

**To: New Jersey Law Revision Commission**  
**From: Samuel M. Silver, Dep. Dir.**  
**Re: Audit Adjustments Involving Returns from Closed Years as discussed in *R.O.P. Aviation, Inc. v. Director, Division of Taxation*, 32 N.J. Tax 346 (2021)**  
**Date: March 07, 2022**

## MEMORANDUM

### Project Summary

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

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

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

### Statute Considered

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

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

<sup>2</sup> *Id.*

<sup>3</sup> *Id.*

<sup>4</sup> N.J. STAT. ANN. §§ 54:48-1 to 54-6 (West 2022); N.J. STAT. ANN. § 54:48-7 (West 2022).

<sup>5</sup> *Id.*

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

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

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

<sup>9</sup> *Id.* at 348.

Whenever it shall appear to the director that any taxpayer fails to maintain its records in accordance with sound accounting principles or conducts its business or maintains its records in such a manner as either directly or indirectly to distort its true entire net income... or the proportion thereof properly allocable to this State... the director is authorized and empowered... to make *any* adjustments in *any* tax report or tax returns as may be necessary to make a fair and reasonable determination of the amount of tax payable under this act.

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

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

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### **Background**

The Plaintiff (R.O.P.) is in the business of aircraft leasing to an affiliate.<sup>10</sup> For the tax years 2007-2011, R.O.P. reported that its total net operating losses carried forward were over \$18 million.<sup>11</sup> The Director did not dispute that R.O.P.'s corporate business returns for these tax years were not audited and were accepted as filed.<sup>12</sup> In tax year 2014, the net operating losses were carried forward and used to offset its taxable income.<sup>13</sup>

In 2017, R.O.P.'s corporate business returns for the tax years 2012-2015 were the subject of an audit by the New Jersey Division of Taxation.<sup>14</sup> The auditor noted that R.O.P. had leased its aircraft to its affiliate at a rate below its total costs.<sup>15</sup> As a result, "allegedly underreporting income from the lease rentals," the auditor adjusted R.O.P.'s income.<sup>16</sup> In addition, the auditor disallowed the use of any net operating losses for 2014, and of carried forward losses from 2007-2011 against the audited increased income for tax years 2012, 2013, and 2015, by reducing the net operating losses to zero.<sup>17</sup> The elimination of these deductions "resulted in the audited income as being the net taxable income... which plus interest totaled \$8,498,890.11."<sup>18</sup>

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<sup>10</sup> *Id.* at 349.

<sup>11</sup> *Id.* at 349-350.

<sup>12</sup> *Id.* at 350.

<sup>13</sup> *Id.*

<sup>14</sup> *Id.*

<sup>15</sup> *Id.*

<sup>16</sup> *Id.*

<sup>17</sup> *Id.*

<sup>18</sup> *Id.*

The Notice of Final Audit determination, citing N.J.S. 54:10A-10 and N.J.A.C. 18:7-5.10 as authority, advised R.O.P. that the net operating losses “were disallowed for 2014 and not applied for 2012, 2013 and 2014 as the prior returns filed did not reflect arms-length transactions.”<sup>19</sup>

R.O.P. filed a direct appeal from the Notice of Final Audit adjustment.<sup>20</sup>

### Analysis

The Tax Court determined that the partial summary judgment was an appropriate method of deciding the issue expeditiously since the underlying facts were not in dispute, nor was there any dispute that R.O.P.’s tax years 2007-2011 were closed.<sup>21</sup> The issue presented was whether the Division’s “elimination of R.O.P.’s [net operating losses] generated in closed years (2007-2011) and carried forward to the open years (2012-2015), [was] valid as an audit adjustment of the open tax years.”<sup>22</sup> In brief, the sole issue before the Court was “simply whether that adjustment was proper as a matter of law.”<sup>23</sup>

#### • *Statute of Limitations for Audit*

The Director of Taxation is authorized to examine, audit, or investigate a filed return and, if there is a deficiency, assess additional penalties against the taxpayer.<sup>24</sup> The State Uniform Tax Procedure Law sets forth the time within which the Director of Taxation can audit a filed commercial business tax return.<sup>25</sup> The statute of limitations, however, provides that “no assessment of additional tax shall be made after the expiration of more than four years from the date of the filing” of a commercial business tax return.<sup>26</sup>

In *R.O.P. Aviation*, it was uncontested that the Division of Taxation did not issue an assessment of additional corporate business tax for the closed years of 2007-2011.<sup>27</sup> Neither the taxpayer nor the Division disputed that at the time of the 2017 audit, the tax years of 2007-2011 were beyond the statute of limitations.<sup>28</sup> The Court noted that N.J.S. 54:49-6b. does not address whether the closed returns can be “audited” after the four-year statute of limitations has expired.<sup>29</sup>

The Court determined that N.J.S. 54:49-6a. and b. must be read together.<sup>30</sup> The Court reasoned that:

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<sup>19</sup> *Id.* (internal citations omitted).

<sup>20</sup> *Id.* at 352.

<sup>21</sup> *Id.* at 353.

<sup>22</sup> *Id.*

<sup>23</sup> *Id.*

<sup>24</sup> N.J. STAT. ANN. § 54:49-6a. (West 2022).

<sup>25</sup> N.J. STAT. ANN. §§ 54:48-1 to 54-6 (West 2022).

<sup>26</sup> N.J. STAT. ANN. § 54:49-6b. (West 2022).

