

**State of New Jersey  
Department of the Treasury  
Division of Taxation**

# **NJMAP**



## **New Jersey Manual of Audit Procedures**

March 1, 2017

## **Disclaimer**

The information contained in this manual is intended to provide general guidance for the Division's Audit Branches. However, the Division reserves the right to depart from the procedures outlined herein, if the facts and circumstances of a particular audit warrant such a departure. Such departure will in no way undermine or invalidate any audit assessment where all applicable statutory and regulatory requirements are met.

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## **Chapter 1 Overview**

### **1.1 Division of Taxation**

The Division of Taxation (Division) within the Department of the Treasury is the State agency responsible for administering New Jersey's tax laws, various fees and programs. A comprehensive list of taxes can be found in Title 54 and on the Division's website at <http://www.state.nj.us/treasury/taxation>. The Division consists of a Director and such offices and organizational units as are allowed by law and are deemed necessary to carry out the Division's statutory mandates. N.J.A.C. 18.1-1.1(a)

The Division audits tax returns and taxpaying entities, processes tax refunds and rebates, takes collection and enforcement actions to secure tax liabilities, makes nexus determinations, investigates tax matters having civil or criminal potential, and provides other tax-related services to the public and tax practitioners.

The Division of Revenue and Enterprise Services, a sister agency within the Department of the Treasury, is responsible for the processing operations through which registrations, tax returns, payments, incorporations and dissolutions are received and processed.

The Division's major Branches are represented in the Organization Chart, which can be viewed at: <http://www.state.nj.us/treasury/taxation/pdf/orgchart.pdf>

### **1.2 Mission Statement of the New Jersey Division of Taxation**

The mission of the New Jersey Division of Taxation is to administer the State's tax laws uniformly, equitably, and efficiently, to maximize State revenues to support public services; and, to ensure that voluntary compliance within the taxing statutes is achieved without being an impediment to economic growth.

- Recognize, in all that we do, that our voluntary tax system requires that all of our clients be treated equally, consistently, and uniformly without regard to race, creed, sex or sexual orientation, ethnicity or political affiliation;
- Recognizing that public confidence in the tax system requires that our taxpayers believe it is administered fairly and honestly, do all in our power to ensure the integrity of our systems and coworkers and to create and foster that image in the minds of our clients. In so doing, we will conduct ourselves in a manner which projects professionalism, always treating our clients with courtesy and responsiveness; and
- Conduct the affairs of our agency in the most efficient manner possible without unnecessarily encumbering the economic well-being of our taxpayers.

### **1.3 Manual of Audit Procedures**

The New Jersey Manual of Audit Procedures (NJMAP) is a comprehensive overview of the procedures and guidelines available to the Division of Taxation for completing all types of audits. This manual is a general reference for current audit procedures and a guide for conducting tax audits.

The NJMAP's purpose is to provide guidance for audit staff and taxpayers. It should be considered a starting point for understanding audit procedures and guidelines used by all members of the Audit Activity Branch so that audits are conducted, and reports prepared, in as uniform a manner as possible, consistent with approved tax auditing practices. The NJMAP is not intended to be a substitute for experience, training in accounting and auditing, or good judgment and supervision. New law, regulations, court decisions, or changes in Division policies and procedures, could affect the validity of the information contained in the NJMAP.

**This manual will be updated periodically to reflect the foregoing changes.**

**The tax rates reflected in this manual are based on laws in effect as of December 31, 2016.**

### **1.4 The Tax Audit**

The purpose of a tax audit is to verify that a taxpayer has filed returns properly and paid the correct amount of tax. Audits are essential for the efficient administration of self-assessed taxes and for ensuring that taxpayers pay neither more nor less tax than the law requires. An auditor will identify reporting errors and provide the taxpayer with proper guidance as to how to avoid such errors in the future. In addition, audits provide the Division with the opportunity to educate taxpayers, the benefits of which are essential for successful administration of a tax system based on voluntary compliance.

## Chapter 2 Rights and Responsibilities

### 2.1 Taxpayers' Bill of Rights

The Taxpayers' Bill of Rights, enacted by N.J.S.A. 54:48-6 (L. 1992, c. 175), ensures that all taxpayers are accorded the basic rights of fair and equitable treatment under the law and receive the information and assistance they need to understand and meet their State tax responsibilities. It also establishes taxpayers' rights and obligations regarding Division of Taxation procedures for refunds, collections, and appeals. There are six tenets of the Taxpayers' Bill of Rights:

- a. All taxpayers have a right to basic fair and courteous treatment;
- b. All taxpayers have the right to information about their rights under the law;
- c. All taxpayers have a right to accurate and reliable information concerning the handling of their audits and other administrative matters;
- d. All taxpayers have a right to be protected from unreasonable deadlines;
- e. All taxpayers have the right to equal treatment; and
- f. All taxpayers have the right to protection from negligent tax collection.

Additional information regarding the Taxpayers' Bill of Rights can be found in ANJ-1, [About New Jersey Taxes: NJ Taxpayers' Bill of Rights.](#)

### 2.2 Right to Representation

Taxpayers may retain representation at any time during an audit and have the right to suspend a meeting or interview at any time in order to retain such representation. Representatives must submit the proper written, executed, authorization (Appointment of Taxpayer Representative) to act on the taxpayer's behalf in his or her absence. See Form M-5008-R

[http://www.state.nj.us/treasury/taxation/pdf/other\\_forms/misc/m5008r.pdf](http://www.state.nj.us/treasury/taxation/pdf/other_forms/misc/m5008r.pdf)

Form M-5008-R is to be used by an individual, business, estate, or trust to:

- Appoint a representative to act on behalf of the taxpayer before the Division of Taxation;
- Specify the tax matters for which the representative can act on the taxpayer's behalf; and
- Grant the representative the authority to receive confidential tax information and to act on the taxpayer's behalf as indicated.

Form M-5008-R must be signed by both the taxpayer and the appointed representative(s) and applies to all tax types and taxable years or privilege periods unless the taxpayer(s) designates otherwise.

### **2.3 Who Can Execute the Appointment of Taxpayer Representative**

- Any individual, if the request pertains to a personal income or individual use tax return filed by that individual (or by an individual and his or her spouse, if the request pertains to a joint income tax return and joint representation is requested). If joint representation is not requested, each taxpayer may file his or her own separate Appointment of Taxpayer Representative;
- A member of a Limited Liability Company (LLC), if the taxpayer is an LLC and there is no manager;
- A manager of the LLC;
- A sole proprietor;
- A general partner of a partnership or limited partnership;
- Guardian;
- The administrator or executor of an estate;
- The trustee of a trust; and
- If the taxpayer is a corporation, a principal officer, or corporate officer who has legal authority to bind the corporation; any person who is designated by the Board of Directors or other governing body of the corporation; any officer or employee of the corporation upon written request signed by a principal officer of the corporation and attested by the secretary or other officer of the corporation; or any other person who is authorized to receive or inspect the corporation's return or return information under I.R.C. § 6103(e)(1)(D).

### **2.4 Revoking an Appointment of Taxpayer Representative**

A taxpayer may not partially revoke a previously filed Appointment of Taxpayer Representative or Power of Attorney. If a previously filed Appointment of Taxpayer Representative or Power of Attorney has more than one representative and the taxpayer does not want to retain all the representatives on the previously filed form, the taxpayer may execute a new Appointment of Taxpayer Representative indicating the representative(s) they want to retain.

### **2.5 Paid Tax Preparer Requirements and Responsibilities**

A paid tax preparer is any person who prepares, for compensation, or who employs one or more persons to prepare, for compensation, any return of tax or claim for refund under any New Jersey tax law(s). Tax preparers of any New Jersey State tax return must sign the return and provide the tax identification number assigned to him or her, as well as to his or her employer, if applicable. A tax preparer who prepared a substantial portion of a return is treated as if he or she prepared the return in full. The Division has the authority to impose penalties on tax preparers who fail to sign returns, fail to provide their assigned identification number, or fail to file returns electronically when required to do so by law or regulation.

## **Chapter 3 Confidentiality**

The Division's records and files are confidential and privileged pursuant to statute, regulation and case law. All Division employees, current and former, are prohibited from divulging, disclosing, using for their own personal advantage, or accessing, for any reason other than the performance of official duties, any information obtained from the records or files of the Division or from any examination or inspection of the premises or property of any person or entity.

### **3.1 Purpose of Confidentiality**

The Division's records and files contain highly confidential personal and financial information with respect to taxpayers. As directed by statute, the privacy rights of taxpayers must be respected and protected by all Division employees in order to maintain the public's confidence in New Jersey's voluntary tax reporting system.

### **3.2 Violating Confidentiality is a Crime**

It is illegal for any Division employee or former employee to divulge or disclose any information contained in the Division's records and files or obtained from the records or files of any taxpayer. Unauthorized disclosure of such records and files (including Federal tax information contained therein) is a crime of the fourth degree. Unauthorized access to those records and files is a disorderly person offense. Any employee who violates confidentiality will also be subject to discipline and dismissal by the Division.

In addition, IRC § 7213 makes it illegal to divulge or disclose any information obtained from any Federal tax report, return, automated or electronic file, internal document, or other source compiled or filed under the provisions of the Internal Revenue Code. All persons having access to Federal tax data may be aware that IRC §§ 7213 and 7431 provide for criminal penalties and civil liability for improper disclosure of such information by any current or former officer, employee, or agent of the State.

### **3.3 Rules Regarding Federal Tax Data**

Division employees must not use any Federal tax data unless the data is to be used for the purpose of, and necessary for, State tax administration. Division employees are responsible for preventing unauthorized disclosure of such information and situations that might create the appearance of unauthorized disclosure.

As a condition for receiving tax data from the IRS, Division employees must follow certain guidelines for the proper use and safeguarding of Federal tax data.

### **3.4 Disclosure of Certain Tax Information Permitted**

Notwithstanding that all of the Division's records and files are confidential and privileged, however, as per N.J.S.A. 54:50-9 the following disclosures are permitted by law:

- a. The delivery to a taxpayer or the taxpayer's duly authorized representative of a copy of any report or any other paper filed by the taxpayer pursuant to the provisions of this subtitle or of any such State tax law;

- b. The publication of statistics so classified as to prevent the identification of a particular report and the items thereof;
- c. The Director, in the Director's discretion and subject to reasonable conditions imposed by the Director, from disclosing the name and address of any licensee under any State tax law, unless expressly prohibited by such State tax law;
- d. The inspection by the Attorney General or other legal representative of this State of the reports or files relating to the claim of any taxpayer who shall bring an action to review or set aside any tax imposed under any State tax law or against whom an action or proceeding has been instituted in accordance with the provisions thereof;
- e. The examination of said records and files by the Comptroller, State Auditor or State Commissioner of Finance, or by their respective duly authorized agents;
- f. The furnishing, at the discretion of the Director, of any information contained in tax reports or returns or any audit thereof or the report of any investigation made with respect thereto, filed pursuant to the tax laws, to the taxing officials of any other State, the District of Columbia, the United States and the territories thereof, providing said jurisdictions grant like privileges to this State and providing such information is to be used for tax purposes only;
- g. The furnishing, at the discretion of the Director, of any material information disclosed by the records or files to any law enforcing authority of this State who shall be charged with the investigation or prosecution of any violation of the criminal provisions of this subtitle or of any State tax law;
- h. The furnishing by the Director to the State agency responsible for administering the Child Support Enforcement program pursuant to Title IV-D of the federal Social Security Act, Pub.L.93-647 (42 U.S.C. s.651 et seq.), with the names, home addresses, Social Security numbers and sources of income and assets of all absent parents who are certified by that agency as being required to pay child support, upon request by the State agency and pursuant to procedures and in a form prescribed by the Director;
- i. The furnishing by the Director to the Board of Public Utilities any information contained in tax information statements, reports or returns or any audit thereof or a report of any investigation made with respect thereto, as may be necessary for the administration of P.L.1991, c.184 (C.54:30A-18.6 et al.) and P.L.1997, c.162 (C.54:10A-5.25 et al.);
- j. The furnishing by the Director to the Director of the Division of Alcoholic Beverage Control in the Department of Law and Public Safety any information contained in tax information statements, reports or returns or any audit thereof or a report of any investigation made with respect thereto, as may be relevant, in the discretion of the Director, in any proceeding conducted for the issuance, suspension or revocation of any license authorized pursuant to Title 33 of the Revised Statutes;
- k. The inspection by the Attorney General or other legal representative of this State of the reports or files of any tobacco product manufacturer, as defined in Section 2 of P.L.1999,

- c.148 (C.52:4D-2), for any period in which that tobacco product manufacturer was not or is not in compliance with subsection a. of Section 3 of P.L.1999, c.148 (C.52:4D-3), or of any licensed distributor as defined in Section 102 of P.L.1948, c.65 (C.54:40A-2), for the purpose of facilitating the administration of the provisions of P.L.1999, c.148 (C.52:4D-1 et seq.);
- l. The furnishing, at the discretion of the Director, of information as to whether a contractor or subcontractor holds a valid business registration as defined in Section 1 of P.L.2001, c.134 (C.52:32-44);
  - m. The furnishing by the Director to a State agency as defined in Section 1 of P.L.1995, c.158 (C.54:50-24) the names of licensees subject to suspension for non-payment of State tax indebtedness pursuant to P.L.2004, c.58 (C.54:50-26.1 et al.);
  - n. The release to the United States Department of the Treasury, Bureau of Financial Management Service, or its successor of relevant taxpayer information for purposes of implementing a reciprocal collection and offset of indebtedness agreement entered into between the State of New Jersey and the federal government pursuant to Section 1 of P.L.2006, c.32 (C.54:49-12.7);
  - o. The examination of said records and files by the Commissioner of Health and Senior Services, the Commissioner of Human Services, the Medicaid Inspector General, or their respective duly authorized agents, pursuant to Section 5 of P.L.2007, c.217 (C.26:2H-18.60e), Section 3 of P.L.1968, c.413 (C.30:4D-3), or Section 5 of P.L.2005, c.156 (C.30:4J-12); and
  - p. The furnishing at the discretion of the Director of employer provided wage and tax withholding information contained in tax reports or returns filed pursuant to N.J.S.A. 54A:7-2, 54A:7-4 and 54A:7-7, to the designated municipal officer of a municipality authorized to impose an employer payroll tax pursuant to the provisions of Article 5 (Employer Payroll Tax) of the "Local Tax Authorization Act," P.L.1970, c.326 (C.40:48C-14 et seq.), for the limited purpose of verifying the payroll information reported by 3.E Disclosure of Certain Tax Information Permitted.

### **3.5 *Furnishing of Tax Information to Private Debt Collection Service Providers***

The Director is authorized by statute to enter into agreements with private debt collectors for the purpose of collecting past due taxes, interest, and penalties. Notwithstanding the confidentiality provisions discussed above, the Director may provide any taxpayer information necessary for the debt collection service provider to fulfill its obligations under the collection agreement, provided that the disclosure is not contrary to the provisions of IRC § 6103(a). Debt collection service providers and their employees are subject to the same confidentiality provisions as all Division employees.

### **3.6 *Communicating with Taxpayer and/or Authorized Representative***

The auditor may direct all correspondence to the taxpayer and/or a duly authorized representative.

All deficiency assessments may be mailed to the taxpayer only. However, if authorization is obtained, copies may be mailed to the representative authorized by the taxpayer.

The auditor must use discretion when conferring with a taxpayer and/or authorized representative on the telephone. The auditor should avoid discussing specific amounts or facts relating to a particular file and should limit discussions to points of law, regulation, or theory. If auditors doubt the authenticity of the caller, they should ask the caller to put his/her concerns in writing.

## Chapter 4 Ethics

It is essential that the conduct of public officials and employees hold the respect and confidence of the public. State employees should avoid conduct that is in violation of the public trust or that creates a justifiable impression among the public that such trust is being violated. Accordingly, all Division employees shall conform to the State Uniform Ethics Code which includes the following:

- No State employee may use his or her position to secure a job, contract, governmental approval, or special benefit for him/herself, a friend, or family member;
- No State employee may accept any compensation, other than salary, for performing his or her State job;
- No State employee may accept any gift of more than nominal value related in any way to his or her official duties;
- No State employee may have any involvement in official matters that involve any private sector individual or entity that employed them or did business with them during one year prior to State employment;
- After leaving public employment, no State employee may represent or assist a person concerning a matter with which the State employee was substantially and directly involved while in State employ;
- After leaving public employment, no State employee may use or disclose any information gained while in State employ that is not available to the public; and
- No State employee may act in any official matter in which they, his/her family members or close friends have a direct or indirect personal or financial interest.

For more information regarding ethics rules and laws for public officials and employees, see the Uniform Ethics Code and the Department of the Treasury Supplemental Ethics Code @ <http://www.nj.gov/ethics>

## **Chapter 5 Audit Standards**

### **5.1 Personal Standards**

**INTEGRITY:** Under no circumstances may an auditor misrepresent any law or fact, or represent a law or fact outside the scope of his/her knowledge. There should be support for any representation made. The auditor may neither solicit nor receive any personal benefit from any person or business examined by him/her, nor have or present the appearance of having a conflict of interest in the auditor's dealings with the taxpayer.

**CONFIDENTIALITY:** Information that comes into the possession of the auditor that is privileged by law must be protected by him/her and may not be disclosed to any unauthorized person under any condition.

**PROFESSIONALISM:** Occasionally, an auditor may be direct and may disagree with a taxpayer. However, the taxpayer and his/her representative are entitled to courtesy from Taxation's audit personnel at all times.

**PROFICIENCY/COMPETENCE:** An auditor will grow in knowledge and skill with experience. To enhance the quality of that experience, the auditor may prepare by researching possible problems and issues before undertaking a new assignment. The auditor should consult with the Supervising Auditor for appropriate guidance.

**OBJECTIVITY:** The auditor is a fact finder and not an advocate. The auditor will gain the respect of the taxpayer by maintaining a detached and objective attitude in the auditor's work. Diligent inquiry and even skepticism are not inconsistent with such detachment and objectivity.

### **5.2 Responsibilities of the Auditor**

All auditors are expected to act in a professional manner and complete audits in a reasonable length of time. The auditor's goal during an audit is to determine whether all applicable State tax returns for a particular taxpayer are filed and accurately reflect the business activity and accounting records of the taxpayer.

The auditor will conduct the audit in a professional auditing manner and should be familiar with generally accepted accounting procedures and auditing techniques. To avoid any conflicts of interest, the auditor cannot have any personal relationships with the taxpayer, the taxpayer's family, or the taxpayer's employees (in the case of a business audit). Additionally, the auditor may not have any personal or financial interest in a business being audited. The auditor must observe all confidentiality and ethics rules at all times. See Chapters 3 and 4 for more information.

### **5.3 Field Audits in General**

A field auditor performs a detailed examination of a taxpayer's books and records to determine if the taxpayer reported the correct information and data on its tax returns and is in compliance with all applicable tax laws. A field audit is conducted at the taxpayer's place of business or at the office of the

individual who prepared the taxpayer's returns. In some instances, the auditor will obtain information from third parties such as banks, creditors, and suppliers to verify items on the returns.

The field auditor may perform any or all of the following functions:

- a. Prior to beginning the audit, review any available information with respect to the taxpayer to be audited. Refer to Chapter 8 for pre-audit preparation;
- b. Maintain a chronological list of audit events, as they occur, in the case history;
- c. Schedule a pre-audit interview with the taxpayer and/or his/her authorized representative;
- d. Complete the Pre-Audit Questionnaire with the taxpayer and/or his/her authorized representative. Refer to Chapter 8 for guidance;
- e. Tour the business facility;
- f. Determine the initial audit approach to be used based on the nature of the business, recognizing that procedures may change as the audit progresses;
- g. Identify related taxpayers and determine whether they should be "spun off" (for additional separate audits). Conduct appropriate auditing tests, including sampling, to determine whether the taxpayer's records accurately reflect the business activity and whether the data reported on the tax returns is reliable;
- h. Compute the dollar amount of any tax assessments and summarize the basis for any assessment in the Audit Narrative and the audit work papers;
- i. Hold post-audit conference with the taxpayer and/or appointed representative to present the audit findings; and
- j. Prepare the Audit Narrative. Refer to Chapter 14.

#### **5.4 Relationship of Taxpayer and Auditor**

Throughout the course of the audit, an auditor is expected to treat a taxpayer in a professional manner; and to apply generally accepted auditing principles and Division procedures and guidelines uniformly to all taxpayers. An auditor should not give the impression that Taxation is harassing a taxpayer or that the objective of the audit is to find something wrong with the taxpayer's returns.

The auditor's function is to determine whether the tax return information and amount of tax liability have been properly reported and to aid the taxpayer in gaining a correct understanding of the governing tax laws. The auditor will inform the taxpayer regarding his/her rights and responsibilities in connection with any audit determinations. The auditor shall conduct an audit with minimal interference of taxpayers and their business affairs.

## **Chapter 6 Audit Activity**

### **6.1 Division Responsibilities**

The Director exercises general supervision over the planning, execution and coordination of the entire audit program. This includes:

- a. Determining the size and scope of the program after consideration of such relevant factors as budgetary limitations, staffing patterns and studies of the manner in which available audit resources can be utilized with maximum benefits to the State;
- b. Overall control of the amount of audit time to be spent in each audit program;
- c. Providing tax audit services to other State agencies, as requested;
- d. Preparation and distribution of administrative interpretations of the tax statutes; and
- e. Compilation and preparation of statistical data.

### **6.2 Responsibilities of Audit Activity**

Audit Activity administrators, with the assistance of their supervisors, are responsible for the performance of all audit functions. This includes:

- a. Selecting, training and directing an efficient auditing staff;
- b. Selecting and auditing business/individual tax accounts deemed most worthy of examination; and
- c. Good field supervision and thorough review of all audit work papers and reports to ensure that audits are performed properly; and that the reports correctly reflect any necessary adjustments of self-declared tax liability.

### **6.3 Organization of Audit Activity**

Audit Activity is managed by a Deputy Director and two Assistant Directors, one of whom is responsible for managing Business Audit Activity, and the other who is responsible for Individual Audit and Audit Selection, and Technical Support. These activities are comprised of the following Branches:

#### Business Audit Activity

- In-State Field Audit
- Out-of-State Audit
- Office Audit
- Excise Tax
- Audit Services

## Individual Audit Activity

- Individual Tax Audit
- Inheritance and Estate Tax
- Taxation Data Warehouse (TDW)
- Audit Selection & Technical Support

The Branches are responsible for the selection, audit and refund of all major taxes including Corporation Business Tax, Sales and Use Tax and Gross Income Tax, as well as Transfer Inheritance Tax, Estate Tax, Atlantic City Luxury Sales Tax, the Litter Control Fee, and others. The Division's voluntary disclosure and nexus programs also are administered by Audit Activity.

### **6.4 In-State Field Audit Branch**

The In-State Field Audit Branch currently consists of 20 field audit teams located throughout New Jersey. Field Auditors are located in Trenton (Hamilton Township), Newark, Neptune, Camden, Hackensack, and Northfield.

In-State Field Audit is responsible for the examination of a taxpayer's books and records to ensure compliance with existing laws and regulations. Audits are usually performed on site, at the taxpayer's place of business or at sites provided by the taxpayer's authorized representative. Audits are comprehensive in nature and intended to include all taxes administered by the Division. However, the primary focus is Sales and Use Tax and Corporation Business Tax. In addition, the cash audit program is an integral part of Field Audit operations.

### **6.5 Out-of-State Audit Branch**

The Out-of-State Audit Branch is responsible for the examination of a taxpayer's books and records that are maintained outside New Jersey to ensure compliance with existing laws and regulations. Audits are usually performed on site at the taxpayer's place of business or at sites provided by the taxpayer's authorized representative. Audits are comprehensive in nature and intended to include all taxes administered by the Division of Taxation. However, the primary focus is Sales and Use Tax and Corporation Business Tax.

Currently the Division has regional offices in Chicago, Illinois and Anaheim, California, with field auditors located in various cities throughout the country.

### **6.6 Office Audit Branch**

The Office Audit Branch is responsible for the audit and refund of Corporation Business Tax. Other taxes audited include the Financial Business Tax, Ocean Marine Tax, Insurance Premiums and corresponding retaliatory Taxes, and various Sanitary Landfill Taxes.

The Office Audit Branch is comprised of seven groups:

Two Corporate Service Audit Groups are responsible for examining taxpayers' records in order to issue Tax Lien Certificates, Tax Clearance Certificates for Domestic Dissolutions, Reinstatements, and Foreign Reauthorizations.

The Special Audit Group is responsible for administering the Financial Business Tax, Ocean Marine Tax, Insurance Premiums and corresponding retaliatory taxes and various Sanitary Landfill Taxes as well as reviewing Internal Revenue audit changes. They also are responsible for auditing Amended Corporation Business Tax Returns not claiming a refund.

The Nexus Audit Group is responsible for discovering and examining out-of-State entities to determine whether they have unsatisfied obligations to file and pay New Jersey taxes.

Two Regular Audit Groups are responsible for auditing large multi-national corporations where field visits are not warranted.

The Corporate Refund Audit Group is responsible for auditing and approving all Corporation Business Tax refund claims.

### **6.7 Excise Tax Branch**

The Excise Tax Branch consists of three groups: the Excise Tax Field Audit Group, the Excise Tax Office Audit Group, and the Excise Tax Cigarette Group.

The Excise Tax Field Audit Group audits businesses to ensure their compliance with certain tax laws. The group also performs compliance inspections relating to the Motor Fuel, Cigarette and Tobacco Taxes.

- The Excise Tax Office Group administers the Motor Fuel Tax; the Petroleum Products Gross Receipts Tax; the Public Utility Excise, Franchise, and Gross Receipts Taxes; the Radiation Emergency Response Assessments; the Sales and Use Energy Tax; the Transitional Energy Facility Assessments; and the Uniform Transitional Utility Assessments. This group is responsible for the licensing and bonding of all motor fuel businesses and maintaining the list of all licensed motor fuel businesses published on the Division's website. The group issues all Direct Payment Permits for the Petroleum Products Gross Receipts Tax and processes and issues all Motor Fuel Tax and Petroleum Products Gross Receipts Tax refunds. The group performs audits and investigations related to the taxes it administers.
- The Excise Tax Cigarette Group administers the Cigarette Tax and the Tobacco Products Wholesale Sales and Use Tax, along with the Alcohol Beverage Tax, and Spill Compensation and Control Tax. This group is responsible for maintaining the cigarette minimum price list along with performing audits and investigations related to the taxes its administers. The group also reviews and maintains records relating to the Tobacco Master Settlement Agreement and assists with the review of cigarette license applications. Information on the Master Settlement Agreement can be found at: <http://www.nj.gov/oag/>

### **6.8 Audit Services Branch**

The Audit Services Branch provides audit, technical, and clerical support for every aspect of Audit Activity. In addition, this Branch administers Sales & Use Tax refunds and Urban Enterprise Zone Sales & Use Tax refunds. This Branch is comprised of four groups.

The Audit Billing Group provides billing and collection support for Audit Activity. This function includes adjusting taxpayer accounts, creating bills, corresponding with taxpayers, applying payments, and various administrative functions.

There are two Sales Tax Refund Groups responsible for auditing and processing all Sales and Use Tax refund claims as well as refunds for the Hotel and Motel State Occupancy Fee and Municipal Occupancy Tax, Cosmetic Medical Procedures Gross Receipts Tax, Atlantic City Luxury Sales Tax, Cape May County Tourism Sales Tax, Domestic Security Fee, 9-1-1 System and Emergency Response Fee, Motor Vehicle Tire Fee, Sales and Use Energy Tax, Transitional Energy Facility Assessment, Recycling Tax, and the Nursing Home Provider Assessment.

The Corporate Billing Group is responsible for reviewing all Corporation Business Tax deficiencies.

### **6.9     *Audit Selection and Technical Support***

Audit Selection provides the Audit Activity Branches with potential audit candidates. This is done through analysis of various internal, external and historical data. Technical Support compiles purchase and sales activity along with other information for use by auditors. The unit also administers the Sales and Use Tax Direct Payment Permit program and provides support for the administration of the Hotel and Motel Municipal Occupancy Tax.

### **6.10    *Individual Tax Audit Branch***

The Individual Tax Audit Branch is comprised of the Gross Income Tax Group and the Transfer Inheritance and Estate Tax Groups.

The Gross Income Tax Group is responsible for the audit of New Jersey Gross Income Tax returns filed by resident and non-resident individuals, estates, and trusts. Audit candidates are selected using a variety of criteria and/or utilizing information from the Internal Revenue Service, from other States, other New Jersey State agencies and public information.

Working both independently and in conjunction with other Division Branches, State agencies, and the Internal Revenue Service, this Branch also pursues delinquent resident and non-resident taxpayers who have been identified as having a New Jersey income tax filing responsibility. These include S corporation shareholders, partners, members of LLCs, beneficiaries of estates and trusts, self-employed individuals, entertainers, and professional athletes as well as delinquent business entities such as partnerships, LLCs and employers that withhold New Jersey Gross Income Tax.

The Transfer Inheritance and Estate Tax Group is responsible for all phases of the administration of the Transfer Inheritance Tax and the Estate Tax.

### **6.11    *Taxation Data Warehouse (TDW)***

The Taxation Data Warehouse Team (TDW) uses data from various Federal, State, and New Jersey agencies to identify taxpayers with unsatisfied filing and payment obligations.

## **Chapter 7 General Concepts**

### **7.1 *Consent Forms***

A Consent Form (also referred to as a waiver) is an agreement between a taxpayer and the Division to extend the statute of limitations for designated periods of time. A Consent Form also extends the time for filing a refund claim. An extension agreement will not revive refund application rights that expired before the agreement was executed.

A signed Consent Form allows flexibility should a taxpayer require additional time beyond the normal 30-day period provided to produce all requested information. In the absence of a signed Consent Form, requests by the taxpayer for an extension of time beyond 30 days are difficult to grant. The taxpayer's failure or delay in providing the requested records within 30 days will likely require the auditor to make an Estimated Tax Assessment, which will be stated in the documents provided to the taxpayer.

A taxpayer is not obligated to sign a Consent Form and if the taxpayer does not, then the audit will continue until it is completed. The Supervising Auditor may assign additional auditors to complete the audit timely.

### **7.2 *Extending the Statute of Limitations***

One of the auditor's many responsibilities is to ensure that the State's rights have been preserved regarding the statute of limitations. When a case is assigned, one of the first steps that should be taken is a review of the available information to determine if a potential for audit exists. Once it is determined that an audit is warranted, then the auditor must pursue the use of a Consent Form in order to protect the State's right of assessment.

Once an audit is completed, the auditor must be sure to advise Audit Billing if the statute of limitations is close to expiration for any part of the audit period. This will help ensure that the possible expiration of the statute will result in immediate action by the Audit Billing Group and no part of the assessment will be lost.

If at least three months prior to the expiration of any statute of limitations it is not practical to expect to complete the audit within 30 days, the auditor will attempt to obtain consent from the taxpayer to extend the statute. Consent Forms are to be executed by the person(s) with the authority to do so on behalf of the taxpayer, as stated in the Pre-Audit Questionnaire or by the taxpayer's appointed representative.

In general and depending on the estimated completion date of the audit, the initial Consent Form(s) will be executed for a period of six to 12 months. If necessary, subsequent Consent Forms will be executed for increments of three to six months, or more, depending on the estimated completion date of the audit.

The auditor is to refrain from using the months of December or January as the expiration end date of any Consent Form. The auditor should also avoid expiration dates that fall at the end of any calendar quarter. This is necessary to provide sufficient time for internal processing by the Division and for the benefit of taxpayers as well.

For annual taxes and fees such as Corporation Business Tax, Gross Income Tax, Litter Control Fee, and Personal Income Tax, Consent Forms will only identify those taxes and periods expiring during the period of time covered by the Consent Form.

Example: The consent period has been extended to 12/31/15. The audit period for Corporation Business Tax is 01/01/10 to 12/31/13 and the returns were all filed timely. The Consent Form would only include the Corporation Business Tax period 01/01/2010 to 12/31/10 because it expires on 04/15/2015. The other periods would not be included because they all expire after 12/31/2015.

For all quarterly and monthly taxes such as Atlantic City Luxury, Hotel Occupancy, Motor Fuel, Petroleum Gross Receipts, Sales and Use, and Spill, Consent Forms will identify all taxes and periods that are in statute with the exception of those taxes and periods that have not been filed.

The auditor is responsible for maintaining and updating all Consent Forms to ensure that no statutory periods are lost. All consent forms are required to be uploaded into the electronic audit case file.

There must be at least 60 days remaining until the expiration of the statute of limitations at the time that a completed audit case is sent to the Audit Billing Group for processing. If a refund offset is involved, there must be at least 75 days before the statute of limitations will expire.

### **7.3 Information Document Requests**

Auditors are expected to fully document the audit process through the use of information document requests. Auditors create these IDRs in the audit management system in the "Information Document Requests" folder.

Taxpayers must respond to all information document requests in writing and all responses are to be properly organized and included in the audit management system file. Upon receipt, auditors should initial and date the information provided and scan any marked-up copies of information document request. As with all correspondence, information document requests and responses should be noted in, and attached to, the case history in the audit management system.

The information document request is to be used for all taxes. Like other audit management system forms, the information document request contains automated calculations that will not function properly outside of the audit management system and must be converted to a PDF file prior to being attached to an electronic mail.

### **7.4 Refunds**

A taxpayer may claim a refund for an overpayment of State taxes by filing a return or amended return, or a Claim for Refund (Form A-3730). If a taxpayer is claiming a refund of a payment of an additional tax assessment, the claim must be filed on Form A-1730, (Claim for Refund of Paid Audit Assessment).

Refund claims, whether filed on a claim for refund form or as part of an amended return, must include the taxpayer's name, address, identification number, signature, and a complete description of the claim. The description must explain, in detail, each ground on which a credit or refund is claimed and must include facts and documents sufficient to support the claim. Citations of relevant statutes, regulations, and cases are not required, but should be included, if known.

If a refund claim does not contain sufficient information, the auditor/reviewer will request the documentation necessary to demonstrate that a refund or credit is due. If the taxpayer doesn't respond to the request for documentation within 30 days, the Division may deny the claim. The taxpayer may refile the claim, with the required documentation, as long as the applicable statute of limitations for filing a refund claim remains open. In addition, the taxpayer has 90 days from the date of the denial to either file a protest with the Conference and Appeals Branch (pursuant to N.J.S.A. 54:49-18) or file an appeal with the Tax Court of New Jersey (pursuant to N.J.S.A. 54:51A-14).

### **7.5 Form A-1730 Refund Claims for Paid Audit Assessments**

A taxpayer who receives an additional tax assessment from the Division has the option of paying the assessment and then filing a refund claim using Form A-1730, provided that certain requirements have been satisfied. See N.J.S.A. 54:49-14(b).

### **7.6 Form A-1730 Refund Claim Requirements**

In order for the taxpayer to be eligible to use Form A-1730, the following requirements must be met:

- a. The additional tax assessment must be for tax periods beginning on or after January 1, 1999;
- b. The taxpayer has not protested or appealed any part of the assessment;
- c. The taxpayer must have paid the additional tax assessment, including all penalty and interest charges associated with the tax, within one year after the expiration of the period for protesting the assessment;
- d. No abatement of penalty was granted;
- e. The refund claim (Form A-1730) must be filed within 450 days from the date the period for protesting the assessment expired;
- f. The grounds for the refund claim are limited to the issues raised by the deficiency assessment and the amount of the refund claimed cannot exceed the amount the taxpayer paid as a result of the additional assessment; and
- g. All information requested on Form A-1730 must be included when the claim is submitted. If the taxpayer did not complete all required lines on the Form or did not attach proper documentation, the claim may be denied.

## **7.7 Refunds for Other Assessments**

A taxpayer may not use Form A-1730 to claim a refund for the following items, because they are not additional tax assessments:

- Jeopardy assessments;
- Delinquency assessments;
- Estimated or arbitrary assessments;
- Penalty and interest assessments;
- Self-assessed taxes; and
- Costs of collection.

## **7.8 Interest on Refunds**

Generally, the Division must pay interest at the prime rate, compounded annually, on refunds that are issued more than six months after the later of: the filing date of the return on which the refund is claimed, the due date of the return on which the refund is claimed, the filing date of the refund claim, or the date the tax was paid. When interest is paid, it is paid from the date of the filing of the refund claim to the check date or the date on the document authorizing electronic funds transfer (EFT) of the refund.

## **7.9 Postmark Rule**

All tax returns postmarked on or before the date of the return will be considered filed on time. For those returns postmarked after the due date, the date the return was received by the Division will be considered the filing date.

## **7.10 Penalties and Interest**

N.J.S.A. 54:49-3: Any taxpayer who shall fail to pay any State tax on or before the day when the same shall be required by law to be paid shall pay in addition to the tax, unless otherwise provided in the law imposing such tax, interest and penalty, if any, on said tax at the rate of three percentage points above the prime rate assessed for each month or fraction thereof, compounded annually at the end of each year, from the date the tax was originally due until the date of actual payment. If the Director is empowered by the law imposing such tax to grant an extension of time in which the tax shall be paid, the taxpayer shall be liable for the payment of interest on the unpaid tax at the rate of three percentage points above the prime rate assessed for each month or fraction thereof, compounded annually at the end of each year, from the date that such tax was originally due to the date of actual payment. Any amount of tax unpaid after the time when the same shall be required by law to be paid, or after an extension of time if granted, is an underpayment for the purposes of R.S.54:49-4.

N.J.S.A. 54:49-6: After a return or report is filed under the provisions of any State tax law, the Director shall cause the same to be examined and may make such further audit or investigation as he may deem necessary, and if therefrom he shall determine that there is a deficiency with respect to the payment of any tax due under such law, he shall assess the additional taxes, penalties, if any, pursuant to any State tax law or pursuant to this subtitle, and interest at the rate of three percentage points above the prime rate due the State from such taxpayer assessed for each month or fraction thereof, compounded annually at the end of each year, from the date the tax was originally due until the date of actual payment, give notice of such assessment to the taxpayer, and make demand upon them for payment.

### **7.11 Trust Fund Taxes**

Trust fund taxes are taxes that a business or person is required to collect or retain on behalf of the State and pay over to the Division. The most common of these taxes are the Sales Tax and Gross Income Tax withholding. Under the law, a business owner, partner, corporate officer, and some employees may be found to be responsible for collecting and remitting these taxes and can be held personally liable to the State for failing to collect when required or for failing to file the required returns when due.

Trust fund taxes include, but are not limited to:

- Atlantic City Luxury Tax;
- Cape May Tourism Tax;
- Cosmetics Medical Procedures Gross Receipts Tax;
- Gross Income Tax Withholding Tax;
- Hotel/Motel State Occupancy Fee and Municipal Occupancy Fee;
- Motor Fuels Tax;
- Motor Vehicle Tire Fee;
- Sales Tax; and
- 9-1-1 Emergency Response Fee.

### **7.12 Responsible Persons**

A responsible person may be any officer or employee of a corporation who is under the duty to collect and remit trust fund taxes to the State of New Jersey on behalf of the corporation. Trust fund taxes are considered to be Sales Tax, Gross Income Withholding tax and Motor Fuels Tax. A responsible person may be held personally liable for any of these taxes due from the corporation.

In 1993, the Tax Court of New Jersey addressed the issues of responsible persons in a case, *Cooperstein v. Director, Division of Taxation*, 13 New Jersey Tax 68 (Tax 1993). The Tax Court analyzed the following nine factors when reviewing responsible person status:

- a. The contents of the corporate by-laws;
- b. Status as an officer and/or stockholder;
- c. Authority to sign checks and exercise of this authority;
- d. Authority to hire and fire and exercise of this authority;
- e. Responsibility to prepare and/or sign tax returns;
- f. Day-to-day involvement in the business or responsibility for management;
- g. Power to control payment of corporate creditors and taxes;
- h. Knowledge of failure to remit taxes when due; and
- i. Derivation of substantial income or benefits from the corporation.

## **Chapter 8 Field Audit - Pre-Audit Preparation**

A Pre-audit preparation allows the auditor to develop basic information about the taxpayer and the taxpayer's business prior to performing the actual audit. The pre-audit interview with the taxpayer will assist the auditor in determining the audit methodology to be used as well as the scope of the audit. The auditor will become familiar with the nature of the taxpayer's business and its accounting and other record-keeping systems by completing the Pre-Audit Questionnaire with the taxpayer.

### **8.1 Preliminary Review of Taxpayer's Records and Tax Returns**

Before the pre-audit interview, the auditor should gather and review documents and records relevant to the taxpayer's business, much of which will be available in the Division's computer system. Items to be reviewed include, but are not limited to, the following:

- Taxpayer's contact information and entity type;
- Taxpayer's tax eligibilities;
- All returns filed for the last seven years;
- Schedule of liabilities, if any;
- Open cases within the Division for bankruptcy, bulk sales, or open investigations; and
- Prior audit files.

In addition, the auditor should take steps to understand the nature and extent of the taxpayer's business, as this will allow the auditor to properly evaluate items such as invoices, paid bills, deductions, and the portion of the business allocable to New Jersey. The auditor should look for the business's website, online advertising, or social media that it uses to promote the business or affiliated businesses. These things may provide insight into the nature of the taxpayer's business, including its principal products and services. These external sources may also provide information regarding the taxpayer's location(s), hours of operations, special promotions, happy hours, cover charges, catering, delivery, menus, party facilities, or other information that may be relevant to the audit. The auditor should include a copy of any such information in the audit file.

### **8.2 Determining the Audit Periods**

The auditor reviews the Division's records to determine all tax eligibilities. The auditor also reviews the taxpayer's filed tax returns to determine the years for which the statute of limitations is still open for each tax type. Any open years will constitute the audit period. The audit periods may be different for each tax type to be audited. Any delinquencies should be addressed during the audit.

Once the auditor has identified the taxes to be audited and the audit periods, he/she will determine the periods for which the statute of limitations are close to expiring. The auditor will need to obtain a consent form for those periods.

### **8.3     *Preparing Analysis Schedules***

After the auditor has gathered and reviewed the necessary information, the auditor should:

- a. Create the Sales and Use Tax summary, then review reported Sales and Use Tax and deductions. The auditor may discuss any discrepancies with the taxpayer at the pre-audit interview;
- b. Create and review the gross receipts summary using the Sales Tax returns and the appropriate income tax return(s) (e.g., CBT-100 or NJ-1040). The auditor may discuss any discrepancies with the taxpayer at the pre-audit interview;
- c. Create the Gross Income Tax summary using the New Jersey-927s; and
- d. Create summaries for any other taxes for which the taxpayer filed.

### **8.4     *Initial Contact Letter***

Once the auditor has completed the preliminary review, he/she will send the taxpayer an initial contact letter and follow up with a call to request a convenient time for the pre-audit interview and tour of the business facilities.

### **8.5     *Pre-Audit Interview and Tour, and Pre-Audit Questionnaire***

During the interview and tour, the auditor establishes a professional rapport with the taxpayer and/or the authorized representative, and at the same time gathers an understanding of the business operations, the taxpayer's affiliates (if any), and its customers. Understanding the taxpayer's business operations and processes can assist the auditor in understanding the taxpayer's accounting system.

During the interview, the auditor will tell the taxpayer the purpose of the audit, the period(s) of time to be addressed by the audit, and the records to be examined. The auditor will use the Pre-Audit Questionnaire appropriate for the taxpayer's business as a guide for the interview. By completing the Questionnaire with the taxpayer, the auditor will gather a significant amount of information necessary for the audit. Under no circumstances should the auditor send the Pre-Audit Questionnaire to the taxpayer in advance of the interview.

While the Pre-Audit Questionnaire serves as a guide as to what the auditor may discuss with the taxpayer, the auditor may not follow it so strictly as to limit the scope and detail of the information obtained during the interview. When completing the Questionnaire, the auditor's goal is to obtain, and then record, detailed responses from the taxpayer. General responses might not provide sufficient information and may hinder the development of a detailed picture of the taxpayer's business practices, which may lead to incorrect conclusions.

