



NEW JERSEY LAW REVISION COMMISSION

Draft Tentative Report Addressing Audit Adjustments Involving Returns for Closed Years

June 06, 2022

The New Jersey Law Revision Commission is required to “[c]onduct a continuous examination of the general and permanent statutory law of this State and the judicial decisions construing it” and to propose to the Legislature revisions to the statutes to “remedy defects, reconcile conflicting provisions, clarify confusing language and eliminate redundant provisions.” *N.J.S. 1:12A-8*.

This Report is distributed to advise interested persons of the Commission's tentative recommendations and to notify them of the opportunity to submit comments. Comments should be received by the Commission no later than **August 15, 2022**.

The Commission will consider these comments before making its final recommendations to the Legislature. The Commission often substantially revises tentative recommendations as a result of the comments it receives. If you approve of the Report, please inform the Commission so that your approval can be considered along with other comments. Please send comments concerning this Report or direct any related inquiries, to:

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Project Summary

In New Jersey, after a tax return is filed, it is incumbent upon the Director of the Division of Taxation (“Director”) to examine the filing.¹ The Director is authorized by statute to make any further audit or investigation that is necessary regarding the tax filing.² If the amount paid in taxes was deficient, the Director may assess additional taxes, penalties, and interest against the taxpayer.³ The Director is granted similar authority regarding corporate filings.⁴

A deficiency assessment for corporate business taxes is governed by the State Tax Uniform Procedure Law provided for in the Taxpayer’s Bill of Rights.⁵ The Director of the Division of Taxation is authorized and empowered with broad discretion to adjust and redetermine the tax returns to make a fair and reasonable determination of the amount of tax payable under the act.⁶ The Director is not permitted to assess additional tax “after the expiration of more than four years from the date of filing of a return.”⁷

During the course of an audit, the Director may determine that a taxpayer has carried forward items, such as net operating losses.⁸ The tax statutes do not address a situation in which the Director adjusts an “open filing” and eliminates the net operating loss carryover from tax years that were never audited and were accepted as filed by the Director. In *R.O.P. Aviation, Inc. v. Director, Division of Taxation*, the Tax Court determined that the Director may not perform an audit adjustment to current filings that eliminated a plaintiff’s carried forward net operating losses from closed filings.⁹

The Commission recommends the modification of N.J.S. 54:10A-10 to reflect the determination of the court in *R.O.P. Aviation, Inc. v. Director, Division of Taxation*, and to make the statute easier to read and more accessible.

Statutes Considered

N.J.S. 54:10A-10 provides, in relevant part:

a. Whenever it shall appear to the director that any taxpayer fails to maintain its records in accordance with sound accounting principles or conducts its business or maintains its records in such manner as either directly or indirectly to distort its true entire net income or its true entire net worth under this act or the proportion thereof

¹ N.J. STAT. ANN. § 54:49-6a. (West 2022).

² *Id.*

³ *Id.*

⁴ N.J. STAT. ANN. §§ 54:48-1 to 54-6 (West 2022); *See* N.J. STAT. ANN. § 54:48-7 (West 2022).

⁵ *Id.*

⁶ N.J. STAT. ANN. § 54:10A-10a. (West 2022). *See generally*, N.J. STAT. ANN. § 54:10A-1 (West 2022) (Corporation Business Tax Act (1945)).

⁷ N.J. STAT. ANN. § 54:49-6b. (West 2022).

⁸ *R.O.P. Aviation, Inc. v. Dir., Div. of Tax’n*, 32 N.J. Tax 346, 354 (2021) (noting that “closed” commonly refers to tax years that are beyond the statute of limitation); N.J. STAT. ANN. § 54:10A-4k.(6)(C) (West 2022) (defining net operating loss as the excess of the deductions over the gross income used in computing entire net income without the net operating loss deduction subject to the requirements of subparagraphs and sections of the statute).

