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JAMES N. STANARD and JANET G. STANARD, Plaintiffs, v. DIRECTOR, DIVISION OF TAXATION, Defendant.	TAX COURT OF NEW JERSEY DOCKET NO. 008149-2018

Approved for Publication
In the New Jersey
Tax Court Reports

Decided: February 24, 2020

Joseph Kernen and Ellis L. Reemer for plaintiff (DLA Piper, LLP, attorneys).

Ramanjit K. Chawla for defendant (Gurbir S. Grewal, Attorney General of New Jersey, attorney).

FIAMINGO, J.T.C.

This is the court's opinion with respect to the parties' cross-motions for summary judgment. At issue is whether plaintiff, James N. Stanard, properly characterized the loss distributed to his single-member limited liability company, Beacon Hill Investments, LLC ("Beacon"), as a partnership loss on his gross income tax return pursuant to N.J.S.A. 54A:5-1(k). Defendant, Director, Division of Taxation ("Director") argues that the loss distributed is to be reported as a business loss of plaintiffs under N.J.S.A. 54A:5-1(b). For the reasons explained more fully below, plaintiffs' motion for summary judgment is granted, and the Director's cross-motion is denied.

I. Finding of Facts and Procedural History

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The court makes the following findings of fact based on the submissions of the parties. On August 2, 2007, plaintiff, James Stanard, formed Beacon as a single-member limited liability company. He was the sole member of Beacon through 2011. Beacon is a disregarded entity for federal income tax purposes.[1]

Beacon is a 50% partner in F&S Ventures, LLC ("F&S"), a Delaware limited liability company formed in 2007. F&S is characterized as a partnership for federal and New Jersey income tax purposes. For tax year 2011 F&S reported Beacon's share of distributive partnership loss in the amount of $1,944,334 for New Jersey Gross Income Tax ("GIT") purposes.[2]

For tax year 2011, plaintiff and his spouse, Janet, were New Jersey residents. They reported the loss from F&S as a distributive share of partnership loss on their New Jersey GIT return for tax year 2011.[3] The New Jersey Division of Taxation (the "Division"), the agency headed by the Director, audited this return and issued a Notice of Deficiency ("NOD") on May 19, 2015, imposing additional GIT, penalties and interest in the amount of $218,995. By way of explanation the NOD stated,

> Your business income has been adjusted to reflect income as reported on the 1065 NJK-1 from F&S Ventures LLC. The shareholder for F&S Ventures LLC is Beacon Hill Investments LLC, and the net profit/loss from Beacon Hill Investments is reported on your Federal Schedule C. Therefore, Beacon Hill investments LLC should net the investment loss from the NJK-1 against Net Profits From Business.
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> An individual, sole proprietor or single-member [limited liability company] . . . cannot be taxed as a partnership under the federal tax

[1] Under federal income tax provisions, a limited liability company is "[d]isregarded as an entity separate from its owner if it has a single owner." 26 C.F.R. 301.7701-3(b)(1)(ii) (2006).

[2] The original Schedule NJK-1 issued reported a loss of $1,969,053 but was subsequently amended to $1,944,334.

[3] Janet Stanard is a plaintiff by virtue of filing a joint income tax return with plaintiff James Standard. This opinion will use plaintiff to reference James Stanard.

> rules since it is essential for partnerships to have more than one member.

On August 7, 2015, plaintiff filed a protest with the Division's Conference and Appeals Branch ("CAB"). On January 16, 2017, a conference was held and on February 16, 2018, the CAB issued a final determination upholding the NOD.[4] The final determination indicated: (1) that under federal income tax rulings a single member limited liability company is disregarded as an entity and treated in the same manner as a sole proprietorship; (2) that under New Jersey GIT statutes the income from sole proprietorships is reported as net profits from business and not as partnership income; and (3) that losses from one category of income (business income) could not offset income from another category of income (partnership income).

Plaintiff timely filed a complaint with the Tax Court of New Jersey contesting the final determination on May 14, 2018. Thereafter, he filed a motion for summary judgment which the Director opposed. The Director filed a cross-motion for summary judgment which plaintiff opposed.

II. Legal Issues and Analysis

A. Summary Judgment

Summary judgment should be granted where "the pleadings, depositions, answers to interrogatories and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact challenged and the moving party is entitled to a judgment or order as a matter of law." R. 4:46-2(c). In Brill v. Guardian Life Ins. Co., 142 N.J. 520 (1995), our Supreme Court established the standard for summary judgment as follows:

[4] The February 16, 2018 final determination was issued to plaintiff at an address in New Jersey. A second identical final determination dated February 27, 2018 was issued directed to plaintiff at a Florida address.