During the interview, the auditor should request a current chart of accounts used by the taxpayer. During the pre-audit interview, the auditor will learn how the taxpayer conducts business. This includes the transportation methods used to ship the products to the customer, and the shipping terms (e.g. FOB) used. The auditor should note the name, location, and authority of each person involved in the audit. With respect to Sales and Use Tax audits, the interview will also include a discussion as to the use of a sampling plan.

If, during the pre-audit interview, the taxpayer indicates that it was audited by the IRS but didn't report the results to the Division, the auditor will obtain the relevant Federal audit reports and adjust the taxpayer's returns accordingly at the end of the audit.

### **8.6 *Discussing Taxpayer's Records and Recordkeeping Systems***

Items that the auditor may discuss with respect to the taxpayer's records and recordkeeping systems include:

- The location of the records to be examined;
- The volume of those records;
- The manner in which the records are filed (e.g., filed alphabetically by vendor name or by sales invoice number);
- The availability of federal income tax returns, excise tax returns, financial statements, corporate minutes, and depreciation schedules;
- The records that are available electronically;
- The taxpayer's process for producing, handling, recording, and filing source documents;
- The taxpayer's system for identifying, recording, and reporting taxes; and
- The taxpayer's method for identifying New Jersey sales and sales in other States.

### **8.7 *Discussing Taxpayer's Accounting Practices***

In New Jersey use tax is a tax on the use of items or services that occurs when sales tax has not been paid on taxable items or services, or paid at a rate less than 7%. Use tax is due when these items are purchased outside of New Jersey and brought into New Jersey.

Items that the auditor may discuss with respect to the taxpayer's accounting practices include:

- Internal control used by the taxpayer to ensure the accuracy and completeness of the records;
- The taxpayer's accounting period (calendar year or fiscal year) and whether the taxpayer maintains a detailed and descriptive chart of accounts;
- The taxpayer's policy for capitalizing fixed assets; and  
Whether the taxpayer has a use tax accrual account, how the taxpayer codes invoices to indicate that use tax was accrued, and how the taxpayer calculates the use tax due.

## **8.8 Evaluating Taxpayer's Internal Control**

To be effective, internal control requires an adequate division of responsibilities among the persons who perform accounting procedures or control activities and those who handle assets. Ideally, separate employees will perform each of the four major duties: authorization or approval, custody of assets, recording transactions, and reconciliation. In a small business, it may not be possible to separate these duties.

Items that the auditor may discuss when evaluating the taxpayer's internal control for strengths and weaknesses include:

- Whether there is a clearly defined separation of responsibility for each duty;
- Whether there is an adequate system of authorization; and
- Whether there is adequate supervision of duties.

## **8.9 Discussing the Audit**

Items the auditor should discuss with respect to the actual audit include:

- When would be a good time to start the audit;
- An estimate as to the amount of time the auditor believes the audit will take;
- The names, locations, and availability of the individual(s) the auditor will be conferring with regarding each of the taxes being audited;
- How the auditor will obtain access to the records needed during the audit;
- Extending the statute of limitations through a Consent Form if necessary; and
- Sampling, including:
  - Sample size;
  - Sample type;
  - Sample period;
  - Sampling method; and
  - Proper application of the sample results.

## **8.10 Requesting Taxpayer's Books and Records**

At the conclusion of the interview, the auditor will issue an information document request indicating the books and records necessary to conduct the audit. The auditor may issue additional information document requests as needed during the course of the audit.

## **8.11 Walk-Away Audit**

If, after the pre-audit interview with the taxpayer, the auditor determines that the taxpayer has filed all returns correctly, the auditor may discontinue the audit. The supervisor, upon his/her approval, will send a walk-away letter to the taxpayer. This will be considered as a no audit and all returns remain open for future examination until the statute of limitations expires.

### **8.12 Sampling Agreement**

At the conclusion of the interview, the auditor will complete a sampling agreement that sets out the auditor's plan for sampling each of the transaction taxes to be audited, and will present it to the taxpayer for acknowledgement and signature. If during the course of the audit, the auditor finds that the sampling plan needs to be changed, he/she may revise the agreement accordingly and present it to the taxpayer for acknowledgement and signature. If the taxpayer does not sign the agreement form, the auditor will follow the sampling plan outlined.

### **8.13 Audit Plan**

Having gathered all the necessary background information, the auditor is now prepared to develop an audit plan, which may include:

- The taxes to be audited, along with periods to be audited;
- The preliminary approach to be used to audit each tax;
- The method for verifying taxable sales and deductions;
- The method for verifying returns and allowances or other credits;
- The method for testing the validity of exemptions and nontaxable deductions;
- The method for the verification of fixed asset accruals – examined in its entirety except in limited situations;
- Tracing use tax accruals to the payment register; and
- With respect to expense accruals for Sales and Use Tax audits:
  - The accounts to be examined; and
  - The sample period.

## **Chapter 9 Field Audit Procedures – Employer Withholding Tax**

The purpose of a Gross Income Tax Employer Withholding audit (GIT-ER) is to determine whether the taxpayer withheld the proper amount of tax from employees' wages and compensation paid to other payees, reported and remitted the amount withheld to the Division, and whether or not the amount of wages the taxpayer reported was reasonable based on the taxpayer's business operations.

### **9.1 *Reviewing Forms W-2 and W-3***

The auditor will review copies of Forms W-2 for the audit period to determine if the taxpayer properly withheld tax from each employee's wages. The auditor may create a schedule and discuss with the taxpayer any Form W-2 that does not reflect proper withholding. For any Form W-2 without the proper withholding tax collected and remitted, the auditor will assess tax at a rate of 2.5%. The auditor will prepare an analysis of total wages and withholdings per Forms W-2 and W-3 and reconcile them to Forms New Jersey-927 and WR-30, note any material differences, and assess tax as appropriate. Because taxpayers may maintain separate payrolls for different groups of employees, the auditor should be sure to check for multiple payrolls.

### **9.2 *Reviewing Forms 1099***

The auditor will review any Forms 1099 the taxpayer issued to ensure that the recipients were independent contractors and not actually employees.

### **9.3 *Employee vs. Independent Contractor***

The Internal Revenue Service has established a 20-point checklist that may be used as a guideline in determining whether or not an independent contractor can be paid by Form 1099. This checklist helps determine who has the "right of control." Does the employer have control or the "right of control" over the individual's performance of the job and how the individual accomplishes the job? The greater the control exercised over the terms and conditions of employment, the greater the chance that the controlling entity will be held to be the employer. The right to control (not the act itself) determines the status as an independent contractor or employee. The 20-point checklist is, however, only a guideline. Over the years, the Internal Revenue Service has recognized changes in business practices and therefore created three categories of factors to assess the degree of control and independence. These factors may be used in conjunction with the 20-point checklist.

### **9.4 *Reviewing Payments to Construction Contractors***

Effective January 1, 2007, New Jersey businesses may withhold New Jersey Gross Income Tax at the rate of 7% from payments for services performed in New Jersey made to unregistered, unincorporated contractors.

The auditor will review all payments the taxpayer made to contractors and subcontractors during the audit period. If the taxpayer has a copy of the contractor's Business Registration Certificate, no withholding was required. The auditor will create a schedule of any payments made to a contractor for which the taxpayer does not have proof of business registration. For any payments for which the taxpayer has no proof of business registration, the auditor will assess tax at the rate of 7% if the taxpayer has not already done so.

## **Chapter 10 Field Audit Procedures - Sales & Use Tax**

The purpose of a Sales and Use Tax audit is to determine the proper amount of tax due on sales of tangible personal property and taxable services and the proper tax liability for use, in New Jersey, of property and services for which the Sales Tax has not been paid.

The auditor should evaluate the accuracy of the taxpayer's accounting records during every audit. Without sufficient and/or correct records, the auditor will not be able to determine whether the taxpayer has filed accurate returns and paid the correct amount of tax due. If the auditor finds that the taxpayer's records are insufficient and/or incorrect, the auditor may be required to use an indirect method to conduct the audit.

The auditor should perform a line-by-line verification of data reported on the taxpayer's filed returns by doing the following:

- a. Summarize the gross receipts from the sales journal and compare with general ledger accounts and Line 1 of the ST-50 return and the CBT-100 return and Schedule J of the Corporation Business Tax return;
- b. Summarize bank deposits and compare to gross receipts from the returns;
- c. Compare daily sales invoices to the sales journal using test checking when necessary;
- d. Compare deductions claimed on Line 2 of the ST-50 return with the sales journal and invoices;
- e. Check the validity of exemption certificates accepted by the taxpayer;
- f. Compare actual tax collected per sales journal and general ledger with tax reported and paid; and
- g. Analyze use tax accrual account and compare to use tax reported on the ST-50 return.

### **10.1 Verifying Gross Receipts**

#### **10.1A Examining Sales Invoices**

Sales invoices, tickets, and guest checks represent the original records of sales. During the pre-audit interview, the auditor and taxpayer should discuss a sampling plan and execute a sampling plan agreement. The auditor will review the taxpayer's books, records, and sales invoices to determine whether the taxpayer charged sales tax when required, calculated the tax correctly, or properly exempted the sale.

## **10.2 Examining General Ledger Accounts**

The auditor will examine the general ledger accounts for debits and credits and create a schedule of those items that may represent unreported taxable transactions. For example, sales of merchandise at cost may have been credited to the purchase of inventory accounts or, sales of by-products may have been credited directly to profit and loss, surplus, or expense accounts.

## **10.3 Examining the General Journal**

Sometimes transactions are recorded in the general journal rather than in general ledger accounts. The auditor will examine general journal entries and create a schedule of those that may indicate taxable transactions. The auditor may examine all supporting documents, such as correspondence, contracts, invoices, and other documents pertaining to these entries to determine whether the entry represents a taxable transaction.

## **10.4 Examining the Cash Receipts Journal**

The auditor will examine the cash receipts records to determine whether receipts from cash sales have been credited to the proper sales accounts.

## **10.5 Examining the Accounts Receivable Journal**

When examining the accounts receivable ledger, the auditor should be sure to examine accounts receivable due from the owners, partners, officers, employees, or related entities of the company for sales that may not be reflected in the sales accounts.

## **10.6 Examining Total Sales**

During the pre-audit interview, the auditor and taxpayer should discuss a sampling plan and execute a sampling plan agreement.

During the audit, the auditor will review and schedule all invoices for the sample period and classify them as taxable, nontaxable, exempt, out-of-State, or as otherwise appropriate to the audit, and verify that all nontaxed sales were included in total sales. The auditor should trace the sales invoices to the sales journal and then trace the sales journal to the general ledger. The auditor will examine invoices for taxable sales to verify that: the tax has been properly computed and added to the invoice; the tax so computed has been properly accrued in the sales tax accrual account; and, that the tax accrued has been remitted to the State. The auditor will schedule any noted exceptions.

## **10.7 Examining Bank Deposits**

The auditor will schedule by month all deposits for the audit period after reviewing the taxpayer's bank statements.

If there is a questionable discrepancy between deposits and gross receipts, the auditor will issue an information document request to the taxpayer requesting documentation to explain the discrepancy. Once the taxpayer provides sufficient documentation, the auditor should:

- Increase the deposits for documentation of cash expenditures and withdrawals from cash receipts before bank deposits are made (for example, wages paid in cash, cash payments to suppliers); and
- Decrease the deposits for documentation of deposits of receipts from sources other than sales (for example, loans, re-deposits of dishonored checks, rental income, charges for cashing customers' checks, sales tax collected included in the deposits).

If the taxpayer fails to provide the requested documentation, or if the documentation provided does not explain the discrepancy to the auditor's satisfaction, the auditor may adjust gross receipts to reflect the amount of the deposits.

### **10.8 Examining Nontaxed Sales/Deductions**

While examining total sales, the auditor will have scheduled all non-taxed, exempt, and out-of-State sales and traced them back to the sales journal and general ledger. The auditor will now trace these scheduled transactions to the deductions reported on the Sales and Use Tax return(s) for the entire audit period or the sample period, whichever is applicable.

Once the auditor has scheduled and traced the non-taxed sales, he/she will then examine the sales invoices to determine whether:

- The scheduled nontaxed sales correspond with the sales invoices; and
- The nontaxed sales were reported correctly. The auditor will examine purchase orders and invoices, which may contain information regarding shipping charges and/or instructions, and supporting documentation such as exemption certificates (or the required data elements, see below), correspondence, or contracts.

The auditor will schedule any sales that he/she determines were incorrectly reported as nontaxed. In addition, the auditor will schedule any sales for which the non-taxed status is questionable and request additional information and documentation from the taxpayer by issuing an information document request. The auditor will give the taxpayer a reasonable period of time (120 days if the auditor is requesting exemption certificates) to provide documentation to support the reported non-taxed status. If the taxpayer does not provide such documentation, the auditor will consider that sale taxable.

### **10.9 Exemption Certificates**

Deductions can be supported by various exemption certificates which relieve the seller from liability for collecting the tax. Each certificate must be fully completed, include all required information, and be up-to-date. A taxpayer's federal identification number or registration certificate is not an acceptable substitute for an exemption certificate.

Below you will find a list of the various exemption certificates. For more detailed information see Tax Topic Bulletin S&U-6, Sales Tax Exemption Administration.

- Form [ST-3-3](#) Resale Certificate
- Form [ST-3NR](#) Resale Certificate for Non-New Jersey Sellers
- Form [ST-SST](#)-SST Streamlined Sales and Use Tax Certificate of Exemption
- Form [ST-4](#) Exempt Use Certificate
- Form ST-4 (BRRAG) Exempt Use Certificate
- Form ST-5 Exempt Organization Certificate
- Form ST-6A Direct Payment Permit
- Form ST-6X Audit Direct Payment Permit
- Form [ST-7](#) Farmer's Exemption Certificate
- Form [ST-8](#) Certificate of Exempt Capital Improvement
- Form [ST-10](#) Motor Vehicle Sales and Use Tax Exemption Report
- Form [ST-10-A](#) Aircraft Dealer Sales and Use Tax Exemption Report
- Form ST-10V Vessel Dealer Sales and Use Tax Exemption Report
- Form [ST-13](#) Contractor's Exempt Purchase Certificate
- Form [ST-16](#) Exemption Certificate for Student Textbooks
- Form SC-6 Salem County Energy Exemption Certificate
- Form UZ-4 Contractor's Exempt Purchase Certificate - Urban Enterprise Zone
- Form UZ-5 Urban Enterprise Zone Exempt Purchase Certificate
- Form UZ-6 Urban Enterprise Zone Energy Exemption Certificate

#### **10.10 Reviewing Exemption Certificates**

The auditor will allow a claimed deduction if, within 90 days of the date of the underlying transaction, the taxpayer has a fully completed exemption certificate on file or obtained and recorded the information contained thereon. Depending when the sale occurred, the auditor will need to determine whether the taxpayer accepted the certificate in good faith. The auditor will follow the requirements of the Streamlined Sales and Use Tax Act for the period being audited. See the following subsections.

##### **10.10A Sales on and after January 1, 2008 - Completed Certificate on File**

For any sale occurring on and after January 1, 2008, the taxpayer is relieved of liability for the tax due if the taxpayer has a fully completed exemption certificate on file. The auditor will accept a fully completed certificate as support for the non-taxable status of the sale and allow the deduction. An exemption certificate is fully completed if it includes the following data elements:

- Purchaser's name and address;
- Date of completion;
- Type of business;
- Reasons(s) for exemption;
- Purchaser's New Jersey tax identification number or, for a purchaser that is not registered in New Jersey, the Federal employer identification number or out-of-State registration number. Individual purchasers may include their driver's license number; and
- The signature of the purchaser (if the purchaser uses a paper exemption certificate).

In the absence of a fully completed exemption certificate, the auditor will allow a deduction for any sale for which the taxpayer has obtained and recorded the required data elements shown above.

**10.10B Sales January 1, 2008 to September 30, 2011 - Completed Certificate Not on File**

For any sale that occurred from January 1, 2008, to September 30, 2011, if the auditor finds that the taxpayer neither obtained an exemption certificate nor recorded the required data elements, or the taxpayer obtained an exemption certificate that is incomplete, the auditor will require the taxpayer to obtain a fully completed exemption certificate or the required data elements. The auditor will allow the taxpayer at least 120 days to obtain the necessary information. Any certificate the taxpayer is required to obtain may be accepted in good faith. For this time period, "accepted in good faith" means that the taxpayer is presumed to be familiar with the law and rules regarding the business in which he/she deals and the exemption certificate may not contain any statement or entry which the taxpayer knows is false or misleading. The good faith requirement applies to the required data elements as well. If the taxpayer does not obtain a fully completed exemption certificate or required data elements for a sale, the auditor will treat the sale as taxable.

**10.10C Sales on and after October 1, 2011 - Fully Completed Certificate Not on File**

For any sale occurring on and after October 1, 2011, if the auditor finds that the taxpayer neither obtained an exemption certificate nor recorded the required information, or the taxpayer obtained an exemption certificate that is incomplete, the auditor will request that the taxpayer obtain a fully completed certificate or other supporting documentation. The auditor will allow the taxpayer at least 120 days to either:

- a. Obtain and provide a fully completed exemption certificate from the purchaser. Any certificate the taxpayer is required to obtain at the auditor's request may be accepted in good faith. For this time period "accepted in good faith" means that the exemption the purchaser is claiming:
  - i. Was statutorily available on the date of the transaction;
  - ii. Could be applicable to the item being purchased; and
  - iii. Is reasonable for the purchaser's type of business.
- b. Obtain and provide information from the purchaser that supports the purchaser's eligibility for the exemption claimed.

If the taxpayer obtains and provides either the certificate or information described above, the auditor will accept it as support for the nontaxable status of the sale and allow the deduction. The taxpayer is relieved of any liability for the tax on the transaction unless the Division establishes that the seller:

- Knew or had reason to know, at the time the purchaser provided such certificate or information, that the information relating to the exemption claimed was materially false; or
- Knowingly participated in activity intended to purposefully evade the tax due.

### **10.10D Sales October 1, 2005 to December 31, 2007**

- Exemption Certificate on File

For any sale that occurred from October 1, 2005, to December 31, 2007, the auditor will accept a sale as nontaxable if the taxpayer has a completed exemption certificate that meets the following conditions:

- a. The certificate must contain no statement or entry which the seller knows is false or misleading;
- b. The certificate must be an official form or an acceptable reproduction, including electronic; and
- c. The certificate must be filled out completely.

The certificate must be dated and include the purchaser's New Jersey tax identification number or, for a purchaser that is not registered in New Jersey, the Federal employer identification number or out-of-State registration number. Individual purchasers may include their driver's license number.

- Exemption Certificate Not on File

If the auditor finds that the taxpayer does not have an exemption certificate or the taxpayer obtained an exemption certificate that is incomplete, the auditor will give the taxpayer the opportunity to obtain and provide a fully completed certificate or other supporting documentation. If the taxpayer does not do so, the auditor will treat the sale as taxable.

### **10.10E Sales before October 1, 2005**

- Exemption Certificate on File

For any sale that occurred before October 1, 2005, if the taxpayer provides an exemption certificate, the auditor will treat the sale as nontaxable if the auditor determines that the taxpayer accepted the certificate in good faith. For sales that occurred before October 1, 2005, "accepted in good faith" means that the taxpayer is presumed to be familiar with the law and rules regarding the business in which he/she deals and that the certificate did not contain any statement or entry which the taxpayer knows is false or misleading.

- Exemption Certificate Not on File

If the auditor finds that the taxpayer does not have an exemption certificate or the taxpayer obtained an exemption certificate that is incomplete, the auditor will give the taxpayer the opportunity to obtain and provide a fully completed certificate or other supporting documentation. If the taxpayer does not do so, the auditor will treat the sale as taxable.

### **10.11 Exception for Fraud**

Relief from liability does not apply if the taxpayer fraudulently fails to collect tax, for example:

- a. Solicits purchasers to participate in the unlawful claim of an exemption; or
- b. Accepts a certificate for an entity-based exemption and:
  - i. The purchaser actually received the products or services covered by the exemption certificate at a location operated by the taxpayer in New Jersey; and
  - ii. The entity-based exemption the purchaser claimed on the certificate is unavailable as indicated on the Streamlined Sales and Use Tax Agreement – New Jersey Certificate of Exemption.

### **10.12 Interstate or Foreign Sales (Shipped Out of New Jersey)**

#### **10.12A Deductions Allowed**

Sales made in New Jersey but shipped out of State by the seller are not taxable. The auditor will allow a deduction for any sale for which the taxpayer provides acceptable documentation that the seller arranged for or actually made the delivery as part of the sales transaction. Acceptable documentation depends on who delivers the item(s) purchased, as summarized below:

- a. If delivered by the taxpayer:
  - i. Correspondence
  - ii. Delivery receipts
  - iii. Expense vouchers supporting delivery expense
- b. If delivered by common carrier:
  - i. Bills of lading
  - ii. Express company receipts
  - iii. Express company or freight invoices
  - iv. Parcel post or delivery receipts
  - v. Parcel post or delivery shipping records
  - vi. Insurance for expensive items
- c. If delivered by the taxpayer's forwarding agent:
  - i. Notation on invoices
  - ii. Invoices for services of forwarding agent
  - iii. Delivery receipts
  - iv. Export declarations

- d. If delivered by the taxpayer to a steamship, airline, or other foreign carrier for shipment to a foreign destination (not deductible if moved in interstate commerce):
  - i. Bills of lading
  - ii. Invoices for export services
  - iii. Export declarations, statements, affidavits, etc.

#### **10.12B Deductions Disallowed**

The auditor will disallow a claimed deduction if the taxpayer does not provide acceptable documentation that establishes that a purchase was shipped out of the State and that delivery was part of the original sales transaction. In addition, a sales transaction is not deductible if:

- a. Delivery is made in New Jersey to the purchaser or the purchaser's agent, regardless of where the purchaser is located;
- b. Shipment is by freight or express, but is actually arranged by the purchaser or his/her agent as indicated by the bill of lading; and
- c. The sale is made to a carrier which transports the property out of the State. In this case the carrier is acting as a purchaser rather than as a common carrier i.e., the property is shipped under a waybill instead of being shipped under a commercial bill of lading.

#### **10.13 Purchases Subject to Use Tax**

The auditor will examine the taxpayer's books and records to determine whether tangible personal property and/or services that the taxpayer purchased without paying Sales Tax are subject to Use Tax.

Use Tax is to be imposed when taxable goods and services are purchased for use in New Jersey but Sales Tax was not collected by the seller in the State of purchase or was collected at a rate less than the New Jersey Sales Tax rate.

Examples of when Use Tax is due from the purchaser:

- Taxable goods and services are purchased out of State for use in New Jersey and no sales tax is collected;
- Taxable goods and services are purchased out of State for use in New Jersey and Sales Tax is collected at a lower rate than New Jersey's (See Reciprocity below); and
- Items of inventory that were purchased tax-free with a resale certificate are used by the Purchaser (e.g., are given away as part of a promotion).

#### **10.14 Purchases Not Subject to Use Tax**

Any taxpayer that does not pay Sales Tax on purchases of goods or services from either an in-State or out-of-State seller must report and pay Use Tax on such purchases unless:

- a. The sale of such property or services is exempt in New Jersey;

- b. The taxpayer properly used an exemption certificate to purchase goods or services that otherwise would have been taxable; or
- c. The taxpayer can document that he/she paid Sales Tax to another State or jurisdiction in another State. If the tax rate in the other State or jurisdiction is less than the rate in New Jersey, New Jersey Use Tax may be due in full or due based on the difference in the rates.
  - i. **Out-of-State Purchases Received Outside New Jersey.** When taxable goods and services are purchased and received in another state and Sales Tax is paid to that State, New Jersey will allow a credit against the Use Tax due, provided that the other state allows a similar credit for Sales Tax paid to New Jersey. If the Sales Tax rate in a reciprocating State is equal to, or greater than, New Jersey's 7% tax rate, no Use Tax is due. If the Sales Tax rate in the state where the purchase is made is less than New Jersey's, Use Tax is due at the rate of 7%. However, if the other state has Sales Tax reciprocity with New Jersey, a credit for the Sales Tax paid there is allowed against the New Jersey Use Tax due.
  - ii. **Out-of-State Purchases Delivered to New Jersey.** When taxable goods and services are purchased in another State and delivered to New Jersey for use in New Jersey, no credit is allowed for Sales Tax paid to the other State. Use Tax is due at the rate of 7% of the purchase price, including delivery charges.
  - iii. **Purchases Made in a Foreign Country.** When taxable goods and services are purchased in a foreign country, no credit is allowed for Sales Tax paid to the foreign country, regardless of whether the purchaser takes possession of the items there or has them delivered to New Jersey. Use Tax is due at the rate of 7% of the purchase price, including delivery charges.

### **10.15 Identifying Purchases Subject to Use Tax**

Depending on the type of business and the adequacy of a taxpayer's records, an auditor will identify purchases that are subject to Use Tax by examining purchase invoices, requisitions, journal entries, inventory credits, and debits to selected general ledger accounts. The auditor will trace general ledger account entries back to the purchase invoices or other source documents.

For fixed asset purchases, the auditor should review fixed asset and depreciation schedules, along with general ledger accounts to identify purchases which are not recorded on those schedules.

### **10.16 Examining Purchase Invoices for Expense Accounts and Fixed Assets**

During the pre-audit interview the auditor and taxpayer should have discussed a sampling plan and executed a sampling plan agreement.

The auditor will:

- Examine and compare invoices with purchase journals;
- Review all purchase invoices for the audit period or sample period; and

- Identify invoices for taxable purchases and schedule the transactions in which tax was not paid.

The auditor will also schedule and treat as taxable any transaction from the purchase journals for which an invoice cannot be located. Unless the taxpayer obtains and provides a copy of the purchase invoice from the seller that shows Sales Tax was paid, the auditor will treat the transaction as subject to Use Tax.

The auditor should provide the taxpayer with the list of taxable exceptions and/or missing invoices and give the taxpayer reasonable time to review the list and locate copies of missing invoices. The list of taxable exceptions, along with any updates, will be reviewed with the taxpayer.

### **10.17 Use Tax Accrual Account**

The auditor will test the reliability of the taxpayer's Use Tax accrual account (if such account exists) by tracing to the account the use tax listed on both expense and asset purchase invoices which the taxpayer coded to indicate that Use Tax was accrued. The auditor may trace enough invoices to be satisfied that the taxpayer's accrual account is either reliable or not reliable. If the auditor determines that the account is reliable, the auditor will schedule only taxable invoices on which Sales Tax was not charged nor use tax accrued. If the auditor determines that the accrual account is not reliable, the auditor will disregard any Use Tax coding on the invoices and proceed as if the taxpayer does not have a Use Tax accrual account, listing all invoices subject to tax and crediting total Use Tax paid against any assessment.

### **10.18 Urban Enterprise Zones (UEZ) and UEZ-Impacted Business Districts**

A business that is located in either a UEZ or UEZ-Impacted Business District is eligible for certain Sales and Use Tax reductions if it applies to be and is certified as a "qualified business." Once a business is certified as qualified, it must file an annual report to verify that it continues to meet the criteria for eligibility. In addition, it must apply for recertification (as a qualified business) every three years. Eligibility for the partial sales tax exemption continues automatically each year unless the business loses its qualified business status. A certified qualified business in a UEZ or a UEZ impacted business district is required to file Form UZ-50 each month, and is issued a certificate of authority (form UZ-2) which is the evidence of entitlement to the partial sales tax exemption.

### **10.19 Benefits for Qualified Businesses**

#### **10.19A Qualified Businesses in UEZ**

A certified qualified business in a UEZ may purchase, lease, or rent tangible personal property (except specified digital products, energy, and motor vehicles, parts or supplies), and most services (except telecommunications services, utility services, and motor vehicle repair services), without paying Sales Tax or Use Tax, provided that the property or service is for exclusive use or consumption by the qualified business at its location in the UEZ. The exemption does not apply to purchases for resale. However, the business may use a resale certificate when purchasing items for resale.

The auditor should keep in mind that certain qualified businesses were required to pay the Sales Tax (and/or any compensating Use Tax) on all purchases made from July 15, 2006, through March 31, 2011, and then file a claim for refund thereafter.

A manufacturer in a UEZ may apply for a UEZ energy exemption. If the manufacturer qualifies, it may purchase natural gas and electricity consumed at its certified location in a UEZ without paying Sales Tax.

A qualified certified retail business may collect Sales Tax on most taxable sales of tangible personal property at 50% of the applicable rate.

#### **10.19B Qualified Businesses in UEZ-Impacted Business Districts**

There are no purchase exemptions available in a UEZ-Impacted Business District. A certified qualified business may collect Sales Tax at 50% of the applicable rate on most taxable sales of tangible personal property.

#### **10.19C Partial Sales Tax Exemption - UEZ**

A certified qualified business in a UEZ or UEZ-Impacted Business District charges and collects Sales Tax on sales, rentals, and leases of eligible tangible personal property at 50% of the rate in effect at the time of the sale. A sale of tangible personal property is eligible for the partial Sales Tax exemption if the sale originates or is completed by the purchaser, in person, at a certified qualified seller's place of business in an enterprise zone or impacted business district. A transaction originates or is completed by the purchaser, in person, if:

- a. The purchaser places his or her order, in person, at the seller's place of business in the zone or district and the seller delivers the tangible personal property directly from the same business location with the zone or district; or
- b. The purchaser personally accepts delivery at the seller's place of business in the zone or district. The transaction may be completed at the same business location in the same zone or district even if the seller operates more than one business location in one or more zones or districts.

The items listed below are not eligible for the reduced Sales Tax rate. Sellers must collect tax on these transactions at the regular rate. Sellers are liable for any Sales Tax not collected and remitted to the State.

- Motor vehicles
- Alcoholic beverages
- Cigarettes
- Catalog or mail-order sales
- Services (e.g., maintenance and repairs). If tangible personal property is sold with the service, the sale of the property may be eligible for the reduced tax rate(see Section F-3a below)
- Prepared food, meals, and beverages
- Charges for room occupancy, admissions, and amusements
- Specified digital products
- Parking, garaging, or storing a motor vehicle
- Membership fees for health, sporting, and shopping clubs

Example 1 – A consumer goes to a UEZ certified retail building supply business to make a purchase of materials. The retailer does not have all the materials in stock and agrees to order from another source or obtain the materials from another location operated by the retailer.

In order for the transaction to be taxed at the reduced rate, the materials must arrive at and be handled by the employees at the seller's location in the zone. Either the purchaser may come to the seller's location in the zone to pick-up the materials or the seller may deliver the materials from the zone location.

Example 2 – A seller has two certified retail stores in different UEZ zones. A purchaser makes an in-person order for goods at one location but the vendor does not have the goods at that location. The goods, however, are in stock at the second location.

In order to be taxed at the reduced rate, the transaction must begin and end at the same certified UEZ location. Thus, the goods that are offered at the reduced rate must be ordered, then picked up or delivered from the same location within the UEZ zone.

#### **10.20 Auditing Reduced Rate Transactions – UEZ**

When auditing a business in a UEZ or UEZ-Impacted Business District which charged and collected Sales Tax at the reduced rate, the auditor must verify that the taxpayer was a certified qualified business. If the auditor finds that the taxpayer was not a certified qualified business for any part of the audit period during which the taxpayer charged and collected tax at the reduced rate, the auditor may assess Sales Tax at the full rate for any sales that occurred during that time.

While examining the taxpayer's total sales, the auditor will have scheduled all sales taxed at the reduced rate and traced them back to the sales journal and general ledger. Once the auditor has scheduled and traced the reduced rate sales, he/she may then examine the sales invoices to verify that:

- The items sold were eligible for the reduced Sales Tax rate; and
- The transaction originated or was completed by the purchaser, in person, at the taxpayer's location in the UEZ or UEZ-Impacted Business District.

If the auditor has questions about whether a transaction was eligible for the reduced Sales Tax rate, he/she may schedule the sale and request additional information and documentation from the taxpayer through an information document request. The auditor will give the taxpayer a reasonable period of time to provide documentation to support the reduced rate. If the taxpayer does not provide such documentation, the auditor will assess tax at the full rate.

#### **10.21 Sales of Services with Qualified Tangible Personal Property**

If a certified qualified business sells both services and qualified tangible personal property in the same transaction, the partial Sales Tax exemption applies to the sale of the tangible personal property as long as the cost therefor is separately stated on the bill. For example, if an invoice for an oil change lists the costs for both the service and the parts used to perform the oil change, the taxpayer may charge Sales Tax at the full rate on the service and at the reduced rate on the parts. However, if the parts are not separately stated, the taxpayer must charge tax at the full rate on the full amount of the bill.

### **10.22 Purchases and Use Tax - UEZ**

The auditor will follow the procedures for reviewing purchases and verifying Use Tax as previously defined for purchases of tangible personal property and services that do not qualify for the Sales Tax purchase exemption.

### **10.23 Salem County**

Certain sales made by businesses located in Salem County are taxable at 50% of the Sales Tax rate in effect during the audit period. Sales of almost all tangible personal property are eligible for the reduced Sales Tax rate.

The items listed below are not eligible for the reduced Sales Tax rate. Sellers must collect tax on these transactions at the regular rate. Sellers are liable for any Sales Tax(es) that are not collected and remitted to the State:

- Motor vehicles
- Alcoholic beverages
- Cigarettes
- Catalog or mail-order sales
- Services (e.g., maintenance and repairs). If tangible personal property is sold with the service, the sale of the property may be eligible for the reduced tax rate (see Section G-2a below)
- Prepared food, meals, and beverages
- Charges for room occupancy, admissions, and amusements
- Specified digital products
- Parking, garaging, or storing a motor vehicle
- Membership fees for health, sporting, and shopping clubs

#### **10.23A Salem County Reduced Sales Tax Rate**

Every business whose address of record in TaxReg (Taxpayer Registration System) is in Salem County is shown as "Salem County Eligible" and is required to file Form ST-450/451. However, a seller is only eligible to charge and collect tax at the reduced rate if the seller:

- a. Regularly operates a retail business location in Salem County where he regularly exhibits items offered for sale; and
- b. Does not use the location primarily for catalog or mail-order sales.

During the pre-audit interview, the auditor must determine whether the taxpayer meets these requirements. If the auditor finds that the taxpayer is not "Salem County Eligible," the auditor may assess tax at the full rate for any transaction on which the taxpayer assessed tax at the reduced rate and there is no need for the auditor to follow the procedures in 10.36 below.

An eligible seller may charge Sales Tax at the reduced rate if the purchaser originated or completed the transaction, in person, at the taxpayer's location in Salem County. A taxpayer that does not have a retail sales location in the County cannot charge tax at the reduced rate.

### **10.23B Auditing Reduced Rate Transactions – Salem County**

While examining total sales, an auditor will have scheduled all sales taxed at the reduced rate and traced them back to the sales journal and general ledger. Once the auditor has scheduled and traced the reduced rate sales, he/she may then examine the sales invoices to verify that:

- The items sold were eligible for the reduced Sales Tax rate; and
- The purchaser originated or completed the transaction, in person, at the taxpayer's location in Salem County. This step is especially important when auditing a business with locations outside of Salem County.

If the auditor has questions about whether a transaction was eligible for the reduced Sales Tax rate, he/she may schedule the sale and request additional information and documentation from the taxpayer through an information document request. The auditor shall give the taxpayer a reasonable period of time to provide documentation to support the reduced rate. If the taxpayer does not provide such documentation, the auditor will assess tax at the full rate.

### **10.23C Sales of Services with Qualified Tangible Personal Property – Salem County**

If a "Salem County Eligible" taxpayer sells both services and qualified tangible personal property in the same transaction, the taxpayer may charge tax at the reduced rate on the tangible personal property as long as the cost therefor is separately stated on the bill and the taxpayer regularly sells such property at its location in Salem County. For example, if an invoice for an oil change lists the costs for both the service and the parts used to perform the oil change, the taxpayer may charge Sales Tax at the full rate on the service and at the reduced rate on the parts. However, if the parts are not separately stated, the taxpayer must charge tax at the full rate on the entire transaction (both the service and parts used).

### **10.23D Purchases and Use Tax – Salem County**

The auditor will follow the procedures for reviewing purchases and verifying Use Tax as previously defined. If taxpayer (a business located in Salem County) purchases items eligible for the reduced rate and the purchase is or becomes subject to Use Tax (e.g. items purchased for resale subsequently removed from inventory), the tax rate depends on where the taxpayer purchased and/or picked up the items as summarized below:

- Purchased/picked up from Salem County business – reduced tax rate
- Purchased from New Jersey business outside Salem County, but not in a UEZ – full tax rate
- Purchased/picked up from New Jersey business in a UEZ – reduced tax rate
- Purchased from out-of-State seller not registered to collect Sales Tax in New Jersey – reduced tax rate
- Purchased from out-of-State seller registered to collect Sales Tax in New Jersey – full tax rate

## **Chapter 11 Sampling**

### **11.1 Overview**

Generally, sampling is used when auditing transactional taxes. A transactional tax, the most common of which is Sales and Use Tax, is one for which the tax due is determined based on the facts and circumstances of each individual transaction. A transaction can be reflected as an invoice or receipt as a whole, as a line on an invoice or receipt, or by other documentation. The best way for an auditor to verify the tax reported is to review all invoices, receipts, and other documentation. In cases where it is impractical to audit all transactions, the auditor uses sampling. This allows the auditor to reach conclusions about a large amount of data by collecting and examining only a portion of the data.

During the course of the pre-audit interview, the auditor will determine whether the taxpayer's records and business activities require the use of sampling, develop an appropriate sampling plan, and prepare a sampling agreement to be reviewed and signed by the taxpayer. The auditor will discuss sampling with the taxpayer and ask the taxpayer for suggestions for designing the sampling plan. The auditor is ultimately responsible for performing adequate tests that assure the accuracy of the records. However, it is important that the taxpayer be in agreement with the sampling method. A detailed examination of all transactions (no sampling) will be performed based on the number of transactions, and the invoices (or receipts) for all transactions are available.

### **11.2 Considerations in Selecting Sampling Method**

Below are some of the factors the auditor may consider when determining the type of sampling to use.

- Type of business
- Business size
- Volume of transactions
- Effectiveness of internal controls
- Involvement of owner(s) in business operations
- Availability of records

### **11.3 Types of Sampling Methods**

#### **11.3A Block Sampling**

Block sampling is the most common method utilized by field audit. Block sampling requires the auditor to examine all invoices (or receipts) for all transactions of a certain type that occurred during a selected period of time within the audit period, known as the "sample period." For example, the auditor's sampling plan may require the examination of all expense purchase transactions in a selected year and all sales transactions in a selected quarter within the four-year audit period.

Extrapolation – If taxable exceptions are found within the sample, the percentage of error for the sample period is extrapolated over the audit period. For example, the error rate calculated for the sample period will be applied to the total amount for the audit period (sales or expenses) to determine the taxable exceptions for the audit period.

### **11.3B Stratified Sampling**

Stratified sampling involves grouping transactions into a histogram using ranges based on dollar amounts. A selected number of transactions are examined within each grouping.

### **11.3C Statistical Sampling**

Statistical sampling is another method used to sample transactions where there are a very large number of transactions to be examined. It requires access to both physical and electronic records that are sufficient.

### **11.4 Sampling Agreement**

At the conclusion of the pre-audit interview, the auditor will prepare a sampling agreement which sets out the audit period and sampling period for each tax and sub-type such as expenses or assets. The sampling method and extrapolation method will also be clearly identified for each tax and sub-type.

The auditor will discuss the agreement with the taxpayer and/or the authorized representative and give them the opportunity to include in the sampling agreement any concerns or reservations with any aspect of the sampling plan and/or propose any alternatives. If reasonable, the auditor may accept an alternative. If the taxpayer disagrees with all or part of the agreement and/or declines to sign, the auditor will note the date of the discussion(s), the parties involved, and the taxpayer's position on the face of the agreement.

1. If during the course of the audit the auditor realizes that the original sampling plan needs to be modified, he/she will prepare a new sampling agreement and present it to the taxpayer and/or taxpayer's authorized representative with a memorandum that states the reason(s) why it was necessary to revise the original plan. As with the original agreement, the taxpayer shall have the opportunity to express any concerns or reservations and/or propose alternatives, which will be noted in the agreement. If the taxpayer disagrees with all or part of the modified agreement and/or declines to sign, the auditor will note the date of the discussion(s), the parties involved, and the taxpayer's position on the face of the agreement.

The sampling agreement, whether or not signed by the taxpayer, including all amended or voided sampling agreements, will be included in the electronic case file, and any discussions regarding the agreement will be noted in the audit narrative.

### **11.5 Extraordinary Items**

An item is considered extraordinary or nonrecurring in nature if it is unusual and not routine in the normal course of the taxpayer's business. Because it is nonrecurring, it may not be representative of the sample population. The auditor should remove these items from the population and audit them separately. The auditor should then examine the population to search for every occurrence of similar transactions which should also be pulled from the population and audited separately. These items will be extrapolated separately.

### **11.6 *Missing Documentation for Sample Items***

If the taxpayer cannot locate the documentation relating to any sample item, the auditor should consider the item taxable and include the total amount of the sample item as an error. The auditor should determine the reason for the missing documents and use supporting evidence and reasonableness to determine the taxability of the item.

## **Chapter 12 Cash Audits**

### **12.1 Definition**

Cash Audits are audits comprised of retail food and beverage establishments and/or retail service-oriented establishments.

When conducting a cash audit, the auditor should follow the pre-audit procedures and the pre-audit questionnaire procedures described in previous chapters as well as those detailed below.

### **12.2 Analysis of Books and Records**

Gross receipts must be reconciled between the tax returns filed, general ledgers, sales journals, and summarized sales records.

Bank deposits from the business operating accounts should be summarized and reconciled to gross receipts on the filed tax returns, general ledgers, sales journals and summarized sales records. The auditor will review the regularity of deposits and compare cash deposits and credit card deposits.

Detailed source documents will be reviewed by the auditor to validate the Sales Tax return due for the most recent quarter under audit to which such detailed source documents pertain. Examples of detailed source documents are individual sales slips, individual invoices, individual receipts, point of sales detailed reports, or detailed cash register tapes. This list of examples is not all encompassing.

The auditor will analyze the data from the cost of goods sold schedule reported on the filed tax returns and compare the audited goods available for mark-on to the reported gross sales for the same period and arrive at a reported mark-on ratio. Goods available for mark-on are determined by adjusting the reported cost of goods sold each year by other costs and/or cost of labor.

### **12.3 Purchases**

The auditor will select a representative test period to analyze purchases.

If possible, the analysis of the purchases should be done for a year with a filed return containing a detailed income statement and cost of goods sold schedule so that totals can be compared. The auditor will utilize the cost of goods sold schedule of the test period selected as a starting point for analyzing purchases.

Source documents in the form of invoices, statements, and/or cancelled checks must be summarized and compared to the purchase journal, general ledger, and cost of goods sold schedule.

Once the auditor has validated the purchases on the cost of goods sold schedule for the test year, the auditor must validate the reported purchases through a gap analysis and/or a third party confirmation.

A gap analysis is comprised of a listing of detailed purchases by vendor and product for a specified period of time. When completing the gap analysis, the auditor must ensure that the products listed encompass those products offered for sale on the business's menu. Once the gap analysis is completed, the auditor reviews the detailed list of purchases to ensure regular intervals of purchases were listed for

all products. If regular intervals of purchases were found to be missing, an average should be calculated based on the reported interval of purchases of that specified product. The calculated average should be applied for the interval period of missing purchases and inserted as additional purchases.

Third party purchases are supplied by vendors for certain industries directly to the State of New Jersey and can also be indirectly provided to the auditor by the taxpayer requesting third party confirmations for a specified period of time. If third party confirmations are provided by the taxpayer, the confirmations must be provided on the vendor's official letterhead and a contact person and phone number must be provided on the confirmation for verification purposes. If the third party purchases are available, the auditor must summarize those purchases by vendor and compare those totals to the taxpayer's general ledger and purchase journals.