<sup>27</sup> *R.O.P. Aviation*, 32 N.J. Tax at 355.

<sup>28</sup> *Id.*

<sup>29</sup> *Id.*

<sup>30</sup> *Id.*

[s]ubsection (a) requires Taxation to examine a filed return and provides it the ability to “audit or investigate” the filed return. If the audit is conducted, and a deficiency is determined, Taxation must assess the additional tax. However, although Subsection (b) separately requires that assessment of any additional tax shall be made within four years of the return's filed date, it does not mean that the return's audit/investigation can be made at any time, and outside the four-year period. The tax assessment flows from the audit made under Subsection (a), therefore, the audit and resultant tax assessment should be subject to the same four-year period.<sup>31</sup>

The Court reasoned that adjusting the amount of R.O.P.’s “carry forward of a closed year, in the audited open year, was an indirect additional assessment of tax for the closed year.”<sup>32</sup> The fact that the Division did not impose any additional assessment of corporate business tax in the closed year was of no moment to the Court.<sup>33</sup> The Court concluded that the act of “auditing a closed year and applying the revisions from that closed year in the open year of audit is doing indirectly what the statute does not permit directly: bypassing the four-year statute of limitations.”<sup>34</sup>

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

In *R.O.P. Aviation*, the Division maintained that pursuant to N.J.S. 54:10A-10, the Legislature vested the Director of the Division of Taxation with broad authority to adjust a taxpayer’s reported entire net income.<sup>35</sup> The Division argued that it may make “any . . . adjustments in any tax report or tax returns as may be necessary to make a fair and reasonable determination of the amount of tax” payable under the Commercial Business Tax Act.<sup>36</sup> Thus, the Division argued that this language authorized the investigation of tax years beyond the statute of limitation for audits and the elimination of carried forward net operating losses.<sup>37</sup>

The Court recognized both the breadth of Division’s powers as set forth in N.J.S. 54:10A-10a. and the “repose and finality underlying the basis of a statute of limitations.”<sup>38</sup> In reading the two statutes harmoniously, the Court refused to “construe [N.J.S. 54:10A-10a] to defeat the statute of limitations for an audit under N.J.S. 54:49-6.”<sup>39</sup> Noting the distinct purpose of each statute, the Court determined that N.J.S. 54:10A-10a. permits the Division to audit a taxpayer’s returns and make adjustments, while N.J.S. 54:49-6 requires that such an audit be conducted within a four-year period.<sup>40</sup>

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<sup>31</sup> *Id.* at 355-356.

<sup>32</sup> *Id.* at 357.

<sup>33</sup> *Id.* at 356.

<sup>34</sup> *Id.* at 357.

<sup>35</sup> *Id.*

<sup>36</sup> *Id.* at 358 (citing N.J. STAT. ANN. § 54:49-6a. (West 2022)) (emphasis original).

<sup>37</sup> *Id.* at 348.

<sup>38</sup> *Id.*

<sup>39</sup> *Id.*

<sup>40</sup> *Id.* at 359 (noting the impact of a contrary decision upon the statutory requirement that a corporate taxpayer retain their records for a period of five years pursuant to N.J.S. 54:10A-14.1).

- *Application of Internal Revenue Service Procedures and Code*

Internal Revenue Service (IRS) “routinely revises the amount of the [net operating loss] carryforwards by revising the [net operating loss] of the source year, even if that year is closed.”<sup>41</sup> The Internal Revenue Manual provides that the IRS “may redetermine correct taxable income in a closed year in order to ascertain either the amount of an NOL, or the amount of an NOL that is absorbed in the closed year for the purposes of determining the correct [NOL] deduction for an open year.”<sup>42</sup> This authority is derived from I.R.C. § 7602(a)(1) which provides that the IRS is “authorized . . . to examine any book, paper, record, or any other data which may be relevant or material to such inquiry” to determine the correctness of any return.<sup>43</sup>

The Court in *R.O.P. Aviation* stated that it was not “bound by the IRS’ construction of a federal income tax statute for purposes of the CBT as to statute of limitations or audit procedures.”<sup>44</sup> The Court reasoned that “the plain language of I.R.C. § 7602(a)(1) itself does not permit opening of closed years or circumventing the statute of limitations.”<sup>45</sup> Further, the Court determined that the IRS’ manual for audit procedures was neither binding nor persuasive authority for how it should interpret the powers granted to the Director of Taxation and the statute of limitations for an audit.<sup>46</sup> The Court also determined that “the IRS’ broad interpretation of § 7602(a)(1) is not binding [on a New Jersey] court and does not permit circumvention of New Jersey’s statute of limitations on an audit.”<sup>47</sup>

### **Pending Legislation**

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

### **Conclusion**

Staff requests authorization to conduct additional research to determine whether N.J.S. 54:10A-10 or N.J.S. 54:49-6 would benefit from modification to address the circumstances found in this case.

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<sup>41</sup> *Id.* at 361.

<sup>42</sup> *Id.* (citing Internal Rev. Manual § 4.11.11.13(2)).

<sup>43</sup> *Id.* (citing IRC § 7602(a)(1)).

<sup>44</sup> *Id.* (internal citations omitted).

<sup>45</sup> *Id.* at 362.

<sup>46</sup> *Id.*

<sup>47</sup> *Id.* Compare *Barenholtz v. United States*, 784 F.2d 375 (Fed. Cir. 1986) (finding “[i]t is well settled that the IRS and the courts may recompute taxable income in a closed year in order to determine tax liability in an open year.”).