⁹ *Id.* at 349.

properly allocable to this State, or whenever any taxpayer maintains a place of business outside this State, or whenever any agreement, understanding or arrangement exists between a taxpayer and any other corporation or any person or firm, for the purpose of evading tax under this act, or whereby the activity, business, receipts, expenses, assets, liabilities, income or net worth of the taxpayer are improperly or inaccurately reflected, the director is authorized and empowered, in the director's discretion and in such manner as the director may determine, to adjust and redetermine such items, and to adjust items of gross receipts, tangible or intangible property and payrolls within and without the State and the allocation of entire net income or entire net worth or to make *any* other adjustments in *any* tax report or tax returns as may be necessary to make a fair and reasonable determination of the amount of tax payable under this act.¹⁰

N.J.S. 54:49-6 provides, in relevant part:

* * *

b. No assessment of additional tax shall be made after the expiration of more than four years after the date of the filing of a return; provided, that in the case of a false or fraudulent return with the intent to evade tax, or failure to file a return, the tax may be assessed at any time.

* * *

Background

In *R.O.P. Aviation, Inc. v. Director, Division of Taxation*, the Plaintiff (R.O.P.) is in the business of aircraft leasing to an affiliate.¹¹ For the tax years 2007-2011, R.O.P. reported that its total net operating losses carried forward were over \$18 million.¹² The Director of the Division of Taxation (Director or Division) did not dispute that R.O.P.'s corporate business returns for these tax years were not audited and were accepted as filed.¹³ In tax year 2014, the net operating losses were carried forward and used to offset its taxable income.¹⁴

In 2017, R.O.P.'s corporate business returns for the tax years 2012-2015 were the subject of an audit by the New Jersey Division of Taxation.¹⁵ The auditor noted that R.O.P. had leased its aircraft to its affiliate at a rate below its total costs.¹⁶ As a result, "allegedly underreporting income from the lease rentals," the auditor adjusted R.O.P.'s income.¹⁷ In addition, the auditor disallowed the use of any net operating losses for 2014, and of carried forward losses from 2007-2011 against

¹⁰ N.J. STAT. ANN. § 54:10A-10a. (emphasis added).

¹¹ *Id.* at 349.

¹² *Id.* at 349-350.

¹³ *Id.* at 350.

¹⁴ *Id.*

¹⁵ *Id.*

¹⁶ *Id.*

¹⁷ *Id.*

the audited increased income for tax years 2012, 2013, and 2015, by reducing the net operating losses to zero.¹⁸ The elimination of these deductions “resulted in the audited income as being the net taxable income... which plus interest totaled \$8,498,890.11.”¹⁹

The Notice of Final Audit determination, citing N.J.S. 54:10A-10 and N.J.A.C. 18:7-5.10 as authority, advised R.O.P. that the net operating losses “were disallowed for 2014 and not applied for 2012, 2013 and 2014 as the prior returns filed did not reflect arms-length transactions.”²⁰

R.O.P. filed a direct appeal from the Notice of Final Audit adjustment.²¹

Analysis

The Tax Court determined that partial summary judgment was an appropriate method of deciding the issue expeditiously, since the underlying facts were not in dispute, nor was there any dispute that R.O.P.’s tax years 2007-2011 were closed.²² The issue presented was whether the Division’s “elimination of R.O.P.’s [net operating losses] generated in closed years (2007-2011) and carried forward to the open years (2012-2015), [was] valid as an audit adjustment of the open tax years.”²³ The sole issue before the Court was “simply whether that adjustment was proper as a matter of law.”²⁴

• *Statute of Limitations for Audit*

The Director of Taxation is authorized to examine, audit, or investigate a filed return and, if there is a deficiency, assess additional penalties against the taxpayer.²⁵ The State Uniform Tax Procedure Law sets forth the time within which the Director can audit a filed commercial business tax return.²⁶ The statute of limitations, however, provides that “no assessment of additional tax shall be made after the expiration of more than **four years** from the date of the filing” of a commercial business tax return.”²⁷

In *R.O.P. Aviation*, it was uncontested that the Division of Taxation did not issue an assessment of additional corporate business tax for the closed years of 2007-2011.²⁸ Neither the taxpayer nor the Division disputed that at the time of the 2017 audit, the tax years of 2007-2011 were beyond the statute of limitations.²⁹ The Court noted that N.J.S. 54:49-6 subsection b. does

¹⁸ *Id.*

¹⁹ *Id.*

²⁰ *Id.* (internal citations omitted).