If disparities and/or irregularities are found while analyzing the test year purchases, the auditor will issue an information document request, requesting additional information to validate the disparities and/or irregularities found. Additionally, if gaps are found in the records or records are missing, the auditor will submit an information document request, requesting missing records.

Once purchases are validated for the test year and adjusted accordingly based on the gap analysis and/or third party confirmations, the audited purchases are summarized. The audited purchases are adjusted by the beginning and ending inventory, and divided by the reported goods available to yield a mark-on for the test period. A second calculation is performed by comparing the audited goods available for sale to the reported goods available for sale to yield an error ratio. These ratios are applied to each year of the audit period as part of the indirect method.

#### **12.4 Indirect Method vs. Direct Method**

The records of a seller may be deemed incorrect or insufficient if an evaluation of the accounting system discloses that the system does not provide adequate internal control procedures which assure the accuracy and completeness of the transactions recorded in the books and records.

If the records of the seller are determined to be incorrect or insufficient, the Sales Tax return(s) filed on the basis of the information obtained from such records may be deemed to be incorrect or insufficient and the Director may determine the amount of tax due the State by using any information available, whether from the seller's place of business or from any other source.

If the auditor determines that the taxpayer's books and records are insufficient and/or incorrect or that the internal controls are not effective, the audit must be conducted using an indirect method. In no case may the auditor use an indirect method until he/she has reviewed the taxpayer's books and records and determined that they are insufficient and/or incorrect or concluded that the internal controls are ineffective.

The auditor may use any or all of the following factors to determine whether the use of an indirect audit method is justified:

- The taxpayer is unable to provide detailed source documents to validate the Sales Tax returns filed for a period not less than 90 days from the last date of the most recent quarterly (or monthly) period for the filing of Sales Tax returns to which such individual sales document pertains;
- The taxpayer is unable to validate disparities between tax returns filed, bank deposits, and summary sales records;
- The taxpayer is unable to validate the disparities between audited purchases derived from gap analysis and/or third party confirmation and reported purchases from test year;
- The taxpayer fails to provide complete purchase invoices for the test period selected;
- The auditor identifies cash payouts that are not included in reported gross receipts;
- There are gaps in the taxpayer's records or records are missing;
- The taxpayer's reported payroll is insufficient to support the business;
- The auditor observes that there are more employees working at the business than are on the payroll; and
- The expenses reported on the corporate tax returns include personal expenses paid by the business.

The decision to use an indirect audit method depends not only on the inadequacy of the taxpayer's records, but also on the auditor's analysis of the internal records. The auditor will include specific findings in the audit narrative as to the sufficiency and/or correctness of the records and effectiveness of the internal controls.

### **12.5 Indirect Audit Methods**

If the auditor determines that the taxpayer's books and records are insufficient and incorrect, or that the internal controls are not effective, the auditor may use an indirect method of audit.

Once the auditor determines that an indirect method of audit is warranted he/she will conduct a mark-on analysis to calculate the audited sales. However, if the auditor determines that he/she does not have enough data to conduct a mark-on analysis, an estimated assessment will be completed.

### **12.6 Mark-On Analysis**

In its simplest form, the taxpayer's mark-on is computed by dividing the selling price of an item by its cost. In other words, the mark-on is the price that the taxpayer charges for the item(s) vs. the cost that the taxpayer pays for the item(s). When several ingredients make up a menu item, the total cost of all ingredients is divided by the selling price of the item. The auditor uses the purchase invoices provided by the taxpayer and the menu prices from the same current period. Calculating the mark-on by using the cost and selling price from the same current period ensures the accuracy of a specific product mark-on.

The auditor will schedule and total all taxpayer's purchase invoices or statements, and/or cancelled checks for the test year and then compare the total to the purchases line on the cost of goods sold

schedule, the purchase journal, and general ledger. If the auditor finds that the total purchases scheduled do not equal the total purchases reported, the auditor will ask the taxpayer to explain the differences.

Once the auditor has reviewed the documented purchases and compared them to the purchases reported on the cost of goods sold schedule for the test year, the auditor may compare the reported purchases to third-party (seller) information, if available, and perform a gap analysis.

### **12.7 Average Weighted Mark-On**

The sample used to determine the mark-on should consist of a period of time that is representative of at least one complete business cycle. Depending on the taxpayer's business, this could be a one or two week period, a one month period, one quarter or one year.

The auditor should be sure to properly weight the mark-on by including items that the taxpayer sells most often. This can be accomplished by using a representative sample period of purchases. The auditor will also account for price variations resulting from coupons, specials, and other discounts. Reasonable allowances for waste, theft, and spillage must be factored into the computation.

### **12.8 Mark-On Calculations**

To calculate the mark-on the auditor shall:

- a. Schedule ingredients and products from the purchase invoices for the sample period and separate them into the following categories: liquor, beer, food, other taxable, and other non-taxable. The auditor will calculate a mark-on for each category;
- b. Determine and list the packaging/selling unit for each scheduled item;
- c. Allocate ingredients to the way(s) in which they are sold. For example, mozzarella cheese is used and sold as part of a whole pizza, as part of a slice of pizza, and as a topping on various items;
- d. Schedule the main component of various menu items and list ingredients such as condiments and side dishes as other costs. For example, the cheese for pizza will be scheduled as the main component while the flour and sauce will be listed as other costs;
- e. Determine the total units available based on the purchase invoices and calculate the total cost;
- f. Calculate the total sales of each item by multiplying total units available by selling price per unit;
- g. Determine the mark-on for each item by dividing total sales of each by total costs; and
- h. Determine the mark-on for each category by dividing total audited sales by total cost.

### **12.9 *Calculating Audited Sales and Audited Mark-On for the Sample Period***

Once the mark-on for each category has been calculated, the auditor must calculate the total sales of each category by multiplying the mark-on by the audited purchases (see below). The auditor must determine the appropriate allowances, if any, that should be made for each category for waste, spoilage, theft, employee meals, etc.

The auditor then determines the audited sales for the sample period by combining the total sales after allowances for each category. The auditor then divides audited sales by audited goods available for sale to determine the audited mark-on.

### **12.10 *Calculating Audited Purchases and Audited Sales for the Audit Period***

The auditor multiplies the audited goods available for mark-on ratio by the reported goods available for mark-on for each year to determine the audited totals for each year in the audit period.

The auditor then multiplies the audited mark-on after allowances by the audited goods available for mark-on for each year to determine the audited sales for each year in the audit period.

If adjustments were required to increase audited sales due to other categories of income such as admission charges or cover charges, the audited sales for each year would be adjusted accordingly.

Once the auditor has calculated the audited purchases and audited sales for each year within the audit period, the normal procedures must be followed for Corporation Business Tax, Gross Income Tax, and Sales Tax.

The auditor will ensure that they adjust the Corporation Business Tax returns accordingly if sales, purchases, and/or wages are adjusted as the result of the mark-on analysis. The auditor also must ensure that wages are adjusted accordingly for Gross Income Tax purposes if the wages reported by the establishment are insufficient to support the business.

### **12.11 *Constructive Dividends and Pro Rata Share Income***

Constructive dividends are payments made by a corporation that result in a benefit to a shareholder even if the payment is not made directly to the shareholder and even if no formal dividend has been declared. Constructive dividends occur most often in closely held corporations where transactions between the corporation and its shareholders are often informal.

If a corporation registered as a C-Corp in New Jersey has an adjustment made to its reported entire net income as a result of an indirect method of audit, the adjustment will be deemed as a constructive dividend and distributed accordingly to the shareholder's New Jersey Gross Income Tax return.

A New Jersey electing S corporation must determine S corporation income and provide each shareholder with a New Jersey K-1 reporting the shareholder's pro rata share based on ownership percentage, the New Jersey allocation factor, or deemed allocation factor, and all other information required for the proper filing of a New Jersey Gross Income Tax return.

If a corporation registered as an S-Corp in New Jersey has an adjustment made to its reported entire net income as a result of an indirect method of audit, the adjustment will be deemed pro rata share income and flow through accordingly to the shareholders New Jersey Gross Income Tax return.

## **Chapter 13 Field Audit Work Papers**

Audit work papers are the summaries, schedules, and worksheets compiled by an auditor in the course of conducting a field audit. The work papers support the auditor's methods and findings. Therefore, clear, descriptive, and properly prepared work papers are important. The auditor will give the taxpayer a complete set of the work papers and review them with the taxpayer or the taxpayer's authorized representative at the post-audit conference.

### **13.1 Work Paper Standards**

- a. Every work paper will contain the following:
  - i. Title heading
  - ii. Taxpayer name, ID number, and case number
  - iii. Auditor's name or initials
  - iv. Page number
  - v. Date prepared and schedule number
  - vi. Source of data (Footnote at bottom of work paper)
  - vii. Invoice date and/or number, when applicable
  - viii. Sufficient cross-referencing to create a clear audit trail
- b. A minimum of one work paper will be prepared for every applicable tax
- c. Applicable audit periods are to be indicated
- d. Whenever possible, copies of sales invoices, purchase invoices and/or exemption certificates that the auditor believes may be necessary to support the audit determination should be included with the work papers.

### **13.2 Indexing**

Work papers are to be indexed by tax. Generally, the first letter of the name of the tax is used to index the schedules for that tax; for example, the letter C is used for Corporation Business Tax schedules, G for Gross Income Tax, S for Sales Tax, and U for Use Tax. Summary schedules are followed by detailed schedules and are numbered, for example, S-1, S-2, S-3, etc.

### **13.3 Cross-Referencing**

When carrying summary figures from one schedule to another, the auditor should use cross-referencing whenever possible. Notations should be made under or next to the figures that are transferred to or from a related schedule.

### **13.4 Contents of Work Papers**

The contents of the work papers should be structured so that the taxpayer, audit supervisor, and others who review the work papers can follow the auditor's procedures and understand how and why the determinations were made.

Each tax is to be considered separately. The auditor will create a separate set of schedules for each tax audited. There will be a summary schedule showing the determinations of tax due or a determination that there is no tax assessment. Any projections used in making the determinations are to be supported by subsidiary schedules containing further details, such as a listing of taxable sales or purchases.

The auditor will include subsidiary schedules to substantiate the summary and/or other subsidiary schedules. The information shown on a subsidiary schedule is an analysis of the data shown on the schedule being supported. Subsidiary schedules contain all details essential to the auditor's determinations and the data used to arrive at audit figures, e.g., monthly totals from the sales account, individual sales from the cash receipts journal, lists of individual sales from sales invoices, lists of individual purchases from purchase invoices, or a detailed mark on analysis.

Unless an explanation of the items on a subsidiary schedule is self-evident from column headings, entries in the "description" column, or otherwise noted, the auditor should be sure to include descriptive comments. A subsidiary schedule should show:

- Source of data and a brief description;
- The basis for any estimates;
- Method of calculating percentages;
- Explanation of differences between reported and audited amounts; and
- Any other comments pertinent to the method or reasoning used to arrive at the facts and figures shown on the schedule.

### **13.5 Data Furnished By Taxpayer**

When the taxpayer furnishes data requested by the auditor, the auditor will import it into the electronic case file (ECF) and may incorporate it into the audit work papers.

### **13.6 Other Miscellaneous Documents**

The following should be retained in the audit file as exhibits, but separate from the audit work papers:

- All correspondence to and from the taxpayer and/or its authorized representative;
- Superseded work papers;
- Research material;
- Third-party information; and
- Other data obtained during the course of the audit, such as annual reports, menus, copies of coupons, specials, or advertisements or invoice copies.

In many cases, these miscellaneous documents will have significant bearing on the audit and therefore, should be carefully preserved.

## **Chapter 14 Field Audit - Post-Audit Procedures**

Once an auditor has completed the audit, reviewed all findings, and made determinations, the Post-Audit process begins. Upon completion of the field work, the auditor will provide a complete set of work papers to the taxpayer, along with explanations and statutory citations supporting all audit adjustments and/or other findings. Assuming that the taxpayer agrees to meet, the auditor then schedules the Post-Audit Conference with the taxpayer. The auditor will then finalize the audit narrative and submit the file to the Supervising Auditor for review.

### **14.1 Post-Audit Conference and Report**

After giving the taxpayer a reasonable period of time to review the audit work papers, the auditor will contact the taxpayer to schedule the Post-Audit Conference. Prior to the conference, the auditor will prepare the Post-Audit Conference Report which will list each tax examined, the audit periods, and the amount of any assessments.

The Post-Audit Conference Report is not a binding document. It is designed to document that the auditor made the taxpayer aware of the audit findings and assessments, if any, and provided detailed work papers, explanations, and statutory citations to the taxpayer. The report will also indicate whether the taxpayer agrees with the audit findings.

The Post-Audit Conference is a face-to-face meeting during which the auditor reviews the audit work papers, explains the audit findings, and presents the Post-Audit Conference Report to the taxpayer and/or taxpayer's authorized representative. At this meeting, the taxpayer will have an opportunity to raise any issues of fact or law and discuss any concerns he/she has with the audit findings. If the taxpayer elects to waive the Post-Audit Conference, the auditor will confirm that in writing. If the auditor is unsuccessful in scheduling a conference, the auditor will send a letter (via certified mail) to the taxpayer offering a final scheduling opportunity. The letter will make it clear that if the taxpayer does not respond within 30 days, the audit will be closed and the Notice of Assessment Related to Final Audit Determination will be issued. By taking these extra steps, it documents and evidences that the auditor made every reasonable effort to have a post-audit conference with the taxpayer.

### **14.2 Taxpayer Agrees With the Audit Findings**

If the taxpayer agrees with the audit findings, the auditor will ask the taxpayer to sign the Post-Audit Conference report.

### **14.3 Taxpayer Disagrees With the Audit Findings**

If the taxpayer disagrees with the audit findings and the disagreement cannot be resolved at the conference or by the taxpayer providing additional documentation, the auditor will ask the taxpayer to list his/her contentions in the Post-Audit Conference report. The auditor will then list:

- Specific issues of fact or law discussed with the taxpayer;
- Laws, rules, or regulations supporting the auditor's determinations and whether the taxpayer agrees or disagrees; and
- The methods the auditor used to make the determinations and whether the taxpayer agrees or disagrees.

If, after discussing the areas of contention, the taxpayer still disagrees with the audit findings or any issue of fact or law, the auditor will advise the taxpayer of his/her right to discuss the matter or meet with the auditor's supervisor.

#### **14.4 Steps Required to Avoid Future Tax Deficiencies**

The auditor will include in the report the steps the taxpayer may take to avoid deficiencies in future tax periods. The auditor will list any records requested during the audit but which the taxpayer did not provide, or which were insufficient and/or incorrect. By doing so, the taxpayer is made aware that those records should be maintained and should be available for future audit.

#### **14.5 Audit Narrative in General**

Every case file must contain a complete Audit Narrative. A test for completeness is whether a third party can review the audit file, understand the findings, follow and comprehend the audit procedures utilized and make use of the information without consulting the auditor. The Audit Narrative provides supervisors, reviewers and conferees with a summary of the entire audit process including: the auditor's findings, the sufficiency and/or correctness of the taxpayer's records, the audit procedures used, and the basis for the auditor's determination of assessments, no changes, or issuance of refunds. If the auditor develops an assessment by projecting the results from a sample to the remainder of the audit period, this will be clearly stated and explained in the narrative.

All narratives should be reviewed for spelling and grammatical errors, as well as typographical errors, prior to submission for supervisory review. Supervisors also should provide a second review for such errors.

The auditor should include as many relevant details as possible, and the Audit Narrative should be clear and concise. The auditor should make reference to applicable work papers, schedules (including subsidiary schedules), and/or exhibits that support the audit facts. The Audit Narrative should be grammatically and technically correct. An inaccurate or incomplete Audit Narrative may affect the outcome of any appeal or legal proceeding stemming from the audit. The auditor will sign and date the Audit Narrative once it is completed.

The Audit Narrative is an internal document that is not part of the audit work papers and is not shared with the taxpayer. It is, however, discoverable should the taxpayer file an appeal of the audit determination with the Tax Court of New Jersey.

#### **14.6 Content of the Audit Narrative**

In addition to the items described in the sub-sections below, the Narrative should include the following general information:

- Title heading;
- Taxpayer name, address, ID number, and case number;
- Auditor's name;
- Supervising auditor's name;
- Date prepared;
- Total hours spent on the audit;
- Name, address and phone number of taxpayer's representative;
- Date that the consent expires and/or the bill-by date; and
- Summary of each tax and period audited and the amounts of tax, penalty, and interest due.

##### **14.6A Description of Taxpayer's Business**

The description of the taxpayer's business should include:

- a. The type of business, for example: retail store, restaurant or bar, wholesale distributor, contractor, fabricator, manufacturer, public utility, supplier of services;
- b. The type of business entity;
- c. The names of the owners/partners/shareholders/officers;
- d. History of the business;
- e. The size, location(s), hours of operation, and number of employees;
- f. The products or services sold;
- g. The products or services purchased;
- h. The types of customers served; and
- i. The manner and methods in which the taxpayer markets its products and services.

##### **14.6B Date(s) of Site Visit(s)**

This should include the Pre-Audit, the site visit, the Post-Audit, and any other significant meetings with the taxpayer. The auditor will include when and where the visit(s) took place, who was present, and what the auditor learned during the visit(s). If no site visit occurred, the auditor will state that and explain why.

##### **14.6C Unusual Circumstances**

The auditor will list any facts, circumstances, or incidents discovered or observed during the audit or pre-audit process that affected the course and/or outcome of the audit.

#### **14.6D Description of Taxpayer's Records**

The auditor will list:

- Records requested;
- Records provided by the taxpayer; and
- Records not provided.

The auditor will discuss whether and why (or why not) the records the taxpayer provided are sufficient and/or correct to support the taxpayer's filing. If the auditor deems the records to be insufficient, the narrative will clearly state this in detail. The auditor should not use words such as adequate, proper, incomplete, inaccurate, acceptable, somewhat, or partially because records are either sufficient or they are not.

#### **14.6E Description of Taxpayer's Accounting Methods**

The auditor will describe the taxpayer's accounting methods and internal controls, and clearly explain any identified weaknesses. The description and identified weaknesses are the basis for the auditor's decision to use certain audit procedures and for the way in which he/she developed the audit assessment. For example, the taxpayer's accounting system may permit cash receipts to be paid out for expense items without ever having been recorded as such, which results in an understatement of gross receipts.

In general, the auditor should focus the description of the taxpayer's accounting methods on those accounts or records that directly affect the lines on the tax returns being audited. Thus, the auditor should address the correctness of the general ledger, sales journal, purchases journal, cash book and general journal, and other similar books and records.

#### **14.6F Reconciliation of Gross Receipts**

The auditor will describe the procedures he/she followed to reconcile the taxpayer's gross receipts from the business tax returns (Corporation Business Tax Schedule A and/or Schedule J) or Schedule C to the Sales Tax returns and bank deposits. When discussing the results of the reconciliation, the auditor may discuss any identified discrepancies, reference both the work papers on which the auditor scheduled the discrepancies and any supporting documentation the taxpayer may have provided. If the auditor did not perform a reconciliation, the reasons for not doing so should be explained.

#### **14.6G The Sample**

The auditor may discuss:

- The sample and test periods used;
- The reasons the periods were selected;
- Whether the taxpayer was given a Sampling Agreement; and
- Whether the taxpayer signed the Sampling Agreement.

If the auditor used invoices for transactions outside of the audit period that affected the assessment, the auditor will explain why those invoices were used. Otherwise the auditor should only use those invoices within the sample period.

#### **14.6H Explanation of Audit Procedures Used**

For each tax audited, the auditor will explain the audit procedures used and the basis for those choices so that audit supervisors, reviewers, and CAB conferees can fully understand how the auditor conducted the audit, which items the auditor examined, and how the auditor arrived at the audit determination. Statements such as “gross receipts were compared” or “adjustments to income were verified” are general in nature and should only be included in the narrative with a detailed explanation that includes:

- The periods examined;
- The items examined, the auditor’s conclusions and resulting adjustments regarding the items, or a statement as to why an item was not questioned or adjusted;
- The information the auditor requested from the taxpayer about the items examined and what the taxpayer provided. This is especially important with respect to the examination of exempt sales and the supporting documentation;
- Details about any concessions which the auditor made (and whether those concessions were approved by a supervisor); and
- With respect to cash audits:
  - Details about the use of third-party information and the resulting findings, if any;
  - Details about the use of a mark-on analysis and why it was or was not done; and
  - When applicable, a discussion as to why certain serving sizes were used and the supporting details, including where the serving sizes were derived and whether the taxpayer agreed.

#### **14.6I Conclusion of the Audit**

The auditor will include details about what occurred at the post-audit conference and the taxpayer’s contentions. Also, it will be indicated whether the taxpayer requested the abatement of penalty and whether any changes were made to the Billing – P&I worksheet.

If there was no post-audit conference held, the auditor will explain why not. The auditor will also explain any adjustments made to the work papers as a result of the post-audit conference(s) or the taxpayer’s stated contentions.

#### **14.7 Report to Assistant Director (AD Report)**

When an assessment exceeds a previously specified amount, the supervisor, upon reviewing the case for Billing, will prepare a Report to the Assistant Director. The Assistant Director Report will identify the taxes audited, any refund amount, the tax amount, penalties and interest, and the total due. It also will explain the reasons for the adjustments and whether the taxpayer agrees. If the taxpayer does not agree, the report will explain the taxpayer’s contentions. Field Audit Supervisors will send an email to the Assistant Chief with the Report to Assistant Director attached. The e-mail will identify that the case is ready for Field Audit Review, the total amount due, and consent expiration date. Any other relevant paperwork that is not in the electronic case file should be provided. After review, the Assistant Director will approve the case for billing.

## **Chapter 15 Sales and Use Tax Refunds**

### ***General***

The Sales Tax Refund Audit Group reviews, examines and processes claims for refund of Sales and Use Tax and other miscellaneous taxes/fees. This group receives claims submitted by taxpayers on Form A-3730, A-3730-UEZ, and through referrals from other groups of the Division.

#### **15.1 *Determining Whether the Refund Claim is Complete***

The reviewer will examine the taxpayer's refund claim for the following:

- Taxpayer's name;
- Taxpayer's address;
- Taxpayer's Social Security number (if an individual) or Federal identification number
- Period covered by the claim;
- Date(s) the amount being claimed was paid;
- Amount of the claim;
- Signature of the taxpayer. The claim for refund should be signed by the taxpayer (if an individual), an authorized representative (e.g., an officer of the corporation or a partner of a partnership), or a representative authorized by the taxpayer on Form M-5008-R, Appointment of Taxpayer Representative; and
- Explanation of the claim with supporting documentation. The explanation should include a detailed description of the grounds for the refund claim, and sufficient facts and documents to support the claim.

If the reviewer finds that any of the required items are missing, he/she will contact the taxpayer to obtain the missing information. Contact will be made via telephone, electronic mail or letter.

#### **15.2 *Confirming the Taxpayer's Address***

The reviewer will confirm the address on the refund claim form by comparing it with the taxpayer's address(es) in the Division's records. If the reviewer is unable to match the address on the refund claim to an address in the Division's records, the reviewer will verify the new address with the taxpayer and then, if correct, add it to the taxpayer's account.

#### **15.3 *Reviewing the Taxpayer's Account***

The reviewer will review all notes and cases in the taxpayer's account to determine if any other area of the Division has an open audit, conference or court case that could affect the refund claim and to ensure that the taxpayer has not filed duplicate claims with multiple groups of the Division.

If any open delinquencies or deficiencies appear on the taxpayer's Schedule of Liabilities, the Sales Tax Refund Group will send a letter, via the USPS, notifying the taxpayer of such items and how to resolve the items.

#### **15.4 Verifying Timeliness of Claim**

The reviewer will determine whether the taxpayer filed the refund claim before the expiration of the statute of limitations. Generally, the statute of limitations for refund claims filed on A-3730 is four years from the date of payment of the tax.

Claims for Refund filed by qualified UEZ businesses on Form A-3730-UEZ for Sales Tax paid or Use Tax accrued on purchases that are used or consumed exclusively at the UEZ business location are subject to a one year statute of limitations from the date of payment.

If the reviewer finds that the claim was not timely filed, the reviewer will deny the refund claim and issue a Notice of Denial.

#### **15.5 Refund Period Extended By Consent Form**

When a taxpayer has signed a consent form to extend the period in which the Division may assess Sales and Use Tax, the period for filing a Sales and Use Tax refund claim will be automatically extended. A taxpayer may file a Sales or Use Tax refund claim up to six months after the end of the extended assessment period, provided that the refund being claimed resulted from an overpayment(s) made during the period(s) covered by the consent. However, a period for filing a refund claim that has already expired cannot be revived through the execution of a consent form.

When the reviewer reviews the Taxpayer's case history and an open audit exists for the same period, the reviewer will contact the assigned field auditor or field audit supervisor to obtain the completed consent form.

#### **15.6 Verifying Validity of Claim**

The reviewer will examine the taxpayer's explanation of claim to determine whether the grounds for the claim are valid and whether the amount of the claim is supported by the documentation provided. If the reviewer finds that the documentation is not sufficient to support the claim, the reviewer will send a letter via USPS detailing the additional information required to substantiate the claim.

#### **15.7 Denying the Refund**

If the taxpayer does not respond to the reviewer's request for additional documentation within 30 days or if the additional documentation the taxpayer submits does not support the claim for refund, the reviewer may deny the claim and issue a notice of denial.

The notice of denial will be sent by certified mail and will include the reason(s) for the denial as well as information regarding the taxpayer's appeal rights and the steps the taxpayer may take to properly and timely protest or appeal.

#### **15.8 Approving the Refund**

If the reviewer finds that the documentation supports the taxpayer's claim for refund, he/she will approve the refund. Prior to issuing the approved refund, the reviewer will examine the taxpayer's account (again) to determine whether there are any outstanding liabilities.

### **15.9 Taxpayer Has No Outstanding Liabilities**

If the reviewer finds that the taxpayer has no outstanding liabilities, he/she will request a check to be issued.

### **15.10 Taxpayer Has Outstanding Liabilities**

If the taxpayer has outstanding schedule of liability items, and a letter was previously sent notifying the taxpayer of the open items, the approved refund will be offset to the open liabilities.

If the taxpayer has an outstanding schedule of liability items, for which it was not previously notified, the reviewer will send a letter to the taxpayer via USPS indicating that a refund is pending and may be applied to the outstanding liabilities unless the liabilities are resolved within the next 30 days. If the outstanding liabilities are not resolved within 30 days from the date of the letter, any approved refund will be used to satisfy the outstanding liabilities.

Approved refunds are used to satisfy all deficiencies before they are used to satisfy delinquencies and will be applied to the oldest liability first.

### **15.11 Denying in Part/Approving in Part**

If the reviewer determines that only a partial refund should be approved, a letter detailing the approved amount, denied amount, denial reasons and appeal rights will be sent via certified mail to the taxpayer. A check will be issued for the approved portion of the refund claim.

If there are open items on the taxpayer's schedule of liabilities, the procedures in Section 15.10 above "Taxpayer Has Outstanding Liabilities" should be followed.

### **15.12 Paying Interest on Refunds**

Interest shall be allowed and paid on overpayments of tax at a rate determined by the Director to be equal to the prime rate, determined for each month or fraction thereof, compounded annually at the end of each calendar year, from the date that such interest commences to accrue to the date of the refund. Interest shall commence to accrue on the later of the date of the filing by the taxpayer of a claim for refund or requested adjustment, the date of the payment of the tax, or the due date of the report or the return. No interest shall be allowed or paid on an overpayment of less than one dollar; or on an overpayment refunded within six months after the last date prescribed. See N.J.S.A. 54:49-15.1. Interest will not be paid on overpayments where the taxpayer has requested that the overpayment be applied to the following year's tax liability. See N.J.A.C. 18:2-5.9. Interest will not be paid on overpayments for which the taxpayer has agreed in writing to waive its right to interest.

### **15.13 Offsetting an Approved Tax Refund Against a Tax Audit Assessment**

During the course of an audit, the auditor or taxpayer may discover that the taxpayer mistakenly paid or accrued Sales or Use Tax that results in an overpayment. If the taxpayer wants to offset the overpayment against any resulting audit assessment, the taxpayer will sign the Offset Agreement (See Sections 15.14, 15.15 and 15.17 below for additional details) and the taxpayer should provide the auditor with a properly completed Form A-3730, Claim for Refund, before the auditor has completed the field work and within the time allowed by the statute of limitations.

#### **15.14 Refund Claim Received Before Field Work Completed**

The auditor should forward the claim for refund to the Sales Tax Refund Group to set up a Division's case tracking system case and contact the taxpayer regarding an Offset Agreement. The taxpayer may sign an Offset Agreement that authorizes the Division to apply any approved refund against any Sales and Use Tax assessment resulting from the audit and waives any interest that may accrue on the refund claim.

#### **15.15 Taxpayer Signs Offset Agreement**

If the taxpayer signs the Offset Agreement, the Sales Tax Refund Group will assign the Division's case tracking system case to the field auditor, who will then incorporate the review of the claim into the ongoing audit.

#### **15.16 Taxpayer Objects to Signing the Offset Agreement**

If the taxpayer objects to signing the Offset Agreement, the Sales Tax Refund Group or a field auditor will review the refund claim in accordance with the general procedures described above. Any approved refund will not be used to offset any audit assessment.

#### **15.17 Refund Claim Received After Field Work Completed (Or Nearly Completed)**

If the taxpayer provides the refund claim to the field auditor after the field work is complete or nearly complete, the field auditor may accept the refund claim and advise the taxpayer that:

- a. The refund claim will not delay the closing of the audit and the claim ultimately may be processed by field audit as a separate matter from the nearly completed audit; and
- b. Any approved refund may be applied against the tax, penalty and interest assessed, but will not be applied prior to the calculation of penalty and interest to reduce the penalty and interest assessed.

The Sales Tax Refund Group will set up a Division's case tracking system case and then assign it to the field auditor for review.

If the taxpayer insists that the refund claim be reviewed as part of the audit, the field auditor's supervisor may authorize the field auditor to delay the closing of the audit. However, if the closing of the audit is delayed, any audit issues that the auditor previously negotiated with the taxpayer may be reconsidered. The field auditor should forward the refund claim to the Sales Tax Refund Group to set up a Division's case tracking system case and then contact the taxpayer regarding an Offset Agreement.

If the taxpayer signs the Offset Agreement letter then, the approved amount of Sales and Use Tax to be refunded will be offset against the Sales and Use Tax audit assessment prior to computing the penalty & interest on the audit assessment. It should further be noted that if the result of combining the Sales and Use tax assessment and the approved amount of the Sales and Use Tax refund claim results in a net refund, no interest will accrue on the assessment portion, or be paid on the approved net refund.

### **15.18 Refund Requests From Other Areas of the Division**

If an employee in another area of the Division is working on a case that involves a Sales and Use Tax refund (e.g., erroneous SOIL/FOIL payments, approved A-1730 requests, redetermination by the Conference and Appeals Branch), the employee's supervisor should submit a request to the Sales Tax Refund Group to review and process the refund.

## **Chapter 16 Office Audit Branch**

The Office Audit Branch is comprised of eight groups, each of which has a specific responsibility. The primary focus of this Branch is the audit of Corporation Business Tax returns. This Branch also is responsible for:

- Examining taxpayers' records in order to issue tax lien certificates, tax clearance certificates for domestic dissolutions, reinstatements, and foreign reauthorizations;
- Discovering out-of-State entities and determining whether they have unreported New Jersey tax obligations (See Chapter 19);
- Auditing Corporation Business Tax returns (See Chapter 17);
- Auditing amended Corporation Business Tax returns;
- Reviewing and approving Corporation Business Tax refund claims (See Chapter 18); and
- Auditing business taxes other than Corporation Business Tax, sales and use and employer withholding.

### **16.1 Refund and Offset Provisions**

It is important that the auditor require the taxpayer to follow the procedural filing requirements contained in the regulations. Any taxpayer failing to timely file an official claim, either by means of an Amended Return or on New Jersey Form A- 3730, will not receive a refund unless a claim is submitted.

### **16.2 Applications of Overpayments to Prior & Subsequent Years**

Applications of overpayments for prior and subsequent years are to be made in accordance with the governing statutory and regulatory guidelines. In making these applications, no adjustment to any prior billings should be made that have not been protested or appealed. The only exception to this is when the prior billing has been made within the 90 day protest and appeal time frames. In such instances, the auditor may take into consideration the effect of any overpayment applied to that year may have had.

### **16.3 Applied Date to Be Used For Overpayment Within the Same Tax**

Any overpayment discovered during the course of an audit, whether claimed by the taxpayer or discovered by the auditor, is to be applied to the other tax periods. The overpayment will be applied effective as of the later of: the "Original" due date of the return having the overpayment; or the date of actual payment of the tax on the return having the overpayment; or the due date of the first quarterly estimated payment for the return related to the overpayment. This will result in the correct amount of penalty and interest being calculated.

### **16.4 Applied Date for Overpayment**

The applied date for overpayments is stated in N.J.A.C. 18:7-13.8 (Claims for Refunds; when allowed). If more than one tax is being examined by the auditor at the same time, the auditor should only apply the refundable portion of one tax against the other tax at the time of discovery of the refundable amount.

### **16.5 Estimated Tax Assessment**

When an auditor finds it necessary to prepare an estimated tax assessment (ETA), the following procedure is to be used to determine the amounts.

The assessment shall be the higher of:

- \$1,000;
- At least 2 times the estimated underpayment based on items being questioned or absent any information for the audit period; or
- At least 2 times the highest liability of a comparable period within the past five years.

If no information is available, then an estimate may be based on similar businesses or other external indices. All Estimated Tax Assessments should be recorded in the Division's case tracking system.

"Bakerman Agreements" If a taxpayer agrees to waive his/her rights to protest or contest a redetermination in writing, the Division may agree to reopen the audit and take into account additional information. This is solely at the Division's discretion.

### **16.6 Corporation Business Tax**

After the expiration of the statute of limitations for protest and appeal, an Estimated Tax Assessment is as collectible as any other assessment.

### **16.7 Documentation**

All audit procedures and decisions should be recorded in sufficient detail so that another auditor would be able to follow the steps and logic used in completing the audit.

Specifically, documentation is essential to:

- Enable another auditor assuming the case to move easily to complete the audit without undue burden either to himself or the taxpayer;
- Facilitate the audit review minimizing supervisory questions or misinterpretations; and
- Provide for contemporaneous records of taxpayer contacts and audit decisions in the event testimony is required in Tax Court.

Documentation should include all items questioned and the disposition of these items. In some cases, it is necessary to explain why certain areas or issues were not examined. All contacts with the taxpayer are to be recorded, including written, telephone or in-person contacts.

In the case of written contacts, a copy of the letter is sufficient. For verbal contacts, a minimum of the date, type of communication, person contacted and a brief summary of the items discussed is required. All documentation of the contacts is to be maintained as a permanent part of the physical audit file or be scanned into the audit management system.

## **16.8 Audit Discontinued**

After starting an audit, it may become clear that there is little potential for an assessment or refund. Since audit time is a limited resource, it is incumbent upon all personnel to use it in the most effective manner possible. In cases when the potential for adjustment is small, the Division and the public are better served if audit time is spent on an audit with more potential for material tax differences.

With the above premise in mind, if after an auditor's or supervisor's initial review or visit, an audit has a potential for an adjustment (assessment or overpayment) of less than \$1,000, the audit should be discontinued. This does not mean that if errors are discovered clearly revealing an adjustment that they should be ignored. In cases in which errors resulting in an adjustment are noted and the remaining issues in question would generate less than \$1,000, the errors should still be billed or returned. In addition, any determination that would result in a clear adjustment of tax where the amount exceeds \$100 should be assessed or refunded as well.

In general, no underpayment of less than \$100 in any one year except mathematical or underpayment of reported liabilities should be assessed. Finally it should be noted that limited audits, initiated principally for a single issue, should not be viewed as full, comprehensive audits, and does not preclude further Division inquiries. In these cases any determinations made should clearly indicate that the returns involved continue to remain subject to further audit and examination.

## **16.9 Corporate Services "A" Group**

The Corporate Services "A" Group is a service oriented group whose functions are comprised of these three distinct duties:

- Issuance of Tax Clearance Certificates (N.J.S.A. 54:50-15 & 16);
- Issuance of Certificates of Corporate Franchise Tax Lien (N.J.S.A. 54:10A-16 & 29); and
- Release of Liens (N.J.S.A. 54:10A-30).

## **16.10 Tax Clearance Certificates**

The Tax Clearance Certificates issued by the Corporate Services "A" Group are for business entities incorporated in the State of New Jersey or in the case of foreign corporations (non-New Jersey), authorized to do business in the State of New Jersey by the New Jersey Division of Revenue and Enterprises Services, Business Services. These Tax Clearance Certificates are issued primarily for three different objectives.

- Corporate Dissolution/Withdrawal;
- Reauthorization of corporate authority for foreign corporations to do business in New Jersey; and
- Corporate Mergers in which the surviving entity of the merger is not incorporated/authorized in the State of New Jersey.

### **1. Corporate Dissolutions/Withdrawals**

- a. Application Process (Division of Revenue) – New Jersey corporations wishing to withdraw their certificate of authority may file a certificate of dissolution or withdrawal with the New

Jersey Division of Revenue. The Division of Revenue requires taxpayers to obtain a tax clearance certificate from the New Jersey Division of Taxation. The actual dissolution/withdrawal is recorded by the New Jersey Division of Revenue. The tax clearance certificate issued by the New Jersey Division of Taxation is a component of the dissolution/withdrawal process. To start this process, the corporation wishing to dissolve/withdraw may file the following with the New Jersey Division of Revenue:

- i. Application for Tax Clearance Certificate (Form A-5088-TC)
- ii. Certificate of Dissolution (Form C-159D) for New Jersey Corporations, or Certificate of Withdrawal (Form C-124P) for foreign (non-New Jersey) Corporations
- iii. Estimated Summary Tax Return (Form A-5052-TC)
- iv. \$120.00 Fee (\$95.00 Recording fee and \$25.00 Tax Clearance Application Fee)

These documents and payment(s) are to be sent together as a package to the following address:

New Jersey Division of Revenue and Enterprise Services  
PO Box 308  
Trenton, New Jersey 08646  
Attn: Business Liquidations

In the event the taxpayer wishes to expedite the delivery of the package using a courier/delivery service, use the following address:

New Jersey Division of Revenue and Enterprise Services  
33 West State St., 5<sup>th</sup> Floor  
Trenton, New Jersey 08608  
Attn: Business Liquidations

Properly executed applications are processed by the Division of Revenue, provided the corporate charter/authority is in good standing. Otherwise the application(s) is rejected and returned to the taxpayer(s). Any incomplete applications also are returned to taxpayers with reason(s) for rejection. Once the complete dissolution/withdrawal package is received, the corporation is placed into a DPP (Dissolution Procedures Pending) status ending all tax eligibilities pending the issuance of a tax clearance certificate by the Division of Taxation. Applications for tax clearance certificates and Estimated Summary Tax Return along with any tax payments are forwarded to the New Jersey Division of Revenue via courier on a daily basis.

The Division of Revenue has also introduced online dissolution/withdrawal service. Corporate entities wishing to dissolve/withdraw may visit <http://www.nj.gov/njbgs> and electronically file a Certificate of Dissolution (C-159D) or withdrawal (C-142P) and pay a \$95.00 filing fee. The application for tax clearance certificate and \$25.00 application fee are to be forwarded separately to the Division of Taxation.

- b. Application Process (Division of Taxation) – Upon receipt of the application for tax clearance certificate and Form A-5052-TC along with other documents from the Division of Revenue or from the taxpayer (if online dissolution service is used), the support staff of the Corporate Services Audit Group “A” of the Office Audit Branch, Division of Taxation collates the applications, logs them in, assigns application numbers (DPP#), compiles a folder file and

applies any tax payments. A Bill of Rights response letter is also initiated at this point. The folders are then filed away in numerical order by the DPP number.

- c. Audit Process – These files are screened on a daily basis and then assigned to the auditors in the group on weekly/bi-weekly basis in the order they are received and commensurate with the experience/expertise of each auditor.

Due to the amount of the workload/backlog, a full audit is not completed. However, each and every file may still be reviewed by an auditor to ensure that all taxes are paid up to the date of dissolution and that any potential gain from the sale of any appreciable corporate assets is properly recorded and reflected on the New Jersey Corporation Business Tax Return (CBT-100) in the taxable year of the sale of these assets. The audit staff may request a copy/copies of the Federal 1120 return(s) and/or copy/copies of the Federal Form 4797 to verify that any gains from the sale of assets have been properly reported. Any installment sale gain may be reported on the final return. Upon the assignment of the files, the auditor reviews all the open cases in the Division's case tracking system. If the corporation has any open Field-Audit, Regular-Audit, or Conference and Appeals cases, the Dissolution/Withdrawal case is held in abeyance, pending the completion of the Audit/Conference case.

Correspondence is sent to the taxpayer/agent as per the address on the application to obtain any delinquent tax returns, to request additional information to substantiate data reported on any tax returns under audit, on the application for tax clearance certificate, and/or the estimated summary tax return. Any deficiencies indicated by the Division's taxpayer accounting system and/or case tracking system, along with any unpaid tax/minimum tax for the final period reflected on the estimated summary tax return, are requested by using the Division's case tracking system notification General Check-Off letter (C-28H) along with a schedule of liabilities (if any). Any returns received by the auditor are forwarded to the Division of Revenue for processing and any payments collected are processed.

If the taxpayer has not complied with the auditor's request in the General Check-Off letter within 30-45 days, the auditor cancels the application, and closes the case. If there are any open deficiency/delinquency items in the auditor's case, the auditor closes these case items to the Division's Special Procedures Branch/Judgment Group for further action. If a follow-up letter to the taxpayer is needed, the auditor may use the additional information letter (A-17H) or if a customized notification is needed, the handwritten letter (C-00H) may also be used. Any assessments/collections are recorded on the auditor's weekly report along with the number of assessments, case completions, and certificates issued.

Once it has been determined that all required tax returns have been filed and all taxes have been paid/provided for, the auditor authorizes and issues the Tax Clearance Certificate (601-H) and cover letter (321-H) using the Division's case tracking system. If a final return is required, the auditor issuing the clearance will indicate this on the tax clearance cover letter. The original Tax Clearance Certificate is sent directly to the Division of Revenue via courier, and a copy to the taxpayer or his/her authorized agent. Once the Division of Revenue receives the original Tax Clearance Certificate from the Division of Taxation, the dissolution/withdrawal is officially recorded and noted on the Division of Revenue's computer system and a confirmation certificate (Certificate Relative to Dissolution/Withdrawal) is issued and mailed directly to the taxpayer.

After the Tax Clearance Certificate has been issued, the auditor closes the case and prepares the file folder to be sent to the Division of Taxation's Records Unit for refiling. If the case was closed due to non-compliance, the application is cancelled and the file is imaged. A memorandum is sent to the Division of Revenue to reverse the pending dissolution status and activate all tax eligibilities.

## 2. Corporate Reauthorizations (Non-New Jersey Entities)

- a. Annual Report Reauthorization – All corporate entities incorporated or authorized to do business in New Jersey are required to pay an annual report fee on-line directly to the New Jersey Division of Revenue. If for two (2) consecutive years annual report fees are not paid, the Division of Revenue will void the corporate charter of a domestic corporation and revoke the corporate authority of a foreign (non-New Jersey) corporation. If the corporation wishes to continue business in New Jersey, the corporate charter/authority must be reinstated/reauthorized.

To do so, corporate entities must file on-line annual reports and pay all outstanding fees including reinstatement/reauthorization fees to the New Jersey Division of Revenue. Once annual reports are filed, the corporation is placed into a RPP (reinstatement/reauthorization procedures pending) status subject to the issuance of a tax clearance certificate by the Division of Taxation.

