss from a nonbusiness bad debt could not be used to offset gains "derived from the sale, exchange, or other disposition of property" under <span style="text-decoration: underline;">N.J.S.A.</span> 54A:5-1(c). The trial judge indicated that "net gains or income from disposition of property" is considered taxable income under <span style="text-decoration: underline;">N.J.S.A.</span> 54A:5-1(c), which provides in part that New Jersey gross income consists of certain categories, including:</p>
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<p style="text-align: left;">Even a cursory comparison of the New Jersey Gross Income Tax and the Internal Revenue Code indicate [sic] that they are fundamentally disparate statutes. The federal income tax model was rejected by the Legislature in favor of a gross income tax to avoid the loopholes available under the Code.</p>
<p style="text-align: left;">The court recognized that in <span style="text-decoration: underline;">Walsh</span> the Legislature determined that the New Jersey Gross Income Tax should contain fewer deductions from income than the federal income tax. This was seen as a way of making the Gross Income Tax fairer. The Legislature did not explicitly provide for a deduction of a nonbusiness bad debt. Thus, in view of the legislative history, it would appear that the Legislature did not intend for <span style="text-decoration: underline;">N.J.S.A.</span> 54A:5-1c to be read broadly to include a deduction for nonbusiness bad debts.</p>
<p style="text-align: left;">On appeal, plaintiffs contend that the decision of the judge conflicts with <span style="text-decoration: underline;">N.J.S.A.</span> 54A:5-1(c) and the Supreme Court's clear direction to apply substantive federal tax rules to determine net gains and loses.</p>
<p style="text-align: left;">In <span style="text-decoration: underline;">Walsh</span>, the taxpayers sought to deduct a nonbusiness bad debt following a personal loan to a corporation in which they were also shareholders. The corporation then transferred its assets to a second corporation, "but [the taxpayers] remained liable as . . . guarantor[s] on the bank loans." After the second corporation defaulted on the bank loans that the taxpayers guaranteed, the taxpayers paid off the debt and deducted the losses on their New Jersey Gross Income Tax return.</p>
<p style="text-align: left;">Quoting the Tax Court, the Appellate Court held that the worthless debt, although treated as a loss from the sale or exchange of a capital asset held for not more than one year . . . under the Internal Revenue Code, does not fit the statutory rubric of sale, exchange or other disposition of property" found in <span style="text-decoration: underline;">N.J.S.A.</span> 54A:5-1(c).</p>
<p style="text-align: left;">Because Waksal's loss from their nonbusiness bad debt cannot be used to offset gains derived from the "sale, exchange or other disposition of property" under <span style="text-decoration: underline;">N.J.S.A.</span> 54A:5-1(c), the judge  concluded that plaintiffs could not report the loss to offset capital gains on their New Jersey income tax return.</p>