²¹ *Id.* at 352.

²² *Id.* at 353.

²³ *Id.*

²⁴ *Id.*

²⁵ N.J. STAT. ANN. § 54:49-6a. (West 2022).

²⁶ N.J. STAT. ANN. §§ 54:48-1 to 54-6 (West 2022).

²⁷ N.J. STAT. ANN. § 54:49-6b. (West 2022) (emphasis added).

²⁸ *R.O.P. Aviation*, 32 N.J. Tax at 355.

²⁹ *Id.*

not address whether the closed returns can be “audited” after the four-year statute of limitations has expired.³⁰

The Court determined that N.J.S. 54:49-6 subsections a. and b. must be read together.³¹ The Court reasoned that:

[s]ubsection (a) requires Taxation to examine a filed return and provides it the ability to “audit or investigate” the filed return. If the audit is conducted, and a deficiency is determined, Taxation must assess the additional tax. However, although Subsection (b) separately requires that assessment of any additional tax shall be made within four years of the return's filed date, it does not mean that the return's audit/investigation can be made at any time, and outside the four-year period. The tax assessment flows from the audit made under Subsection (a), therefore, the audit and resultant tax assessment should be subject to the same four-year period.³²

The Court reasoned that adjusting the amount of R.O.P.’s “carry forward of a closed year, in the audited open year, was an indirect additional assessment of tax for the closed year.”³³ The fact that the Division did not impose any additional assessment of corporate business tax in the closed year was of no moment to the Court.³⁴ The Court concluded that the act of “auditing a closed year and applying the revisions from that closed year in the open year of audit is doing indirectly what the statute does not permit directly: bypassing the four-year statute of limitations.”³⁵

• *Division’s Authority to Adjust Any Tax Report or Return*

In *R.O.P. Aviation*, the Division maintained that pursuant to N.J.S. 54:10A-10, the Legislature vested the Director of the Division of Taxation with broad authority to adjust a taxpayer’s reported entire net income.³⁶ The Division argued that it may make “any . . . adjustments in any tax report or tax returns as may be necessary to make a fair and reasonable determination of the amount of tax” payable under the Commercial Business Tax Act.³⁷ Thus, the Division argued that this language authorized the investigation of tax years beyond the statute of limitation for audits and the elimination of carried forward net operating losses.³⁸

The court acknowledged the tension in “reconciling the finality afforded to auditing tax returns by the statute of limitations with the flexibility afforded to [the Director]. . . .”³⁹ Although the court recognized that Taxation is “allowed the utmost discretion under N.J.S.[] 54:10A-10” it

³⁰ *Id.*

³¹ *Id.*

³² *Id.* at 355-356.

³³ *Id.* at 357.

³⁴ *Id.* at 356.

³⁵ *Id.* at 357.

³⁶ *Id.*

³⁷ *Id.* at 358 (citing N.J. STAT. ANN. § 54:49-6a. (West 2022)) (emphasis original).

³⁸ *Id.* at 348.

³⁹ *Id.* at 363.

simultaneously recognized that “statutes of limitations are construed strictly.”⁴⁰ The court concluded that even if the statute of limitations was ambiguous “as to adjusting NOLs of a closed tax year so that its effects are reflected in the open audited year” that ambiguity would be construed in favor of the taxpayer.⁴¹ The court reasoned that “Taxation’s reduction or elimination of NOLs by a purported audit of the closed tax years resulted in increased tax upon the taxpayer.”⁴²