> [W]hen deciding a motion for summary judgment under Rule 4:46-2, the determination whether there exists a genuine issue with respect to a material fact challenged requires the motion judge to consider whether the competent evidential materials presented, when viewed in the light most favorable to the non-moving party in consideration of the applicable evidentiary standard, are sufficient to permit a rational factfinder to resolve the alleged disputed issue in favor of the non-moving party.
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> [Id. at 523.]

"The express import of the Brill decision was to 'encourage trial courts not to refrain from granting summary judgment when the proper circumstances present themselves.'" Township of Howell v. Monmouth Cty. Bd. of Taxation, 18 N.J. Tax 149, 153 (Tax 1999) (quoting Brill, 142 N.J. at 541).

> [T]he determination [of] whether there exists a genuine issue with respect to a material fact challenged requires the motion judge to consider whether the competent evidential materials presented, when viewed in the light most favorable to the non-moving party in consideration of the applicable evidentiary standard, are sufficient to permit a rational factfinder to resolve the alleged disputed issue in favor of the non-moving party.
>
> [Ibid.] (quoting Brill, 142 N.J. at 523.]

The movant bears the "burden to exclude any reasonable doubt as to the existence of any genuine issue of material fact" regarding the claims asserted. Judson v. Peoples Bank and Trust Co., 17 N.J. 67, 74 (1954) (citation omitted).

Here, no genuine issue of material fact exists in the record to preclude entry of summary judgment and one party is entitled to judgment as a matter of law. The court finds that this matter is ripe for summary judgment.

A. Classification of Gains & Losses

Under N.J.S.A. 54A:5-1, the Legislature created separate and distinct categories of gross income. Marrinan v. Dir., Div. of Taxation, 17 N.J. Tax 47, 52 (Tax 1997) (citing and quoting Smith v. Dir., Div. of Taxation, 108 N.J. 19, 32-33 (1987). First, N.J.S.A. 54A:5-1(b) defines net

profits from business as one category of taxable gross income. Second, N.S.J.A. 54A:5-1(k), defines distributive share of partnership income as a different category of taxable income. These two categories are separate and distinct from one another. Thus, income from one category may only be offset by losses from the same distinct category. See e.g. Walsh v. Dir., Div. of Taxation, 15 N.J. Tax 180, 184 (Tax 1995). Furthermore, the law expressly prohibits the netting of income and losses among the different gross income categories:

> Losses which occur within one category of gross income may be applied against other sources of gross income within the same category of gross income during the taxable year. However, a net loss in one category of gross income may not be applied against gross income in another category of gross income.
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> [N.J.S.A. 54A:5-2.]

As explained below, plaintiff asserts that the loss distributed to Beacon constituted partnership loss and thus he properly offset the same against other partnership income reported on his 2011 GIT return. The Director contends that the loss distributed to Beacon constitutes a loss from a sole proprietorship classified as a business loss described in N.J.S.A. 54A:5-1(b) for GIT purposes since Beacon is a single-member limited liability company, therefore, that loss cannot be used to offset income from another category such as distributive share of partnership income described in N.J.S.A. 54A:5-1(k). The resolution of the correct categorization of the partnership loss distributed to Beacon is key to resolving the present conflict between plaintiff and the Director.

B. Disregarded Entity Treatment

i. Federal Income Tax Concept of Disregarded Entity

Under federal income tax provisions, a limited liability company is "[d]isregarded as an entity separate from its owner if it has a single owner." Treas. Reg. § 301.7701-3(b)(1)(ii). "[I]f the entity is disregarded, its activities are treated in the same manner as a sole proprietorship . . .

." Treas. Reg. § 301.7701-2(a). For GIT purposes, "[s]ole proprietors shall report their income and loss as net profits from business." N.J.A.C. 18:35-1.1(b). Thus, the Director argues that the loss distributable to plaintiff from Beacon constitutes a loss from a sole proprietorship, properly characterized as business income or loss.

It is indisputable that the New Jersey GIT Act is not modeled after the federal personal income tax law:

> We disagree that the Legislature patterned the New Jersey [GIT] . . . Act on the Internal Revenue Code. Even as a cursory comparison of the New Jersey [GIT]. . . and the Internal Revenue Code indicate that they are fundamentally disparate statutes. The federal income tax model was rejected by the Legislature in favor of a gross income tax to avoid the loopholes available under the Code.
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> [Smith, 108 N.J. at 32.]

