

TAX UPDATES FROM NEW JERSEY – MARCH 2022

Hodgson Russ Tristate Tax Alert
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In this installment of the TriState Tax Alert, the focus is recent developments in New Jersey. Both developments involve refund claims, so this is a friendly reminder that New Jersey’s extended refund deadline due to COVID-19 expires on April 1, 2022. More on that below.

Update from New Jersey on the *Shechtel* Decision

It has been more than a year since the New Jersey Division of Taxation suffered a litigation loss when the New Jersey appellate court held that the federal “at risk” rules of I.R.C. § 465 apply for purposes of determining a partner’s Gross Income Tax (“GIT”) liability. *Shechtel v. Dir., Div. of Tax’n*, 32 N.J. Tax 180 (App. Div. 2020), cert. denied, 245 N.J. 258 (2021). What that means is that for GIT purposes a partner with “at risk” losses must follow the same timing rules that apply under federal law.

As a result of the federal at risk limitations, the taxpayer in *Shechtel* had a suspended loss on his 2009 federal return. That loss became available for use on his 2010 federal return. But according to the Division, since the GIT statutes expressly prohibit individual taxpayers from applying losses from one tax year to offset income in another tax year, the Division would not allow the taxpayer to claim the suspended loss on his 2010 GIT return. Instead, the Division took the position that the suspended loss should have been claimed on the 2009 GIT return, a return year that was closed to adjustment by the time of the audit.

As recognized by the appellate court, the problem with the Division’s position is that the GIT statutes require that a taxpayer’s accounting method for purposes of the GIT “shall be the same as their accounting method for Federal income tax purposes” and I.R.C. § 465 is located squarely within the sections of the Internal Revenue Code that are designated “methods of accounting” (I.R.C. §§ 446-475). The appellate court further found there was no violation of the GIT prohibition on applying losses from one year against income from a later year because under the applicable federal accounting method, there was no loss that could be applied in 2009. For federal purposes the loss did not become available until 2010.

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After an unsuccessful attempt to have the New Jersey Supreme Court review the appellate court decision in 2021, the Division issued its position on the *Shechtel* decision in a January 19, 2022 news release, stating:

The *Shechtel* decision determined that for New Jersey Gross Income Tax (NJ-GIT) purposes taxpayers should follow the IRC Section 465 “at-risk” limitations.

Taxation is considering proposal of a regulation on this subject. The decision applies to partners in partnerships and sole proprietors. However, the decision is not applicable to S corporation shareholders in view of N.J.S.A. 54A:5-12, which provides specific language limiting shareholders’ losses. In addition, taxpayers may not use a loss following the “at-risk” rules if they have previously used the loss for NJ-GIT purposes.

Similarly situated taxpayers with facts and circumstances like those found in the opinion may amend their New Jersey Gross Income Tax returns. Amended returns may be subject to audit. Although a taxpayer may amend a return at any time, in order to claim a refund, the amended return must be filed within three years from the original due date of the return or two years from the time the tax was paid, whichever is later. Additionally, taxpayers may be required to provide documentation demonstrating that any loss disallowed pursuant to IRC 465 was not used in a previous tax year for NJ-GIT purposes. Taxpayers will need to keep track of any New Jersey and federal differences in basis.

The Division’s news release highlights that *Shechtel* does not apply to S corporation shareholders. That is because the GIT statute governing S corporations has its own version of an at risk limitation. Under the GIT, the aggregate amount of losses or deductions of an S corporation taken into account by a shareholder of the S corporation may not exceed the shareholder’s combined adjusted basis in the stock of the S corporation and any indebtedness of the S corporation to the shareholder. N.J.S.A. 54A:5-12(a). Any loss or deduction of an S corporation which is disallowed under this provision may not be treated “as incurred by the corporation in any succeeding taxable period with respect to that shareholder.” N.J.S.A. 54A:5-12(a).

As to potential refund claims, the Division advises no “double dips” will be allowed and taxpayers may not seek a refund under the reasoning of *Shechtel* if they claimed the loss for GIT purposes in a previous tax year.

If you have a refund claim relating to the *Shechtel* issue keep in mind that the statute of limitations on refund claims is still extended by executive order due to COVID-19. The deadline for filing a claim with a statutory deadline on or after March 9, 2020 is currently April 1, 2022. See our prior alert on refund claim deadlines (found [here](#)). That means the 2016 and 2017 years should still be open for individual taxpayers for a few more days.

Update from New Jersey on Sales Tax Refund Claim Requirements

Did you know New Jersey has some fairly onerous requirements for perfecting a sales tax refund claim? And last month the Tax Court denied a taxpayer’s challenge to the validity of those requirements in *Solvay Specialty Polymers v. Director, Div. of Taxation*, Docket No. 009365-2019 (N.J. Tax Court Jan. 19, 2022).