The Court recognized both the breadth of Division’s powers as set forth in N.J.S. 54:10A-10a. and the “repose and finality underlying the basis of a statute of limitations.”⁴³ In reading the two statutes harmoniously, the Court refused to “construe [N.J.S. 54:10A-10a] to defeat the statute of limitations for an audit under N.J.S. 54:49-6.”⁴⁴ Noting the distinct purpose of each statute, the Court determined that N.J.S. 54:10A-10 subsection a. permits the Division to audit a taxpayer’s returns and make adjustments, while N.J.S. 54:49-6 requires that such an audit be conducted within a four-year period.⁴⁵

- *Application of Internal Revenue Service Procedures and Code*

The Internal Revenue Service (IRS) “routinely revises the amount of the [net operating loss] carryforwards by revising the [net operating loss] of the source year, even if that year is closed.”⁴⁶ The Internal Revenue Manual provides that the IRS “may redetermine correct taxable income in a closed year in order to ascertain either the amount of an NOL, or the amount of an NOL that is absorbed in the closed year for the purposes of determining the correct [NOL] deduction for an open year.”⁴⁷ This authority is derived from I.R.C. § 7602(a)(1) which provides that the IRS is “authorized . . . to examine any book, paper, record, or any other data which may be relevant or material to such inquiry” to determine the correctness of any return.⁴⁸

The Court in *R.O.P. Aviation* stated that it was not “bound by the IRS’ construction of a federal income tax statute for purposes of the CBT as to statute of limitations or audit procedures.”⁴⁹ The Court reasoned that “the plain language of I.R.C. § 7602(a)(1) itself does not permit opening of closed years or circumventing the statute of limitations.”⁵⁰ Further, the Court determined that the IRS’ manual for audit procedures was neither binding nor persuasive authority for the manner in which it should interpret the powers granted to the Director of Taxation and the statute of limitations for an audit.⁵¹ The Court also determined that “the IRS’ broad interpretation

⁴⁰ *Id.*

⁴¹ *Id.*

⁴² *Id.* (citing *Fedders Fin. Corp. v. Dir., Div. of Taxation*, 96 N.J. 376, 385 (1984) (ambiguity in a taxing statute with no legislative guidance to resolve the same, results in construing doubts in favor of the taxpayer).

⁴³ *Id.*

⁴⁴ *Id.*

⁴⁵ *Id.* at 359 (noting the impact of a contrary decision upon the statutory requirement that a corporate taxpayer retain their records for a period of five years pursuant to N.J.S. 54:10A-14.1).

⁴⁶ *Id.* at 361.

⁴⁷ *Id.* (citing Internal Rev. Manual § 4.11.11.13(2)).

⁴⁸ *Id.* (citing IRC § 7602(a)(1)).

⁴⁹ *Id.* (internal citations omitted).

⁵⁰ *Id.* at 362.

⁵¹ *Id.*

of § 7602(a)(1) is not binding [on a New Jersey] court and does not permit circumvention of New Jersey’s statute of limitations on an audit.”⁵²

Preliminary Outreach

Following the guidance of the Commission during the March 2021 meeting, Staff conducted targeted outreach to knowledgeable individuals and organizations.⁵³ Those individuals and organizations included: the Office of the Attorney General; the New Jersey Tax Management Office; private practitioners; and the majority of the County Tax Boards.

To this time, the Commission has not received any opposition to working in this area. On May 16, 2022, The New Jersey Division of Taxation advised Staff that “[t]he Division of Taxation is recommending a legislative fix to the decision which limits adjustments in open tax years based on disallowed NOL carryforwards generated in closed tax years.”⁵⁴ In addition, the Division of Taxation suggested that “[i]f the NJ Law [Revision] Commission has specific recommendations to make regarding revised statutory language” to please forward it to them as soon as possible.⁵⁵

This information was informally conveyed to the Commission at its May 2022 meeting.⁵⁶ The Commission authorized Staff to prepare a Draft Tentative Report on this subject for its consideration at the June 2022 meeting.⁵⁷

Pending Legislation

To this date, there is no legislation currently pending regarding either N.J.S. 54:10A-10 or N.J.S. 54:49-6.

