

Don't Overlook State Income Tax Planning Opportunities (Real Estate Investors Beware)



By Brian T. Kloza, CPA

All too often many tax advisors focus solely on the federal impacts during the tax planning process. Indeed, federal taxes take a much larger bite out of your income; however, the state income tax burden should not be taken lightly, especially by New Jersey residents.

When the New Jersey income tax law was enacted in 1976 the maximum rate was only 2.5%, so the fact that it was a tax on gross income had little significance to most taxpayers. However, as the years went by, the rate escalated to 7% (a whopping 180% increase) and now stands at 9% for gross income over \$500,000.

While New York State tax law mostly follows the federal rules, New Jersey employs a “Gross” income tax format which allows no deduction of losses, no carry-forwards, and no offsets of losses from certain categories of business ventures against income from others and vice-versa.

Historically, closely held developers of commercial, residential and industrial real estate have operated a S-Corporations during the construction process to insulate against personal liability. Losses were often generated during the pre-construction phase of the development. Unless the shareholders had sufficient income from other New Jersey S-Corps the tax benefit from those losses disappear unused.

Additionally, capital gains and losses inside New Jersey S-Corps, Partnerships and LLC's lose their identity during the pass through process and cannot be used to offset capital gains or losses from other sources.

Similarly, owners of rental real estate have operated as partnerships ordinarily reporting losses in early years from interest and depreciation expenses. After aggregating all partnerships any resulting net loss may not be used to offset income from other activities, ergo the benefit from these losses are lost forever.

To illustrate the harsh reality of the law, consider the following example:

Adam Smith (a New Jersey resident) is the sole shareholder of a New Jersey S-Corporation which owns a large shopping center in Fort Lee. His income therefrom is \$500,000. He also has a 75% partnership interest in a New Jersey partnership that owns three small recently acquired shopping centers in Paterson. His loss therefrom is \$500,000.

Adam's personal federal income tax return will net the gain and loss and have no tax, but he will owe the state of New Jersey personal taxes on the \$500,000 profit with no offset

or carry over of the \$500,000 loss. This neither seems fair nor makes sense, but it's the law.

Watch out for pass through losses from estates and trusts because they also have their own line items limitations of the New Jersey return.

Therefore, the selection of the type of entity used by real estate operators is critical in the state tax planning process. Fortunately, several years ago, New Jersey has enacted legislation to permit the use of LLC's (Limited Liability Companies). LLC's purportedly provided the same protection of a corporation but are partnerships for taxation purposes.

Don't despair. Opportunities exist. Consider forming new entities, de-activating old ones and income shifting to help mitigate the inequities of the New Jersey tax law.

In conclusion, when you meet with your tax advisors be sure to review with them not only the federal tax aspects but also the details of your New Jersey or other state tax situation.

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