**Title:** That’s It, We’re Splitting Up! The Disconnect Between the New Jersey Gross Income Tax and the Federal Income Tax

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**Date:** 10-3-2011

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**Raw Content:** In a recent New Jersey Tax Court memorandum case [Dalton V. Director of Division of Taxation (Doc. No. 020540-2010), the Division of Taxation was ordered to refund income taxes paid on dividend and capital gain reported as earned income in 2006-2008.  The taxpayer was a Madoff victim and was subsequently caught between the differences between two systems of taxation, although the underpinning of the NJ gross income tax is federal.
The IRS tackled this issue by setting forth a global procedure (Rev. Rul 2009-9, 2009-14 (IRB 735) to deal with the deductibility of losses and classified as theft losses. The Taxpayer has the option to deduct 95% of the loss if he or she did try to obtain it, and 75% if he or she did (Rev. Proc. 2009-20). The opinion recites that the taxpayer took advantage of the procedure, but did not request refunds for returns of capital and tax-exempt income.  Most readers recognize that the federal system requires a taxpayer to recognize income constructively received, such as interest added to a savings account, but not withdrawn.
<strong>SO WHAT?</strong>
<strong> </strong>New Jersey’s Gross Income Tax (“GIT”) differs from the federal income tax in several ways, and it this lack of symmetry that often causes unexpected results that often surprise taxpayers. In the Madoff-type cases, New Jersey demanded that the losses be deducted as investment losses because the GIT statutes do not have a provision for theft losses. However, the court disposed of that argument by noting the inconsistency of the Director’s position, which characterized the losses from theft, not investment. The opinion pointed out a weakness in the position of  the Director that there weren’t any assets--much less investment assets--and that “stolen” does not mean “sold”. The Court ended up stating that the taxpayer would be in a position of having paid tax on income erroneously reported.
There are two issues that annoy taxpayers.  First, the absence of a theft category in New Jersey’s Gross Income Tax produces some abnormalities because there is always a question as to what parts of the federal system have to do with the GIT.  Second, the GIT has categories of income that cannot be used against gains in another. Thus, the results of a federal tax analysis do not always translate to the GIT.
<strong>IS IT COMPLICATED ENOUGH YET?</strong>
Consider other disconnects between the two systems.  Depreciation deductions are not always identical, which also produces a disparity between the tax basis used to calculate gain on sales. Corporation losses are another source of taxpayer torment, where the inability to use the losses on a state basis theoretically creates the same disparity. Ultimately, when a corporation’s Certified Public Accountant does not do the individual return for each corporation shareholder, the analysis of a transaction may produce disparate results, much to the surprise—and dismay—of the shareholder group.
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