For foreign corporations, this function is the responsibility of Corporate Services Audit Group "A". After the corporation has completed the on-line registration and has been placed into a RPP (reinstatement/reauthorization procedures pending) status, an Application for Tax Clearance Certificate (Form A-5088-TC) must be completed and submitted directly to the New Jersey Division of Taxation, to the attention of the Corporate Services Audit Group "A" along with the \$25 application fee separate from any other fees already paid to the New Jersey Division of Revenue. The application is processed by the support staff in the Division of Taxation's case tracking system and an application number is assigned and stamped on the application. These reauthorization cases are stored in a separate area from the dissolution/withdrawal files and are assigned on a priority basis within a two week time frame.

The examination process is different from a dissolving corporation in that an Estimated Summary tax return or final return is not required as the corporation is an on-going entity. Also, the cases are not held in abeyance if an Office/Field Audit is in process. Upon the assignment of the files, the auditor verifies that all required returns have been timely filed and paid using the Division's taxpayer accounting system and Division's case tracking system. The same notifications and schedules used in the dissolution/withdrawal process also are used during the reauthorization process. Once it is determined that all delinquencies/deficiencies are resolved, the auditor authorizes and issues the Tax Clearance Certificate (601-H) with a cover letter (560-H) from the Division's case tracking system. These Tax Clearance Certificates also are delivered directly to the Division of Revenue on a daily basis via courier. Upon receipt, the Division of Revenue files the original Tax Clearance Certificate and the reauthorization is officially recorded and noted on the Division of Revenue's computer system. A confirmation is issued directly to the taxpayer.

If the taxpayer has not complied with the auditor's request in the General Check-Off letter within 30-45 days, the auditor cancels the application, and closes the case. The corporate authority remains revoked in a RPP status.

- b. Revocation Due to Tax Delinquency & Reauthorization – Prior to December 31, 1994, the Division of Taxation prepared annually delinquent taxpayers reports and forwarded those to the Division of Revenue for voidance of charter of domestic corporations or revocation of certificate of authority of foreign corporations. Occasionally an application for Tax Clearance Certificate to be used in reauthorization proceedings would be received from one of those foreign entities whose certificate of authority was revoked due to non-filing of tax returns and nonpayment of taxes. Once it has been determined that all returns have been filed and all taxes have been paid/provided for, the auditor authorizes and issues the Tax Clearance Certificate in the same manner as above except the cover letter indicates a \$145.00 fee to record the reauthorization. This cover letter and Tax Clearance Certificate are issued directly to the taxpayer. The taxpayer is required to file the original Tax Clearance Certificate along with recording fees, a completed application for certificate of authority and a good standing certificate from the taxpayer's home state directly to the Division of Revenue to finalize the reauthorization. At this point, the auditor may close the case in the same manner as above. Non-compliant taxpayer cases are closed in the same manner.
- c. Corporate Mergers - When two or more corporations wish to record a corporate merger with the State of New Jersey, and the surviving entity of the merger is a non-authorized foreign corporation, then in order to record this merger with the State of New Jersey, Tax Clearance Certificates are required for each entity involved in the merger. To initiate this process, the taxpayer may submit the Application for Tax Clearance Certificate and \$25 application fee for each entity that is part of the merger, including the non-authorized survivor, directly to the New Jersey Division of Taxation. Application processing is the same as above. Since there is no corporate profile for the non-authorized survivor corporation, a Division case tracking system case is created only for the merging entity, and a note is left on the system indicating that the case is for a corporate merger and both application numbers are noted on the system. Non-authorized entities involved in a merger, including the survivor, are required to submit prior years' activity affidavits.

Case assignment and the audit process are the same as above. Upon assignment of the case, the auditor reviews all the open cases in the Division's case tracking system. If the corporation has any open Field-Audit, Regular-Audit, or Conference & Appeal cases, the merger case is held in abeyance, pending the completion of the Audit/Conference case.

Once it is determined that all required returns have been timely filed and paid, the auditor issues Tax Clearance Certificates to all entities incorporated or authorized to do business in New Jersey involved in the merger. Non-authorized entities including the survivor are issued Certificates of Non-Assessment (Division's case tracking system notification 610H). Correspondence is sent to the taxpayer/agent at the address on the application. It is noted on the cover letter that the taxpayer is required to submit both Certificates, the recording fee (\$115.00 for a 2 company merger & \$20.00 for each additional entity that is part of merger), and the merger documents directly to the New Jersey Division of Revenue. Once the Division of Revenue receives these merger documents and the recording fee from the taxpayer, the merger

is officially recorded and noted on the Division of Revenue's computer system and confirmation is issued directly to the taxpayer. The case is closed in the same manner as above.

Note: If the surviving entity is a New Jersey corporation or a foreign corporation authorized to do business in New Jersey, merger documents should be filed with the New Jersey Division of Revenue without a Tax Clearance Certificate.

3. Corporation Franchise Tax Lien (Status) – Certificates of Corporate Franchise Tax provides title companies and other applicants with advice as to the amount of Corporation Business Tax due which is a lien against corporate property and franchise.

N.J.S.A. 54:10A-29 provides that "Upon ... written application ... the Director shall issue ... a certificate ... that there are no liens in favor of the State ... or that there are such liens ... or such other status as the Director's records may disclose." The lien is imposed on the corporation's property as of January 1<sup>st</sup> of the year following the year in which the tax return was due. The tax status and lien concern only the Corporation Business Tax.

To request the status of a corporation, the applicant may file an Application for Certificate of Tax Lien Search (Form CS-152R) and pay the required \$25 application fee. The application requires the applicant's name and address, the corporation's name, incorporation date, if known, and the purpose of the application, such as the sale of real property, mortgage acquisition, financial closing, or general information.

The applications and the checks are numbered and then the remittances are sent to the Division of Revenue for deposit.

A support staff member enters the corporation's Federal Identification Number or Corporation Business Tax number on the HLLAPI (VB) computer software program, which interfaces with the Division's TaxNet system, creates a case in the Division's case tracking system and screens the taxpayer's filing records for Corporation Business Tax in the Division's taxpayer accounting system to determine any delinquencies, deficiencies or discrepancies. If none is found, the HLLAPI approves the certificate which is sent for typing. The original is mailed to the applicant and the copy is attached to the application and is used for closing the Division's case tracking system case item and then returned to the Records Unit. Cases rejected by HLLAPI are assigned to the auditors who review the taxpayer's account to determine the validity of the discrepancies, make the correct determination, and adjust the account if warranted. The delinquencies/deficiencies are noted on the application worksheet and sent for typing. This information is transcribed on the certificates indicating that liens exist.

In some instances, files may also be assigned for audit. The auditor will examine the returns and correspond with the taxpayer to resolve any audit issues, issue determinations and process any payments when received.

4. Release of Lien – In those instances when a clear certificate of corporate franchise tax lien cannot be obtained, a taxpayer can file for a release of lien. To initiate this, an Application for Release of Lien (Form #9533) is file, along with the required \$5 check made payable to the State of New Jersey. The application is accompanied by a Rider outlining the description of the property along with any deeds showing the consideration paid. This fee is recorded in the Corporate Services Audit Group "A"

record book, assigned a Release Lien number (R/L #) which is then noted on the Release of Lien application and on the \$5 check. The payment is sent to the Division of Revenue along with the other fees from the Certificate of Tax Lien Search requests.

It is important to note that the applicant seeking the release may not be an interested party in the corporation.

The release is issued on behalf of the Regulatory Services Group of the Division of Taxation. Upon receipt and processing of the application for a release of lien, the auditor determines an appropriate fee based on the review of whatever corporate records are available. The Office Audit Chief reviews the documentation and if approved, a letter requesting payment is sent to the applicant. When payment is received, the Release of Lien Certificate is processed under the Seal of the Director of the Division of Taxation. Such payment is a fee for consideration of release of lien against the property and may not be construed as payment of tax.

5. Other – When a corporation is attempting the dissolution/withdrawal process and is initially filing the required documents, occasionally the estimated summary tax return has not been completed, but the corporation wishes to expedite the issuance of the Tax Clearance Certificate. The tax clearance can be expedited, provided that the corporation’s Application for Tax Clearance Certificate is submitted with an Assumption of Tax Liability for all taxes due and executed by a domestic corporation or a foreign corporation authorized to do business in New Jersey that meets one or more of the following requirements:
  - a. A corporation owns 50% or more of the applicant’s outstanding shares of capital stock; or
  - b. A corporation has purchased or is about to purchase all, or substantially all, of the assets of the applicant.

Note: The assumption of liability by a corporation qualifying under (a) or (b) above may be accompanied by an opinion by an attorney-at-law of the State of New Jersey, who states that he/she is familiar with the facts of the transaction and that the requirements for such exception have been met; or, in the case of a corporation that now has a net worth not less than ten times the amount of all taxes paid by the applicant corporation during the last complete year in which it filed tax returns with the State of New Jersey, such assuming corporation may attach to the assumption a balance sheet as of the end of its last accounting period together with a notarized statement that there has been no subsequent decrease in the assuming corporation’s net worth.

Once the auditor/supervisor approves the Assumption of Tax Liability, the auditor issues the usual Tax Clearance Certificate and the cover letter requesting the final return. It is important to note that the auditor will keep the case open until the final CBT-100 is received and the tax liability is paid. At this point, the auditor may close the case. Any assessments/collections are recorded on the auditor’s weekly report along with the number of assessments, case completions, and certificates issued. After the case has been closed and the Tax Clearance Certificate has been issued, the auditor prepares the file folder to be re-filed to the Division’s file storage area. If the final CBT-100 has not been filed and the tax liability remains unpaid, the auditor will pursue the filing of this return with the assuming corporation listed in the Assumption of Tax Liability. The auditor along with the group supervisor are to take whatever steps necessary to ensure the filing of the final CBT-100 and the payment of the tax liability. Once the final return has been filed and payment has been made, the

auditor can start the audit process and once completed, close the case and re-file the folder to the file storage area.

Any of the above functions can be inquired about directly with the Corporate Services Audit Group "A" and questions can be directed at (609) 292-5323 or by mail at:

New Jersey Division of Taxation  
Corporate Services Audit Group "A"  
50 Barrack Street – P.O. Box 277  
Trenton, New Jersey 08695-0277

Most of the required forms and additional information can be found at:

<http://www.state.nj.us/treasury/taxation/>

### **16.11 Corporate Services "B" Group**

The Corporate Services "B" Group is a service oriented group whose functions are comprised of two distinct types of audit cases for the reinstatements of charter. These cases are based on the type of voidances involved. The memoranda generated to secure these two different types of voidances and steps of completion also differ.

Voidances prior to and including July 30, 1993 were executed by the Division for failure to stay current on Corporation Business Tax filings. Those are classified as VPC (Void by Proclamation).

Voidances as far back as December 30, 1993, can be attributed to failure to stay current on CARs (Corporate Annual Reports). These corporations are classified as DRV (Domestic Revocation Voidance).

#### **1. Tax Clearance Memos and Letters**

The following memos and letters are related to VPC cases, and are sent in two installments to the taxpayer regarding the process of obtaining the approval for reinstatement:

- a. The R9338 "Reinstatement Fee Letter" (which explains the required, certified funds fee of \$95);
- b. The 651H "Revised Instruction for Petition" (instructions for filling out the individual lines and sections of the petition, and what is and is not applicable to the specific corporation based on its formation), and the letter in "a" above, both go to the taxpayer along with the "Petition for the Reinstatement of Franchise of a Corporation of the State of New Jersey." This Petition is four pages long, and should have affixed the stamps of a notary public, as well as the corporate seal. A letter of attestation to the Treasurer is also required;
- c. The 251H "Division of Revenue Certification Memo" is sent in duplicate via interoffice with the petition and check to a Deputy Attorney General in the Division of Law and Public Safety for processing and examination, before forwarding acknowledgement of receipt to the Division of Revenue, Commercial Recording; and

- d. The 220H “Authority to Resume Letter”, is sent to the taxpayer or taxpayer representative, and provides evidence that transactions can now be generated in good faith with corporate protections intact, even though official active status may not yet have been granted by the Division of Revenue.

The following documents are related to the DRV cases for reinstatement, and are sent to the taxpayer in a single installment:

- a. The TU-38A “Division of Revenue Certification Memo” informs the taxpayer or its representative that an interoffice memorandum was sent to the Division of Revenue stating that all subjectivities are current and complete, filed and paid in full (at the same time subject to further audit and adjustment of liability); and
- b. The 560H “TC Certificate Delivered Letter” informs the taxpayer or its representative that the TU-38A memo was forwarded to the Division of Revenue, and directs the taxpayer to finalize annual report obligations with Commercial Recording within Division of Revenue, including verification of all CARs (Corporate Annual Report) filed and paid through current time. The taxpayer can also inquire as to the timing of the actual reactivation of the charter and receipt of written acknowledgement of reinstatement by the Division of Revenue. This is often required by third parties involved in closings, sales of assets, securing of lines of credit, etc.

## 2. VPC for Corporation Business Taxes

The point of voidance will show in Commercial Recording records as VPC (Void by Proclamation). The last date for Void by Proclamation for domestic New Jersey corporations was July 30, 1993.

The information is first scanned in the C-9021 (Application for Reinstatement of Corporate Charter). Once determining in Commercial Recording records the point of suspension in the Amendments section, we can determine which years Corporation Business Tax were the cause of the voidance, and therefore the likely targets for an information request. Those periods are examined to see if those returns were filed and/or paid.

Tax periods that are not satisfied in Division records would be added to the list of outstanding items listed in the Schedule of Liabilities, or shown as gaps in tax filings for periods covered in the Division’s taxpayer accounting system (1988 to present). For periods prior to 1988, the Division can accept a statement of receipts, income and assets (in place of CBT-100 returns).

The Schedule of Liabilities is included in the 240H letter (Initial Request for Returns letter). Once the returns and payments are reasonably satisfied and in place, the memoranda outlined above for the two rounds of issuances involving mailings to the taxpayer, Division of Revenue and Division of Law and Public Safety are sent. Once the returns are in place, there may be a need for assessment. This list of taxes, penalties and interest is covered in the R-9338 Reinstatement Fee letter, which can be used for VPC tax assessments.

If there is no outstanding judgment filed against the corporation, and the corporation requests a reduction of penalties, as well as interest on penalties, a written request can be made. For years prior to 1988, all of the penalty and half of the interest can be abated. For all years 1988 and after,

abatements can be considered on tax penalties and interest on penalties. If the request is accepted, an amended assessment can be tentatively put forward. This request would be sent out on an Abatement Accepted letter. This letter would show items separated out by tax, penalty and interest balances, with a subtracted proposed "abatement" leaving a final assessment.

If the taxpayer decides that this proposed assessment is unacceptable, the taxpayer can pursue an appeal with the Conference and Appeals Branch.

The first round of approval notifications involves the R-9338 (Reinstatement fee letter) and the 651H (Revised Instruction for Petition).

Once the Petition has been completed and forwarded back to the Division with the certified payment, the payment and petition are sent to the Attorney General's Office along with the 251H Division of Revenue Certification memo (two copies), and the 220H Authority to Resume letter is issued to the taxpayer. A Deputy Attorney General will notify the Division of Revenue as to the approval of the reinstatement. This would complete the Reinstatement process.

### 3. Void in Error Determination

If there is evidence in the Division records showing that CBT-100 returns for the proper range of periods responsible for the avoidance have been satisfied, the TU-38B Void in Error Certification Memo is issued. This document is forwarded interoffice to the Division of Revenue. The C40H Void in Error letter is issued to the taxpayer (representative).

### 4. DRV (Void due to being Delinquent for Annual Reports) – Effective December 31, 1993

Once the delinquency has been confirmed in the amendments section of Commercial Recording, the Division's taxpayer accounting system and the Schedule of Liabilities are examined. Gaps in filings are added to requirements listed in Taxpayer Schedule of Liabilities. Sometimes there are errors in the Schedule in the form of gaps in the recorded filings. These gaps may be filled. In the TU-38A certification memorandum, the Division is certifying to Division of Revenue that the tax subjectivities of the corporation are current, complete and paid in full (subject to later audit and adjustment of liability).

The taxpayer is notified using either the 240-H Initial Request for Returns or 242H Initial Request for returns letter when there are delinquencies outstanding for Corporation Business Tax, Sales and Use, Gross Income Tax/Withholdings or other relevant subjectivities. If all returns appear to be in place but an assessment needs to be sent or reiterated, the A-67H Assessment letter is sent. Depending on the problem or item preventing issuance of approval memos, a C00H Handwritten letter may be sent.

### 5. Procedures and Functions

Assignment of Cases: This occurs on a regular basis with the auditing staff.

All files are examined by members of audit staff and reviews of filings and payments are completed.

If there is a concurrent field or office audit case, we may not hold the reinstatement case in abeyance. In some instances, we may allow field or regular audit to come to a purely tentative determination on assessment for reinstatement purposes that they will be free to amend later on.

If the taxpayer does not respond and/or comply with initial or subsequent information requests involving missing returns or payments, in approximately thirty-five days, after the unanswered request, a follow-up letter (304-H) is sent. It is mailed along with a copy of the most recent letter.

If there is no response over the next thirty days, the case is closed for lack of compliance. If there are deficiencies or delinquencies in the auditor's case, it would be closed to COD-Judgments. If the taxpayer requested a deferred payment plan, the case might be closed to Deferred Payments. If the taxpayer decides to pursue the right of appeal, the case and file may be closed to the Conference and Appeals Branch.

If a taxpayer later seeks to reopen a closed case (due to non-compliance), the auditor can recreate the case with assistance of the taxpayer. The auditor may also be able to retrieve hardcopy cases from Judgments or other areas, including Deferred Payments or Conference and Appeals.

Imaging of Files – More complex files, some involving letters issued outside the Division's case tracking system, may be submitted for imaging for later retrieval.

Fees – \$95.00 is the basic reinstatement fee, plus \$50.00 Corporate Annual Report per year on and after 2002; \$40.00 per year for years 1995 to 2001; \$20.00 for years 1988 to 1994; and \$15.00 for years prior to 1988. There is an additional fee of \$10.00 for expedited reinstatement imposed by Revenue.

Reinstatement Memoranda – These memoranda are delivered to Commercial Recording on a daily basis for DRV memos. There is another envelope for delivery of VPC memos.

Schedule of Liability – Generally most tax subjectivities will show up on the Schedule of Liabilities. An exception is litter tax, which would have to be checked independently in the Division's taxpayer accounting system.

Bankruptcy Cases – For reinstatement cases for corporations in bankruptcy, auditors should ask the Supervisor to contact the Bankruptcy supervisor and ask the case status. In some scenarios, there will be delinquencies and/or deficiencies present. Nevertheless, reinstatements required by a bankruptcy court will be issued to tax clearance towards reinstatement.

## 6. Conflicts in Records

When the records of the Division of Revenue are materially at variance with Taxation's records (such as Client Registration) or Taxation records are internally in conflict between groups, the Auditor should research the statute regarding that particular issue and obtain supervisory or management advice.

## 7. Determining Tax Liability of an Audit Item

Proper amount of an audit item is the correct tax, penalty and interest for a return.

## 8. Determining Tax Liability of GIT/ER Audit Item

Corporate Services B creates two audit items:

- One audit item will have figures for Total UI, WF & HC tax that ultimately will be claimed by the Department of Labor and Workforce Development and that will show no penalty and interest. The Department of Labor will make its own determination regarding those charges; and
- The second audit item covering the same period will apply penalty and interest to Gross Income Tax withheld, an amount which will be held by Taxation.

## 9. Expediting Reinstatement Cases

To expedite a reinstatement case, Corporate Services B will compose the necessary list of outstanding returns or list of assessment items if all returns are filed. Before actually composing the letter, Corporate Services B will strive to contact the taxpayer (representative) as quickly as possible and provide the information required verbally. Corporate Services B may then compose the letter and do the subsequent mailing. Corporate Services B may also fax and/or email scans of the letter to the taxpayer.

## 10. Liquor License Cases

The above procedures for expediting completion of requirements for tax clearance issuance can be applied to corporations whose liquor licenses are affected. However, there is no expediting of approval issuances as described below. The name of the corporation and the taxpayer EIN are placed on the Liquor License list that goes to the Alcohol Beverage Control Group of Taxation. Approval issuances are processed under normal procedure (unless specifically requested or warranted).

## 11. Expediting Approval Issuance

Corporate Services B will draft the approval memo outside the manual letter and fax (with cover notice) e-mail it to the attention of Division of Revenue along with the taxpayer (representative) fax number.

## 12. Cancelling of Cases

After 30 days without a response, a follow-up letter is generally sent reminding the taxpayer of earlier correspondence and setting a new deadline for taxpayer response. After 14 more days, the case is closed with no clearance approved. It can either be closed for noncompliance or it can be closed and referred to COD-Judgments when delinquencies or deficiencies exist in the case.

## 13. Interaction with Other Audit Groups

As some accounts will have been audited by other audit groups, the Division consults internally, if other groups have made adjustments or determinations regarding taxpayer records. These adjustments or determinations affect the requirements the reinstatement group may impose on

taxpayer corporations. The other audit groups serve as sources of information for Corporate Services B. Corporate Services B likewise serves as a source of information for other audit groups.

### **16.12 Special Audit Group**

The Special Audit Group of the Office Audit Branch examines IRS Revenue Agent Reports and amended Corporation Business Tax returns; audits banking and financial business corporation returns; examines and reconciles returns filed for the Insurance Premiums Tax (including the Retaliatory Tax, Ocean Marine Tax, Surplus Lines Tax and Risk Retention Group Tax) and Sanitary Landfill Tax; and examines applications to participate in the Technology Business Tax Certificate Transfer program.

### **16.13 Processing IRS Revenue Agent Reports (RAR) and Related Amended Returns**

The Special Audit Group receives and reviews information regarding Revenue Agent Reports issued to New Jersey taxpayers. In addition, this Group reviews amended returns filed by taxpayers reporting any change or correction made by the IRS to Federal taxable income (Line 28).

When the Special Audit Group receives Revenue Agent Reports information or amended returns filed by taxpayers reporting a change or correction made by the IRS to Federal taxable income, technical staff creates a case for each taxpayer in the Division's case tracking system and processes any included payments. The technical staff divides the cases into refunds and assessments, and the cases are stored accordingly. Priority is given to refund cases to avoid or minimize the amount of interest paid should the refund request become interest bearing.

Appropriate cases are assigned to auditors.

### **16.14 Checking for Open Audits**

Upon receiving a Revenue Agent Reports case, the auditor may check for any open assigned office audits or field audits of the taxpayer that include the audit period(s) covered by the Revenue Agent Reports. If the auditor finds an open audit case, he/she notifies the auditor assigned to the open case about the Revenue Agent Reports. The assigned auditor will either agree to include the Revenue Agent Reports information in his/her audit or agree to have Special Audit conduct the Revenue Agent Reports examination. If the assigned auditor agrees to include the Revenue Agent Reports information in the open audit, the Special Audit case will be closed in the Division's case tracking system and the documentation is forwarded to the assigned auditor.

### **16.15 Examining Revenue Agent Reports Information/Amended Returns**

If the Revenue Agent Report examination remains with Special Audit, the auditor may check for and review any previous audit adjustments. The auditor may check the Division's case tracking system for:

- Any prior audit cases for the taxpayer;
- Any previously submitted amended returns; and
- Any Revenue Agent Reports adjustment cases.

Any previous adjustments may impact the current years that are reporting Revenue Agent Reports adjustments and would be incorporated into the taxpayer's schedule.

The auditor will also review the information obtained to determine if the previous adjustments have an impact on the current case.

#### **16.16 Amended Return Filed as a Result of Revenue Agent Reports**

If a taxpayer files an amended return as a result of the Revenue Agent Reports, the auditor may compare the taxpayer's amended return to the original return to determine the changes the taxpayer made both above and below Line 28. If the taxpayer did not file an amended return as a result of the Revenue Agent Reports, the auditor will need to determine the changes to the Corporation Business Tax return from the federal documents provided by the taxpayer when the change was reported.

The auditor must review the amended return and all documentation submitted to verify that the taxpayer made the proper adjustments required by the Revenue Agent Reports as well as any changes that go beyond the scope of the Revenue Agent Reports. If the taxpayer did not include all documentation necessary to support the adjustments made on the amended return (e.g. Form 4549 and 4549-B), which detail the adjustments made to all the potential taxpayers, the auditor may request same from the taxpayer. If the auditor determines that the taxpayer made adjustments not warranted by the Revenue Agent Reports or failed to make adjustments required as a result of the Revenue Agent Reports, the auditor will adjust the return as appropriate.

#### **16.17 Net Operating Losses**

The auditor should review any net operating losses the taxpayer claimed on the amended return. That review may extend to any prior audits or other returns that may have affected the net operating losses amount the taxpayer reported on the amended return. In addition, the auditor may verify that the taxpayer properly calculated the net operating losses in each year claimed. The auditor may also determine whether the Revenue Agent Reports adjustment affects the net operating losses the taxpayer claimed on returns filed for subsequent years and make any necessary adjustments. The auditor needs to be mindful of the potential impact of the 2002 through 2005 net operating losses carry-forward limitations.

#### **16.18 Allocation Factor**

Changes to the allocation factor are not permitted beyond the four-year statute of limitations. If the taxpayer made any changes to the allocation factor on the amended return, the auditor may determine whether those changes were made within the statute of limitations and whether the change is justified by the information the taxpayer provided.

#### **16.19 Tax Credits**

The auditor may review any tax credits the taxpayer claimed on the amended return. That review may extend to any prior audits or other returns that may have affected the amount of the tax credit the taxpayer claimed on the amended return. In addition, the auditor may verify that the taxpayer properly calculated the tax credit in each year claimed. The auditor may also determine whether the Revenue Agent Reports adjustment affects the credit the taxpayer claimed on returns filed for subsequent years and make any necessary adjustments.

### **16.20 Worksheets**

The auditor may prepare worksheets that detail all adjustments he/she makes to the taxpayer's income, net operating losses, tax credits, and/or allocation factor, and any resulting assessment, penalties, and interest. The auditor should include schedules that show adjustments made to net operating losses and tax credits in subsequent tax years, and an explanation of all changes made (with appropriate statutory citations).

### **16.21 Assessments**

If the Revenue Agent Reports examination results in an underpayment, the auditor updates the Division's case tracking system, and prepares a Notice of Assessment; however, no assessment of additional tax may be made beyond the four-year statute of limitations. The Notice is sent by certified mail, along with worksheets detailing the adjustments to the account and explanations for the adjustments.

If the taxpayer fails to respond after 30 days, interest will be updated and a DEMAND letter will be sent via certified mail. If the taxpayer does not respond after 60 days, the interest will be updated again and the case transferred to the Judgments Group for further collection action. When the taxpayer pays a Notice of Assessment, the check is processed, adjustments are made in the Division's taxpayer accounting system, and the Division's case tracking system case is updated and closed.

### **16.22 Refunds and Credits**

If the Revenue Agent Reports examination results in an overpayment, the auditor must confirm the date on which the Revenue Agent Reports were finalized by the IRS. If the Division was notified of the changes within statute, the auditor may approve the refund. However, the auditor must first determine whether the corporation is in good standing and if other liabilities exist. If the taxpayer is not in good standing, the auditor must notify the taxpayer that the refund is being held pending the taxpayer's reinstatement. If other liabilities exist, these liabilities should be verified and offset against the refund.

If the refund is not sent out within 6 months of the date the claim was received by the Division, interest will be calculated and paid.

### **16.23 Banking & Financial Corporations (BF-CBT) CBT-BK and CBT-FN Eligibility**

When examining Banking and Financial Corporations the first step is to determine if the taxpayer qualifies to file returns for CBT-BK and CBT-FN. Eligibility will be adjusted in the Division's Taxpayer Registration files accordingly.

BFC-1 returns for Banking and Financial institutions with or without payment are filed with the Division of Revenue for processing. The return information and payments are processed and entered into the Cash Receipts Accounting System. Following processing, the BFC-1 returns are then forwarded to the Division of Taxation, Special Audit Group for review and storage.

Once received by this Group, all returns are added as a Division's case tracking system case item in either an existing case or a new case that is created. The creation of the case item is done to reflect the

filing of a return by the taxpayer and that a return is available for audit if so chosen. These case items remain unassigned and are part of the Special Audit backlog until chosen for Audit.

The information processed into CRAS (Cash Receipts Accounting System) by the Division of Revenue and Enterprise Services is reviewed for accuracy by comparing the information per the return to the information in CRAS, and adjustments are made to correct any processing errors. The payments/credits claimed on the return are reconciled with the payments/credits as shown in CRAS as actually being made.

Any deficiencies and/or penalty and interest issues are addressed with the taxpayer. Notices are sent explaining the amount due and requesting payment for balance due. A separate case is created for CBT-BK returns to handle the deficient items for tax, penalty and/or interest. Refunds/credits are processed and any discrepancies are addressed with the taxpayer.

Amended returns either initiated by the taxpayer or for the purpose of reporting adjustments made by the Internal Revenue Service are received by the Special Audit Group. A case is then created in the Division's case tracking system and assigned to an auditor who works on the BFC-1 returns for banking or financial institutions respectively.

All paper copies of the BFC-1 returns are stored within the Special Audit Group for convenient access.

#### **16.24 Insurance Premiums, Retaliatory, Ocean Marine and Risk Retention Taxes**

Insurance Premiums Tax is the largest of the above listed taxes and is administered in collaboration with the Department of Banking and Insurance (DOBI).

Insurance Premiums Tax returns are filed directly with the New Jersey Division of Taxation and processed by the Division of Revenue. At the time of filing of the original return, a copy is also filed with the Department of Banking and Insurance. Once the returns are processed by the Division of Revenue, they are then forwarded to the Division of Taxation, Special Audit Group, for review and storage.

The information processed into the taxpayer accounting system by the Division of Revenue is reviewed for accuracy by comparing the information per the return to the information in the Division of Revenue's taxpayer accounting system and adjustments are made to correct any processing errors. The payments/credits claimed on the return are reconciled with the payments/credits as shown in the taxpayer accounting system as actually being made. Any deficiencies for tax, penalties and/or interest are billed through the taxpayer accounting system showing the amount due. Any overpayments are reviewed for accuracy and refunded accordingly.

After the accounts have been balanced, the prepayments due by June 1<sup>st</sup> are billed in early May.

Amended returns are received by the Special Audit Group, reviewed, and processed according to whether the amended returns show a balance due or request an overpayment. Once completed, the amended returns are maintained within the Special Audit Group.

Audits are considered if issues are noticed during the review of the return when reconciling with Division's taxpayer accounting system or audits are initiated per advice from the Department of Banking

and Insurance. Once a taxpayer's return is identified as a candidate for audit, it is then assigned to an Auditor.

Risk Retention returns are received by this Group with data entry into the CRAS system. Payments for Risk Retention are processed by the Division of Revenue. Ocean Marine returns and collections are reviewed for accuracy and stored within the Special Audit Group.

#### **16.25 Auditing Sanitary Landfill Tax Returns**

Returns, and any payments, for Sanitary Landfill Tax are sent to the Division of Revenue for processing. Once the processing of the returns is completed by the Division of Revenue, the paper returns are forwarded to the Special Audit Group for review and storage.

The return information is not accessible through a mainframe system. However, the paper return is reviewed for correctness and any discovered issues are addressed with the taxpayer. This tax is based on the amount of waste accepted per each landfill, verified by the Department of Environmental Protection for accuracy.

Payments/credits shown as received by the Division are reconciled against the payments/credits claimed on the return. Any deficiencies are addressed with the taxpayer.

The paper filed returns are stored within the Special Audit Group.

#### **16.26 Reviewing for the Tax Benefit Transfer Program**

The originally filed returns must be filed by June 30<sup>th</sup> with the New Jersey Division of Taxation to be considered for the current year's Tax Benefit Transfer Program.

Applications to participate in the program are made to the New Jersey Economic Development Authority. The New Jersey Economic Development Authority provides the Special Audit Group with a list of applicants and copies of the applicant information. The Special Audit Group creates a case in the Division's case tracking system for each taxpayer and assigns the cases to an auditor for review.

The auditor reviews the return and verifies the amount of Net Operating Losses and/or Research & Development Tax Credits available to be sold. Once the amounts are verified, a confirmation letter is sent to the taxpayer confirming the amounts available for sale.

After the review is completed and the confirmation letter sent to the taxpayer, any original returns received by the Special Audit Group are sent to the Division of Revenue for processing and the case in the Division's case tracking system is closed.

Upon completion of the sale, the Tax Benefit Transfer Certificate is issued by the Branch Chief's office. A copy of the transfer certificate is kept with the files of the Special Audit Group.

#### **16.27 "Regular Audit" Groups**

The Regular Audit Groups of the Office Audit Branch perform desk audits of Corporation Business Tax filers that are selected for audit by the Audit Selection group. The audits are conducted primarily through correspondence. For details regarding Regular Audit procedures see Chapter 17.

## **Chapter 17 “Regular Audit” Procedures**

The Office Audit Branch is responsible for auditing Corporation Business Tax returns.

### **17.1 The Selection Process**

Using established criteria in combination with public records and information from the IRS, other States, and other New Jersey agencies, corporations are selected for audit by the Audit Selection Group and assigned to one of the Audit Groups. The Audit Group Supervisor assigns a particular audit case to an auditor.

### **17.2 Determining the Audit Period**

The auditor must review the taxpayer’s filed returns to determine which years are currently in statute. Any open years will constitute the potential audit period. The auditor must then:

- Check to see if any other branch, group or section of the Division is currently auditing the taxpayer. If so, the auditor will not include any year already under audit; and
- Check for any other concurrent cases that may impact the audit. Some examples of other concurrent cases would be Bankruptcy, Special Audit, Refund, Amended Return and Dissolution cases. The auditor should coordinate with the other Group(s) to determine the impact of such cases on the audit, and make the other Group aware of their audit case.

### **17.3 Preparing to Audit the Returns**

The auditor may determine whether he/she will be able to conduct and complete the audit before the statute of limitations for adjustments expires. If the auditor concludes that this is not possible, he/she may attempt to obtain consent from the taxpayer to extend the statute (using the Consent Form in the audit management system).

The auditor may then gather all available information to determine if the return was filed correctly. This includes: the filed return and all attachments, the taxpayer’s entire account (including amended returns, adjustments, and notes from previous audits), the filed New Jersey returns of all identified flow-through entities connected to the taxpayer (e.g. partnerships, LLCs, S corps), and data received from external sources.

### **17.4 Auditing the Returns**

The auditor will begin the audit by reviewing the Corporation Business Tax returns for any obvious errors or filing inconsistencies.

### **17.5 Schedule A – Lines 1 through 28**

Lines 1 through 28 are based on the provisions of the Internal Revenue Code on a non-consolidated basis.

**17.6 Federal Return Prepared On a Separate-Entity Basis**

If the Federal tax return was prepared on a separate-entity basis, the auditor may need to confirm that the amounts reported on Lines 1 through 28 are the same as the amounts reported on the corresponding lines of the Federal return. Any differences should be analyzed.

**17.7 Federal Return Prepared On a Consolidated Basis**

If the Federal return was prepared on a consolidated basis, the auditor may need to obtain either a pro forma Federal return prepared as if it were on a separate entity basis, or examine the Federal consolidating income schedules that contain the entity that is being audited. The breakdown should be examined to identify and isolate the consolidating eliminations.

**Note - New Jersey Tax Return Line and Schedule References below, based on 2014 CBT-100**

**17.8 Line 29 – Interest on Federal, State, and Municipal Obligations**

The auditor must verify that any tax-exempt interest earned by the taxpayer that was not reported above Line 28, is added back to Entire Net Income. The taxpayer is permitted to deduct any interest expense, not previously deducted in computing Federal taxable income, incurred to carry such investments.

**17.9 Line 30 – Related Interest Addback**

The auditor may verify that all interest paid, accrued, or incurred to related members was deducted as interest expense unless all or part qualifies for an exception to the addback. Any interest paid, accrued, or incurred should be reported on Schedule G. Any exceptions should be reported on Schedule G-2. The auditor may also ask to see loan agreements and other documents regarding the claimed exceptions.

**17.10 Line 31 – New Jersey State and Other States’ Taxes Deducted Above**

The auditor must verify that the amount the taxpayer added back to Entire Net Income includes all taxes based on income, net profits, business activity or business presence deducted to compute Federal taxable income. The auditor may examine and verify that the amount of taxes deducted thereon is properly reported and categorized on Schedule H, and that the proper amount is added back to Entire Net Income.

**17.11 Line 32 – Depreciation and Other Adjustments from Schedule S**

The auditor should verify the amount the taxpayer reported on Line 32 by examining Schedule S and Federal Form 4562 to ensure the correct adjustment is reported.

**17.12 Line 33(a) - Deduction for IRS Sec 78 Gross-up not Deducted at Line 37**

The auditor should review the underlying affiliate to ensure that the deduction taken here is not duplicated in the Dividend Exclusion.

### **17.13 Line 33(b) - Other Deductions and Additions**

The auditor should analyze the amount(s) that the taxpayer reported on Line 33(b) by reviewing the supporting schedules and riders and determining whether the deductions and additions are permissible.

### **17.14 Line 33(c) - Elimination of Nonoperational Activity**

The auditor may need to verify the amount of income the taxpayer reported as non-operational by examining Schedule O and any supporting documentation that the taxpayer attached to the return. The auditor may ensure that income and expenses related to claimed non-operational activity are excluded from the computation of entire net income. Any expenses the taxpayer deducted in previous years as operational but that are related to a non-operational asset that was sold may be recaptured and added back or offset against any gain from the sale of the non-operational asset.

NOTE: Activity claimed as non-operational should be excluded from the apportionment factor.

### **17.15 Line 33(d) - Interest and Intangible Expenses and Costs Addback**

The auditor should verify that all interest and intangible expenses and costs paid, accrued, or incurred to related members are properly added back on this Line unless all or part qualifies for an exception to the addback. This addback includes expenses paid, accrued, or incurred in relation to factoring activities conducted with a related party. Any exceptions should be reported on Schedule G-2. The auditor may need to determine whether the taxpayer included intangible expenses on Schedule A, Line 26. The auditor may review the addback items listed on Schedule G, Part II, and any addback exceptions listed on Schedule G-2. The auditor may need to add to the list of items to be obtained from the taxpayer on any royalty, franchise, or other intangible fee agreements for which the taxpayer claimed an addback exception.

The auditor may need to verify that any related members listed on Schedule G, Part II, or Schedule G-2 that are receiving income from the use of an intangible asset in New Jersey are filing the required New Jersey returns.

### **17.16 Line 35 – Net Operating Loss Deduction**

The auditor should verify the amount the taxpayer reported on Line 35 by:

- Examining Form 500;
- Examining the prior year returns on which the losses generated were reported;
- Verifying that the taxpayer did not include on Line 35 losses deducted in previous years; and
- Reviewing the taxpayer's account to determine whether the taxpayer filed amended returns that affect the amount on Line 35 and making any necessary adjustments.

### **17.17 Line 37 – Dividend Exclusion**

The auditor may verify the amount the taxpayer reported on Line 37 by checking the amount of dividends reported on Schedule A, Line 4, and comparing that amount to the breakout provided on Schedules P and R. Dividends received from 80% or more owned subsidiaries are 100% deductible, dividends from 50% - 79% owned subsidiaries are 50% deductible and dividends from less than 50%

owned subsidiaries are not deductible. Dividends received from money market funds or Real Estate Investment Companies are not eligible for exclusion.

#### **17.18 Line 3, Schedule B – Loans to Stockholders/Affiliates**

If the taxpayer reported on Line 3, Schedule B, that it made loans to its stockholders or affiliates, the auditor may determine whether the taxpayer received interest from the borrower. The auditor may examine any supporting schedules for interest income. If the auditor determines that the taxpayer did not receive interest, the auditor may impute interest pursuant to N.J.A.C. 18:7-5.10.

#### **17.19 Line 24, Schedule B – Loans from Stockholders/Affiliates**

If the taxpayer reported on Line 24 that it borrowed funds from its stockholders or affiliates, the auditor may need to determine from whom the loan was obtained and whether the taxpayer paid interest to the lender(s). The auditor must examine any supporting schedules attached to the return for interest expense. If the auditor determines that the taxpayer paid interest, the auditor may need to impute interest income to the lender.

#### **17.20 Schedule J – Allocation Schedule**

For privilege periods beginning on or after July 1, 2010, any corporation is entitled to allocate any part of its entire net income outside New Jersey by using its calculated allocation factor.

For privilege periods beginning before July 1, 2010, a corporation is entitled to allocate only if it maintained a regular place of business pursuant to N.J.S.A. 54:10A-6 outside New Jersey during the entire tax year. If the taxpayer maintained a regular place of business outside New Jersey for only part of the year, the taxpayer may be eligible for Section 8 relief under N.J.S.A. 54:10A-8. The auditor may first determine whether the taxpayer did, in fact, maintain a regular place of business outside the State before reviewing Schedule J. However, if the taxpayer is a corporation that is entitled and elects to report as an investment company, regulated investment company, or real estate investment trust, it is not required to maintain a regular place of business in order to allocate.

If the auditor concludes that the taxpayer did not maintain a regular place of business, the statutory allocation is 100%.

The auditor should review Schedule J to verify the fractions the taxpayer used to allocate its property, receipts, and payroll. The auditor may verify that the denominator of each fraction matches the corresponding amounts the taxpayer reported on Schedule A or B, as appropriate.

#### **17.21 Property Fraction**

The numerator of the property fraction is comprised of the average values of the taxpayer's tangible personal and real property in New Jersey; the denominator is comprised of the average values of all of the taxpayer's tangible personal and real property, regardless of where that property is located. Tangible personal and real property includes property that the taxpayer owned, leased, rented, or used, and does not include property that is not yet in service, was removed from service, or is under construction. The average value of property that is leased or rented is determined by multiplying annual rent or lease payments times eight. The average value of property is based on book value and is generally averaged on a quarterly basis.

### **17.21A Verifying the Denominator**

The auditor may need to verify that the taxpayer properly calculated the denominator of the property fraction by examining the taxpayer's balance sheet and income schedule for the following items:

- Land;
- Buildings and Other Improvements less accumulated depreciation;
- Machinery and Equipment less accumulated depreciation;
- Inventories;
- All Other Tangible Personal Property (Net);
- Cost of Goods Sold;
- Rents multiplied times eight; and
- Other deductions.

### **17.21B Verifying the Numerator**

The auditor may need to verify that the taxpayer included the average value of all property located, used, rented, or leased in New Jersey. Property that is stored in a bonded warehouse in this State, or that is held in New Jersey by the taxpayer's agent, consignee, or factor is considered to be located in New Jersey.

The auditor may need to request a schedule of property by State and may also seek to obtain copies of lease agreements, or a copy of the title to owned property.

### **17.22 Receipts Fraction**

The numerator of the receipts fraction is comprised of the taxpayer's receipts allocable to New Jersey; the denominator is comprised of all of the taxpayer's receipts, regardless of where earned. However, both the numerator and denominator may relate to the taxpayer's entire net income reported as income during the period covered by the return.

#### **17.22A Verifying the Denominator**

The auditor may need to verify that the taxpayer properly calculated the denominator of the receipts fraction by examining the taxpayer income statement which is comprised of the following:

- Gross receipts or sales less returns and allowances;
- Dividends;
- Interest;
- Gross rents;
- Gross royalties;
- Capital gain net income;
- Net gain or (loss) from Federal Form 4797;
- Other income;
- Interest on Federal, State, Municipal and other obligations not included in Interest (not including any interest expense); and
- Dividend exclusion.

In years when the throw-out rule was applicable, the auditor should verify that the amount of throw-out receipts was calculated properly (see below).

