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## NJ Partnerships End Up Winners in Tax Court Decision

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In February 2018, the New Jersey Tax Court delivered another blow to the Division of Taxation's attempts to use partnership income tax withholding to tax out-of-state limited partners. In doing so, the tax court has arguably called into question New Jersey's entire partnership remittance or withholding regime.

### Case Discussion

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In *National Auto Dealers Exchange LP v. Director, Division of Taxation*,<sup>[1]</sup> the tax court held that the division could not impose the partnership remittance in accordance with NJSA Section 54:10A-15.11 on a limited partnership whose 99-percent corporate limited partner declared that it maintained a regular place of business in New Jersey.

The National Auto Dealers Exchange, or NADE, a limited partnership operating a wholesale automotive auction business in New Jersey, filed its form NJ-1065 partnership return without remitting a tax on behalf of its 99-percent corporate limited partner. The partner had provided NADE with a form NJ-1065E declaring that it maintained a regular place of business in New Jersey and was thus subject to corporation business tax, or CBT. The corporate limited partner filed for and paid CBT.

After the appellate division decided *BIS LP Inc. v. Director, Division of Taxation*,<sup>[2]</sup> NADE's corporate limited partner filed for a CBT refund on account of not having nexus with New Jersey. In *BIS*, a 99-percent corporate limited partner was found not to have nexus with New Jersey because it lacked a unitary relationship with a New Jersey-based limited partnership, despite the fact that the corporate partner's only asset and sole source of income was the 99-percent limited partnership interest it owned.



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While denying the refund, the division also assessed NADE for the partnership remittance under NJSA Section 54:10A-15.11, which requires a partnership to remit a tax to New Jersey on behalf of its nonresident partners. The tax is computed as follows: New Jersey-source income is determined using a single-receipts factor in accordance with NJSA Section 54:10A-6; then the New Jersey-source income allocated to nonresidents is multiplied by the applicable tax rate, which is 6.37 percent for nonresident individuals and 9 percent for business entities with no regular place of business in New Jersey.

A partnership avoids paying the tax imposed by NJSA Section 54:10A-15.11 by obtaining a form NJ-1065E from its nonresident corporate partners (including any entity treated as a partnership). NADE obtained an NJ-1065E and argued it did not have a responsibility to pay.

The division, on the other hand, argued that the corporate limited partner's refund claim, by which it asserted it had no New Jersey nexus under BIS, acted as a revocation of its NJ-1065E, and as such, NADE was required to pay the corporation business tax.

While the division's position appears to make sense under the CBT statutory framework and amendments made by the Business Tax Reform Act of 2002, the tax court sided with the taxpayer and struck down the assessment of CBT on NADE. The tax court determined that a partnership has two potential responsibilities under the CBT: it either pays the tax imposed under NJSA Section 54:10A-15.11; or it obtains the partner's NJ-1065E. Since NADE did the latter, it could not be assessed CBT.

## Broader CBT Implications

While the case appears to have limited application beyond the specific facts involved, the language and conclusions expressed in the opinion are quite compelling and instructive as applied to other situations involving limited partnerships and passively owned entities.

In its discussion of the BIS case and the refund claim filed by NADE's corporate limited partner, the tax court noted that BIS "effectively changed the law regarding nexus between a nonresident corporate limited partner and New Jersey."

If BIS is considered to have changed the law regarding nexus, then a nonresident corporate partner should not be deemed to have nexus with New Jersey by virtue of owning a noncontrolling or managing interest in a nonunitary, pass-through entity doing business or based in New Jersey. Such an entity is not deriving receipts from New Jersey sources.<sup>[3]</sup>

Another logical conclusion stemming from the NADE decision is that a partnership doing business in New Jersey does not have to pay tax on behalf of partners lacking nexus with New Jersey. This conclusion is supported by the tax court's determination that partnerships are not taxpayers under the CBT and that:

[T]he state cannot assess a deficiency against the partnership for not remitting the tax on behalf of the nonconsenting partner when no such tax is due. New Jersey law does not allow taxation in violation of the United States Constitution or federal statutes.<sup>[4]</sup>

The tax court was quite clear that the state of the law in New Jersey is that a limited partnership cannot be compelled to make tax payments on behalf of partners with no nexus with New Jersey. Such an imposition of tax would have constitutional problems due to the partners' lack of nexus. In addition, the tax would be applicable only to pass-through entities with nonresident partners, versus those with resident partners — another constitutional issue.