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In *Solway* the dispute involved the taxpayer's failure to submit proof of payment of the sales tax sought in the refund claim. According to the Division's regulation at N.J.A.C. 18:2-5.8, proof of payment requires:

(1) Proof of sales tax remitted to sellers is required and the Division will accept copies of canceled checks. If payment was made electronically, the Division will accept copies of bank statements with an itemization of all the transactions that make up the electronic payment. A request for use of an alternative proof of payment must be requested in writing to the Sales and Use Tax Refund Section and written approval received by the claimant prior to submission of such alternative proof of tax payment in support of the refund claim. Any approved alternate proof of payment must provide a trail between the documents presented by use of notation, highlighting, or other identification of the particular matching transactions.

The taxpayer in *Solway* produced letters from its vendors stating that payment of the tax at issue was received by the vendors in full, as well as internal reports from the taxpayer's accounting system that provided the reference numbers necessary to trace line items on bank statements to particular payments and invoices. However, the Division deemed the proof of payment inadequate under its regulatory requirements.

The taxpayer argued that the Division's sales tax refund requirements are arbitrary and capricious and place too high a burden on taxpayers because they do not comport with modern business practices. The Tax Court disagreed, finding the regulations provide "straightforward requirements to simplify the process for taxpayers."

In addition to the proof of payment requirement that was upheld by the Tax Court, here is a summary of the so-called straightforward requirements for perfecting a New Jersey sales tax refund that taxpayers must comply with when filing a refund claim:

- Refund claims of sales and use tax must include documentation of all transactions to substantiate the tangible personal property or service that is the subject of the refund claim and the amount requested.
- The Claim for Refund on Form A-3730 must be filed with documents, such as invoices, receipts, proof of payment of tax, and exemption certificates. These documents must be provided in a format suitable to determine the correctness of the grounds for the refund and the amount of the refund or credit.
- Imaged documents, which can be read with universal readable software, such as Adobe PDF and presented on CD may be submitted if first:

(1) The taxpayer submits a proposed plan for the submission to the Sales Tax Refund Section and received a written approval; and

(2) In claims of 25 or more transactions, the images of the documents are presented in an organized manner, which permits examination of the documents together with an electronic spreadsheet listing the transaction and the taxpayer retains the original invoices for Division examination.

- All sales/purchase documentation must clearly identify the seller, purchaser, invoice number, invoice date, description of the transaction, amount of the invoice excluding the tax, and the amount of sales tax billed for the transaction.

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- For those transactions exempt from sales tax by the tendering of an exemption certificate, the documentation relevant to all transactions with the issuer of the exemption certificate must clearly identify the purchaser.
- Cash receipts, register tapes or other receipts that do not identify the purchaser are not acceptable.
- When the basis of a claim for refund is the receipt of an exemption certificate from the customer after the seller has remitted the tax on their ST-50 return, then copies of the following documents are required:
 - (1) The exemption certificate;
 - (2) The initial invoice showing the amount of tax billed; and
 - (3) Proof of issuance and use of customer credit or other proof of repayment of the tax to the customer.
- Amended quarterly returns are required for any period where the claim for refund results in the change of any of the figures previously reported. The amended return(s) should be filed online at the time of submitting a refund claim.
- Refund claims of sales and use tax with 25 or more separate transactions or credit memoranda must be filed with a computer spreadsheet, which should be edit-locked. The spreadsheet must include, but is not limited to:
 - (1) The names of seller and customer;
 - (2) The location of the transaction (for example, delivered to Pennsylvania, shipped by carrier or customer pick-up);
 - (3) The invoice number;
 - (4) The invoice date;
 - (5) The item sold/purchased;
 - (6) The amount of the sale/purchase subject to refund;
 - (7) The amount of sales tax or use tax claimed for refund; and
 - (8) A statement of the grounds for the claimed refund.
- The computer spreadsheet shall be submitted with the refund claim on a compact disc or similar medium in common use. Receipt of a computer spreadsheet without simultaneous or prior filing of Form A-3730 does not constitute the filing of a claim for purposes of statute of limitations.
- The taxpayer must submit proof of payment, as described above.

Although not discussed in the *Solvay* decision, the regulations also provide that if a refund claim does not contain sufficient information, “the Division will provide the taxpayer with guidance on the information required to demonstrate an overpayment.” If the taxpayer does not respond to the Division's request for documentation within 30 days of receipt of such guidance, the Division will deny the claim. While the taxpayer may refile the claim, the regulations provide that the

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re-filed claim has to be filed within the applicable statute of limitations. N.J.A.C. 18:2-5.8.

Under the express provisions of the regulation, taxpayers have a right to expect the Division to provide notice of an incomplete refund claim. If the Division fails to comply with its own regulation and does not notify a taxpayer of missing information needed to support a refund claim and provide the taxpayer with 30 days to submit the information, then the Division should not be permitted to argue that any supplemental information received after the close of the statute of limitations was filed too late. Even so, the prudent option for any taxpayer filing a sales tax refund claim is to comply with the requirements in the Division's regulation and not omit any information or documentation that is required to support the refund claim.

Contact [Open Weaver Banks](#) (646.218.7524), [Debra Herman](#) (646.218.7532), or [Elizabeth Pascal](#) (716.848.1622) if you have any questions about how these tax updates may impact you or your business.