### **17.22B Verifying the Numerator**

The auditor should review whether the taxpayer included all receipts allocable to New Jersey. Receipts allocable to New Jersey include:

- Receipts from services performed in New Jersey;
- Rent receipts from property situated in New Jersey;
- Royalties from the use in New Jersey of patents or copyrights;
- All other business receipts earned in New Jersey;
- Receipts from the sales of tangible personal property shipped to New Jersey; and
- A 51 State (including DC receipts breakout schedule) may be requested.

### **17.23 Throwout**

For taxable periods beginning on or after January 1, 2002 and beginning before July 1, 2010, the receipts fraction denominator may be adjusted to exclude non-sourced receipts. This is referred to as “throw out.” See regulation N.J.A.C.18:7-8.7 (d)(e)(f) and (g).

Regarding Non-sourced receipts (throw-out provision) – The auditor may verify that receipts sourced to a State, possession or territory of the United States or District of Columbia or to any foreign country in which the taxpayer is not subject to a tax on or measured by profits or income or business presence or business activity are excluded from the denominator of receipts fraction, with the exception of sales sourced to Nevada, South Dakota, and Wyoming, since these States do not have a corporate tax. The throw-out provision has been eliminated for privilege periods beginning on or after July 1, 2010. The auditor may ask for a schedule of receipts by State and country, asking the taxpayer to indicate in which States and countries the taxpayer does not pay a tax measured by profits, income, business presence or business activity. The auditor may need to inquire about throw-back receipts. Any receipts that are included in the numerator of a jurisdiction’s receipts fraction by reason of the operation of a throwback provision are deemed not to be receipts assigned to that jurisdiction are, therefore, excludible from the denominator of the receipts fraction.

### **17.24 Payroll Fraction**

The numerator of the payroll fraction is comprised of the taxpayer’s payroll for all officers and employees in New Jersey; the denominator is comprised of the taxpayer’s entire payroll, regardless of where the officer or employee is located. Payroll means wages, salaries, and other compensation the taxpayer paid to its employees for services rendered, but does not include amounts paid to non-employees for services rendered.

### **17.24A Verifying the Denominator**

The auditor may need to verify that the taxpayer properly calculated the denominator of the payroll fraction, which is comprised of the following expenses:

- Cost of labor (Schedule A-2, Line 3);
- Compensation of officers (Schedule A, Line 12);
- Salaries and wages less jobs credit (Schedule A, Line 13); and
- Other deductions (Schedule A, Line 26).

The auditor may also request that the taxpayer submit copies of the applicable Federal 940 and 941 returns.

### **17.24B Verifying the Numerator**

The auditor may verify that the taxpayer included all payroll allocable to New Jersey by reviewing the taxpayer's New Jersey 927 wage reports.

### **17.25 Alternative Minimum Assessment**

For tax periods beginning after June 30, 2006, the Alternative Minimum Assessment is imposed on taxpayers who are exempt from paying the Corporation Business Tax because they are protected by P.L. 86-272 (unless the taxpayer has consented to be subject to Corporation Business Tax). If the taxpayer reported an Alternative Minimum Assessment liability (as opposed to a Corporation Business Tax liability) on Line 12, the auditor may verify that the taxpayer is protected by P.L. 86-272. If the auditor determines that the taxpayer is protected by P.L. 86-272, the auditor may verify the taxpayer's calculations on Schedule AM.

### **17.26 Tax Credits**

The auditor should determine whether the taxpayer was eligible for the tax credits reported on the Summary of Tax Credits, Schedule A-3. Once the auditor confirms that the taxpayer was eligible for a credit, he/she should verify the amount of the credit claimed.

- Angel Investor Tax Credit from [Form 321](#)
- Grow NJ Tax Credit from [Form 320](#)
- Wind Energy Facility from [Form 322](#)
- Urban Transit Hub Tax Credit from [Form 319](#)
- Business Retention and Relocation Tax Credit from [Form 316](#)
- Neighborhood Revitalization State Tax Credit From [Form 311](#)
- Film Production Tax Credit from [Form 318](#)
- Sheltered Workshop Tax Credit from [Form 317](#)
- AMA Tax Credit from [Form 315](#)
- Economic Recovery Tax Credit from [Form 313](#)
- Effluent Equipment Tax Credit from [Form 312](#)
- HMO Assistance Fund Tax Credit from [Form 310](#)
- Small New Jersey-Based High-Technology Business Investment Tax Credit from [Form 308](#)
- New Jobs Investment Tax Credit from [Form 304](#)

- Manufacturing Equipment and Employment Investment Tax Credit From [Form 305](#)
- Research and Development Tax Credit from [Form 306](#)
- Recycling Equipment Tax Credit from [Form 303](#)
- Redevelopment Authority Project Tax Credit from [Form 302](#)
- EITHER: Urban Enterprise Zone Employee Tax Credit from [Form 300](#) OR Urban Enterprise Zone Investment Tax Credit from [Form 301](#)

### **17.27 Minimum Tax**

If the taxpayer reported a Corporation Business Tax liability of less than \$2,000 on Line 11 (or alternative minimum assessment on Line 12, if applicable), the auditor may need to review the validity of this reported amount. The taxpayer must pay the greater of this liability or the minimum tax due based on its gross receipts. The auditor should verify the amount of the taxpayer's gross receipts as calculated on Schedule A-GR to confirm that the taxpayer reported the proper amount of minimum tax. However, if the taxpayer is a member of an affiliated or controlled group (under Sections 1504 or 1563 of the Internal Revenue Code) with total payroll of \$5,000,000 or more, the minimum tax is \$2,000, regardless of the taxpayer's gross receipts.

### **17.28 Schedules C and C-1**

The auditor should examine these schedules to determine if the taxpayer reported any unusual items and, if necessary, ask the taxpayer to explain any unclear entry to ensure that the entry does not impact the reported tax liability.

### **17.29 Schedule P-1**

If the taxpayer reported ownership in a partnership, LLC, or any other entity that is treated as a partnership for Federal tax purposes, the auditor should determine whether the corporation had any partnership activity and if that activity is flowing through to the taxpayer's allocation factor or if it should be reported separately. See [N.J.A.C. 18:7-7.6](#).

### **17.30 Requesting Information From the Taxpayer**

#### **17.30A Initial Inquiry and Follow-up Request**

After the auditor completes the initial review of the taxpayer's returns, the auditor may need to draft a letter of inquiry to the taxpayer detailing the items on the return about which he/she has questions. The letter may need to include a request for a description of the taxpayer's business and an explanation as to how the taxpayer allocated its receipts. The auditor may request copies of documents, such as loan agreements, lease agreements, management/intercompany fee agreements, licensing agreements, etc., that are necessary to verify various portions of the taxpayer's returns. Generally, the taxpayer is given 30 days to comply with the auditor's request.

Before sending the letter to the taxpayer, the auditor may submit the draft to his/her supervisor or reviewer, along with the taxpayer's returns. Once the letter is finalized, the auditor sends it to the taxpayer and updates the case status in the audit management system.

If after 45 days the auditor has not received a response to the initial inquiry, the auditor should send a follow-up to the taxpayer giving another 30 days to comply.

### **17.30B Estimated Assessment**

If the taxpayer does not comply with the auditor's requests for information, the auditor issues an estimated tax assessment based on available information, in accordance with the current policy memorandum on issuing estimated assessments.

### **17.30C Auditor Requires Additional Information**

If the taxpayer responds to the initial or follow-up inquiry, the auditor reviews the information received and determines if he/she has sufficient information to make a determination or if additional information is needed. The auditor should send a second request for information if he/she determines that what the taxpayer previously provided was not sufficient to make a determination.

### **17.31 Making the Audit Determination**

Once the auditor receives all the information requested from the taxpayer, the auditor reviews it and makes a determination/recommendation of either: no change; proposed assessment; or refund.

### **17.32 Issuing the Proposed Audit Assessment – No Change**

If the auditor determines that the taxpayer properly calculated its Corporation Business Tax (i.e., "no change"), the procedures are as follows:

- a. The auditor changes the case status in the audit management system and submits the determination/recommendation to the reviewer or supervisor;
- b. The reviewer or supervisor examines the auditor's findings. If the reviewer disagrees with the findings, the case is sent back to the auditor for further analysis in the audit management system;
- c. Once the supervisor and auditor agree as to the audit findings, the supervisor approves the case and gives it back to the auditor within the audit management system;
- d. The auditor forwards the case to Audit Billing in the audit management system;
- e. The supervisor sends the case in the Division's case tracking system to Audit Billing; and
- f. Audit Billing sends a Final Notice to the taxpayer informing him or her that the audit resulted in no change. The notice will include appeal rights.

### **17.33 Issuing the Proposed Audit Assessment/Refund**

If the auditor determines that the taxpayer did not properly calculate its Corporation Business Tax and finds that required adjustments to the return will result in either a refund or additional tax due, the auditor changes the case status in the audit management system and submits his/her findings to the reviewer or supervisor.

The reviewer will examine the auditor's findings. If the reviewer or supervisor disagrees with those findings, the case is sent back to the auditor in the audit management system for further analysis. Once

the reviewer or supervisor and auditor agree with respect to the audit findings, the supervisor sends the case to management if required for review. The dollar amount associated with the case dictates the level of management review.

If a manager does not approve the proposed adjustments, that manager moves the case to “Proposed Assessment – Rejected” in the audit management system and refers it back to the supervisor, for further analysis. Once management approves the proposed assessment, the case is sent to “Send to Proposed Approved” in the audit management system and notifies the supervisor, who then notifies the auditor assigned the case.

Once the auditor is advised that the proposed assessment has been approved, the auditor will send the approved proposed assessment to the taxpayer, along with a billing sheet and detailed work papers that show how the adjustments were derived and the statutory and regulatory basis for those adjustments. The auditor then moves the case in the audit management system to “Proposed Assessment Sent.”

Sending the proposed adjustments to the taxpayer gives the taxpayer an opportunity to review the adjustments and identify any areas of disagreement before the auditor finalizes the adjustments. The auditor will consider the taxpayer’s disagreements, if any; decide whether they have merit; and make adjustments accordingly. At this point, the auditor will either issue revised proposed adjustments; a no-change letter, if warranted; or finalize the original adjustments. Regardless of the path taken, the auditor will re-send the case through the review process for approval, either as a revised proposal, no-change, or a final determination.

The taxpayer generally has 30 days to examine the proposed adjustments before the auditor finalizes them. However if there is not enough time before the statute of limitations will expire, the auditor may have to finalize the adjustments immediately or give the taxpayer less than 30 days to examine the proposal, unless the taxpayer agrees to sign a consent form extending the statute of limitations for assessment.

#### ***17.34 Issuing the Final Audit Assessment/Refund***

Once the auditor is ready to finalize the assessment, the case is moved in the audit management system to “Send to Final Assessment,” then “Send to Final Review.” The case then goes through the same review process described in Section 17.42 above. Once the final level of review approves the proposed assessment, the case is moved to “Send to Final Approved” in the audit management system and the reviewer notifies the Supervisor, who then notifies the auditor. The auditor then sends the case to the reviewer or supervisor who sends the case to Audit Billing.

#### ***17.35 Audit Narrative and Report to the Assistant Director***

An Audit Narrative is to be prepared for all audit cases. The Audit Narrative is to be included before sending the case for proposed or final review. A Report to the Assistant Director is required for all audit assessments or refunds exceeding \$1,000,000 and is to be included when sending the case for proposed or final review. The Audit Narrative and the Report to the Assistant Director are internal documents. The taxpayer does not receive these as part of the auditor’s work papers.

## **Chapter 18 Corporation Business Tax Refunds and Credits**

The Corporation Business Tax Refund Audit Group processes, reviews, and examines claims for refunds and credits of Corporation Business Tax. This group receives claims in the form of original returns, amended returns, and Forms A-3730. The group also receives claims through correspondence, referrals from other groups of the Division, and telephone calls. The group is responsible for ensuring that refunds and credits are processed correctly, in a timely manner, and in accordance with applicable New Jersey tax laws.

### **18.1 Processing a Claim for Refund**

The following are the steps the auditor should take when processing a claim for refund.

### **18.2 Verify Status of Corporate Charter**

The auditor may review the taxpayer's profile in the Division's case tracking system to determine how the taxpayer is registered and to verify the status of the corporate charter. If the auditor finds that the corporation's charter has been voided or revoked, the refund/credit claim is denied. The auditor then sends the taxpayer a letter notifying the taxpayer that the refund/credit claim has been denied and cannot be reviewed until the corporation completes the reinstatement process with the Division of Revenue. A Notice of Final Audit Determination is then sent to the taxpayer.

### **18.3 Verify Timeliness of Claim**

The auditor should determine whether the taxpayer filed the refund/credit claim timely, i.e., before the expiration of the statute of limitations. If the auditor finds that the claim was not filed timely, the auditor will deny the refund/credit claim and issue a Notice of Denial. For Corporation Business Tax purposes, generally, the taxpayer may file a claim for refund within four years after making a payment of any original or additional State tax assessed.

### **18.4 Confirm Taxpayer's Mailing Address(es)**

The auditor should confirm the taxpayer's mailing address by comparing the address on the refund/credit claim with the address(es) in the Division's case tracking system.

- If the auditor finds that the mail indicator for the general mailing address in the Division's taxpayer registration file shows as "valid," and the address on the refund/credit claim differs, the auditor will add a Corporation Business Tax specific address if one does not already exist. If a Corporation Business Tax specific address already exists in TaxReg but differs from the address on the refund/credit claim, the auditor should update that address; and
- If the mail indicator for the general mailing address in the TaxReg shows as "invalid," the auditor updates the general mailing address to match the address on the refund/credit claim.

### **18.5 Review Taxpayer's Cases**

The auditor should review all notes and cases in TaxReg and the Division's case tracking system to determine if any other group of the Division has an open or closed case that could affect the refund/credit claim.

### **18.6 Verify Taxpayer's Payments/Credits**

The auditor should review and verify that all payments and/or credits the taxpayer reported on the refund/credit claim were made as indicated.

### **18.7 Review All Tax Periods**

The auditor may review the taxpayer's Corporation Business Tax account, beginning with the date the corporation began doing business in New Jersey, to determine whether all returns have been filed, payments have been posted properly, and whether any deficiencies or delinquencies exist.

### **18.8 Claim for Refund/Credit Made On Original Corporation Business Tax Return**

A claim for refund/credit made on the original Corporation Business Tax return falls into one of the following categories.

#### **18.8A Taxpayer Filed Correctly**

If the auditor finds that the taxpayer filed the return correctly, there are no penalties or interest to assess, all payments/credits that were claimed on the return have been made, and no deficiencies or delinquencies exist in another tax period, the auditor should approve the refund/credit as requested.

#### **18.8B Taxpayer Filed Correctly - Penalties and Interest Assessed**

##### **18.8B-1 Taxpayer Claimed a Refund**

If the taxpayer claimed a refund and the auditor finds that the taxpayer filed the return correctly and confirms that all payments/credits that were claimed on the return have been made, but penalties and interest have been previously assessed by the computer system, the auditor approves the refund, reduces it by the amount of penalties and interest assessed, and issues a refund for the balance, if any. If after applying the refund against the penalties and interest there is still a balance due, a bill will be sent to the taxpayer by the Division's computer system.

##### **18.8B-2 Taxpayer Claimed a Credit**

If the taxpayer claimed a credit and the auditor finds that the taxpayer filed the return correctly and confirms that all payments/credits that were claimed on the return have been made, but penalties and interest have been assessed by the computer system, the auditor approves the credit, without reduction as requested. A bill is then sent to the taxpayer for the balance due for the return year.

### **18.8C Taxpayer Filed Correctly - Payments/Credits Incorrect**

If the auditor finds that the taxpayer filed the return correctly but has not made all payments/credits claimed on the return, the auditor reduces or increases the refund/credit accordingly. The auditor generates a notice that informs the taxpayer of the reduced or increased refund/credit.

### **18.8D Taxpayer Filed Correctly – Deficiency or Delinquency in a Prior Tax Period**

#### **18.8D-1 Taxpayer Filed a Claim for Refund**

##### **18.8D-1a Existing Deficiencies**

If the taxpayer claimed a refund and the auditor finds that the taxpayer filed correctly but has a deficiency in another tax period(s) or another tax, the auditor may apply the refund to the deficiency. If there are deficiencies in multiple periods, the refund is applied against the oldest period first. If, after all deficiencies are satisfied an overpayment still remains, the auditor issues the net refund.

##### **18.8D-1b Existing Delinquencies**

If the auditor looks at the filing history of the taxpayer and discovers a delinquency in another tax period(s) or tax, the auditor must send a letter to the taxpayer requesting the missing return(s). If the taxpayer files the missing return(s), the auditor forwards the returns to the Division of Revenue for processing. Once the returns have posted in the system, the auditor takes the appropriate action with respect to the refund at issue. If the taxpayer does not respond within 30 days, the auditor estimates the taxpayer's liability for the year(s) in question, subtracts it from the requested refund amount, and sends the taxpayer a notice advising of the adjustment. If, after all delinquencies are satisfied an overpayment still remains, the auditor issues the net refund.

#### **18.8D-2 Taxpayer Filed a Claim for Credit**

If the taxpayer claimed a credit and the auditor finds that the taxpayer filed the return correctly but has a deficiency in another tax period(s) or another tax, the auditor approves the credit as requested. If the auditor finds that the taxpayer has a delinquency in another period(s), or another tax, the auditor approves the credit as requested and may notify the taxpayer of any delinquencies.

### **18.8E Taxpayer Filed Incorrectly**

If the auditor finds that the taxpayer filed incorrectly (e.g., used wrong tax rate, assessed the incorrect minimum tax), the auditor may correct the error and approve the corrected refund/credit as appropriate. If the change the auditor makes to the return goes beyond a correction and rises to the level of an adjustment, it will be considered to be an audit determination. In that event, the auditor will send the taxpayer a Notice of Audit Determination advising that adjustments were made and citing the appropriate statutory and/or regulatory authority. An assessment schedule and information regarding appeal rights will also be provided to the taxpayer.

If after making the corrections/adjustments the auditor finds that the taxpayer no longer has an overpayment, he/she will deny the refund/credit request. A notice will be sent to the taxpayer informing it that the request has been denied and advising the taxpayer as to the balance due, if any.

### **18.8F Refund/Credit Request – Partnership Payments Made**

When a taxpayer requests a refund/credit and a partnership(s) has made Corporation Business Tax payments on behalf of the taxpayer, the auditor may verify that the following has occurred:

- Schedule NJK-1, Form NJ-1065 for each partnership has been filed with the taxpayer's CBT-100; and
- Schedule P-1, Form CBT-100 (or Form CBT-100S if taxpayer is an S corporation) has been completed.

If the taxpayer does not submit both the Schedule NJK-1 for each payment claimed, the taxpayer's claim for refund/credit will be denied.

The amount reported on Schedule NJK-1, Form 1065, submitted with the CBT-100 or CBT-100S should match the amount reported by the partnership in the Partner's Directory of Form NJ-1065. If a discrepancy exists, the auditor may only approve a refund or credit for the amount reported in the Partner's Directory.

### **18.8G S Corporation Refund/Credit Request**

When a refund/credit request is made by an S Corporation that reports Gross Income Tax paid on behalf of non-consenting shareholders (Line 13, Form CBT-100S), the auditor should verify that the taxpayer filed the required Schedule NJ-K-1, Form CBT-100S, for each shareholder. The tax paid on behalf of non-consenting shareholders cannot be credited to the shareholder's account unless the fully completed Schedule NJK-1, Form CBT-100S, is filed.

### **18.9 Claim for Refund/Credit Made On Amended CBT Return**

After the auditor has completed the general procedures discussed above, the following steps may be necessary:

- a. Review the taxpayer's explanation as to the reason(s) why the amended return was filed and compare each Line on the first page, Schedule A, and Schedule J of the amended return, with that of the original return. If the taxpayer did not provide an explanation, the auditor should contact the taxpayer to request this information;
- b. If the taxpayer amended Federal net income, verify that the taxpayer provided copies of Federal Form 1120X, the original Form 1120, and the Federal refund check. If the taxpayer did not provide the required copies, the auditor may need to contact the taxpayer to obtain additional information. If the requested refund exceeds a specified amount, or if the taxpayer is amending the return based on an accounting change or an extraordinary deduction, the taxpayer may provide a copy of the letter of acceptance from the IRS and a copy of the refund check;
- c. Examine the entire amended return to determine whether it is filed correctly under the laws and regulations in effect for the amended return period. The auditor should check all computations, verify that the taxpayer properly included and/or added back to entire net income all statutory adjustments on Schedule A (e.g., Federal exempt interest income,

State income taxes, depreciation, affiliated Interest/royalty expense, nonoperational income, net operating loss deduction, and the dividend exclusion), and verify and reconcile the amounts listed on the Federal Form 1120, to their respective New Jersey schedules;

- d. Examine the New Jersey allocation factor on Schedule J to determine whether the taxpayer removed the non-sourced receipts from the denominator of the receipts allocation fraction, whether the property allocation factor can be reconciled with Schedule B, and whether the receipts and payroll allocation factors can be reconciled to Schedule A for those years prior to full phase-in of single sales factor; and
- e. Verify any New Jersey credits that are taken on Page 1 against the corresponding New Jersey credit form.

If the information provided in the return is insufficient, the auditor should place all credits/refunds on hold and send the taxpayer a letter requesting the necessary information. Once received, the auditor will review the information and make a determination.

After a determination is made by the auditor and a refund/credit has been issued, all returns remain subject to further audit.

#### **18.10 Claim for Refund made on Form A-3730**

If a taxpayer has overpayments in its account that have not been claimed on the CBT-100 or 100S, the taxpayer may file a claim for refund on Form A-3730. The auditor follows all general procedures noted above.

#### **18.11 Refund/Credit Request from Other Groups of the Division**

Auditors in different groups within the Division may be working on a case that needs a Corporation Business Tax refund/credit approved. These auditors may not have the authorization to approve the refund/credit request; therefore, the request is forwarded to the Corporation Business Tax Refund Audit Group. The same general procedures detailed above are followed when reviewing the request, unless otherwise specified. If the overpayment was created by the group requesting approval, the refund/credit will be approved without further review.

The refund group does not override decisions made by competent authority in other groups of the Division. However, if an egregious error is suspected, Branch management should be notified.

#### **18.12 Refund/Credit Request Not Made on Return or Form**

When an auditor receives a refund/credit request by letter or receives a telephone call from a taxpayer concerning a claim, the auditor handles it in the same manner as if the case had been assigned by the auditor's supervisor and follows the procedures outlined above.

## **Chapter 19 Office Audit Nexus Group**

The function of the Office Audit Nexus Group is to identify and register foreign corporations (corporations incorporated in a State other than New Jersey), and Limited Liability companies (LLC) that have nexus with New Jersey but are not authorized to do business in this State or are not filing and paying business taxes. Once a taxpayer is identified, the Nexus Group determines the date(s) the taxpayer became subject to New Jersey taxes.

### **19.1 Determining Nexus**

A Nexus Questionnaire is sent when the auditor identifies a foreign corporation or LLC that may have nexus with New Jersey. The objective of the questionnaire is to determine the entity's specific activities and connections with this State. The questions are intended to obtain the information necessary to determine whether the entity has a taxable status in New Jersey.

### **19.2 Certificate of Authority**

If a corporation holds a Certificate of Authority to do business in this State, the corporation is subject to the Corporation Business Tax from the date the Certificate was issued. The answers provided in the Nexus Questionnaire may indicate that the corporation became subject to the Corporation Business Tax before the certificate was issued, and when the subjectivity began.

### **19.3 Other Authorizations**

A corporation may have nexus if it has a certificate, license, or any authorization that permits it to carry on business activity in the State.

### **19.4 Doing Business in New Jersey**

#### **19.4A P.L. 86-272 - Exception to Nexus**

Federal law prohibits any State from imposing a net income tax on income derived within that State from interstate commerce if the business's only activities in the State are the solicitation of orders for the sale of tangible personal property and the orders are approved and filled outside the State. This prohibition does not apply to domestic corporations.

If a corporation merely solicits sales in New Jersey, but the orders are approved and the goods are shipped from out of State, and no other duties, functions or activities are performed in New Jersey, the sales may be subject to Sales and Use Tax, but the income derived from the sales may not be subject to the Corporation Business Tax. In those cases, the corporation would only be subject to the minimum Corporation Business Tax.

### **19.5 Activities Exceeding Solicitation of Sales**

If a corporation's activities in New Jersey go beyond the mere solicitation of sales and include any of the following, the income derived from the sales would be subject to the Corporation Business Tax:

- a. Picking up and/or replacing damaged, returned, or repossessed goods;

- b. Checking inventory;
- c. Arranging advertising set-ups;
- d. Providing technical assistance or expertise to their customers in this State;
- e. Carrying goods for direct sale;
- f. Having salesmen with the authority to approve or accept sales orders; and
- g. Any other duties not directly and specifically related to sales solicitation (e.g., delivery in the taxpayer's vehicles).

A corporation would also be subject to the Corporation Business Tax if any services are performed in New Jersey. Services include, but are not limited to:

- a. Construction and erection;
- b. Installations and/or repairs;
- c. Consulting or training; and
- d. Holding seminars or conferences.

#### **19.6 *Owning or Employing Capital in New Jersey***

The existence of one or more of the following will be sufficient to subject the corporation to the Corporation Business Tax:

- a. Owning a general partnership interest in a partnership having New Jersey source income;
- b. Owning a limited partnership interest in a New Jersey partnership where the corporation is actively involved or has a unitary relationship with the partnership;
- c. Having franchisees located in New Jersey; and
- d. Having intangibles located in New Jersey from which royalties or licensing fees are derived (e.g., software licensing agreements).

The following, alone, are not sufficient to subject a corporation to the Corporation Business Tax:

- a. Holding bank accounts in New Jersey;
- b. Maintaining corporate securities and registrations in New Jersey; and
- c. Holding meetings of Board of Directors or shareholders in New Jersey.

### **19.7 *Owning or Employing Real or Personal Property in New Jersey***

A corporation will be subject to the Corporation Business Tax when it:

- a. Has inventory in a warehouse or on consignment in New Jersey;
- b. Has office equipment or machinery in New Jersey; or
- c. Rents, leases or owns real estate (raw land, improved land, buildings and permanent fixtures) in New Jersey.

If a corporation's only connection to New Jersey is that it owns or leases automobiles registered in the State and the vehicles are solely for use by sales representatives soliciting sales in New Jersey, the corporation will be subject to the minimum Corporation Business Tax.

### **19.8 *Maintaining an Office in New Jersey***

A corporation that maintains an office in New Jersey will be subject to the Corporation Business Tax, regardless of whether the office is:

- a. Owned, rented or leased;
- b. In the corporation's name or in the name of an affiliated or related company; and
- c. Staffed full-time or part-time.

## Chapter 20 Audit Procedure Depreciation

### 20.1 General Guidelines

If, during the course of an audit, an auditor discovers that a taxpayer has claimed more than the total amount of depreciation allowable in any given year (on a year-by-year basis), the auditor may adjust the depreciation. If any of the years affected are out of statute, the adjusted basis may be depreciated in accordance with the taxpayer's New Jersey method to ensure that no more than the total allowable depreciation is used.

If the only information available to the auditor is the total amount of accumulated depreciation the taxpayer claimed for New Jersey purposes (which taxpayer can provide), the adjusted basis of the asset may be recomputed (cost less accumulated depreciation) and then depreciated in accordance with the taxpayer's New Jersey method.

If, during the course of an audit, the auditor discovers that a taxpayer has claimed less than the total amount of depreciation allowed, he/she may notify the taxpayer, who may then file an amended return in order to claim the full amount of allowed depreciation and receive any refund or credit due or any offset. During an audit, the auditor is required to determine the correct amount of tax due. If the years involved are beyond the statute of limitation, the taxpayer cannot claim the unused depreciation.

New Jersey depreciation adjustments should be made using these guidelines:

- If, after a previous office audit, the auditor made no changes, and the taxpayer was not notified that an audit had been performed, the current auditor may proceed as if no audit had been performed, and may adjust the lives and/or methods used by the taxpayer if the adjustment is deemed necessary and the tax consequence is significant;
- If, after a previous audit, the auditor issued a no-change letter, thereby accepting the lives and/or methods used by the taxpayer, the current auditor is bound by that decision and may accept the amount of depreciation taken by the taxpayer for the remaining lives of the assets;
- If, during the course of a previous audit, the auditor adjusted the lives and/or methods used by the taxpayer, the current auditor is bound by those adjustments for all assets that the taxpayer placed in service during prior years;
- With respect to new assets placed in service during the years currently under audit, the auditor may change the lives and/or methods used if the adjustment is deemed necessary and the tax consequence is significant. This is true even if the new assets are of the same category as those accepted in a previous audit; and
- If a prior audit was not performed, the auditor should use discretion with respect to Accelerated Cost Recovery System (ACRS) adjustments, taking into consideration both the practicality and materiality of the adjustment. If an asset has one-half or more remaining of the total life for New Jersey purposes (e.g., an asset has a total life of eight years for New Jersey purposes and there are four years or more remaining, which are years under audit), the auditor should make the required adjustment. However, if the majority of the years have expired, the auditor may not have to make the adjustment.

For all new assets placed in service during years under audit, the required adjustments should always be made if the tax consequence is significant. When determining whether the tax consequence is

significant or not, two factors that should be examined are the allocation factor and whether the tax consequence is greater than \$100.

The auditor should remember that the above information provides general guidelines. When in doubt, the auditor should consult with his/her supervisor.

If the taxpayer indicates that depreciation schedules are too voluminous for submission, the auditor may accept depreciation schedules for one of the years under audit. The auditor may perform sample tests from each of the categories of the assets. An error factor can then be computed and applied to the adjustment required on Schedule A, Line 32, of the CBT-100 or Schedule A, Line 35, of the CBT-100S.

Because future audits are bound by the findings of prior audits, whenever a depreciation allowance is accepted as filed by the taxpayer, all Field Audit and Office Audit auditors may document in the work papers why he/she did or did not make any adjustments to New Jersey depreciation claimed.

## **Chapter 21 Audit Corporation Business Tax**

### **21.1 Adjustments to Net Operating Loss Carryover**

An audit adjustment to entire net income shall serve to revise the amount of any net operating loss for the year of the change and the net operating loss carryover to which it relates. A net operating loss carryover may be carried forward to each tax period following a loss but cannot be carried back. It applies to accounting periods ending on or after July 31, 1984. The net operating loss will be lost when there is a change of 50% or more of the voting stock and a significant change in the operation of the business occurs and when a corporation is absorbed into another through merger.

Richard's Auto City, Inc. v. Director, Division of Taxation New Jersey Supreme Court. The taxpayer, an auto leasing company merged with its parent, an auto dealership. The auto dealership, the survivor, claimed a deduction for net operating loss incurred by the non-surviving leasing company prior to the merger. Under the applicable regulation, net operating losses can only be carried over by the actual corporation that sustained the loss. In the case of a merger, net operating losses can only be carried over if the corporation that sustained the loss was the survivor. The statute does not directly address the treatment of net operating losses in mergers.

Originally, the Tax Court ruled in favor of the Division while the Superior Court, recognizing the Federal treatment and general corporate law where the surviving corporation is entitled to the attributes of the non-surviving corporation, ruled in the taxpayer's favor and overturned the regulation. The New Jersey Supreme Court ruled that the regulation was a reasonable interpretation of the statute. The legislative history did not show any intent other than that reflected by the regulation. Therefore, the survivor of a merger is entitled to take only its own net operating losses.

### **21.2 Requests for Section 8 Relief**

Requests for "Section 8 Relief" by foreign corporations claiming that the allocation factor, pursuant to N.J.A.C. 18:7-8.3, does not adequately reflect their activity, business, receipts, capital or entire net income attributable to New Jersey, are treated as refund claims.

An entity seeking Section 8 Relief may file its return statutorily and pay the tax shown due. The return may be accompanied by an amended return or a Claim for Refund, as well as by materials supporting the entity's request for an adjustment of its business allocation factor. Requests for Section 8 Relief are subject to the same limitations period as any other refund claim. In addition, a claim for refund may accompany the return as filed.

### **21.3 Section 10 Adjustments**

The Division of Taxation's auditors have a very strong audit tool in N.J.S.A. 54:10A-10 (sometimes hereinafter called "10A-10"). Briefly stated, this section allows the Director to make redetermination and adjustments when taxpayers' accounting principles or business conduct results in distortion of entire net income. While the statute uses the expression "for the purpose of evading tax under this act", it does not mandate the imposition of criminal charges in all cases.

More specifically, under 10A-10 the Division may make "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." N.J.A.C. 18:7-5.10(a)3 provides: For purposes of this section, "fair and reasonable tax" is the tax that would have been payable by a taxpayer reporting the same transaction(s) on a separate entity basis where the parties to the transaction(s) had independent economic interests.

Thus, the Director may initiate adjustments under 10A-10 to determine a fair and reasonable tax, and without respect to any benefit arising out of inter-corporate relationships or the relationship of any person holding a substantial portion of the stock of the taxpayer. In this context a "substantial portion of the stock" means "20% or more of the out-standing shares of any class of stock".

In utilizing 10A-10, the Division shall not be limited to indices, trade practices, cost sheets, Internal Revenue Reports or any other factor in determining the appropriate transfer price for goods, services, intangibles or other dispositions made to related parties. Where the Director determines that there is an adjustment to net income under this section, he or she may also make a corresponding adjustment to the allocation factor.

#### **21.4 Internal Revenue Code 482**

An important determination to be made by the auditor is whether or not the adjustment should be made above or below Line 28 of Schedule A, CBT-100. This is because adjustments above Line 28 would impact upon taxpayers' filings with other States or the federal government (see N.J.S.A. 54:10A-13) but adjustments below Line 28 would not impact other filings. The Division has taken the position that when auditing and adjusting items above Line 28 of Schedule A, it will utilize Internal Revenue Code 482 standards. If the taxpayer can demonstrate that it has met the standards of Internal Revenue Code 482, no adjustments are likely to be made to items above Line 28 of Schedule A.

Conversely, if the standards of Internal Revenue Code 482 are not met, the Division will likely make its adjustment below Line 28. It should be noted that the language of N.J.S.A. 54:10A- 10(a) goes beyond Internal Revenue Code 482 situations since, for example, N.J.S.A. 54:10A-10(a) refers to "any person or persons directly or indirectly interested" rather than being restricted to "two or more organizations, trades or businesses" as under Internal Revenue Code 482.

It should also be noted that auditors may have difficulty when related corporations may or may not be New Jersey taxpayers. In this context, the Division seeks to "apply equitable principles to prevent unjust situations from occurring."

For the assistance of taxpayers, the Division has incorporated certain standards of Internal Revenue Code 482 as follows: "Where a service by one member of a group to another member is rendered for less than an arm's length charge, the Division of Taxation may make appropriate allocations to reflect an arm's length charge for that service. The arm's length charge is equal to the costs or deductions incurred by the member performing the service, except in cases where the service is an integral part of the business activity of either member." (N.J.A.C. 18:7-5.10(a)6).

### **21.5 Proper Allocation Between Seller and Buyer**

If tangible property is made available by one member of the group to another, the latter should be charged the arm's length rental charge. (N.J.A.C. 18:7-5.10(a)7). When one member of a group of controlled entities sells or otherwise disposes of tangible property to another at other than an arm's length price, a proper allocation will be made between the seller and the buyer first using the following methods as applicable (N.J.A.C. 18:7-5.10(a)8):

- a. Comparable uncontrolled price method: This method may be used if there are comparable uncontrolled sales (sales between outsiders or a member and an outsider in which the property sold and the circumstances involved are identical, or nearly identical, to those in the controlled sale). To the extent they are not identical, adjustments are made;
- b. Resale price method: If there are not comparable uncontrolled sales, the resale price method may be used if the standards for its application are met. A typical situation in which this method is required is when a manufacturer sells products to a related distributor which, without further processing, resells the products to unrelated parties; and
- c. Cost plus method: If the standards for application of the resale price method are not satisfied, cost plus method is used. Normally, the cost plus method is appropriate where a manufacturer sells products to a related entity which performs substantial manufacturing, assembly, or other processing of the product or adds significant value by use of its intangible property (trademark, for example) before resale.

Under both the comparable uncontrolled price method and the resale price method, market conditions faced by the affiliate are taken into account. Thus, goods may be sold, for a period, at a price which is below the full cost of manufacture in order to establish or maintain a market. (N.J.A.C. 18:7-5.10(a)9).

Assuming that the requirements of one of the above three methods is met, it may be used unless the taxpayer can show that some other method is clearly more appropriate. When none of the three methods can reasonably be applied, some other appropriate method can be used.

When a taxpayer makes controlled sales of many different products or many sales of the same product and it is impractical to calculate an arm's length price for each product or sale, it is permissible to apply the proper method of pricing to product lines or other groupings. Also, the Division of Taxation may use statistical sampling techniques to verify or determine the arm's length price of all sales to a related entity.

### **21.6 Methods for Calculating Interest Charges Between Related Parties**

In addition, the Division has outlined methods for properly calculating interest charges between related parties. Under N.J.S.A. 54:10A-10(b), interest should be charged on loans or advances made by one related party to another from the day after the debt arises until the debt is satisfied. With respect to intercompany trade receivables of related taxpayers, interest is not required to be charged on an intercompany trade receivable before the first day of the third calendar month.

If the creditor is regularly engaged in the business of making loans or advances, the arm's length interest rate should be charged. Upon failure to do so, the Division of Taxation can determine what interest

should have been charged. When the creditor is not in the business of loaning money or making advances, either an arm's length rate based on the facts and circumstances or a safe haven rate is acceptable. However, the safe haven rule does not apply to any loan or advance in which the interest or principal amount is expressed in a currency other than U.S. dollars.

For interest paid or accrued on a loan or advance, a safe haven rate is one that is between 100% and 130% of the Applicable Federal Rate (AFR) as determined under Internal Revenue Code Section 1274(d) in effect on the date that the loan or advance is made. Adjustments for inadequate interest are made at 100% of the AFR and adjustments for excessive interest are made at 130% of the AFR. In the case of a sale-leaseback transaction, the lower limit is 110% of the AFR. In determining the rate of interest actually charged on a written loan or advance, any original issue discount included in income by the lender or any bond premium deducted by the lender must be taken into account.

### **21.7 Unreasonable/Excessive Compensation**

Pursuant to IRC Section 162(a)(1), a deduction is allowed for ordinary and necessary salaries and other compensation paid or incurred for services actually rendered in a trade or business. Reasonable compensation is determined by the facts in each case. Generally, it is the amount that would ordinarily be paid for like services, by like businesses, under similar circumstances.

The question of reasonableness may be determined in light of total benefits provided to the employee. This determination includes deferred compensation to which the employee has a non-forfeitable right as well as current compensation. The fact that an employer and employee have a written contract for certain compensation does not always mean the amount paid is reasonable. The circumstances existing when the contract was entered into may be considered.

Issues of excessive or unreasonable compensation are most likely to occur in these two situations:

- a. **Interfamily Business** - In an interfamily business arrangement, a parent-employer may pay an employee-child an amount exceeding the reasonable worth of the child's services. Perhaps the child is in college and the excessive compensation may be a substitute for an allowance or a way to pay college tuition and deduct it from business profits. The excess compensation paid to the child might be treated as a dividend to the parent and as a gift from the parent to the child. Also, situations in which a parent "retires" and turns over a business to a child and yet still receives a salary may be investigated; and
- b. **Closely Held Corporations** - A so-called salary paid by a corporation may in reality be a dividend on stock ownership. This situation is most likely to occur when the corporation has only a few shareholders and all the shareholders draw salaries. The amounts paid in excess of what is reasonable usually bear a close parallel to the level of stock ownership, stockholders/employees are entitled to compensation for the services they perform as employees and a share in the equity of the corporation as an owner issued as dividends. However, the compensation should remain separate. The advantage of disguising the dividends as salaries and bonuses is that they are tax deductible to the corporation as a business expense and dividends paid are not. The income is taxable to the recipient regardless of classification (although receiving dividends may affect the basis of his/her investment).

Of note, many of the unreasonable compensation issues that the New Jersey Division of Taxation may be concerned with involve Subchapter S Corporations because the Internal Revenue Service may not include the issue in its audit plans. Also, bonuses paid to employee-shareholders may be closely scrutinized. Finally, pursuant to Internal Revenue Code 404, accrual method taxpayers may not deduct expenses for deferred compensation or accrued bonuses until they are includible in the payee's gross income when the taxpayers are related partners.

### **21.8 Determining Reasonableness**

The amount of reasonable compensation is determined based upon the facts in each case. If part of the compensation is excessive, only the part that is reasonable is deductible. Consideration may be given to the following substantial factors:

- a. Comparable salaries paid by like enterprises under like circumstances (Audit Hint: use studies and surveys of average salaries);
- b. Salaries paid by taxpayers to unrelated employees doing similar jobs;
- c. Company profits and the individual's contribution to same;
- d. Volume of the taxpayer's business;
- e. The amount of time required to perform the services for which the taxpayer is compensated; character and amount of responsibility involved in the service;
- f. Working conditions;
- g. Local living conditions;
- h. The employee's expertise and how it contributed to profit;
- i. History of dividends;
- j. Level of compensation, including bonuses designed to absorb most of the corporate income; and
- k. The amount of compensation, including bonuses geared to the level of ownership of stock.

The test of reasonableness is based on the individual's salary and the services performed rather than the aggregate salaries paid to all officers or employees. It is immaterial to the test of reasonableness if property or stock is distributed instead of cash (property or stock is valued at fair market). Property of nominal value, such as holiday turkeys, is not considered wages; however, gift certificates are considered compensation.

A limitation of IRC 162(a)(1) is that amounts paid or incurred may be for personal services actually rendered. The current year's deduction cannot include amounts applicable for services to be rendered in the future. Compensation for past services, so-called "catch up" compensation, is deductible as long as

the compensation is reasonable. Compensation for past services is a frequent potential rebuttal in any issue of unreasonable compensation.

When an employee works for two separate but related taxpayers, one taxpayer should not deduct the entire compensation. The compensation may be allocated to and deducted according to the services performed for each. A distribution to an employee treated as compensation remains includible in the recipient's gross income, even when some of the distribution is deemed unreasonable and not deductible to the corporation.

Excessive compensation payments made by corporations are usually treated as a dividend provided that the taxpayer has sufficient earnings and profits to call it a dividend.

**Additional Concerns:** In small businesses, in assessing whether a salary/bonus is reasonable, auditors may recognize that basic principles are usually involved in many aspects of the corporation's affairs. The small businessperson sells, manages people, designs products, handles finances, etc. All of these activities may be aggregated and weighed to determine what a reasonable salary would be.

In personal service businesses, where there is not significant capital investment, the Courts have tended to be more lenient in determining what is reasonable. They recognize that the success of the business depends upon the ingenuity, skill and decision-making of the principals and that earnings result from individual efforts rather than the employment of capital assets. High compensation is more reasonable where there is a corresponding lack of fringe benefits, such as pension plans or stock options which might otherwise be expected.

### **21.9 Adjustment Below Line 28**

- a. Tax exempt interest – All interest income received from federal, State or municipal obligations not included in federal taxable income may be added. The taxpayer is permitted to deduct any interest expense, not previously deducted in computing federal taxable income that is incurred to carry such investments;
- b. Related Interest Expense – Interest paid to a related member or entity deducted in arriving at federal taxable income may be added back. Exceptions to this rule may be claimed by the taxpayer by filing Schedule G-2;
- c. State and Local Taxes – The total expenses deducted, paid or accrued to the United States, a State, political subdivision thereof, foreign country or subdivisions thereof, on or measured by profits, income, business presence or business activity may be added back;
- d. Related Intangible Expenses – Add back the total amount of intangible expenses deducted from federal taxable income that were paid to related members or entities. Exceptions may be claimed by the taxpayer filing Schedule G-2. This add back includes expenses incurred and deducted related to factoring activities conducted with a related party;
- e. Dividend Received Deduction – Taxpayers may exclude from net income 100% of dividends received from subsidiaries which are more than 80% controlled. Dividends received from 50% or more controlled subsidiaries are 50% excludable. Dividends received from Money Market funds or Real Estate Investment Companies are not eligible from exclusion; and

- f. Nonoperational Activity – Income and Expenses related to Nonoperational Activity may be excluded from the computation of entire net income subject to allocation. Activity is required to be reported on Schedule O.