## 2014 Statutory Change

If partnerships cannot be compelled to pay New Jersey tax on behalf of partners lacking nexus with the state, how should taxpayers and partnerships comply with NJSA Section 54:10A-15.11 after the enactment of Public Law 2014, c.13?

The 2014 amendment, passed in reaction to the BIS case, made a subtle but important change to NJSA Section 54:10A-15.11. The statute had always provided that the nonresident partner can claim a credit on its return for the tax paid on its behalf by a partnership under the CBT. However, Public Law 2014, c.13, imposed the following limitation:

Provided, however, that only a nonresident partner who files a New Jersey tax return and reports income that is subject to tax in this state may apply the tax paid by the partnership and credited to the nonresident partner's partnership account against the partner's tax liability; and provided further that a partnership that pays tax pursuant to this section shall not be entitled to claim a refund of payments credited to any of its nonresident partners.

The statutory change essentially conditioned the credit of tax paid (or resulting refund) on the partner having income subject to tax by New Jersey. In other words, New Jersey will force the nonresident partner to concede nexus, or else the tax paid on its behalf remains trapped with the division. The partner is not afforded the opportunity to claim credit for the tax paid if it does not have nexus with New Jersey and the partnership is not permitted to claim a refund.

This more recent partnership tax regime is exactly what the tax court was referring to when it proclaimed that the division "cannot assess a deficiency against the partnership for not remitting the tax on behalf of the nonconsenting partner when no such tax is due." Such an attempt would run afoul of the U.S. Constitution and state law.

Accordingly, nonresident corporate partners (including pass-through entities) having no nexus with New Jersey should consider either ignoring Public Law 2014, c.13, and claiming refunds of the amount of tax paid on their behalf or, alternatively, instructing the partnership not to make payment of New Jersey tax on their share of New Jersey-source income.

## NJ-1065E

An interesting question left unanswered by the tax court is whether partnerships have a duty of good faith in accepting the NJ-1065E from nonresident corporate partners. Neither the statute, the regulations nor the tax court suggest that such a standard is applicable to relieve the partnership from paying tax.

If there is no duty of good faith, nonresident corporate partners could opt to provide their partnerships with NJ-1065Es to avoid the payment and the subsequent trapping of tax by New Jersey. While this would be an improper use of the form, an aggrieved taxpayer could assert that it was left with no other choice under the statute. Alternatively, an aggrieved taxpayer could challenge the underlying constitutionality of a tax that is withheld from an entity that does not have constitutional nexus with New Jersey.

## Planning Opportunities

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The use of limited partnerships to potentially reduce tax should be considered alive and well in New Jersey with the correct structuring to avoid a unitary business relationship between the entities involved. Certain hallmarks of a unitary business relationship should be avoided, such as sharing of officers and employees, common management, and sharing of resources, facilities and intellectual property.

Even if a no-nexus position cannot be established, the unitary analysis could be helpful in trying to use flow-through or separate accounting for apportioning pass-through entity income. The unitary factors relied on by the division and the New Jersey courts are also used for purposes of determining the appropriate apportionment method under NJAC Section 18:7-7.6.

Limited partnerships, pass-through entities and their respective partners or members may have significant refund opportunities in light of the tax court's recent holding. Even if there are no refund opportunities, pass-through entities doing business in New Jersey should pay careful attention to this evolving tax regime.

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[1] National Auto Dealers Exchange LP v. Director, Division of Taxation, No. 000028-2014.

[2] BIS LP Inc. v. Director, Division of Taxation, 26 N.J. Tax 489 (App. Div. 2011).

[3] See N.J.S.A. 54:10A-2.

[4] Slip. op. at 14.