Conclusion

The Commission recommends the modification of N.J.S. 54:10A-10 to reflect the determination of the court in *R.O.P. Aviation, Inc. v. Director, Division of Taxation* and to make the statute easier to read and more accessible.

⁵² *Id. Compare Barenholtz v. United States*, 784 F.2d 375 (Fed. Cir. 1986) (finding “[i]t is well settled that the IRS and the courts may recompute taxable income in a closed year in order to determine tax liability in an open year.”).

⁵³ N.J. Law Revision Comm’n, *Minutes NJLRC Meeting*, at *8, Mar. 17, 2022, www.njlrc.org.

⁵⁴ E-mail from Alan S. Kline, Counsel to the Dir., N.J. Div. of Tax. to Samuel M. Silver, Dep. Dir., N.J. Law Revision Comm’n (May 16, 2022, 11:20 AM EST) (on file with the NJLRC).

⁵⁵ *Id.*

⁵⁶ N.J. Law Revision Comm’n, *Minutes NJLRC Meeting*, at *---, May 19, 2022 (pending adoption).

⁵⁷ *Id.*

Appendix

The tax evasion statute, N.J.S. 54:10A-10, was amended four times since its enactment in 1945: L.1947, c. 50, p. 173, § 3; L.1958, c. 63, p. 193, § 5; L.2002, c. 40, § 10, eff. July 2, 2002; L.2018, c. 48, § 9, eff. July 1, 2018. The legislative modifications and additions have each been identified with an explanatory footnote, where appropriate.

The proposed modifications to **N.J.S. 54:10A-10** are shown with underlining (for the addition of text) and ~~striketrough~~ (for the removal of text) as follows:

a. (1) The director⁵⁸ may proceed, as authorized by subsection (a)(2) below, ~~W~~whenever it shall appear to the director⁵⁹ that:

(A) any taxpayer fails to maintain its records in accordance with sound accounting principles;⁶⁰ ~~or~~

(B) any taxpayer conducts its business or maintains its records in such manner as ~~that~~ either directly or indirectly ~~to~~ distorts its true⁶¹ entire net income or its true entire⁶² net worth under this act or the proportion thereof properly allocable to this State;⁶³ ~~or whenever⁶⁴~~

(C) any taxpayer maintains a place of business outside this State;⁶⁵ ~~or~~

(D) ~~whenever⁶⁶~~ any agreement, understanding or arrangement exists between a taxpayer and any other corporation or any person or firm, for the purpose of evading tax under this act, ~~or⁶⁷~~

(E) ~~whereby~~ the activity, business, receipts,⁶⁸ expenses, assets, liabilities, income,⁶⁹ or net worth of the taxpayer are improperly or inaccurately reflected⁷⁰ in

⁵⁸ L. 2002, c. 40, § 10 (replacing the term “commissioner” with the term “director” throughout the statute and rendering the statute gender neutral).

⁵⁹ *Id.*

⁶⁰ L. 1958, c. 63, p. 193, § 5 (authorizing the director to act when a taxpayer fails to maintain their records in accordance with sound accounting principles).

⁶¹ L. 1947, c. 50, p. 173, § 3 (authorizing the director to act when a taxpayer conducts the business in a way that distorts its net worth or the proportion allocable to the State). *See also* notes 63-65 *infra* for subsequent amendments to this statutory sentence.

⁶² L. 1958, c. 63, p. 193, § 5 (adding the phrase “entire net income or its true entire [net worth]” to this statutory sentence).

⁶³ L. 1947, c. 50, p. 173, § 3.

⁶⁴ L. 1958, c. 63, p. 193, § 5 (replacing the word “that” with the word “whenever”).

⁶⁵ L. 1945, c. 162, p. 570, § 10 (original statutory language).

⁶⁶ L. 1958, c. 63, p. 193, § 5 (replacing the word “that” with the word “whenever”).

⁶⁷ L. 1945, c. 162, p. 570, § 10 (part of original statute as enacted).