## **21.10 Allocation**

### **21.10A General Guidelines**

The statute does not define allocation per se, but makes reference to a measure of the tax imposed by Section 5. Such measure is determined by an allocation factor which is the average of the three fractions, the property, receipts and payroll fractions. In order for a fraction to be excluded from the formula both the numerator and the denominator must be 0. The allocation formula is known as the Massachusetts formula and has been upheld many times at every level of our court system. In the Hess Realty Corporation case, discussed below, the New Jersey Tax Court reiterated the three part formula to be the benchmark against which other apportionment formulas are judged.

### **21.10B Who Can Allocate**

New Jersey Corporation Business taxation dates back to 1946 when it was based on capital stock. A corporation engaged in multi-State activities was permitted to allocate total capital stock only on the basis of the ratio of the gross income from the business done in the State to the total gross income from its entire business. The basic corporation franchise tax law presently in effect was enacted in 1945 by Chapter 162 and is known as the Corporation Business Tax Act (1945), N.J.S.A. 54:10A-1, et seq., thus Section 6 of that act, giving the right to allocate, came into force.

For taxable periods beginning on or after January 1, 1992 and beginning before July 1, 2010 the receipts fraction denominator may be adjusted to exclude non-sourced receipts. This is referred to as “throw out.” See regulation 18:7-8.7 (d)(e)(f) and (g).

No corporation, foreign or domestic (other than a corporation entitled and electing to report as an investment company, regulated investment company or real estate investment trust) is entitled to allocate any part of its entire net income outside New Jersey unless during the period covered by the return it maintained a regular place of business outside the State. During the period covered by the return means if the taxpayer had an office outside the State for the full year, it is allowed to allocate. If the taxpayer maintains an out-of-State office for a portion of the year, Section 8 may be considered. A regular place of business is any bona fide office (other than a statutory office which is an office where notice can be served), factory, warehouse, or other space of the taxpayer which is regularly maintained, occupied and used by the taxpayer in carrying on its business and in which one or more regular employees are in attendance.

A bona fide office is one in which an employee in attendance performs significant duties related to the business of the taxpayer. A token office, space of the taxpayer or any place where an employee does not actually perform significant duties constituting part of taxpayer's business does not constitute a regular place of business.

The taxpayer may be directly responsible for the expenses incurred in maintaining the regular place of business and may either own or rent the facility in its own name and not through a related person or entity. The regular place of business should be identifiable as belonging to the taxpayer by, for example,

reflecting the taxpayer's name on the exterior and interior of the building and being listed in the taxpayer's name in a telephone book.

The taxpayer must regularly maintain, occupy and use the premises by employing one or more regular employees who are in attendance during normal business hours. Premises are not regularly maintained, occupied and used in the event employees are not in attendance the majority of the normal business hours and, in their absence, telephone messages are received by an answering service or recording device.

A regular employee must be under the control and direction of the taxpayer in transacting the taxpayer's business and/or performing work on behalf of the taxpayer. The officers of the taxpayer are generally deemed to be regular employees of the taxpayer while independent contractors and members of the taxpayer's board of directors are not regular employees of the taxpayer. The method or procedure by which a taxpayer reports the compensation paid to an individual (such as a W-2 form) shall not be conclusive as to whether the individual is a regular employee.

Below are examples of some approaches that may be utilized to solicit from a taxpayer the supporting information upon which to reach a reasonable determination:

- a. Describe fully the space occupied by the taxpayer out of State, specifically location, size, kind and quantity of the office equipment and other equipment and the cost of such equipment;
- b. State the name of the employee in attendance at the out-of-State office, time he or she devotes to taxpayer's business, description of duties, and indicate whether or not his or her time and/or payroll are shared with another business. Also, state whether or not unemployment taxes are paid out-of-State for the employment and furnish a copy of the employee's Federal Wage and Tax Statement (Form W-2);
- c. Were sales orders received and accepted at the out-of-State office? If yes, describe a typical sales transaction insofar as receipt and acceptance of the order, and furnish copies of forms completed in connection therewith;
- d. Were orders approved at the out-of-State office? If so, to what extent;
- e. Explain if the out-of-State office did any billing or collecting on sales;
- f. Explain if the out-of-State office approved or disapproved customer credit;
- g. Did the out-of-State office maintain sales and receivable records? If so, describe the type of records kept; and
- h. State the names and locations of banks in which deposits were made. If any such banks were located outside New Jersey, state the purpose of the account and the approximate cash balance carried.

In the absence of a regular place of business, 100% of the taxpayer's entire net worth and entire net income may be allocated to New Jersey. The mere ownership of assets outside New Jersey does not

constitute a basis for allocating less than 100% of the taxpayer's entire net worth or entire net income to New Jersey.

A tax credit provision currently exists in the rules as a form of relief when the taxpayer does not maintain a regular place of business outside New Jersey and its allocation factor is 100% and the taxpayer in fact pays a tax based on or measured by income to another State. N.J.A.C. 18:7-8.3 provides for the eligibility and method in computing a reduction in the tax for such taxpayers. This will be explained under the topic - Adjustments to Allocation.

### **21.10C Receipts Factor**

The legal provisions defining the receipts fraction are found at N.J.S.A. 54:10A-6B(1) to (6) and in a series of regulations N.J.A.C. 18:7-8.7 to 8.12. Some other jurisdictions refer to the receipts fraction as the "sales" fraction.

The calculation of the receipts fraction ties into several reportable provisions on Schedule A, CBT-100. In general, total receipts everywhere (Line 2g Schedule J) should equal the sum of Lines 1 and 4 to 10 plus Line 29 less the dividend exclusion (Line 37) on Schedule A. Net losses reported for income purposes cannot be reported below zero for allocation purposes.

Briefly, the receipts fall into the following categories:

- a. Sales of its tangible personal property located within this State at the time of the receipt of or appropriation of the orders where shipments are made to points within this State;
- b. Sales of its tangible personal property located outside this State at the time of the receipt of or appropriation to the others where shipments are made to points within this State;
- c. Services performed within the State;
- d. Rentals from property situated, and royalties from the use of patents or copyrights, within this State; and
- e. All other business receipts (excluding dividends excluded from entire net income by subsection (k)(1) of Section 4 hereof) earned within this State.

Once the taxpayer or Division auditor determines whether or not a given receipt is includible in the numerator of the receipts fraction as a New Jersey receipt, then the fraction itself may be calculated.

The receipts of the taxpayer are to be computed on the cash, accrual or other method of accounting used in computation of its net income for Federal income tax purposes. The numerator and denominator of the receipts fraction may relate to the entire net income recognized during the period covered by the return. For example, entire net income shall be recognized as follows:

All receipts used in computing net income may be included in the numerator and denominator of the receipts fraction. (Example: Tax exempt interest is exempt for federal purposes, but is included in entire net income for New Jersey Tax purposes).

Any income which is excluded from entire net income is also excluded from the numerator and denominator of the receipts fraction, except for banking corporations with international banking facilities as provided by law. See N.J.S.A. 54:10A-6 and 54:10A-34, 54:10A-4(K)(4).

Examples:

- Dividends recognized as income for purposes of determining Federal income tax, but which are excluded from entire net income under Section 4(k)(1) of the law may also be excluded in computing the receipts fraction; and
- Subpart F income included in Federal taxable income before net operating loss deduction and special deductions is excluded from New Jersey net income and for allocation purposes.

Allocable New Jersey Receipts include sales transactions. Sales of tangible personal property in which shipments are made to points in New Jersey and the sale of goods shipped to a New Jersey customer and possession is transferred in New Jersey results in a receipt allocable to New Jersey. The sale of goods shipped to a non-New Jersey customer when possession is transferred in New Jersey results in a receipt allocable to New Jersey.

The sale of goods shipped by a taxpayer from outside of New Jersey to a New Jersey customer by a common carrier results in a receipt allocable to New Jersey. The common carrier is deemed an agent of the seller regardless of the F.O.B. point. The sale of goods shipped from outside New Jersey to a New Jersey location where the goods are picked up by a common carrier and transported to a customer outside of New Jersey results in receipts which are not allocable to New Jersey.

Receipts from sales of capital assets may be includible in the fraction. The gross receipts from sales of capital assets (property not held by the taxpayer for sale to customers in the regular course of business) either within or without New Jersey should not be included in either the numerator or denominator of the receipts fraction. The net gains from such sales which are included in entire net income are the amounts which are properly to be included in the computation of the receipts fraction. For the purpose of the numerator in the computation of the receipts fraction, a net loss should not offset a net gain.

If the taxpayer's business is the buying and selling of real estate or buying or selling of securities for trading purposes, these assets are not deemed to be capital assets and the gross receipts from such sales are included in the same manner as other includible receipts. The regulations supply a number of examples of these principles.

Receipts from services performed within New Jersey are allocable to New Jersey. All amounts received by the taxpayer in payment for such services are New Jersey receipts regardless of whether such services were performed by employees or agents of the taxpayer, by subcontractors, or by any other persons and regardless of whether the receipt is accounted for as an item of income or a reduction in expense. It is irrelevant where the amounts were payable or where they actually were received.

Commissions received by the taxpayer are allocable to New Jersey if the services for which the commissions were paid were performed in New Jersey. If the taxpayer's services for which commissions were paid were performed by the taxpayer or by sales representatives attached to or working out of a New Jersey office of the taxpayer, the taxpayer's services will be deemed to have been performed in New Jersey.

For example: The taxpayer is a New Jersey sales agent of a Pennsylvania manufacturer and receives in New Jersey an order from a New York customer. The order is forwarded to the manufacturer which accepts it and fills it by shipment direct to the customer. The taxpayer's commission is allocable to New Jersey.

If a lump sum is received by the taxpayer in payment for services within and without New Jersey, the amount attributable to services performed within New Jersey is to be determined on the basis of the relative values of, or amounts of time spent in the performance of, those services within and without New Jersey, or by some other reasonable method which should reflect the trade or business practice and economic realities underlying the generation of the compensation for services. Full details may be submitted on a rider with the taxpayer's return.

Receipts from rentals of real and personal property situated in New Jersey, and royalties from the use in New Jersey of patents or copyrights, are allocable to New Jersey. Receipts from rentals include all amounts received by the taxpayer for the use or occupation of property, whether or not such property is owned by the taxpayer. Receipts from royalties include all amounts received by the taxpayer for the use of patents or copyrights, whether or not such patents or copyrights were originally issued to or are owned by the taxpayer. A patent or copyright is considered used in New Jersey to the extent that activities pursuant to it are carried on in New Jersey.

All other business receipts earned by the taxpayer within New Jersey are allocable to New Jersey. Other business receipts include all items of income entering into the determination of entire net income during the year for which the business allocation factor is being computed and not otherwise provided for in these rules. Examples of such business receipts include, but are not limited to, interest income, dividends which are not excluded from entire net income, governmental subsidies or proceeds from sales of scrap.

#### **21.10D Payroll Factor**

The percentage of the taxpayer's payroll allocable to New Jersey is determined by dividing the amount of wages, salaries and other personal service compensation of employees within New Jersey during the period covered by the return by the total amount of compensation of all the taxpayer's employees during the period. Payroll includes wages, salaries and other compensation paid for personal services rendered to the taxpayer, but it does not include amounts paid if the relationship of employer and employee does not exist. Generally, the relationship of employer and employee exists when the taxpayer has the right to control and direct the individual not only as to the result to be accomplished by him or her, but also as to the means by which such result is accomplished. If such a relationship exists, the measure, method or designation of the compensation is immaterial.

All executive salaries are includible in both the numerator, as applicable, and the denominator. Compensation paid to officers including chairman, president, vice-president, secretary, assistant secretary, treasurer, assistant treasurer, comptroller and any other officer charged with and performing general executive duties of the corporation must also be included.

Directors are not employees. Therefore, compensation or fees paid to Directors for acting as such should not be included in either the numerator or the denominator of the payroll fraction.

Wages, salaries and other compensation are computed on the cash or accrual basis, in accordance with

the method of accounting used by the taxpayer in reporting for Federal income tax purposes.

In general, a taxpayer reporting to the New Jersey Division of Employment Security must allocate to New Jersey all wages, salaries and other compensation, and other items reportable to that Division, including any portion in excess of the amount prescribed by the New Jersey Department of Labor. Generally, copies of Department of Labor forms WR-30 State of New Jersey Employer Report of Wages Paid and UC-27 State of New Jersey Quarterly Contributions Report are requested to verify the accuracy of wages allocable to New Jersey. However, it must be noted that such reports reflect wages and other remuneration actually paid, whereas the numerator and denominator of the payroll fraction may reflect accruals.

Compensation of officers and employees within New Jersey includes all the wages, salaries and other personal services compensation for services performed within or both within and outside this State, if:

- The service is performed entirely within this State;
- The service is performed both within and outside this State, but the service performed outside New Jersey is incidental to the individual's service within the State (e.g., service which is temporary or transitory in nature or which consists of isolated transactions); or
- The service is not performed entirely in any State, but some of the service is performed in this State; and
  - The base of operations, or if there is no base of operations, then the place from which the service is directed or controlled, is in this State; or
  - The base of operations or place from which the service is directed or controlled is not in any State in which some part of the service is performed, but the individual's residence is in this State. Contributions are not required or paid with respect to such service under an unemployment compensation law of any other State.

Whether an individual is an employee or an independent contractor is a factual question. New Jersey case law enumerates the following eight relevant factors which distinguish an independent contractor from a common law employee:

- a. The relationship which the parties believe they have created;
- b. The extent of control exercisable (regardless of actual exercise) by the person receiving the benefit of the services over the manner and method of performance;
- c. Whether the person rendering the service undertook substantial costs to perform the service;
- d. Whether the service required special training or skill;
- e. The duration of the relationship between the parties;
- f. Whether the person rendering the service had a risk of loss;
- g. Whether the person who received the benefit of the service could discharge without cause the person who performed the services; and

- h. The method of payment (by time or by job).

See the cases Boudrot v. Taxation Div. Director, 4 New Jersey Tax 268 (Tax Ct. 1982) at 274. Poppe v. Taxation Div. Director, 6 New Jersey Tax 108 (Tax Ct. 1983) at 114.

The Internal Revenue Service has established a 20-point checklist that can be used as a guideline in determining whether or not a worker is an independent contractor who should be issued a Form 1099. This checklist helps determine who has the "right of control." The auditor should consider whether the employer has control or the "right of control" over the individual's performance of the job and how the individual accomplishes the job. The greater the control exercised over the terms and conditions of employment, the greater the chance that the controlling entity will be held to be the employer. The right to control (not the act itself) determines the status as an independent contractor or employee. The 20-point checklist is only a guideline.

Over the years, the Internal Revenue Service has recognized changes in business practices and therefore created three categories of factors to assess the degree of control and independence. These factors may be used in conjunction with the 20 factors.

#### **21.10E Property Factor**

The property fraction of the Business Allocation Factor is derived from average values. The percentage of the taxpayer's real and tangible personal property within New Jersey is determined by dividing the average value of such property within New Jersey by the average value of real and tangible personal property everywhere. The average values in both the numerator and the denominator should be determined without deduction of any encumbrance.

Real and tangible personal property includes property owned, leased, rented or used by the taxpayer. It does not include property not yet in service or removed from service or under construction (exclusive of inventory work in progress).

Tangible personal property means corporeal property, such as machinery, fixtures, tools, implements, goods, physical inventory and merchandise but does not mean money, deposits in banks, shares of stock, bonds, notes, credits or evidence of an interest in property and evidence of debt. The average values used in determining the property fraction of the allocation factor are normally based on book value with respect to property owned, including property on consignment. Leased or rented property is valued at eight times its annual rent, including any amounts (such as taxes) paid or accrued in addition to or in lieu of rent during the period covered by the return. Sub rents do not reduce annual rents, but rather enter into the determination of the receipts fraction.

Property used that is neither owned, leased or rented should be valued at book value. Property on consignment held by the consignee is considered property in use. Leasehold improvements are treated as owned by the taxpayer. The numerator and the denominator shall take into account depreciation disallowed by N.J.A.C. 18:7-5.2 where the taxpayer accounts for its property on a Federal income tax basis on its books.

Generally it is considered located in New Jersey if physically situated or located in this State, including stored in a bonded warehouse or if held in this State by an agent, consignee or factor.

The average values used are normally based on book value for both the numerator and denominator generally computed on a quarterly basis if the taxpayer's accounting practice permits such computation. However, the taxpayer or the Director may use a more frequent basis such as month, weekly or daily. When taxpayer accounting practice does not permit computation on a quarterly basis or a more frequent basis, a semi-annual or an annual basis may be used if no distortion of value results.

**21.10F Single Sales Factor**

Effective for taxable periods beginning after January 1, 2012, New Jersey began to phase in an increase in the relative weighting of the receipts fraction until the property and wage fractions are eliminated. The phase-in weighting schedule is as follows:

	<u>Property</u>	<u>Receipts</u>	<u>Payroll</u>
Periods beginning prior to 1/1/12	25%	50%	25%
Periods beginning after 1/1/12	15%	70%	15%
Periods beginning on/or after 1/1/13	5%	90%	5%
Periods beginning on/or after 1/1/14	0%	10%	0%

**21.10G Adjustment of Allocation Factor**

N.J.S.A. 54:10A-8 (Section 8) provides the authority for the Director to adjust an allocation factor determined pursuant to N.J.S.A. 54:10A-6 (Section 6) that does not properly reflect the activity, business, receipts, capital, entire net worth or entire net income of a taxpayer reasonably attributable to the State. The Director may adjust the allocation factor by:

- Excluding 1 or more of the fractions therein;
- Including 1 or more other fractions, such as expenses, purchases, contract values (minus subcontract values);
- Excluding 1 or more assets in computing an allocation percentage; or
- Applying any other similar or different method calculated to effect a fair and proper allocation of the entire net income.

Based on its long-standing audit practices and experience, the Division has determined special rules for the calculation of the receipts fraction for special industries such as trucking or shipping. In the trucking industry, receipts can be determined on the basis of revenue miles in New Jersey versus revenue miles everywhere plus other costs as outlined in the regulations. The percentage of the taxpayer's receipts within New Jersey is determined by ascertaining the taxpayer's receipts allocable in New Jersey during the period covered by the return and dividing the sum of the receipts by the taxpayer's total receipts within and without New Jersey during such period. For example, the transportation revenue of an airline from services performed in New Jersey can be based on the ratio of departures from New Jersey to total departures. For details, see N.J.S.A. 18:7-8.10.

Example: For the communications industry, audience share - which means the percentage of audience in New Jersey versus the total audience – can be used to determine the receipts fraction.

Other rules may apply as follows: Mobile or movable property, such as construction equipment or trucks, are within New Jersey based on the ratio of time the property is used within New Jersey to the

time the property is used everywhere. Ships are in New Jersey based on the ratio of time the vessels are in operation in New Jersey to the time everywhere, including sailing days, days in port for loading, unloading, ordinary repairs, refueling and provisioning. Satellites used in the communications industry are included in the fraction based on the ratio of ground stations serviced in New Jersey to the number of such ground stations everywhere. If property is in transit, then it is considered located in New Jersey if it is in transit from one New Jersey location to another. It is considered outside of New Jersey if it is in transit from one location outside of New Jersey to another location outside of New Jersey. It is omitted from both the numerator and the denominator if it is in transit from points outside of New Jersey to points in New Jersey or vice versa. Property ceases to be in transit when it is delivered to or becomes subject to actual possession by the owner at the point of destination.

In order to implement Section 8, the Director adopted two regulations.

1. N.J.A.C. 18:7:10.1 requires the taxpayer requesting an adjustment of its allocation factor to first file its return and pay its tax in accordance with the regular statutory formula. The taxpayer may also attach a rider to the return with Form A-3730 setting forth in full the data on which its application is based, together with a proposed method.

Section 6 usually produces a fair apportionment of the taxpayer's net worth and net income within and without New Jersey. However, in some circumstances the results are not equitable and do not accurately reflect the business activity within New Jersey for the taxpayer or the State.

Adjustment of the business allocation factor may be made by the Director upon his/her own initiative or upon request of a taxpayer. No taxpayer may vary the regular statutory formula without the prior consent of the Director.

2. N.J.A.C. 18:7-8.3 provides relief for duplication of income in cases when an allocation factor determined pursuant to the provisions of Section 6 of the Act is 100% and the corporation in fact paid a tax based on or measured by net income to a foreign State(s). The corporation may, under Section 8 of the Act, apply for a reduction of the amount of tax required to be paid.

A taxpayer claiming a reduction may attach a rider to its return reflecting in detail its computation together with a copy of the return as filed with the foreign State(s).

The reduction is available only where the taxpayer in its own right acquired a taxable status in the foreign State by reference to at least one of the criteria described at N.J.A.C. 18:7-1.6 as if the New Jersey Corporation Business Tax Act were the law of that foreign State.

For purposes of calculating the reduction:

- It may be based upon only so much of adjusted entire net income appearing on its Corporation Business Tax Return as is reported to the foreign State;
- The formula apportionment used in the foreign State may not exceed the Business Allocation Factor as determined under Section 6 of the Act and these rules; and
- It may be computed by using the lesser of the tax rates of the foreign State or the tax rate under the New Jersey Corporation Business Tax Act.

### **21.11 Federal Taxable Income**

Schedule A, Lines 1 through 28, of the CBT Form 100 represents an income schedule mirroring the schedule found in the taxpayer's Federal corporate income tax return and is used as New Jersey's starting point in determining entire net income as Federal Taxable Income before special deductions.

## **Chapter 22 Corporate Billing**

### **22.1 Corporate Billing**

The Corporate Billing Group sends notices to corporations that have Corporation Business Tax deficiencies, responds to inquiries, and resolves issues regarding those notices. This group also reviews retroactive S corporation election applications and amended Corporation Business Tax returns that have a zero balance or a balance due that is not the result of an Internal Revenue Adjustment.

### **22.2 Notices of Deficiency**

When the Division receives a CBT-100 or CBT-100S and calculates a deficiency (total liability exceeds the taxpayer's payments and credits), the tax filing is reviewed. If it meets certain pre-determined parameters, the computer system automatically generates a notice that is printed and mailed to the taxpayer without further review. If the account does not meet all the parameters, it falls into review status. Lists of these accounts are generated periodically and auditors review them to determine whether the deficiencies are correct. The auditors will make adjustments to the accounts as necessary and approve the notices that are then printed and mailed to the taxpayers.

### **22.3 Taxpayer Inquiries**

Notices of deficiency include a phone number, mailing address, and e-mail address that taxpayers may use to contact the Division with any questions or to resolve issues regarding the notices they receive. Caseworkers handle their assignments in the following order: phone calls, voicemails, correspondence (including email), followed by review lists.

### **22.4 Amended Returns**

Auditors examine amended returns for accuracy and completeness. If the auditor finds that additional information is needed, he/she will send a letter to the taxpayer requesting same. Once the auditor determines that he/she has all the information, he/she will adjust the taxpayer's account as necessary and, if there are any resulting deficiencies, approve a notice of deficiency to be sent to the taxpayer. The notice will include a schedule of liabilities (including penalty and interest).

### **22.5 Retroactive S Corporation Election Applications (CBT-2553-R)**

Corporations that have been timely filing the CBT-100S without an approved S corporation election may apply for retroactive S status by filing CBT-2553-R with the Division of Revenue and Enterprise Services (DORES). DORES processes any payment remitted with the application and then forwards the application to Corporate Billing. The billing team supervisor assigns the application to an auditor who then:

- a. Reviews the taxpayer's Corporation Business Tax account, beginning with the date the corporation began doing business in New Jersey, to determine whether all returns have been filed, payments have been posted properly, and whether any deficiencies or delinquencies exist. If the caseworker finds that there are missing returns or deficiencies, he/she denies the application and sends the taxpayer a denial letter; and

- b. Reviews the Gross Income Tax returns of the corporation's shareholders for the years in which the corporation filed Form CBT-100S. The caseworker reviews the Gross Income Tax returns to ensure that the shareholders reported their pro rata share of S corporation income. If the caseworker finds that any of the shareholder(s) did not report their pro rata share of S corporation income, the caseworker denies the application and sends the corporation a denial letter.

If the auditor determines that the taxpayer has no deficiencies and timely filed its returns in accordance with the S corporation regulations, the caseworker will approve the retroactive S corporation election. The caseworker then sends a letter to DORES advising of the approved election. DORES then adjusts the taxpayer's records in the Commercial Recording system to indicate the date on which the taxpayer's status as a C corporation ended and when its status as an S corporation began. Once the adjustment occurs, the caseworker converts any C corporation returns (CBT-100) in the taxpayer's account to S corporation returns (CBT-100S).

## **Chapter 23 Individual Audit- Gross Income Tax**

The Gross Income Tax Audit Branch is responsible for auditing resident and non-resident Gross Income Tax returns filed by individuals, estates and trusts. This Branch also contacts taxpayers identified as having a New Jersey income tax filing responsibility but for whom the Division has no record of a return having been filed.

### **23.1 The Selection Process**

Using established criteria in combination with public records, information from the IRS, other states, and other New Jersey agencies, tax returns and/or individuals are selected for audit and assigned to auditors for review.

### **23.2 The Pre-Audit Process**

When a Gross Income Tax return is assigned, the auditor must gather and review all available information to determine if the return was filed correctly. This includes, but is not limited to: the filed return and all attachments, the taxpayer's entire account (including amended returns, adjustments, and notes from previous audits), the filed New Jersey returns of all identified flow-through entities connected to the taxpayer (e.g., partnerships, LLCs, S corps), and data received from external sources. The auditor must then make a preliminary evaluation as to whether adjustments will be necessary.

If the auditor believes that adjustments to the return will be necessary, the auditor must determine whether he/she will be able to conduct and complete the audit before the statute of limitations for adjustments expires. Generally, the statute of limitations expires three years after a return is filed. If the auditor concludes that this timeframe is too short for an audit, he/she will attempt to obtain consent from the taxpayer to extend the statute, using the Consent Form in the Division's audit case management system. If the taxpayer does not consent to extend the statute, and there are 45 days or less until the expiration of the statute of limitations, the auditor will issue an Estimated Notice of Deficiency based on all information available.

### **23.3 The Audit Process**

Once the auditor has reviewed all available information, he/she considers whether there is sufficient information to make a determination as to whether the return is correct as filed, without requesting additional information from the taxpayer.

### **23.4 Available Information Sufficient**

In most cases, if the taxpayer filed a return and included all supporting documents and schedules, the auditor should have sufficient information to review in order to make a determination. Once the auditor has completed the review, the auditor has two options:

- a. Accept the return as filed, note in the audit file and in the taxpayer's account the reason(s) for accepting the return, and close the case in the Division's audit case management system (no contact is made with the taxpayer); or
- b. Adjust the return as necessary and issue either a Notice of Deficiency or a refund.

### **23.5 Available Information Insufficient**

If the auditor has a reasonable basis to believe that a deficiency exists but the information available is insufficient, he/she will proceed as set forth in Sections 23.6 through 23.9, below.

### **23.6 Letter of Inquiry**

If there are more than 45 days until the expiration of the statute of limitations, the auditor must send a letter of inquiry to the taxpayer requesting additional documentation and/or information.

Examples of documentation and/or information that the auditor may request include, but are not limited to:

- A complete copy of the taxpayer's Federal income tax return for the period being audited;
- Forms W-2 and 1099;
- If the taxpayer claimed a credit for taxes paid to other jurisdictions, complete copies of out-of-State tax returns and proof of payment of such taxes;
- Copies of tax returns for related flow-through entities;
- Copies of Federal, out-of-state, and New Jersey K-1s;
- Documentation to support any deductions claimed; and
- Documentation to support basis amounts reported

The auditor must include Form M-5008-R, Appointment of Taxpayer Representative, with the documentation request. Generally, the taxpayer has 30 days to comply with the auditor's request. If more time is needed, the taxpayer or Division may request an extension of time.

### **23.7 No Response – Follow-Up Request**

If, after 45 days the auditor has not received a response to the initial inquiry, he/she sends a follow-up request to the taxpayer giving another 30 days to comply.

### **23.8 Taxpayer Responds – Additional Information Required**

If the taxpayer responds to the initial inquiry, the auditor reviews the information received and determines if additional information is needed or if there is now sufficient information to make an audit determination. If the auditor determines that additional information is required, he/she sends a second request.

### **23.9 No Response/Under 45 days to Statute of Limitations - Estimated Assessment**

If the taxpayer does not comply with the auditor's initial and/or subsequent request(s) for information, the auditor issues an estimated assessment based on available information. The estimated assessment includes the same items as the Notice of Deficiency (see Section 23.14, below) except that the cover letter states that an estimated assessment has been made due to the taxpayer's failure to provide requested information.

If there are 45 days or less until the expiration of the statute of limitations, the auditor issues an Estimated Notice of Deficiency based on the information available. The Notice is sent to the taxpayer via certified mail, and includes a schedule of adjustments, a schedule of explanations of the adjustments, Form A1014 (Taxpayer Rights), and Form M-5008-R (Appointment of Taxpayer Representative). In addition, the schedule of explanations advises the taxpayer as to the information needed to refute the Notice and to submit the information within 90 days from the date of the Notice.

The schedule of adjustments consists of three columns: the taxpayer's return as originally reported, the adjustments and the return as audited. This schedule also details the additional tax, penalty, and interest due. The date to which interest has been calculated serves as the date by which the taxpayer must make payment in order to avoid additional interest charges.

### **23.10 Making the Audit Determination**

The auditor reviews all the available information, makes any necessary adjustments to the taxpayer's account(s), and then makes one of the determinations in the sections below.

#### **23.11 No Change**

If the auditor determines that the taxpayer's Gross Income Tax was properly calculated and paid, the auditor sends the taxpayer a letter stating that the audit has been completed and no changes to the Gross Income Tax return were made. The auditor must inform the taxpayer that his/her tax could be changed at a later date if the taxpayer is a shareholder in an S corporation, a beneficiary of a trust, or a partner in a partnership, because an examination and change to any one of those returns could result in a change of reportable income to the taxpayer. The auditor notes in both the audit file and the taxpayer's account the reason(s) for accepting the return as filed, closes the case in the Division's audit case management system, and prepares the file for imaging.

#### **23.12 Refund Due**

If the adjustments to the return result in an overpayment of Gross Income Tax, the auditor approves the refund and prepares a letter for the taxpayer. This letter is mailed along with a schedule of adjustments, a schedule of explanations for the adjustments, Form A1014 (Taxpayer Rights) and, if one was not previously submitted, Form M-5008-R (Appointment of Taxpayer Representative).

#### **23.13 Deficiency**

If the adjustments to the return result in an underpayment of Gross Income Tax, the auditor prepares a Notice of Deficiency. The Notice is mailed along with a schedule of adjustments, a schedule of explanations for the adjustments, Form A1014 (Taxpayer Rights) and, if one was not previously submitted, Form M-5008-R (Appointment of Taxpayer Representative).

The Notice of Deficiency is sent to the taxpayer via certified mail and a copy is sent to the taxpayer's appointed representative, if applicable. The auditor also prints out a copy of the proof of receipt of the Notice, obtained from the United States Postal Service, and includes it in the file.

### **23.14 The Post-Audit Process**

After an audit has been completed and the auditor has sent the appropriate notice to the taxpayer (and the taxpayer's appointed representative, if any), one or more of the following events will occur.

### **23.15 Taxpayer Agrees With Adjustments – Remits Full Payment**

When a taxpayer sends full payment of the amount stated in the Notice of Deficiency, the auditor records receipt of the payment electronically in the Division's computerized system and the case history, and places a copy of the check in the audit file. The auditor must forward the check to the Division of Revenue for processing within one business day of receipt.

### **23.16 Taxpayer Remits Partial Payment**

When a taxpayer indicates that he/she cannot make full payment, the auditor instructs the taxpayer to send a written request for a payment plan that indicates the amount the taxpayer wishes to pay each month and the total number of months the taxpayer wishes to make payments. The auditor must advise the taxpayer that interest will continue to accrue until the balance is paid in full.

### **23.17 Deferred Payment Plan – 4 Months or Less**

If the taxpayer requests a payment plan of 4 months or less, the auditor will hold the file open and record and process the payments as they are received each month. Before receiving the final payment, the auditor must send the taxpayer a letter detailing the payments received and the balance due with accrued interest. If the taxpayer fails to remit any payment as scheduled, the auditor will issue a system bill. If the taxpayer does not respond within 30 days, the auditor transfers the file to Compliance for collection.

### **23.18 Deferred Payment Plan – More Than 4 Months**

If a taxpayer requests a payment plan of more than 4 months and the total liability is \$500 or less, the auditor must advise the taxpayer that:

- The Division will not offer a payment plan for a debt of \$500 or less;
- The debt will be submitted to the Federal Offset of Individual Liability Program, which applies Federal Income Tax refunds to New Jersey State tax debt; All or part of any refund, rebate, or credit due the taxpayer from the State may be withheld by the Division and applied against the outstanding income tax liability; and
- If it is necessary for the Division to refer the outstanding debt to an outside collection agency contracted by the Division, a 10% Referral Cost Recovery Fee will be added to the liability.

If the taxpayer requests a payment plan of more than 4 months and the total liability is more than \$500, the auditor will advise the taxpayer that the audit file is being transferred to the Deferred Payment Control Center and that a representative from that section will contact the taxpayer to set up a payment plan within the established parameters.

### **23.19 Taxpayer Disagrees With Adjustments**

When a taxpayer disagrees with the auditor's adjustments, the taxpayer may protest or appeal the audit determination. The taxpayer also has the option of paying the full amount of the assessment and then filing a claim for refund.

### **23.20 Taxpayer Files Protest With Conference and Appeals Branch**

The taxpayer has 90 days from the date of the Notice of Deficiency within which time he/she may send a written letter of protest requesting a conference with the Division's Conference and Appeals Branch. When Conference and Appeals Branch receives a protest that includes supporting documentation, Conference and Appeals Branch notifies the Gross Income Tax Audit Branch to forward the complete file.

### **23.21 Taxpayer Files Appeal With Tax Court**

Alternatively, the taxpayer may file a complaint directly with the Tax Court of New Jersey. If the taxpayer is appealing a Notice of Deficiency, the court must receive the complaint within 180 days from the date of the Notice.

### **23.22 Claim For Refund**

A taxpayer who does not timely protest or appeal an assessment may pay the full assessment within one year after the expiration of the period allowed for filing a protest, and then file for a refund of the payment by submitting Form A-1730, Claim for Refund of Paid Audit Assessment. Form A-1730 must be filed within 450 days of the expiration of the period allowed for filing a protest. These forms are received in Audit Billing where personnel identify the auditor who issued the assessment and then forward the form, and any supporting documentation, to the auditor's supervisor for review and determination. Form A-1730 cannot be used to claim a refund of the following: jeopardy assessments, delinquent assessments, penalty and interest assessments, estimated, or arbitrary assessments.

### **23.23 Refund Due**

If the supervising auditor determines that the information and/or documentation provided by the taxpayer supports the claim for refund, the supervising auditor approves the refund and notifies the taxpayer.

### **23.24 Partial Refund Due**

If the supervising auditor determines that the taxpayer is entitled to a partial refund based on the information and documentation provided, the supervising auditor makes the necessary adjustments to the account and sends a letter informing the taxpayer that a partial refund has been approved. The supervising auditor provides a detailed explanation and/or worksheet(s) supporting the determination, along with the taxpayer's protest and appeal rights.

### **23.25 No Refund Due**

If the supervising auditor determines that the taxpayer is not entitled to a refund based on the information and documentation provided, the supervising auditor sends the taxpayer a letter denying the refund request and provides a detailed explanation supporting the determination, along with the taxpayer's protest and appeal rights. All protests and appeals of A-1730 determinations are forwarded to the Conference and Appeals Branch for further review.

### **23.26 Taxpayer Does Not Respond to Notice**

If, after 180 days from the date of the Notice of Deficiency the taxpayer has not responded to the auditor, the auditor:

- Closes the case in the Division's audit case management system and the Division's case tracking system;
- Sends a copy of the Notice of Deficiency to Compliance for collection proceedings; and
- Prepares the file for imaging.

Once the auditor has closed the case, the auditor's supervisor transfers the case to Compliance in the Division's case tracking system.

### **23.27 Audit File and Case History**

The audit file must be well organized and detailed so that another person would be able to follow the steps and logic used in conducting the audit.

The auditor must keep copies of all correspondence sent to and received from the taxpayer (and/or the taxpayer's representative) in the file. All supporting documentation received from the taxpayer must also be kept in the audit file.

The auditor must complete the Case History in the Division's audit case management system for every audit and must update it with detailed entries throughout the course of the audit each time activity or an event occurs, including all telephone conversations relevant to the audit (e.g., spoke with taxpayer and requested copy of K-1 for partnership ABC; instead of "called taxpayer"). All correspondence sent or received must be attached to the corresponding entry in the Case History.

### **23.28 Prepare File For Imaging**

Once the audit is complete and no further action is required, the auditor prepares the audit file for scanning. The auditor must prepare and place a cover sheet detailing the contents of the file on top of the file, and a batch sheet for scanning purposes on the bottom. Copies of internal documents that are available electronically, such as imaged tax returns and the Division's taxpayer accounting system screen prints, should be removed from the audit file. The Gross Income Tax Audit Branch completes the scan.

## **Chapter 24 Individual Audit -Transfer Inheritance and Estate Taxes**

The Transfer Inheritance and Estate Tax Branch of Individual Audit Activity is responsible for auditing all inheritance and estate tax returns filed on behalf of resident and non-resident decedents.

For resident decedents, the Transfer Inheritance Tax is imposed on the transfer to beneficiaries of real or tangible personal property located in New Jersey, and on intangible property wherever situated. For non-resident decedents, the tax is imposed only on the transfer to beneficiaries of real property or tangible personal property located in New Jersey.

For resident decedents dying after December 31, 2001, but before January 1, 2017, the Estate Tax is imposed on taxable estates in excess of \$675,000 and is applied in reference to the provisions of the Internal Revenue Code in effect on December 31, 2001.

For resident decedents dying on or after January 1, 2017, but before January 1, 2018, the Estate Tax is imposed on taxable estates in excess of \$2,000,000 and is applied in accordance with the provisions of the current Internal Revenue Code.

Under current law, there is no New Jersey Estate Tax imposed on the estates of resident decedents dying on or after January 1, 2018.

### **24.1 General Audit Procedures**

- a. The auditor must issue an assessment within four years from the date a return is filed or 15 years from the date of death;
- b. The auditor must make every effort to issue any refunds due within six months from the date of the request in order to avoid the payment of interest;
- c. The auditor must maintain the files for the cases assigned to him/her in an orderly manner and in a file specifically assigned for this purpose. Supervisors must have access to audit files in the auditor's absence. The auditor must keep a record of pending audits and ensure that required follow-up actions are taken in a timely manner; and
- d. On a daily basis, the auditor must record the time spent on each audit and include the totals in the monthly report to his/her supervisor.

### **24.2 Screening Filed Returns**

Auditors screen each filed return and determine which returns are accepted as filed and which returns require further review. Once returns are screened, they are forwarded to the Division of Revenue for processing.

### **24.3 Returns with No Balance or Refund Due**

For any return that has no balance or refund due and is accepted as filed, the Bookkeeping Group forwards the corresponding file to the Waiver Processing Group. The Waiver Processing Group then issues the required waivers for each return, as well as a zero balance Notice of Assessment.

#### **24.4 Returns with a Balance or Refund Due or selected for Audit**

For any return requiring further review, the Bookkeeping Group forwards the corresponding file to a designated auditor. The auditor makes any necessary adjustments then, with supervisor approval, issues a refund or bill as appropriate and returns the file to the Bookkeeping Group. The Bookkeeping Group holds the file until the refund is issued or payment is received, and there is a zero balance in the account. The file is then forwarded to the Waiver Processing Group, which issues the required waivers for each return, along with the system-generated zero-balance notice of assessment.

#### **24.5 Initial Audit Preparation and Review**

An auditor must begin pre-audit preparation of a case within 30 days from the date that it is assigned. This means that the auditor must prepare the file and review the contents to determine whether all required forms and documentation were provided with the return. Within 45 days of the date the case is assigned, the auditor must contact the estate's representative to obtain missing documentation, if any.

#### **24.6 Preparing the File**

The auditor must arrange the case file in the following order:

- a. The tax return(s) and schedules are placed at the bottom of the file;
- b. Documentation submitted with the tax return is located immediately above the return; and
- c. Any other documents should be added in reverse chronological order, with most current on top.

#### **24.7 Reviewing the File**

The auditor must review the file and determine whether the following required items have been submitted and have been properly completed:

- A copy of the decedent's Last Will and Testament, if the decedent died testate, along with any codicils, separate writings, and letters of appointment;
- A copy of the decedent's Federal income tax return, if any, for the year prior to death;
- A copy of any contract of sale and/or HUD-1 statement (or its equivalent), if available, for all real property in which the decedent held an interest at the time of death or transferred within three years of death;
- A copy of any trust instrument for a trust that the decedent created or in which he/she held an interest;
- A copy of any disclaimer filed on behalf of the decedent or by any of his/her beneficiaries;
- All schedules that are part of the New Jersey Inheritance Tax Return (Forms IT-R or IT-NR), even if blank;  
A copy of any Federal estate tax return (Form 706) filed with the Internal Revenue Service; and
- If a New Jersey Estate Tax return is filed using the Simplified Method (Column A), a completed New Jersey Inheritance Tax return (Form IT-R).

- If a New Jersey Estate Tax return is filed using the Federal Form Method (Column B), both of the following:
  - a. A completed 2001 Federal estate tax return (Form 706). However, if the estate is required to file Form 706 for the year of the decedent's death, only the front page of the 2001 Form 706 is required; and
  - b. Applicable waiver request schedules.
- If a New Jersey Estate Tax return is filed for the estate of a decedent dying on or after January 1, 2017, but before January 1, 2018, both of the following:
  - a. A completed current Federal estate tax return (Form 706, Rev. August 2013 version) whether or not the estate is required to file with the Internal Revenue Service; and
  - b. Applicable waiver request schedules.

New Jersey Inheritance Tax and Estate Tax returns must be signed by the executor or administrator of the estate and the signature must be notarized. If a return is submitted without a notarized signature, the auditor must send a signature form to the authorized representative, who must return it to the auditor once it has been signed and notarized.

#### **24.8 Requesting Information and Documentation**

If the auditor determines that required items are missing or are incomplete, or if the auditor requires additional information to review the accuracy of the filed return, the auditor must send the estate representative a letter requesting the information required to properly complete the audit. The representative is normally given a 60-day period to comply. The auditor makes additional requests for information as needed throughout the course of the audit.

As additional documentation is received, the auditor will add it to the file. The documentation is to be arranged based on the date received with the most recent being placed on top.

#### **24.9 TaxReg Profile and Address Verification**

The auditor must verify that the taxpayer profile and registration information for the decedent is correct. This includes checking the spelling and format of the decedent's name (Last name-First name-Jr/Sr/III with no commas or periods), along with the date of death, the decedent's Social Security number, and the estate representative's name and mailing address.

#### **24.10 Examination**

The auditor reviews the tax return(s) and all supporting documentation to verify that the estate has correctly valued its assets and transfers, that all deductions taken are proper, and that all distributions are made in accordance with the will and other governing instruments, if any, or the laws of intestacy. The auditor will make appropriate notations indicating which items are acceptable as reported and which require further investigation.

## **24.11 Asset Valuation**

Assets are valued as indicated below for Inheritance Tax and Estate Tax.

### **24.11A Inheritance Tax**

For Inheritance Tax purposes, all assets are valued as of the date of decedent's death. The valuation of an interest in a partnership (including a family limited partnership) or shares in a closely held or family corporation requires the review of certain information as specified in N.J.A.C. 18:26-8.14 and 8.15, respectively.