⁶⁸ *Id.*

⁶⁹ L. 1958, c. 63, p. 193, § 5 (adding expenses, assets, liabilities and income to items subject to examination if improperly or inaccurately reflected in a tax report or return).

⁷⁰ L. 1945, c. 162, p. 570, § 10 (part of original statute as enacted).

any tax report or return.

(2) ~~Subject to subsection (a)(1) above and N.J.S. 54:49-6(b),⁷¹ the director⁷² is authorized and empowered, in the director's⁷³ discretion and in such manner as the director⁷⁴ may determine, to adjust⁷⁵ and redetermine such items, and to adjust⁷⁶ items of gross receipts, tangible⁷⁷ or intangible⁷⁸ property and payrolls within and without the State and the allocation of⁷⁹ entire net income or entire⁸⁰ net worth or to make any other adjustments in any tax report or tax returns as may be necessary⁸¹ to make a fair and reasonable determination of the amount of tax payable under this act.⁸²~~

Comments

The current statutory language in subsection a. of the corporate “tax evasion” statute, N.J.S. 54:10A-10, is set forth in one sentence that is 211 words long and contains twenty-five conjunctions.⁸³ Consistent with contemporary legislative drafting practices, the proposed modifications to this subsection further divide the subsection into two additional subsections – (a)(1) and (a)(2) – to promote readability and accessibility.

Subsection (a)(1)(A)-(E) - Conditions Precedent

The proposed modifications to this subsection set forth each of the five conditions precedent that must occur before the director may make an adjustment in any tax report or return to secure a fair and reasonable determination of the tax payable under the Act.

Subsection (a)(2)(1) - Conditions Precedent

The proposed modifications are consistent with the decision of the court in *R.O.P. Aviation, Inc. v. Dir., Div. of Tax'n*, in which the court determined that the adjustment of net operating losses (NOLs) carried forward from a “closed year” were impermissible under N.J.S. 54:49-6 – the statute of limitations.⁸⁴ The court opined that such an adjustment is “tantamount to an adjustment of the income reported in those years and constitutes an audit of closed years....”⁸⁵

The Legislature has vested the director with the authority to make “any other adjustments in any tax report or tax return as may be necessary to make a fair and reasonable determination of the amount of tax payable under this

⁷¹ *R.O.P. Aviation, Inc. v. Dir., Div. of Tax'n*, 32 N.J. Tax 346, 359 (2021).

⁷² L. 2002, c. 40, § 10 (replacing the term “commissioner” with the term “director” throughout the statute and rendering the statute gender neutral).

⁷³ *Id.* (replacing the word “his” with the term “the director’s” when the statute was rendered gender neutral).

⁷⁴ *Id.* (replacing the word “he” with the term “the director” when the statute was rendered gender neutral).

⁷⁵ L. 1945, c. 162, p. 570, § 10 (this language, with the modifications noted, *supra*, is part of the original statute).

⁷⁶ L. 1958, c. 63, p. 193, § 5 (reflects language added).

⁷⁷ L. 1945, c. 162, p. 570, § 10 (part of original statute as enacted).

⁷⁸ L. 1958, c. 63, p. 193, § 5 (reflects language added).

⁷⁹ L. 1945, c. 162, p. 570, § 10 (part of original statute as enacted).

⁸⁰ L. 1958, c. 63, p. 193, § 5 (reflects language added).

⁸¹ L. 1945, c. 162, p. 570, § 10 (part of original statute as enacted).

⁸² L. 1958, c. 63, p. 193, § 5 (adding the language “to make a fair and reasonable determination of the amount of tax payable under this act.”).

⁸³ N.J. STAT. ANN. § 54:10A-10a. (West 2022) (contains nine “ands” and sixteen “ors”).

⁸⁴ 32 N.J. Tax 346, 359 (2021).

⁸⁵ *Id.*

act.”⁸⁶ The proposed language simplifies the statutory language regarding the authority of the director and eliminates language that appears to be superfluous.

⁸⁶ N.J. STAT. ANN. § 54:10A-10a. (West 2022).