### **24.11B Estate Tax**

#### For resident decedents dying after December 31, 2001, but before January 1, 2017

If the estate files a Federal estate tax return (Form 706), the assets must be valued for New Jersey Estate Tax purposes using the Federal Form Method (Column B).

If an estate is not required to file a Federal Estate Tax return and does not do so, the assets can be valued using either the Simplified Method (Column A of the New Jersey Estate Tax return) or the Federal Form Method (Column B of the New Jersey Estate Tax return).

- When the Simplified Method is used, all assets are valued as of the decedent's date of death.
- When the Federal Form Method is used, monetary assets are valued as of the date of death, while market-value based assets (i.e. – real property, stocks, bonds, etc.) may be reported on the return using an alternate valuation date (within 6 months of the date of death). Both date of death values and alternate date values must be reported for all eligible assets. The election must be taken for all such assets, and only if the aggregate value is lower than the date of death value. In no case can an alternate valuation date be elected on returns filed more than 1 year past the date of death.
- In all cases, the valuation of an interest in a partnership (including a family limited partnership) for Estate Tax purposes must be made in accordance with the specifications listed in N.J.A.C. 18:26-3A.2(b).

#### For resident decedents dying on or after January 1, 2017, but before January 1, 2018

There is only one method for filing the New Jersey Estate Tax Return. The taxable estate is determined pursuant to section 2051 of the current federal Internal Revenue Code (26 U.S.C. s.2051).

- Monetary assets are valued as of the date of death, while market-value based assets (e.g., real property, stocks, bonds, etc.) may be reported on the return using an alternate valuation date (within 6 months of the date of death). Both date of death values and alternate date values must be reported for all eligible assets. If the alternate valuation date election is to be used, it must be applied for all such market-value based assets, and is used only if the aggregate value is lower than the date of death value. In no case can an alternate valuation date be elected on returns filed more than 1 year past the date of death.

- In all cases, the valuation of an interest in a partnership (including a family limited partnership) for Estate Tax purposes must be made in accordance with the specifications listed in N.J.A.C. 18:26-3A.2(b).

#### **24.12 Transfers**

Transfers of assets are presumed to have been made in contemplation of death if the transfers were made within three years of the decedent's date of death or intended to take effect in possession or enjoyment at or after death and were made without adequate consideration.

##### **24.12A For Inheritance Tax Purposes**

For Inheritance Tax purposes, transfers made in contemplation of death must be included in the decedent's taxable estate and valued as of the decedent's date of death.

##### **24.12B For Estate Tax Purposes**

For Estate Tax purposes, transfers made in contemplation of death are treated as follows:

- When the Simplified Method is used, transfers made in contemplation of death that are includable on the Inheritance Tax return must be included in the gross estate;
- When the Federal Form Method is used, the auditor must review Schedule G, Form 706 and any Federal Gift Tax forms (Form 709). The auditor will determine which transfers, if any, made in contemplation of death are taxable pursuant to the Internal Revenue Code in effect on December 31, 2001; and
- If a New Jersey Estate Tax return is filed for the estate of a decedent dying on or after January 1, 2017, but before January 1, 2018, the auditor must review Schedule G, Form 706 and any Federal Gift Tax forms (Form 709). The auditor will determine which transfers, if any, made in contemplation of death are taxable pursuant to the current Internal Revenue Code.

#### **24.13 Deductions**

The estate may deduct only the following:

- Funeral and last illness expenses;
- Administration expenses, including allowable executor/administrator commissions and legal fees for estate matters. In addition, any settlement charges or capital expenses associated with the sale of property for which the broker's commissions (see below) may be deducted are considered to be administration expenses and are deductible as such;
- State, county, and local taxes accrued prior to death;
- Taxes paid or payable to other jurisdictions on any transfer of property also subject to the inheritance tax. No deduction is allowed for federal estate tax paid or payable;
- Debts of the decedent owing at the date of death except for those specified in N.J.S.A. 54:34-5 and the Internal Revenue Code in effect on December 31, 2001; and
- Real estate broker's commissions that fall within the specific conditions specified in the Administrative Code.

#### **24.14 Audit List**

The auditor must compile a list of the items identified during the examination as requiring further investigation. Once the list is compiled, the auditor will send a letter to the estate representative requesting the information or documentation necessary to resolve any outstanding issues. The auditor may call the representative to settle easily resolved matters, provided that the call is properly documented.

#### **24.15 Realty Appraisal**

If, at any time during the course of the audit, the auditor cannot verify the value of real property in which the decedent had an interest with the available information, the auditor will immediately request an appraisal from Property Administration and notify the estate's representative. The auditor must request all documentation that supports the appraisal provided by Property Administration and include such support in the file. If the estate's representative does not agree with the appraisal provided by Property Administration, the auditor must give the representative the opportunity to provide additional documentation or independent valuation appraisal.

#### **24.16 Distributions**

The distribution of assets for tax purposes is calculated in accordance with the provisions of the will and existing governing instruments (e.g., deed, trust, insurance or annuity policy, account designation), if any, unless otherwise directed by a court order that specifically holds, after a trial or hearing, that the decedent's will is invalid. If the decedent did not have a will, then any assets not covered by a governing instrument are distributed according to the laws of intestacy as defined in the Uniform Probate Code. NOTE: Settlement agreements among beneficiaries as to distribution of assets are not considered when calculating distributions for tax purposes.

#### **24.17 Analysis of Tax Forms**

Once all necessary data has been received and reviewed, the auditor will make a determination as to the corresponding tax due. The auditor will then complete an "Analysis of Tax" form for Inheritance Tax and for Estate Tax. The auditor must place a copy of the analysis form(s) in the estate file and send a copy to the estate's representative.

For both Inheritance Tax returns and Estate Tax returns, the Analysis of Tax form must include:

- Values, as determined by the auditor, of real property, personal property, transfers, debts, and other allowed deductions; and
- A detailed list and explanation of any changes the auditor made to the original return.

For Inheritance Tax returns, the Analysis of Tax form must include the following for each beneficiary:

- Assets passing to beneficiaries (by will or intestacy, survivorship, *intervivos* transfer, transfer intended to take effect in possession or enjoyment at or after death, court order, etc);
- Relationship to the decedent;
- Appropriate tax rate and tax assessed, if any; and
- Any other pertinent information.

For Estate Tax returns, the Analysis of Tax form must list the following as determined by the auditor:

- Gross estate;
- Allowed deductions;
- Net estate;
- Tax due; and
- Any other pertinent information.

#### **24.18 *Estimated Tax Assessment***

If the auditor requests additional information and the estate's representative does not respond within sixty days, the auditor must send a follow-up letter. If the requested information is not submitted within a reasonable period after the second request (typically 60 days), the auditor will send the representative a list of the intended adjustments, followed by an "estimated tax assessment."

When making an estimated tax assessment, the auditor will review all available information and include assets at their maximum value as supported by the information provided, eliminate questionable deductions, and, if the distribution is in question, assign the distribution of assets in a manner that is supported by the information available and will generate the maximum tax. A Notice of Estimated Assessment will be sent to the estate's representative by certified mail and should include a schedule of adjustments, a schedule of explanations of the adjustments, and an explanation of the taxpayer's rights and responsibilities with respect to the assessment. The schedule of explanations should advise as to the information needed to refute the assessment and that the requested information should be submitted within 90 days from the date of the assessment.

#### **24.19 *Compromise Tax – Inheritance Tax Only***

When the disposition of a portion of the taxable estate is contingent or defeasible, the tax thereon is not due until the contingency occurs. In those cases, the auditor will offer the estate representative a compromise tax so that the Inheritance Tax process can be concluded before the contingency occurs. In general, the compromise tax is calculated on the present value of future interests based on the beneficiaries' actuarial life expectancy. Guidance for computing the compromise tax, as well as applicable present value and life tables, are contained in the New Jersey Transfer Inheritance Tax Guide for Computation of the Compromise Tax.

An estate representative who accepts the compromise tax must submit a supplemental affidavit that indicates acceptance and that the compromised contingencies have yet to occur. If the representative does not accept the compromise tax, the tax is deferred until a contingency occurs. The representative must guarantee the payment of the tax due by posting a bond in an amount that is double the maximum tax due for the contingency. The auditor will set up a contingent tax of \$1.00 in the Division's taxpayer accounting system and will send annual follow-up letters to the representative inquiring as to whether any contingency has occurred. Once a contingency does occur, the auditor must assess a contingent tax. Interest will accrue on any portion of the contingent tax that is not paid within two months from the date of the occurrence of the contingency.

## **24.20 Waivers**

Unpaid Inheritance Tax is a lien on real and personal property located in New Jersey. Therefore, written consent of the Director, referred to as a waiver, is required for the transfer of certain assets held in the name of, or belonging to, a decedent and located in this State. Waivers are not required for the transfer of automobiles, household goods, personal effects, accrued employee benefits, U.S. obligations, cash, checks, mortgages, or any item reported on Form IT-R, Schedule C.

### **24.20A For Resident Decedents**

When the decedent was a New Jersey resident, waivers are required for the transfer of the following:

- Real property located in New Jersey;
- Stocks and bonds of corporations incorporated in New Jersey; and
- Bank accounts, brokerage accounts, and accounts in other financial institutions that are located or doing business in New Jersey.

### **24.20B For Nonresident Decedents**

When the decedent was a nonresident, the only transfer for which a waiver is required is the transfer of real property located in New Jersey.

### **24.20C Issuing Waivers**

Waivers are issued based on the information provided by the estate representative and information gathered by the auditor during the audit process. The representative is responsible for properly listing the items which require tax waivers and the auditor must ensure that all required waivers are issued without unnecessary delay once the tax due has been paid.

### **24.20D When All Beneficiaries Are Class A**

Transfers to Class A beneficiaries (spouse, civil union partner, domestic partner, child, mutually acknowledged child, parent, grandparent, grandchild, or stepchild) are exempt from Inheritance Tax. When all beneficiaries of an estate are Class A, no Transfer Inheritance Tax is due and no return need be filed unless the assets are passing into a trust, or a claim of mutually acknowledged child exists. However, for resident decedents dying after December 31, 2001, but before January 1, 2017, if the gross estate plus adjusted taxable gifts (determined in accordance with the provisions of the Internal Revenue Code in effect on December 31, 2001) exceeds \$675,000, an Estate Tax return must be filed. Likewise, for resident decedents dying on or after January 1, 2017, but before January 1, 2018, if the gross estate (determined in accordance with the provisions of the current Internal Revenue Code) exceeds \$2,000,000, an Estate Tax return must be filed.

Waivers are required to transfer most assets, as set forth in this Chapter. Forms L-8 and L-9 can be used to transfer assets to Class A beneficiaries. However, if an Estate Tax return must be filed, those forms cannot be used. In that case, the auditor will issue waivers based on the information provided on Schedules E-4, E-5, E-6, and E-7.

#### **24.20E Form L-8 - Affidavit and Self-Executing Waiver**

Form L-8 is used by the estate to transfer certain intangible assets located in New Jersey, including bank and brokerage accounts, stocks, and bonds. The form may be filed to transfer assets to Class A beneficiaries, even when all beneficiaries are not Class A.

The estate's representative files Form L-8 directly with the banking institution or transfer agent, who may then release the asset(s). The institution will forward Form L-8 to the Division and the Transfer Inheritance and Estate Tax Branch reviews the form for accuracy and completeness. The Branch will contact the estate's representative if it appears that the estate may be required to file an Inheritance Tax and/or New Jersey Estate Tax return.

#### **24.20F Forms L-9 and L-9NR – Affidavit Requesting Real Property Tax Waiver(s)**

Forms L-9 and L-9NR may only be used when all beneficiaries are Class A. In addition, for resident decedents dying after December 31, 2001, but before January 1, 2017, Form L-9 may only be used if the gross estate plus adjusted taxable gifts (determined in accordance with the provisions of the Internal Revenue Code in effect on December 31, 2001) does not exceed \$675,000. Likewise, for resident decedents dying on or after January 1, 2017, but before January 1, 2018, Form L-9 may only be used if the gross estate (determined in accordance with the provisions of the current Internal Revenue Code) does not exceed \$2,000,000.

Forms L-9 and L-9NR are filed directly with the Division to obtain a waiver to transfer real property located in New Jersey unless the property was owned jointly by spouses or civil union partners as tenants by the entirety. No waiver can be issued if it appears that the estate may be required to file an Inheritance Tax and/or New Jersey Estate Tax return.

#### **24.20G When All Beneficiaries Are Not Class A**

If all beneficiaries are not Class A, the estate representative must file a Transfer Inheritance Tax return and pay any applicable tax in order to obtain waivers. The Division will issue waivers following the filing of the return and the payment of any tax due. If the estate requires waivers prior to the filing of the return, the estate's representative may file Form L-4 to request waivers for specific assets. An auditor will review all such requests and determine which waivers, if any, may be issued in advance of the filing of the return. The auditor must give consideration to the estate's needs and the Division's obligation to collect any tax due. A payment of estimated taxes may be required. The auditor must verify that the following information has been provided:

- For real estate: Block and lot, street address, city, county, and the percentage of the decedent's interest;
- For bank and brokerage accounts: All accounts in which the decedent had an interest and the manner in which each account was held or registered. Joint accounts, POD (Pay on Death) accounts and ITF (In Trust For) accounts should be clearly marked. Only account totals for brokerage accounts are accepted for waiver purposes;
- For shares of stock: The number of shares for each corporation, as well as the manner in which the shares were registered. Because only shares of New Jersey corporations require waivers, they should be clearly marked; and
- For investment bonds: The face value, issuing entity, and all terms of the bond.

#### **24.21 Supervisor Approval**

Upon completion of the audit but prior to finalizing it, the auditor must forward the file to the team supervisor for review and approval. The supervisor will review the Analysis of Tax form(s), address any concerns with the auditor, approve the audit determination, and then return the file to the auditor. If an audit results in a large tax increase over an amount designated by management, the appropriate Branch manager must review and approve the audit before the file is returned to the auditor for completion.

#### **24.22 Finalizing the Audit**

When the supervisor returns the file to the auditor, the auditor must make any necessary account adjustments in the Division's taxpayer accounting system, approve the appropriate Notice of Assessment, and ensure that the mailing address in the Taxpayer profile and registration is correct. The Notice should reflect the tax liability, interest (if any), penalty (if any), total payments received, previously issued refunds, and either the balance due, amount to be refunded, or a zero balance and includes information regarding the taxpayer's rights and responsibilities. The auditor should then do the following:

- If there is a balance due, the auditor should approve the bill in the Division's taxpayer accounting system, generate the Notice of Assessment, authorize any required waivers (which will be issued once the balance due is paid), prepare a list of the changes made to the original return and an explanation of the changes (to be mailed with the notice), and tag the file to be sent by certified mail;
- If there is an overpayment, the auditor should prepare a refund voucher and return the file to the team supervisor for approval of the refund in the Division's taxpayer accounting system. Refunds are made payable to the executor or administrator of the estate c/o the estate representative (if applicable). The auditor must also generate a Notice of Assessment, authorize any required waivers, prepare a list of changes made to the original return and an explanation of those changes (to be mailed with the notice), and tag the file to be sent by certified mail; and
- If there is no balance or refund due, the auditor will generate a Notice of Assessment reflecting a zero balance, authorize any required waivers, prepare a list of changes and an explanation of those changes, if any, made to the original return (to be mailed with the notice), and tag the file to be sent by certified mail.

Once the auditor generates the appropriate Notice of Assessment, he/she signs and dates the file, writes the Document Locator Number from the original return on the back of the file, and forwards it to the Bookkeeping Group of the Branch.

### **24.23 Protests and Appeals**

An estate representative who does not agree with a Notice of Assessment may submit a written letter of protest to Inheritance Tax Branch and request an informal administrative hearing. The representative has 90 days from the date of the notice, to submit a signed, written letter of protest to the Inheritance and Estate Tax Branch. If there is a balance due, the estate representative also has the option of paying the full amount of the assessment and filing a claim for refund (Form IT-PRC or A-1730).

#### **24.23A Handling a Letter of Protest**

The letter of protest is assigned to the original auditor, who then sends a letter to the estate representative confirming receipt. The auditor then prepares a statement of the facts and forwards it, along with the file, to the team supervisor. If the team supervisor is not able to resolve the matter, he/she will turn the file over to the supervisor of the Inheritance and Estate Taxes Branch Conference and Appeals Section, who will assign the protest to a Branch Conferee.

The Conferee will review the letter of protest and contact the estate representative within 15 days to request any additional information that may be necessary to make a final determination. In addition, the conferee will discuss with the estate representative the various protest options which include: an administrative review, a telephone conference, and an in-person conference.

Once a letter of protest has been received and the file assigned to a conferee, any correspondence or phone calls from the estate representative must be forwarded to the conferee assigned to the file.

##### **24.23A-1 Representative Requests an Administrative Review**

If the estate representative requests an administrative review, the conferee will review the file and recommend what action to take to best resolve the issue.

##### **24.23A-2 Representative Requests a Telephone or In-Person Conference**

If the representative requests a telephone or an in-person conference, the conferee will schedule a conference which will include the conferee, the estate representative, and may include the team supervisor, Conference supervisor, and/or a designated member of Branch management.

##### **24.23B Issuing the Final Determination**

Once the conference and/or administrative review of the file is completed, the conferee will consult with the Conference team supervisor and prepare a final determination which confirms, modifies, and/or vacates portion(s) of the Notice of Assessment.

##### **24.23C Handling an Appeal**

An estate representative who does not agree with a Notice of Assessment may file a complaint with the Tax Court of New Jersey within 90 days from the date of the notice. If the representative sends their appeal directly to the auditor, they are to immediately notify their supervisor, then prepare a detailed fact sheet setting forth all pertinent facts related to the protest to include the basis for the Division's assessment. They are to then make a complete copy of the file (less notes, work papers and comments) and forward this, along with the fact sheet, to the Branch Conference and Appeals Branch. Once a conferee learns that the estate representative has filed an appeal with the Tax Court, the conferee will

prepare a summary of pertinent facts and discuss the matter with the Conferences supervisor. The supervisor and conferee will then discuss the case and the Division's position with the Branch manager. The conferee will forward the copy of the file to the designated person at the Attorney General's Office. The conferee will act as a liaison between the Division and the Attorney General's Office during the disposition of the case.

#### **24.24 Amended Returns**

When an amended return or affidavit amending the original return is submitted, these documents will be assigned to the original auditor (or successor) for review and adjustment. The auditor will follow the review procedures detailed above, as applicable. If the audit of the amended return results in an assessment, and the audit of the original return has been completed and the protest period for the original assessment has expired, the estate representative can only protest the portion of the assessment resulting from the amended return.

When an amended return is filed for a return that was not previously audited (i.e., accepted as filed), an auditor will be assigned to review the amended return and make appropriate adjustments.

#### **24.25 Refund Claims**

All claims for refund of both Inheritance Tax and Estate Tax (including protective refund claims) must be made within three years from the date the Division received the tax payment. For refunds of Inheritance Tax, claims may also be filed within three years from the date that a court of competent jurisdiction issues a finding that the decedent had no legal or equitable interest in the property on which the tax was assessed. However, no refund will be issued where such a finding is issued more than 20 years after the date of decedent's death.

#### **24.26 Protective Refund Claims**

If an estate's representative believes that a reasonably anticipated event may affect a claim for refund of either Inheritance Tax or Estate Tax, the representative may file a protective refund claim within three years from the date the tax payment was received by the Division. For example: a protective refund claim may be filed if the estate has paid the tax liability but anticipates incurring additional counsel fees as a result of litigation which may go beyond the three-year statutory period.

To be a valid protective claim, the refund claim must be made on a fully completed "Protective Claim for Refund" form (Form IT-PRC), and include the estimated refund amount and the basis for the claim. Within 90 days of the occurrence of the anticipated event, the representative must notify the Division of the actual refund amount.

#### **24.27 Form 0-71 – Reporting of Insurance Proceeds**

Insurance companies licensed in New Jersey are required to complete and submit Form 0-71 whenever proceeds from life insurance or annuities are payable by reason of the death of a New Jersey resident. Branch personnel review these forms to ensure that all taxable benefits have been properly reported. The auditor is to use this information when performing an audit.

#### **24.28 Form 0-14 – Notification from County Surrogates**

County Surrogates are required to complete and submit Form 0-14 whenever an estate is submitted for probate or administration. The Branch retains these forms for approximately one year and then verifies whether any required return has been filed.

#### **24.29 Pursuing Delinquent Returns**

When the Branch has information indicating that an Inheritance Tax or Estate Tax return may have to be filed for an estate and no return has been received one year or more after the date of death, Branch personnel will mail Form D-1 to the estate's representative. The form will indicate that no return has been filed and requests information about the decedent's assets and beneficiaries. If the estate's representative responds, an auditor from the Inheritance Tax Delinquent Group will review the response and determine if further action is needed. If a return is required, blank forms and filing instructions will be mailed to the estate representative. If the estate representative does not respond to Form D-1 or file a return within 90 days, the auditor will issue an arbitrary assessment, which will be sent by certified mail to the representative. The assessment will be cancelled upon the filing of a valid return. If there is no response within 90 days, the assessment becomes a final determination and the case will be sent for collection.

#### **24.30 Collection Procedures**

After an auditor approves the initial bill in the Division's taxpayer accounting system, the file is sent to the Bookkeeping Group. If the balance due is not paid within 60 days, the Bookkeeping Group will issue a follow-up bill with updated interest and penalty (if applicable). If the estate's representative does not respond to the follow-up bill or pay the balance due within 45 days, the file is forwarded to the Branch's Delinquent Group for the following actions.

#### **24.31 Demand Letter Sent**

A letter is mailed to the estate representative demanding immediate payment of the balance due, which includes updated interest. The letter advises that further collection action will be taken and costs of collection will be imposed if the estate representative does not respond or pay the balance due.

#### **24.32 Notices of Taxpayer Responsibility Sent**

If the estate's representative takes no action regarding the demand letter, a notice will be sent by certified mail to the representative and all beneficiaries for whom addresses are available. The notice will advise each recipient of his/her responsibility for his/her share of the tax and interest due, and the appeal rights with respect to the tax assessed. The notice will also advise that if cause is not shown within 90 days, the Division will file a Certificate of Debt with the Superior Court of New Jersey naming each recipient as a party liable for the tax due.

#### **24.33 Certificate of Debt Filed**

If, after 90 days following the mailing of the Notices of Taxpayer Responsibility, neither the estate representative nor any of the beneficiaries make filing or payment arrangements with the Branch, the Division will file a Certificate of Debt with the Superior Court that names all parties determined to be liable for the payment of the tax.

## **Chapter 25 Excise Tax - Motor Fuels Tax**

### **25.1 Point of Taxation**

The tax imposed on the use of motor fuel or aviation fuel shall be measured by invoiced gallons of fuel removed, other than by a bulk transfer:

- a. From the terminal transfer system within New Jersey;
- b. From the terminal transfer system outside of New Jersey for delivery to a location in New Jersey as represented on the shipping papers, provided that the supplier imports the motor fuel or aviation fuel for the account of the supplier, or the supplier has made a tax pre-collection election; and
- c. Upon sale in a terminal or refinery in New Jersey to a person not holding a supplier's or Permissive Suppliers License.

The tax is imposed on motor fuel and aviation fuel that is imported into New Jersey, other than by a bulk transfer, at the time the product is imported into the State.

The tax imposed on blended fuel made in New Jersey is payable by the blender at the point the blended fuel is made in the State outside of the terminal transfer system. The tax on blended fuel imported into New Jersey is payable by the importer of that blended fuel, provided the tax imposed has not already been paid to a Permissive Supplier through a pre-collection agreement.

### **25.2 Records**

Records of all fuel received, sold or used shall include the name of the purchaser, the number of gallons used or sold and the date of the use or sale. With the exception of fuel that is sold at a service station and delivered into the fuel supply tank of a vehicle, the seller must provide to the purchaser a written statement containing the date, the number of gallons delivered, the names of the purchaser and seller, and that statement shall show a separate charge for the tax on each gallon. In addition a physical inventory of fuel on hand on the first or last day of each month is required to be taken and a record of that inventory shall be kept. The records and written statements shall be preserved for a period of four years and shall be offered and available for inspection upon request.

### **25.3 Pre-Audit Activities**

Pre-audit activities can include reviewing any previous audits that were completed. If there was a prior audit the audit period should be noted to prevent a re-audit of the same periods. Noting the adjustments made during the previous audit the auditor may want to discuss with the taxpayer the corrective actions taken by the taxpayer to prevent the errors from continuing to occur. The auditor should note when the corrective actions were made as months prior to when the corrective action was taken could contain the same mistakes. If the results of the prior audit were protested the auditor should review the outcome of the conference to see how the outcome affected the audit adjustments.

An auditor should not rely on a prior audit as the sole guide for the current audit. Prior audits should be used to augment the current audit. Changes in things such as business operations and tax law since the prior audit was completed could have a profound impact on the current audit.

Auditors have many sources of information available to them during the course of an audit. Auditors are not restricted by the information provided by the taxpayer and can access information provided by third parties such as terminal operators, suppliers, customers, and transporters. In addition to following office and field audit procedures auditors performing motor fuels audits can take advantage of any third-party information that is available. Transactions involving other license holders can be traced and verified by accessing supplier and/or customer tax returns, terminal operator reports and/or carrier reports.

Also, auditors may review the information provided by the taxpayer on his/her most recent license application. Information such as types of products handled, and customer, supplier, and terminal information may be available on the application and could be useful during the audit.

Prior to beginning the examination of the taxpayer's books and records an auditor conducting a motor fuels field audit should meet with the taxpayer and/or the taxpayer's representative. The purpose of the meeting is to gain insight into the taxpayer's business and establish the tone of the audit.

During the pre-audit meeting the auditor can establish the purpose of the audit, the parameters of the audit, and the expectations of both the taxpayer and auditor. In addition the auditor should complete a pre-audit questionnaire which the taxpayer and/or representative must sign.

During the pre-audit meeting the auditor may question the taxpayer to determine the taxpayer's knowledge of the law and request information regarding his/her accounting systems and internal controls. With this information the auditor may be able to determine areas of weakness and develop an audit plan to focus on those areas. The auditor may ask for a chart of accounts, a list of internal product codes, internal terminal numbers, and internal mode of transport codes. In addition the auditor may ask the taxpayer to provide an overview of its accounting system and document the types of reports available and how data is received and transmitted from sources outside the system and within the system. Attention should be given to how the tax returns are prepared using the available system data.

The auditor will want to establish the type of business operated by the taxpayer whether a supplier, distributor, retailer, terminal operator, transporter, or a combination of those. The auditor should determine the types of products purchased and sold along with any storage facilities the taxpayer may maintain.

The auditor should also address with the taxpayer the types of customers that the taxpayer has and how the products are delivered to the customer. It is also important to know how the taxpayer identifies tax exempt sales and whether or not the taxpayer uses any of the fuel themselves.

After completing the pre-audit meeting and completing the pre-audit questionnaire the auditor should have an understanding of the taxpayer's business operations and should be able to proceed with conducting the audit.

## **25.4 Fuel Tax Evasion**

Uncovering fuel tax evasion through the audit can often be accomplished if the auditor knows what to look for and is aware of the ways in which fuel tax has and can be evaded. Some evasion techniques include blending other products with diesel fuel or gasoline to extend tax paid products, selling off-spec products as fuel, importing tax-free fuel and selling it as tax paid fuel, purchasing fuel tax free for export but selling it in State, purchasing fuel tax paid in one State and exporting it to a higher tax State and the use of daisy chain schemes. This is not a comprehensive list of evasion techniques but should aid the auditor in uncovering fuel evasion.

## **25.5 Inventory Analysis**

Performing an analysis of a taxpayer's inventory begins with identifying the type of inventory facility or facilities the taxpayer maintains, the location of each facility, the number of storage tanks at each facility and the capacity of each tank. Some of this information may be found on the taxpayer's MFA-1, the Combined Motor Fuels License Application.

Auditors may review a taxpayer's inventory records to identify the type of inventory records (electronic, book, physical, or both) that are kept, how often the inventory is taken, and if the inventory records conform to current statutes. In addition, the auditor can verify if separate inventory is maintained for different products. A mathematical check of the inventory records may be performed taking note of the beginning and ending inventory records and noting discrepancies between the beginning inventory and the ending inventory of the prior month.

Any unaccounted-for inventory should be noted by the auditor and documentation to substantiate the unaccounted-for inventory should be obtained. Terminal operators in particular are held liable for any unaccounted-for losses at a terminal that exceed one-half of one percent of the number of net gallons removed from that terminal during the calendar year. The loss is the difference between:

- a. The total amount of all inventory at the applicable terminal at the beginning of the year plus the total amount of all fuel received at the terminal during the year; and
- b. The total amount of all inventory at the terminal at the end of the year plus the total amount removed from the terminal during the year.

## **25.6 Purchase Analysis**

All fuel carries the presumption that it is used or consumed on the highways of New Jersey if the fuel is removed from a terminal in New Jersey, imported into New Jersey other than by bulk transfer within the terminal transfer system, or delivered into a consumer's bulk storage tank from which motor vehicles can be fueled.

Fuel purchases are evaluated by looking at the types of fuel purchased, from whom the fuel was purchased, from where the fuel came, how it was delivered and whether the fuel was purchased tax free or tax included. It is important to verify that the fuel purchased has been reported and is properly accounted for. All purchases of fuel, unless specifically exempted, made from a Supplier or Permissive Supplier should be purchased with the tax included.

## **25.7 Sales Analysis**

The auditor should examine both taxable and non-taxable sales along with any fuel that is used by the license holder. The auditor may examine any records available including the accounting records of the license holder, sales invoices, delivery tickets, meter readings, and any other relevant records required to be maintained in order to verify the proper accounting of all fuel sold and the remittance of the required tax. Non-taxable transactions should be examined to verify the proper classification and recorded as non-taxable.

## **25.8 Supplier/Permissive Supplier**

Before becoming a position holder in a terminal in New Jersey or engaging in a terminal bulk transfer, a person must first obtain a Supplier's License. A supplier located outside of New Jersey may elect to be licensed as a supplier in New Jersey and is recognized as a Permissive Supplier.

A licensed supplier or Permissive Supplier who wants to pre-collect the tax may make a blanket election to treat all removals of fuel from all of its out-of-state terminals with a New Jersey destination as if the fuel was removed across the rack from a terminal in New Jersey.

In addition to being a position holder in a terminal or terminals in New Jersey, a supplier may be a position holder in a terminal or terminals in other States, may operate a terminal or refinery, may transport fuel, may make above and/or below rack sales and/or purchases, or may operate retail locations.

Auditing a supplier requires an auditor to develop an understanding of the supplier's operations in New Jersey as well as its operations in other States. Key information that may be obtained by the auditor includes:

- A list of the terminals operated or terminals in which the Supplier is a position holder. This list may include the location of the terminal, The Terminal Control Number of the terminal, the products with identifying product code stored at each terminal, and the number of tanks with capacity of each tank. The auditor may perform an analysis of the activity at each terminal paying particular attention to out-of-state terminals where the supplier has elected to pre-collect the New Jersey tax on all removals of fuel with a New Jersey destination. If the supplier operates a terminal, a list of the companies storing product at the terminal should be required;
- A list of fuel transportation vehicles used by the supplier and a list of transporters hired by the supplier. The list should include the name and FID Number of the carrier along with the mode of transportation. If the supplier transports fuel for other entities, a list of the entities for which the supplier transports fuel should be obtained;
- A list of customers identified by type, (supplier, distributor, retailer, government, etc.). The auditor should also verify proper licensure of all customers;
- A list of all products stored at and sold from each terminal. An inventory reconciliation of all products may be performed by the auditor as part of the audit;
- An accounting of all contaminated fuel and documentation to support the disposal or exempt use of the contaminated fuel; and
- Contracts with terminals to store product, contracts with which the supplier has a two-party exchange agreement, and contracts with customers.

The Supplier of Motor Fuels Report (SMF-10) is filed by all licensed suppliers and Permissive Suppliers. The return contains the activity of the licensed supplier and provides a full accounting of product removed from a terminal. Information reported on the SMF-10 and supporting schedules include taxable and tax-free sales and movements of fuel along with credits for the previous month's overpayment, credit for delinquent distributors, and credit for fuel purchased with tax included. The supplier should include the date of the shipment, name and FID number of the customer, the name and FID number of the carrier, the mode of transportation, terminal code, point of origin and destination, document number, net, gross and invoiced gallons, and product code.

A list of all products purchased should be obtained and reported gallons may be compared to available third-party reports, purchase invoices, and/or other available documentation. The auditor should be aware of any blending products purchased that increase the volume of fuel sold and should verify that the blending products are properly accounted for when blended and sold.

Sales of fuel should be reported using invoiced gallons as opposed to gross or net gallons. The auditor should trace the sales to accounting records and returns. The auditor should verify that all tax collected was remitted and look for missing transactions. The auditor may examine the supplier's accounts payables, determine the terms of payment of the fuel, and reconcile that information to invoices. If any transaction has not been reported, an explanation for the unreported transaction should be requested.

Tax-free sales such as those made to governmental entities, fuel exported directly from the rack, and sales of dyed diesel fuel should be verified. The auditor may verify the tax-free sales by examining the taxpayer's accounting records, requesting any required New Jersey tax forms, reviewing available third-party information, employing a confirmation process, and/or requesting any other documents/information required by statute. Particular attention should be given to any amount reported on the Other Exempt Sale line on the return. The taxpayer should provide a reason for the exemption which should be verified by the auditor.

The auditor may examine the transactions made between the supplier and retail stations with particular attention to transactions where the retail station is company owned. The auditor should verify that the transactions have been properly recorded and reported. This verification should include diversions of fuel that could result in either a credit or additional tax due.

If credit for the previous month's overpayment, for delinquent distributors or for fuel purchased with the tax included are reported, the auditor should obtain proper documentation to verify the credit. The auditor may examine the taxpayer's accounting records, purchase invoices, and/or available third-party information to verify the credit.

### **25.9 Distributors**

Any person who acquires motor fuel from a supplier, Permissive Supplier or from another distributor for subsequent sale must be licensed as a distributor in New Jersey.

A distributor may make an election as to the timing of its tax remittance to its supplier or Permissive Supplier. A distributor may delay its tax remittance that is pre-collected by its suppliers and Permissive Suppliers until up to two business days prior to the date on which the tax is required to be submitted by

the supplier or Permissive Supplier. The payments made to suppliers and Permissive Suppliers must be made by EFT. The election is made through the Combined Motor Fuels License Application, the MFA-1.

As with auditing a supplier, auditing a distributor requires an auditor to develop an understanding of the distributor's operations in New Jersey as well as its operations in other States. Relevant information that may be obtained by the auditor includes:

- A list of the companies that the distributor purchases product from, along with a list of the terminals from which the distributor obtains product. Distributors might purchase fuel from multiple sources, and obtain product from multiple terminals. The list should include the name and FID number of the entity from which the distributor purchased fuel, the type of license held by each entity that the distributor purchases fuel from, the location of the terminal, the Terminal Control Number of the terminal, and the products with identifying product code(s) obtained at each terminal. The auditor should pay particular attention to out-of-state terminals where the distributor is purchasing product and importing it into New Jersey to verify that all taxes have been paid;
- A list of fuel transportation vehicles used by the distributor and a list of transporters hired by the distributor. The list should include the name and FID Number of the transporter along with the mode of transportation. If the distributor transports fuel for other entities a list of the entities for which the distributor transports fuel should be obtained;
- A list of customers identified by type, (supplier, distributor, retailer, government, etc.). The auditor should also verify proper licensing of all customers;
- A list of all places where the distributor stores fuel, the products stored at each location, and the number of tanks with capacity. An inventory reconciliation of all products may be performed by the auditor as part of the audit;
- An accounting of all contaminated fuel and documentation to support the disposal or exempt use of the contaminated fuel; and
- Contracts with terminals to store product, and contracts with customers.

The Distributor of Motor Fuels Report (DMF-10) is filed by all licensed distributors. The return contains the activity of the licensed distributor and provides a full accounting of products purchased and sold. As with any motor fuels audit, the nature of the business, the scale of business operations, and the diversity of products purchased and sold have an impact on the preparation and execution of the audit and will inform the auditor in his or her request for records.

Purchases and sales of fuel should be reported using invoiced gallons as opposed to gross or net gallons. The auditor should examine accounting records, sales tickets, delivery tickets, meter readings, and any other related records to verify purchases and sales and reconcile those purchases and sales to tax returns.

The auditor should verify that all taxes were remitted to the supplier and look for missing or tax-free transactions. Using the list of all suppliers and the products purchased, the auditor can compare reported gallons to available third-party reports, purchase invoices, and/or other available documentation.

Tax-free purchases should be verified. The auditor may verify the tax-free purchases by examining the taxpayer's accounting records, reviewing required New Jersey tax forms, reviewing available third-party

information, employing a confirmation process, and/or requesting any other documents/information required by statute. Particular attention should be given to any amount reported on the Other Untaxed Purchases line on the return. The taxpayer should provide a reason for all untaxed purchases, which should be verified by the auditor.

The auditor may examine the distributor's accounts payables, determine the terms of payment of the fuel and reconcile to invoices. If any transaction has not been reported, an explanation for the unreported transaction will be requested.

Tax-free sales such as those made to governmental entities, exported fuel, and sales of dyed diesel fuel should be verified. The auditor may verify the tax-free sales by examining the taxpayer's accounting records, requesting any relevant tax forms, reviewing available third-party information, employing a confirmation process, and/or requesting any other documents/information required by statute. Particular attention should be given to any amount reported on the Other Exempt Sale line on the return. The taxpayer should provide a reason for the exemption, which should be verified by the auditor. The auditor should be aware of any blending products purchased that increase the volume of fuel sold and should verify that the blending products are properly accounted for when blended and sold.

#### **25.10 Terminal Operators**

A terminal operator is a person that owns, operates, or otherwise controls a terminal. A terminal operator may own the fuel that is transferred through, or stored in the terminal. A terminal is a bulk fuel storage and distribution facility which is a qualified terminal to which fuel is supplied by pipeline or marine vessel, or is supplied by truck or railcar in the case of fuel grade alcohol and from which fuel can be removed at a rack. Qualified terminals are assigned a terminal control number by the Internal Revenue Service.

Terminal operators are required to file two returns, one return is the terminal operator loss return (OMF-10) which is filed on a calendar year basis and is due February 22nd of the following year and the other return is a monthly terminal operator (OMF-11) return due on or before the 25th of the month following the reporting month.

An auditor should obtain some information regarding the operation of the terminal. Information such as whether the terminal is leased or owned, how many storage tanks make up the terminal, the capacity of each tank, what products are stored at the terminal, including a list of blend stocks, and how fuel is received at the terminal should be obtained by the auditor. Also the auditor should inquire as to how the terminal handles and reports transmix, and how the terminal disposes of contaminated fuel.

The auditor should obtain a list of position holders at the terminal and a list of those conducting business within the terminal. Also a list of companies who are authorized to remove fuel from the terminal should be obtained. The auditor should verify the list for proper licensing. A terminal operator is jointly and severally liable for the tax on any fuel removed from the terminal on account of any supplier who is not licensed.

The auditor should perform an inventory reconciliation for all products received and disbursed from the terminal. As the terminal operator is liable for any unaccounted for loss exceeding one-half of one

percent of the total number of net gallons removed from the terminal during the year the auditor should examine and evaluate all excessive losses or gains.

### **Motor Fuels Glossary**

**Aviation fuel** means aviation gasoline or aviation grade kerosene.

**Aviation fuel dealer** means a person that acquires aviation fuel from a supplier or from another aviation fuel dealer for subsequent sale.

**Aviation gasoline** means fuel specifically compounded for use in reciprocating aircraft engines.

**Aviation grade kerosene** means any kerosene type jet fuel covered by ASTM Specification D 1655 or meeting specification MIL DTL 5624T (Grade JP 5) or MIL DTL 83133E (Grade JP 8).

**Biodiesel** means any motor fuel or mixture of motor fuels that is derived, in whole or in part, from agricultural products or animal fats, or the wastes of such products or fats, and is advertised as, offered for sale as, suitable for use or used as motor fuel in an internal combustion engine.

**Blend stock** means a petroleum product component of motor fuel, such as naphtha, reformate, toluene or kerosene that can be blended for use in a motor fuel without further processing. The term includes those petroleum products defined by regulations issued pursuant to Sections 4081 and 4082 of the federal Internal Revenue Code of 1986 (26 U.S.C. ss. 4081 and 4082), but does not include any substance that:

- a. will be ultimately used for consumer non-motor fuel use; and
- b. is sold or removed in fifty five gallon drum quantities or less at the time of the sale or removal.

**Blended fuel** means a mixture composed of motor fuel and another liquid, including blend stock other than a de minimis amount of a product such as carburetor detergent or oxidation inhibitor that can be used as a fuel in a highway vehicle. "Blended fuel" includes but is not limited to gasohol, biodiesel, ethanol, methanol, fuel grade alcohol, diesel fuel enhancers and resulting blends.

**Blender** means a person that produces blended motor fuel outside the terminal transfer system.

**Blending** means the mixing of one or more petroleum products, with or without another product, regardless of the original character of the product blended, if the product obtained by the blending is capable of use or otherwise sold for use in the generation of power for the propulsion of a motor vehicle, an airplane, or a motorboat. The term does not include the blending that occurs in the process of refining by the original refiner of crude petroleum or the blending of products known as lubricating oil and greases, or the commingling of products during transportation in a pipeline.

**Blocked pump** means a pump that, because of the pump's physical limitations, for example, a short hose, cannot be used to fuel a vehicle, or a pump that is locked by the vendor after each sale and unlocked by the vendor in response to a request by a buyer for undyed kerosene for use other than as a fuel in a diesel powered highway vehicle or train.

**Bulk plant** means a bulk fuel storage and distribution facility that is not a terminal within the terminal transfer system and from which fuel may be removed by truck or rail car.

**Bulk transfer** means a transfer of fuel from one location to another by pipeline tender or marine delivery within the terminal transfer system.

**Consumer** means the ultimate user of fuel.

**Delivery** means the placing of fuel into the fuel tank of a motor vehicle or into a bulk fuel storage and distribution facility.

**Diesel fuel** means a liquid that is commonly or commercially known or sold as a fuel that is suitable for use in a diesel powered highway vehicle. A liquid meets this requirement if, without further processing or blending, the liquid has practical and commercial fitness for use in the propulsion engine of a diesel powered highway vehicle. "Diesel fuel" includes biodiesel, number 1 and number 2 diesel.

**Diesel powered motor vehicle** means a motor vehicle that is propelled by a diesel powered engine.

**Director** means the Director of the Division of Taxation in the Department of the Treasury.

**Distributor** means a person who acquires fuel from a supplier, permissive supplier or from another distributor for subsequent sale.

**Dyed fuel** means dyed diesel fuel or dyed kerosene that is required to be dyed pursuant to United States Environmental Protection Agency rules or is dyed pursuant to Internal Revenue Service rules or pursuant to any other requirements subsequently set by the United States Environmental Protection Agency or Internal Revenue Service including any invisible marker requirements.

**Export** means to obtain fuel in this State for sale or other distribution outside of this State. In applying this definition, fuel delivered out-of-State by or for the seller constitutes an export by the seller, and fuel delivered out-of-State by or for the purchaser constitutes an export by the purchaser.

**Exporter** means any person, other than a supplier, who purchases fuel in this State for the purpose of transporting or delivering the fuel outside of this State.

**Fuel** means:

- a. a liquid or gaseous substance commonly or commercially known or sold as gasoline, regardless of its classification or use; and
- b. a liquid or gaseous substance used, offered for sale or sold for use, either alone or when mixed, blended, or compounded, which is capable of generating power for the propulsion of motor vehicles upon the public highways.

**Fuel grade alcohol** means a methanol or ethanol with a proof of not less than one hundred ninety degrees (determined without regard to denaturants) and products derived from that methanol and ethanol for blending with motor fuel.

**Fuel transportation vehicle** means any vehicle designed for highway use which is also designed or used to transport fuel.

**Gasoline** means all products commonly or commercially known or sold as gasoline that are suitable for use as a motor fuel. Gasoline does not include products that have an ASTM octane number of less than seventy five as determined by the "motor method," ASTM D2700-92. The term does not include racing gasoline or aviation gasoline, but for administrative purposes does include fuel grade alcohol.

**General aviation airport** means a civil airport located in this State other than the international airports located in Newark and Atlantic City.

**Gross gallons** means the total measured volume of fuel, measured in U.S. gallons, exclusive of any temperature or pressure adjustments.

**Import** means to bring fuel into this State by any means of conveyance other than in the fuel supply tank of a motor vehicle. In applying this definition, fuel delivered into this State from out of State by or for the seller constitutes an import by the seller, and fuel delivered into this State from out of State by or for the purchaser constitutes an import by the purchaser.

**Import verification number** means the number assigned by the Director with respect to a single fuel transportation vehicle delivery into this State from another State upon request for an assigned number by an importer or the transporter carrying fuel into this State for the account of an importer.

**Importer** includes any person who is the importer of record, pursuant to federal customs law, with respect to fuel. If the importer of record is acting as an agent, the person for whom the agent is acting is the importer. If there is no importer of record of fuel imported into this State, the owner of the fuel at the time it is brought into this State from another State or foreign country is the importer.

**Invoiced gallons** means the gallons actually billed on an invoice for payment to a supplier which shall be either gross gallons or net gallons on the original manifest or bill of lading.

**Kerosene** means the petroleum fraction containing hydrocarbons that are slightly heavier than those found in gasoline and naphtha, with a boiling range of one hundred forty nine to three hundred degrees Celsius.

**Liquefied petroleum gas dealer** means a person who acquires liquefied petroleum gas for subsequent sale to a consumer and delivery into the vehicle fuel supply tank.

**Liquid** means any substance that is liquid in excess of sixty degrees Fahrenheit and at a pressure of fourteen and seven tenths pounds per square inch absolute.

**Motor fuel** means gasoline, diesel fuel, kerosene and blended fuel.

**Motor vehicle** means an automobile, truck, truck tractor or any motor bus or self propelled vehicle not exclusively operated or driven upon fixed rails or tracks. "Motor vehicle" does not include tractor type, motorized farm implements and equipment but does include motor vehicles of the truck type, pickup truck type, automobiles, and other vehicles required to be registered and licensed each year pursuant to the provisions of the motor vehicle license and registration laws of this State. "Motor vehicle" does not

include tractors and machinery designed for off road use but capable of movement on roads at low speeds.

**Net gallons** means the total measured volume of fuel, measured in U.S. gallons, when corrected to a temperature of sixty degrees Fahrenheit and a pressure of fourteen and seven tenths pounds per square inch absolute.

**Permissive supplier** means an out of State supplier that elects, but is not required, to have a supplier's license pursuant to P.L.2010, c.22 (C.54:39-101 et al.).

**Person** means an individual, a partnership, a limited liability company, a firm, an association, a corporation, estate, trustee, business trust, syndicate, this State, a county, city, municipality, school district or other political subdivision of this State, or any corporation or combination acting as a unit or any receiver appointed by any state or federal court.

**Position holder** means the person who holds the inventory position in fuel in a terminal, as reflected on the records of the terminal operator. A person holds the inventory position in fuel when that person has a contract with the terminal operator for the use of storage facilities and terminating services for fuel at the terminal. The term includes a terminal operator who owns fuel in the terminal.

**Propel** means operate the drive engine of a motor vehicle, whether the vehicle is in motion or at rest.

**Qualified terminal** means a terminal which has been assigned a terminal control number by the federal Internal Revenue Service.

**Rack** means a mechanism for delivering fuel from a refinery or terminal into a railroad tank car, a fuel transportation vehicle or other means of transfer outside of the terminal transfer system.

**Racing gasoline** means gasoline that contains lead, has an octane rating of 110 or higher, does not have detergent additives, and is not suitable for use as a motor fuel in a motor vehicle used on public highways.

**Refiner** means a person that owns, operates, or otherwise controls a refinery.

**Refinery** means a facility used to produce fuel from crude oil, unfinished oils, natural gas liquids, or other hydrocarbons and from which fuel may be removed by pipeline, by ship or barge, or at a rack.

**Removal** means any physical transfer of fuel from a terminal, manufacturing plant, pipeline, ship or barge, refinery, from customs custody, or from a facility that stores fuel.

**Retail dealer** means a person that engages in the business of selling or dispensing motor fuel to the consumer within this State.

**Supplier** means a person that is:

- a. registered or required to be registered pursuant to Section 4101 of the federal Internal Revenue Code of 1986 (26 U.S.C. s.4101) for transactions in fuels in the terminal transfer system; and

b. satisfies one or more of the following:

- (1) is the position holder in a terminal or refinery in this State;
- (2) imports fuel into this State from a foreign country;
- (3) acquires fuel from a terminal or refinery in this State from a position holder pursuant to either a two party exchange or a qualified buy sell arrangement which is treated as an exchange and appears on the records of the terminal operator; or
- (4) is the position holder in a terminal or refinery outside this State with respect to fuel which that person imports into this State. A terminal operator shall not be considered a supplier based solely on the fact that the terminal operator handles fuel consigned to it within a terminal.

**Supplier** also means a person that produces fuel grade alcohol or alcohol derivative substances in this State, produces fuel grade alcohol or alcohol derivative substances for import to this State into a terminal, or acquires upon import by truck, rail car or barge into a terminal, fuel grade alcohol or alcohol derivative substances.

Supplier includes a permissive supplier unless the "Motor Fuel Tax Act," P.L.2010, c.22 (C.54:39-101 et seq.) specifically provides otherwise.

**Terminal** means a bulk fuel storage and distribution facility:

- a. which is a qualified terminal;
- b. to which fuel is supplied by pipeline or marine vessel, or, for the purposes of fuel grade alcohol, is supplied by truck or railcar; and
- c. from which fuel may be removed at a rack.

**Terminal bulk transfer** includes but is not limited to the following:

- a. a boat or barge movement of fuel from a refinery or terminal to a terminal;
- b. a pipeline movement of fuel from a refinery or terminal to a terminal;
- c. a book transfer of product within a terminal between suppliers prior to completion of removal across the rack; and
- d. a two party exchange within a terminal between licensed suppliers.

**Terminal operator** means a person that owns, operates, or otherwise controls a terminal. A terminal operator may own the fuel that is transferred through, or stored in, the terminal.

**Terminal transfer system** means the fuel distribution system consisting of refineries, pipelines, vessels, and terminals. Fuel in a refinery, pipeline, vessel, barge or terminal is in the terminal transfer system. Fuel in the fuel supply tank of an engine, or in a tank car, rail car, trailer, truck, or other equipment suitable for ground transportation is not in the terminal transfer system.

**Transmix** means the buffer or interface between two different products in a pipeline shipment, or a mix of two or more different products within a refinery or terminal that results in an off grade mixture.

**Transporter** means an operator of a pipeline, barge, railroad or fuel transportation vehicle engaged in the business of transporting fuel.

**Two party exchange** means a transaction in which:

- a. the fuel is transferred from one licensed supplier or licensed permissive supplier to another licensed supplier or licensed permissive supplier;
- b. the transaction includes a transfer from the person that holds the original inventory position for fuel in the terminal as reflected on the records of the terminal operator;
- c. the exchange transaction is simultaneous with removal from the terminal by the receiving exchange partner; and
- d. the terminal operator in its books and records treats the receiving exchange party as the supplier which removes the product across a terminal rack for purposes of reporting such events to this State.

**Ultimate vendor blocked pump** - means a person that sells clear kerosene at a retail site through a blocked pump and who is registered with both the Division of Taxation in the Department of the Treasury and the federal Internal Revenue Service as an Ultimate vendor blocked pumps.

**Undyed diesel fuel** means diesel fuel that is not subject to the federal Environmental Protection Agency dyeing requirements, or has not been dyed in accordance with federal Internal Revenue Service fuel dyeing provisions.

**Undyed kerosene** means kerosene that is not subject to the federal Environmental Protection Agency dyeing requirements, or has not been dyed in accordance with federal Internal Revenue Service fuel dyeing provisions.

**Vehicle fuel supply tank** means any receptacle on a motor vehicle from which fuel is supplied to propel the motor vehicle.

## **Chapter 26 Excise Tax - Petroleum Products Gross Receipts Tax**

A petroleum product is defined as refined products made from crude petroleum and its fractionation products, through straight distillation of crude oil or through redistillation of unfinished derivatives, but shall not mean the products commonly known as number 2 heating oil, number 4 heating oil, number 6 heating oil, kerosene and propane gas to be used exclusively for residential use.

Petroleum products do not include any finished manufactured products that may include petroleum as an ingredient but are not themselves petroleum products such as plastics, candles, animal feed, anti-freeze, ink, roofing shingles, and synthetic fibers. It is important to note that only certain finished manufactured products that have lost their petroleum identity are exempt from the tax, but other products, including products sold at retail which contain petroleum are subject to the Petroleum Products Gross Receipts tax.

The Petroleum Products Gross Receipts Tax is imposed on the gross receipts from the first sale of petroleum products delivered to a location in New Jersey however; the applicable tax rate for fuel oils, aviation fuels and motor fuels subject to tax is converted to a cents per gallon rate. The tax is also imposed when a company imports or causes to be imported petroleum products for its own use or consumption within New Jersey.

Amendments were made to the Petroleum Products Gross Receipts Tax Act that went into effect on November 1, 2016. The changes increased the tax rate, and added a number of exemptions.

Effective November 1, 2016, companies that refine and/or distribute petroleum products (other than highway fuel and aviation fuel) pay a tax on their gross receipts from the first sale of those products in New Jersey. Highway fuel which is defined as gasoline, blended fuel that contains gasoline or is intended for use as gasoline, liquefied petroleum gas (LPG), and diesel fuel, blended fuel that contains diesel fuel or is intended for use as diesel fuel, and kerosene, other than aviation grade kerosene are subject to tax at a different rate than other petroleum products. The tax rate on highway fuel and fuel oil is converted to a cents-per-gallon rate.

The tax rate for gasoline is based on the average retail price per gallon of unleaded regular gasoline in the State of New Jersey and will be adjusted quarterly. The rate for diesel fuel will also be adjusted quarterly and will be based on the average retail price per gallon of number 2 diesel in the State.

Fuel oil is taxed at the same rate as other petroleum products, however the rate for fuel oil is converted to a cents-per-gallon rate based on the average price per gallon of number 2 fuel oil in the State.

The taxation of aviation fuel is unaffected by the amendments to the law and continues to be subject to the tax at a cents-per-gallon rate.

A floor stock tax return is due with the increase in the tax rate. A floor stock tax is a tax imposed on inventory that a taxpayer has on hand the day before the new tax rate goes into effect. The floor stock tax due is the difference between the tax that was previously paid on the number of gallons in inventory at the close of the business day on the day before the new tax rate goes into effect and the tax that is due on those gallons at the increased tax rate. For purposes of the floor stock tax, close of the business day means the time at which the last transaction has occurred for that day. For businesses that operate 24 hours a day, the last transaction occurs at 11:59 p.m.

## **26.1 Pre-Audit Activities**

In addition to following other office or field audit procedures a field auditor prior to beginning the Petroleum Products Gross Receipts Tax audit should meet with the taxpayer and/or the taxpayer's representative to gain insight into the taxpayer's business and establish the tone of the audit. If the audit is to be conducted by an office auditor, the auditor should use all research tools available to gain knowledge about the taxpayer's business so that the auditor can develop questions tailored specifically to the taxpayer and his/her business.

Sometimes a Petroleum Products Gross Receipts Tax audit will be done in conjunction with a motor fuels audit, but because the tax is levied on petroleum products many taxpayers who are subject to the Petroleum Products Gross Receipts Tax do not require a motor fuels license. The auditor should understand the correlation between the Petroleum Products Gross Receipts Tax law and the motor fuels law. The common misconception is that all transactions reported on the PGRT return will also appear on the motor fuels return. Data reported on a Petroleum Products Gross Receipts Tax return may get reported on a motor fuels return, but the auditor should be aware that there are differences in the laws which may require data to be reported on one return and not the other. The amendments to the law that went into effect on November 1, 2016 included exemptions that are also in the Motor Fuels Tax law. The auditor should be aware that products considered taxable prior to November 1, 2016 may no longer be taxable.

The auditor may question the taxpayer to determine the taxpayer's knowledge of the law and request information regarding their accounting systems and internal controls. Attention should be given to the periods both before and after November 1, 2016 when changes were made to the law. With this information the auditor may be able to determine areas of weakness and develop an audit plan to focus on those areas. The auditor may ask the taxpayer to provide an overview of their accounting system and document the types of reports available and how data is received and transmitted from sources outside the system and within the system. Attention should be given to how the tax returns are prepared using the available system data. The auditor will want to establish the type of business operated by the taxpayer, and the types of products purchased, sold and/or manufactured. The auditor should inquire as to how the taxpayer determines and tracks sales that are exempt from the tax and the documentation obtained in support of the exemption.

The auditor should obtain a complete list of all products sold by the taxpayer. This is particularly important in a case where a retail establishment is making the first sale of petroleum products. The auditor should review the list of products sold and make a determination of which products are petroleum products and therefore subject to the tax. In the case of a manufacturer the auditor will want to examine not only the products sold, but the products purchased.

The auditor should have a working knowledge of the taxpayer's business operations, the types of products being purchased, sold, and/or used, the taxpayer's customers, and how and from where the taxpayer acquires those products. At this point, the auditor should determine what books and records will be requested.

## **26.2 Auditing PGRT Taxpayers**

The Petroleum Products Gross Receipts Tax Return is due the 25th day of the month following the end of the quarter. A quarterly return must be filed whether or not tax is due. A monthly remittance is due for all other months. The remittance is due the 25th day of the month following the end of the month.

The taxpayer will report purchases of petroleum products made in New Jersey. The auditor may review the purchase invoices to determine if the appropriate tax was charged and to verify the correct reporting of the gallons and/or consideration. If the taxpayer is the holder of a direct payment permit the purchase by the taxpayer will be tax free and the subsequent sale or use of the product may be subject to the tax as a first sale in New Jersey.

The taxpayer should report total sales of petroleum products made to points in New Jersey. The auditor should be aware that depending on the products the taxpayer sells they may report sales in more than one column.

The auditor should verify the nature of the products reported in each column. Sales of petroleum products should be reported in the proper columns and are based on the nature of the product. If the auditor identifies any sales in one column that should be reported in another column the auditor must obtain the information relevant to the product and make the appropriate adjustment.

Work-papers and accounting records used to prepare Petroleum Products Gross Receipts Tax returns should be examined in order to determine the accuracy of tax reporting. The auditor may verify the total sales of petroleum products by reviewing the taxpayer's sales journal, accounts receivable, sales invoices, bank statements, Motor Fuels Tax returns and any other relevant data or returns available that the auditor can use to reconcile total sales of petroleum products.

The auditor should then begin to examine deductions reported on the return to make sure they are allowable under the statute. Allowable deductions may include sales to direct payment permit holders, sales to governmental or exempt entities, sales of exempt products, and other exempt sales.

The auditor has many forms of documentation available that they can examine to verify the deductions reported on the return. Sales invoices, delivery tickets, meter readings, accounts receivable, bank statements, tax returns, customer lists, exempt use certificates, export certificates, and direct payment permits are some of the documents available for examination.

A sale to the holder of a direct payment permit is not considered to be a first sale of petroleum products within New Jersey and is therefore not subject to tax. When the purchaser who holds a direct payment permit in turn makes a sale of petroleum products delivered to a location in New Jersey the sale unless it otherwise qualifies for exemption, exclusion, or deduction is subject to tax. If the purchaser uses the petroleum product such use is also subject to tax. All sales made to a holder of a direct payment permit must be documented by a properly completed direct payment permit. A direct payment permit, once issued, shall remain valid unless voided by the Director. The taxpayer claiming a deduction for a sale to a direct payment permit holder must obtain a copy of the direct payment permit from the purchaser and keep it on file to support the sale.

The auditor should request copies of all direct payment permits the taxpayer has on file to support the deduction for sales to a direct payment permit holder. The auditor may also review other available

resources such as the Division's Website or internal records to verify the direct payment permit. In addition a review of the accounting records and/or invoices should be completed by the auditor to verify the amount of the deduction.

A company making a purchase of petroleum products for immediate export from New Jersey must issue a properly executed export certificate to the seller. An export certificate may take the form of a blanket certificate covering the period of one year. The seller shall maintain records identifying all sales for export for a given customer's account and attributable to the certificate and shall make them available upon request. The auditor should review all export certificates, sales invoices, accounts receivable, shipping documents and any other available records to verify the deduction.

Other exempt sales include sales of petroleum products bunkered into marine vessels engaged in interstate or foreign commerce, aviation fuels used by common carriers in interstate or foreign commerce, and sales of asphalt and asphaltic material, and polymer grade propylene used in the manufacture of polypropylene are exempt from the tax. The purchaser should issue, to the seller, an exempt use certificate. To verify the deduction for exempt use the auditor should examine all exempt use certificates along with sales invoices, accounts receivable, purchase invoices, and any other available records.

Petroleum products bunkered into marine vessels engaged in interstate or foreign commerce are exempt from the tax. Commercial fishing or shell fishing vessels are deemed to be vessels engaged in interstate commerce, however other vessels engaged in charter, sport fishing, or commercial party boat (head boat) fishing do not qualify for exempt purchases of fuel. In addition to verifying the amount of the deduction the auditor should also verify the nature of the customer's business operations.

Also, Aviation fuels used by common carriers in interstate or foreign commerce are not subject to tax except for the portion of the fuel used and consumed in New Jersey. The auditor should verify the accuracy of the calculation the taxpayer uses to report the exemption. For flights taking off in New Jersey and landing outside of New Jersey the calculation is based on the type of aircraft, the number of flights originating in New Jersey and the standard aircraft fuel consumption for taxiing and take off used by the aircraft. For all flights taking off and landing in New Jersey all of the fuel consumed is taxed.

Purchases of petroleum products outside New Jersey for use or consumption in New Jersey are subject to tax. Purchase invoices, accounts payable journal, bank statements, tax returns, export reports, carrier reports, shipping papers are examples of the documents an auditor can request to verify the import.

The changes to the law that went into effect on November 1, 2016 levied a tax on highway fuel, however some highway fuel is exempt from the tax. Highway fuel used for the following purposes is exempt from the tax:

- Autobuses (as described in N.J.S.A. 54:15B-2.1b(1));
- Agricultural tractors not operated on a public highway;
- Farm machinery;
- Ambulances;

- Rural free delivery (RFD) carriers in the dispatch of their official business;
- Vehicles that run only on rails or tracks, and such vehicles as run in substitution therefor;
- Highway motor vehicles that are operated exclusively on private property;
- Motor boats or motor vessels used exclusively for or in the propagation, planting, preservation and gathering of oysters and clams in the tidal waters of this State;
- Motor boats or motor vessels used exclusively for commercial fishing;
- Motor boats or motor vessels, while being used for hire for fishing parties or being used for sightseeing or excursion parties;
- Fire engines and fire-fighting apparatus; Stationary machinery and vehicles or implements not designed for the use of transporting persons or property on the public highways;
- Heating and lighting devices;
- Motor boats or motor vessels used exclusively for Sea Scout training by a duly chartered unit of the Boy Scouts of America; and
- Emergency vehicles used exclusively by volunteer first-aid or rescue squads.

### **26.3 Post-Audit Procedures**

Standard field and office audit procedures regarding preparation and issuance of work papers, writing reports, conducting a post audit conference, and any other standard procedures regarding the completion of the audit that is detailed in the manual should be followed.

## **Chapter 27 Excise Tax - Tobacco Products Tax**

The Tobacco Products Tax (TPT) is imposed on the sale of tobacco products, other than cigarettes, to a retailer or consumer in New Jersey. A tobacco product is defined by New Jersey law as any product containing any tobacco for personal consumption including, but not limited to, cigars, cigarillos, chewing tobacco, pipe tobacco, smoking tobacco and their substitutes, and dry and moist snuff, but does not include cigarettes as defined in the "Cigarette Tax Act".

The tax is levied on the wholesale price upon the sale, use or distribution of a tobacco product within this State except in the case of moist snuff which is taxed on the net weight, as listed by the manufacturer, of the moist snuff. A compensating use tax shall be levied on a distributor or wholesaler who uses a tobacco product within this State unless the tobacco product has already been or will be subject to the wholesale Sales Tax. There are some instances where the tax is imposed upon the retail dealer or consumer.

### **27.1 Pre-Audit Activities**

When conducting a TPT audit, the auditor may follow the standard pre-audit and post-audit procedures detailed in the office and field audit chapters of this manual as well as those procedures detailed below. Some of the procedures detailed below may be followed in lieu of standard office and field audit procedures.

In addition to following other office or field audit procedures a field auditor prior to beginning the TPT audit should, meet with the taxpayer and/or the taxpayer's representative to gain insight into the taxpayer's business and establish the tone of the audit. If the audit is to be conducted by an office auditor, the auditor should use all research tools available to gain knowledge about the taxpayer's business so that the auditor can develop questions tailored specifically to the taxpayer and their business. The auditor should understand that cigarettes are not considered to be tobacco products and the tax on cigarettes is separate and distinct from the tax on tobacco products under the Tobacco Products Tax.

The auditor may question the taxpayer to determine the taxpayer's knowledge of the law and request information regarding their accounting systems and internal controls. With this information the auditor may be able to determine areas of weakness and develop an audit plan to focus on those areas. The auditor may ask the taxpayer to provide an overview of their accounting system and document the types of reports available and how data is received and transmitted from sources outside the system and within the system. Attention should be given to how the tax returns are prepared using the available system data. The auditor will want to establish the type of business operated by the taxpayer, and the types of tobacco products purchased, sold, and/or used.

At the conclusion of the pre-audit activities, the auditor should have a working knowledge of the taxpayer's business operations and the flow of the sales figures to the tax returns. At this point, the auditor should develop an audit plan and determine what books and records will be requested in the initial NJ-IDR. The audit plan will vary according to the nature of the business, the types of products the taxpayer sells or distributes and the accounting system used.

Depending on the taxpayer's monthly tobacco products activity, the auditor may determine if it is more feasible to base the audit results on a sample period rather than examining all months of the audit

period. The auditor may also determine if examining a sampling of invoices is preferred to examining all of the invoices. If the auditor decides to utilize a sample period, the auditor should document why he or she chose to use a sample period instead of reviewing all months of the audit, and explain in detail why a particular period was chosen. The auditor must also ensure to utilize a sample period within the specified audit period. If the taxpayer agrees to a sample period, such agreement should be expressed in writing, signed by the taxpayer, and such agreement should be retained in the auditor's file.

A field auditor may conduct inspections of all of the taxpayer's locations and identify the tobacco products sold at each location, noting quantity, brand, and manufacturer. The auditor must complete a Cigarette Retail Inspection Sheet (CRIS) for each location.

## **27.2 Auditing Tobacco Products Taxpayers**

The taxpayer is required to report all tobacco products purchased, imported, received or acquired in New Jersey. For all tobacco products except moist snuff the taxpayer is required to report the name of the supplier along with wholesale sales price of the product. In the case of moist snuff the taxpayer is required to report the name of the supplier and the number of ounces sold or purchased.

The auditor may examine purchase invoices, accounts payable, bank statements, shipping documents, and other records to verify that the taxpayer has disclosed all purchases and has reported all tobacco products purchased, imported, received or acquired in New Jersey.

In addition to verifying that all tobacco products purchased, imported, received, or acquired in New Jersey have been reported the auditor should examine the invoices to determine if the supplier has charged the customer the tobacco products tax on the purchases. If a supplier states that "Tobacco Products Taxes have been satisfied" (or language to this effect) on its invoices, the auditor may review the Division's records to verify that the supplier is registered, is reporting the sale, and is remitting the tax. If the auditor's review reveals that a supplier's claim that tobacco products taxes have been satisfied is not supported, the auditor should recommend the supplier for audit.

The auditor may examine the taxpayer's sales records to ensure consistency between stated purchases and sales of tobacco products. The auditor may request to review documents related to tobacco products exported and products sold, used, or distributed in a non-taxable manner.

All tobacco products including moist snuff exported out of New Jersey may be confirmed through the review of shipping documents or through other documentation such as tax returns filed by the taxpayer in another State or jurisdiction. A properly completed Tobacco Products Wholesale Sales and Use Tax Wholesale Resale Certificate, form TPT-3, should be requested to document all sales of tobacco products sold, or distributed in a non-taxable manner.

The auditor should also review sales invoices, accounts receivables, bank statements, and any other available records to verify the amount of tax charged and collected was remitted.

Besides making a determination as to whether the taxpayer has paid the correct tax and filed the required reports accurately the purpose of a Tobacco Products Tax audit is to make sure the taxpayer is in compliance with the provisions of the Master Settlement Agreement.

The Division of Taxation is required to enforce some provisions of the Master Settlement Agreement. The requirements with respect to the tobacco products tax focuses on Roll-Your-Own (RYO) tobacco.

Roll-Your-Own Tobacco purchased, acquired, or shipped into New Jersey is reported on Schedule E of the Tobacco Products Tax Return (TPT-20). If a taxpayer purchased, acquired or sold RYO during a month the auditor must verify that all information including the name of the manufacturer, name of supplier, brand, quantity, net weight in ounces, and total weight in ounces is reported on the schedule. If any of the information is missing the auditor must request that the information be provided.

The auditor must review the taxpayer's accounting records, invoices, and/or shipping records to verify the reported information is accurate. The auditor must also verify that each brand listed on schedule E is on the AG's tobacco manufacturer directory. If a brand is not on the tobacco manufacturer directory it cannot be sold in New Jersey. If the taxpayer is a distributor and purchases, sells, or acquires RYO that was manufactured by a Non-Participating Manufacturer the auditor should ask for a copy of NPM-1 filed with the State of New Jersey.

### **27.3 Post-Audit Procedures**

The auditor must document the entire audit process with respect to the MSA in his/her audit narrative. A copy of the narrative should be forwarded to the Excise Tax Branch. In addition the auditor should follow the field audit or office audit post-audit procedures outlined in this manual.

## **Chapter 28 Excise Tax - Cigarette Tax**

The Cigarette Tax is imposed on the sale, use, or possession of cigarettes in New Jersey. A cigarette is defined as any roll for smoking made wholly or in part of tobacco, or any other substance or substances other than tobacco, irrespective of size, shape or flavoring, the wrapper or cover of which is made of paper or any other substance or material, except tobacco.

The tax is collected primarily from licensed distributors who receive cigarettes directly from manufacturers. Cigarette distributors prepay the tax through the purchase of stamps that they affix to each package of cigarettes subject to the tax. No tax is imposed on cigarettes in possession of licensed manufacturers prior to delivery to duly licensed distributors or on the sale of cigarettes made by licensed manufacturers to duly licensed distributors. Unless otherwise provided by law, every package of cigarettes must be stamped before being transferred from the original acquirer in New Jersey. Licensed distributors shall not sell, borrow, loan, buy or exchange unstamped cigarettes or stamps with other licensed distributors except for cigarettes bearing the cigarette revenue stamps of other States. This tax is not imposed on other tobacco products because tobacco products are taxed under the Tobacco Products Wholesale Sales and Use Tax Act.

A New Jersey resident is not permitted to possess or transport untaxed or non-New Jersey taxed cigarettes within New Jersey. There is no exemption for small quantities under the law and the State is fully authorized to assess taxes, penalties and interest on cigarettes purchased outside New Jersey. The Cigarette Tax is imposed on the sale, use, or possession of cigarettes in New Jersey. Cigarette distributors prepay the tax through the purchase of stamps that they affix to each package of cigarettes subject to the tax. The distributor may be either a resident distributor or non-resident dealer.

### **28.1 Pre-Audit Activities**

In addition to following other office or field audit procedures, prior to beginning a Cigarette Tax audit, a field auditor should meet with the taxpayer and/or the taxpayer's representative to gain insight into the taxpayer's business. If the audit is to be conducted by an office auditor, the auditor should use all research tools available to gain knowledge about the taxpayer's business so that the auditor can develop questions tailored specifically to the taxpayer and its business.

The auditor may question the taxpayer to determine the taxpayer's knowledge of the law and request information regarding the taxpayer's accounting systems and internal controls. With this information, the auditor may be able to determine areas of weakness and develop an audit plan to focus on those areas. The auditor may ask the taxpayer to provide an overview of its accounting system, document the types of reports available, and explain how data is received and transmitted from sources outside the system and within the system. Attention should be given to how the taxpayer controls and accounts for its inventory of cigarettes and how it tracks its purchases and sales. In the case of a taxpayer who stamps cigarettes, the auditor should also focus on the taxpayer's stamping operations and how the taxpayer controls and accounts for tax stamps that are purchased and used. Purchases and sales that are exempt from the tax should be documented and the taxpayer should provide documentation in support of the exemption. The auditor should have a working knowledge of the taxpayer's business operations, the products and brands being purchased, sold, and/or used, the taxpayer's customers, and how and from where the taxpayer acquires those products. At this point, the auditor should determine what books and records will be requested.

The auditor must review the taxpayer's filing history and any returns, schedules, or forms not submitted or not properly completed are to be filed and completed properly with all of the required information provided. The auditor must make sure the information is received and the taxpayer is compliant with the provisions of the Master Settlement Agreement.

## **28.2 Auditing Cigarette Taxpayers**

Auditors may review a taxpayer's cigarette inventory records to identify the type of inventory records that are kept, how often the inventory is taken, and if the inventory records conform to current statutes.

In addition, the auditor can also verify if separate inventory is maintained for each brand of cigarettes, stamped cigarettes, unstamped cigarettes, and tax stamps.

A mathematical check of the inventory records may be performed, taking note of the beginning and ending inventory records and noting discrepancies between the beginning inventory and the ending inventory of the prior month.

Any unaccounted for inventory should be noted by the auditor and, in certain cases, documentation to substantiate the unaccounted for inventory should be obtained.

The auditor may review purchase invoices, shipping documents, general ledgers, accounts payable, checkbooks, check registers, cancelled checks, bank statements, and any other financial records to verify that the taxpayer reported all cigarettes received. In addition, if the taxpayer is a licensed manufacturer, the auditor may verify the number of cigarettes manufactured.

The auditor may verify the number of cigarettes exported out of New Jersey or sold to United States government entities by reviewing sales invoices, sales journals, shipping documents, general ledgers, accounts receivable, bank statements, and any other documents available.

To verify returns to the manufacturer, the auditor should review purchase order credit memos, shipping documents, general ledgers, accounts payable, bank statements, and any other documents available. To verify other deductions, the auditor may identify the reason for the deduction and determine whether it is a valid deduction. If the deduction is valid, the auditor may then verify the number of cigarettes by reviewing purchase order credit memos, correction memos, truck shipping documents, general ledgers, accounts payable, accounts receivable, purchase invoices, sales invoices, bank statements, and any other documents available.

If the taxpayer is purchasing and stamping cigarettes, the auditor should also perform an inventory analysis of the cigarette tax stamps, noting the stamps purchased, stamps used, and any remaining in inventory.

The auditor may verify the number of stamps the taxpayer purchased during the month by reviewing general ledgers, accounts payable, bank statements and any internal documents available.

If the taxpayer is purchasing and stamping cigarettes, the auditor should perform a comparison of the number of cigarettes purchased and stamped to the number of stamps purchased and used during the month. Inventory of stamped cigarettes may be taken into account when making this comparison and the auditor should obtain documentation to explain any discrepancies. The auditor may verify the

ending inventory of stamps and the number of returned or damaged stamps by reviewing general ledgers, accounts receivable, bank statements, and any other documents available. In addition, the auditor may review internal records of stamps returned by the taxpayer. The auditor may take a physical inventory, review inventory records and previous audits to determine the correct ending inventory.

### **28.3 Post-Audit**

The auditor must document the entire audit process with respect to the MSA in his/her audit narrative. A copy of the narrative should be forwarded to the Excise Tax Branch. In addition, the auditor should follow the field audit or office audit post-audit procedures outlined in this manual.

## **Chapter 29 Excise Tax - Alcoholic Beverage Tax**

The Alcoholic Beverage Tax Act imposes a per-gallon tax on the first sale or delivery of alcoholic beverages sold to a retailer in New Jersey. The tax is due from manufacturers, wholesalers, and other persons licensed by the Division of Alcoholic Beverage Control.

### **29.1 Pre-Audit Procedures**

When conducting an Alcoholic Beverage Tax audit, the auditor may follow the standard pre-audit and post-audit procedures detailed in the office and field audit chapters of this manual as well as those procedures detailed below. Some of the procedures detailed below may be followed in lieu of standard office and field audit procedures.

In addition to following other office or field audit procedures a field auditor prior to beginning the Alcoholic Beverage Tax audit should meet with the taxpayer and/or the taxpayer's representative to gain insight into the taxpayer's business and establish the tone of the audit. If the audit is to be conducted by an office auditor, the auditor should use all research tools available to gain knowledge about the taxpayer's business so that the auditor can develop questions tailored specifically to the taxpayer and their business.

The auditor may question the taxpayer to determine the taxpayer's knowledge of the law and request information regarding his/her accounting systems and internal controls. With this information the auditor may be able to determine areas of weakness and develop an audit plan to focus on those areas. The auditor may ask the taxpayer to provide an overview of his/her accounting system and document the types of reports available and how data is received and transmitted from sources outside the system and within the system. Attention should be given to how the tax returns are prepared using the available system data. The auditor will want to establish the type of business operated by the taxpayer, and the types of products manufactured, purchased, sold, and/or used.

Depending on the taxpayer's monthly activity, the auditor may determine if it is more feasible to base the audit results on a sample period rather than examining all months of the audit period. The auditor may also determine if examining a sampling of documents is preferred to examining all of the documents.

At the conclusion of the pre-audit activities, the auditor should have a working knowledge of the taxpayer's business operations and the flow of the figures to the tax returns. At this point, the auditor should develop an audit plan and determine what books and records will be requested. The audit plan will vary according to the nature of the business, the types of products the taxpayer manufactures, sells or distributes and the accounting system used.

### **29.2 Auditing Alcoholic Beverage Tax Taxpayers**

The auditor should obtain a complete list of all products containing alcohol sold by the taxpayer. The auditor should review the list of products sold and make a determination as to the classification of each product to ensure the proper tax rate is charged. In the case of a manufacturer the auditor will want to examine not only the products sold, but the products purchased.

The auditor should verify that the taxpayer along with all of his/her suppliers and purchasers of alcoholic beverages are properly licensed. All sales made to a holder of a valid Alcoholic Beverage Tax distributor or wholesale license are exempt from tax. The auditor may request copies of all licenses the taxpayer has on file to support any deduction. The auditor may also review other available resources to verify the deduction.

Auditors may review a taxpayer's alcoholic beverage inventory records to identify the type of inventory records that are kept, how often the inventory is taken, and if the inventory records conform to current statutes.

A mathematical check of the inventory records may be performed taking note of the beginning and ending inventory records and noting discrepancies between the beginning inventory and the ending inventory of the prior month.

Any unaccounted for inventory should be noted by the auditor and in certain cases documentation to substantiate the unaccounted for inventory should be obtained.

The auditor may review purchase invoices, shipping documents, general ledgers, accounts payable, check books, check registers, cancelled checks, bank statements, and any other financial records to verify that the taxpayer reported all alcoholic beverages received. In addition, if the taxpayer is a licensed manufacturer, the auditor may verify the quantity of beverages manufactured.

The auditor may examine the taxpayer's sales records such as sales invoices, accounts receivables, bank statements, shipping records and/or any other available records to ensure consistency between stated purchases and sales of alcoholic beverages. The auditor may request to review documents related to alcoholic beverages exported and/or alcoholic beverages sold, used, or distributed in a non-taxable manner where an exemption is claimed.

### **29.3 Post-Audit**

Standard field and office audit procedures regarding preparation and issuance of work papers, writing reports, conducting a post audit conference, and any other standard procedures regarding the completion of the audit that is detailed in the manual should be followed.

## **Chapter 30 Excise Tax - Spill Compensation and Control Tax**

The Spill Compensation and Control Tax (Spill Tax) is imposed on the transfer of hazardous substances within the jurisdiction (lands and waters) of New Jersey. In general, the tax is payable by the owner or operator of a major facility (i.e., the transferee) who receives a transfer of a hazardous substance. However, when a hazardous substance is transferred to a major facility that qualifies as a public storage terminal, the owner of the hazardous substance is considered to be the transferee and the taxpayer for the purposes of the tax.

### **30.1 Pre-Audit Activities**

When conducting a Spill Tax audit, the auditor may follow the standard pre-audit and post-audit procedures detailed in the office and field audit chapters of this manual, as well as those procedures detailed below. Some of the procedures detailed below may be followed in lieu of standard office and field audit procedures.

In addition to following other office or field audit procedures, prior to beginning the Spill Tax audit, a field auditor should meet with the taxpayer and/or the taxpayer's representative to gain insight into the taxpayer's business. If the audit is to be conducted by an office auditor, the auditor should use all research tools available to gain knowledge about the taxpayer's business so that the auditor can develop questions tailored specifically to the taxpayer and its business.

The auditor may question the taxpayer to determine the taxpayer's knowledge of the law and request information regarding the taxpayer's accounting systems and internal controls. With this information, the auditor may be able to determine areas of weakness and develop an audit plan to focus on those areas. The auditor may ask the taxpayer to provide an overview of its accounting system, document the types of reports available, and explain how data is received and transmitted from sources outside the system and within the system. Attention should be given to how the tax returns are prepared using the available system data. The auditor will want to establish the type of business operated by the taxpayer, and the types of products manufactured, purchased, sold, and/or used.

Depending on the taxpayer's monthly activity, the auditor may determine if it is more feasible to base the audit results on a sample period rather than examining all months of the audit period. The auditor may also determine if examining a sampling of documents is preferred to examining all of the documents. If the auditor decides to utilize a sample period, the auditor should document why he or she chose to use a sample period instead of reviewing all months of the audit, and explain in detail why a particular period was chosen. The auditor must also ensure to utilize a sample period within the specified audit period. If the taxpayer agrees to a sample period, such agreement should be expressed in writing, signed by the taxpayer, and such agreement should be retained in the auditor's file.

A field auditor may conduct inspections of all of the taxpayer's locations in order to determine the scope of the taxpayer's operations and combined storage capacity, which includes all storage space at the facility, whether above or below ground, and the entire capacity of all tanks, any enclosed storage space (such as warehouse space), open land, or unenclosed storage space (such as outdoor yard storage). Auditors may also review the taxpayer's Spill Compensation and Control Tax Registration Form and/or any documents required to be submitted under the Spill Compensation and Control Act.

At the conclusion of the pre-audit activities, the auditor should have a working knowledge of the taxpayer's business operations and the flow of the data to the tax returns. At this point, the auditor should develop an audit plan and determine what books and records will be requested. The audit plan will vary according to the nature of the business, the types of products the taxpayer manufactures, sells, or distributes and the accounting system used.

### **30.2 Auditing Spill Compensation and Control Tax Taxpayers**

The auditor should request a list of all products transferred to and/or from each of the facilities at which the taxpayer receives, stores, or distributes substances so that the auditor can make the determination of which products are subject to the Spill Tax. Hazardous Substances subject to the tax appear on the environmental hazardous substance list adopted by the New Jersey Department of Environmental Protection. The auditor may also examine the taxpayer's books and records for evidence of transfers of products subject to the Spill Tax.

Books and records that may be examined include purchase and sales invoices, general ledger accounts, the purchases journal, sales journal, bank statements, inventory records, shipping documents, bills of lading, and any other available records. The auditor may examine other records available that may include any reports filed by the taxpayer, such as Public Storage Terminal Information Return, Terminal Operator Reports, Motor Fuels Supplier Reports, Motor Fuel Distributor Reports, and Carrier Report.

Verification of the total quantity of substances transferred may be made by examining records such as purchase and sales invoices, general ledger accounts, the purchases journal, sales journal, bank statements, inventory records, shipping documents, bills of lading, and any other available records. The auditor may examine other records available to verify total quantity received, which may include any reports filed by the taxpayer, the taxpayer's supplier, or the taxpayer's customer such as Public Storage Terminal Information Returns, Terminal Operator Reports, Motor Fuels Supplier Reports, Motor Fuel Distributor Reports, and Carrier Reports.

The auditor should remember that liquid substances are reported in gallons and non-liquid substances are reported in pounds, and the quantities of both liquids and non-liquids that the taxpayer reports should be measured at 60 degrees Fahrenheit. Also the taxpayer must convert both the gallons and/or pounds into barrels before computing the amount of tax due. The auditor must verify that the taxpayer has made the proper conversion to barrels.

After examining purchase invoices, bills of lading, and other records available, and by observing the taxpayer's business operations, the auditor may determine the validity of the taxpayer's deductions for tax-exempt transfers from the total quantity of hazardous substances transferred to the taxpayer. Exempt transfers include transfers received for use in tax exempt fueling and refueling operations and transfers received by the taxpayer from a non-major facility by any conveyance other than a vessel.

The auditor may request, and the taxpayer is required to produce, properly completed secondary transfer certificate(s) as evidence that the Spill Tax was previously paid on the transfer(s) of hazardous substance(s). The transferor is required to complete and provide the transferee with the certificate(s), which must remain in the transferee's physical possession. If the transferee fails to produce a properly completed certificate, the transaction may be deemed to be taxable. If the secondary certificate was not properly completed, the transferor has the burden of proving that the tax was not required to be paid.

A properly completed secondary transfer certificate will govern additional transfers to the same transferee of the same general type of product. Secondary transfer certificates are not valid when delivery of the hazardous substance is made from a point outside of New Jersey to a point inside New Jersey, or where the transfer of a hazardous substance is the first taxable transfer in New Jersey.

Other hazardous substances reported are taxed at a percentage of the fair market value while petroleum and petroleum products and precious metals, elemental phosphorus, elemental antimony or antimony trioxide are taxed at a per barrel rate. The auditor must verify that the taxpayer has used the correct fair market value of the product. The fair market value is the total of all invoice prices, including transportation charges of all non-petroleum hazardous substance transfers for the taxable period that are subject to tax. Where no invoice price is so fixed, fair market value is the market price as of the nearest day to the transfer paid for similar non-petroleum hazardous substances.

### **30.3 Capped Taxpayers**

A taxpayer who incurred a tax liability and made payments for calendar year 1986 may be subject to the Spill Tax Cap. These taxpayers are referred to as “capped” taxpayers because they pay no more than 125% of the tax due and paid in 1986, plus an additional \$0.0025 per barrel. When a hazardous substance is directly converted to, and comprises more than 90% by weight of a nonhazardous final product, the taxpayer pays no more than 100% of the tax due and paid in 1986, plus an additional \$0.0025 per barrel.

The auditor may verify that the taxpayer qualifies for the “cap” by confirming that the taxpayer was registered during the 1986 calendar year. The “cap” amount is calculated using payments that were made on returns due in 1986. This will include transfers made in December 1985 on which payment was due in January 1986 and does not include transfers made in December 1986 for which payment was due in January 1987. Also, the “cap” year covers a 12-month period beginning with the December return (tax due in January) and ending with the November return (tax due in December). A “capped” taxpayer may begin paying tax starting with the December return. A taxpayer loses its qualification as a “capped” taxpayer if it ceases to exist as a corporate entity due to a merger, consolidation, or other corporate reformation resulting in a new legal entity.

### **30.4 Post-Audit Procedures**

Standard field and office audit procedures regarding preparation and issuance of work papers, writing reports, conducting a post audit conference, and any other standard procedures regarding the completion of the audit that is detailed in the manual should be followed.