Unless the Legislature has directly referenced the federal tax provisions in the statute, federal definitions do not apply. See Koch v. Dir., Div. of Taxation, 157 N.J. 1, 10 (1999). Moreover, as explained below, here the Legislature has spoken as to the income tax classification of single member limited liability companies. Thus, while the Director refers to the treatment of limited liability companies under the federal taxing statutes as its initial justification for his position in this matter, such references are inapposite and unnecessary. The federal taxing statutes have very limited application to those narrowly described circumstances specifically set forth in N.J.S.A. 42:2C-92(b) discussed below. For GIT purposes that the activities of a disregarded entity are treated in the same manner as a sole proprietorship for federal tax purposes do not control.

ii. The Limited Liability Company Acts

The New Jersey Legislature first adopted provisions as to the creation and regulation of limited liability companies in 1993 by the adoption of the New Jersey Limited Liability Company Act, N.J.S.A. 42:2B-1 to -70 (the "Act"). Under the Act, a limited liability company was required

to have two members. N.J.S.A. 42:2B-2 (repealed 2012). For GIT purposes a limited liability company was "classified as a partnership" and a member of a limited liability company was "treated as a partner in a partnership." N.J.S.A. 42:2B-69 (repealed 2012).

In 1998, the Act was amended to permit single member limited liability companies and the now repealed N.J.S.A. 42:2B-69 was amended by adding subsection (b) which reads as follows:

> b. For all purposes of taxation on income under the laws of this State and only for those purposes, a limited liability company formed under P.L. 1993, c.210 (c. 42:2B-1 et seq.) or qualified to do business in this State as a foreign limited liability company with one member is disregarded as an entity separate from its owner, unless classified otherwise for federal income tax purposes, in which case the limited liability company will be classified in the same manner as it is classified for federal income tax purposes. For all purposes of taxation on income under the laws of this State and only for those purposes, the sole member or an assignee of all of the limited liability company interest of the sole member of a limited liability company formed under P.L. 1993, c.210 (C.42:2B-1 et seq.) or qualified to do business in this State as a foreign limited liability company is treated as the direct owner of the underlying assets of the limited liability company and of its operations, unless the limited liability company is classified otherwise for federal income tax purposes, in which case the member or assignee of a member will have the same status as the member or assignee of a member has for federal income tax purposes.[5]
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> [N.J.S.A. 42:2B-69 (repealed 2012).]

The Assembly Judiciary Committee Statement to Senate No. 378 which contained the foregoing amendment provides in part that the bill "amends the law to treat single member limited liability companies as sole proprietorships for State income tax purposes unless the company is

[5] Under the applicable federal taxing regulations, unless the single member limited liability company elects otherwise it is disregarded as an entity separate from its owner if it has a single owner. Treas. Reg. § 301.7701-3(b)(1)(ii). Thus, the only time the federal income tax classification is consequential for GIT purposes is when the single member limited liability company makes an election out of the default classification, which is not the case here.

classified otherwise for federal income tax purposes."[6] Assemb. Judiciary Comm. Statement to S. Comm. Substitute for S. 378 (June 4, 1998).

In 2012, the Legislature repealed the Act in its entirety and adopted the "Revised Uniform Limited Liability Company Act," N.J.S.A. 42:2C-1 to -94 (the "Revised Act"). The Revised Act retained the tax classification provision set forth in section 69(b) of the Act, re-codified as N.J.S.A. 42:2C-92(b). Nothing contained within the Revised Act or the legislative history contemporaneous with the Revised Act clarifies the meaning of N.J.S.A. 42:2C-92(b), and no other provision within the Revised Act refers to the tax classification of limited liability companies. As it is identical to its predecessor provision, its interpretation is similarly identical.

N.J.A.C. 18:35-1.1, adopted by the Director to provide guidance with respect to the calculation of "net profits from business," provides that,

> For purposes of the Gross Income Tax Act, a sole proprietorship, which shall include self-employed individuals and independent contractors, is a form of business in which one taxpayer owns all the assets of a business and which is not a partnership or corporation. *A single member limited liability company whose member is an individual, estate, or trust shall be treated as a sole proprietorship, unless classified otherwise for Federal tax purposes*. Sole proprietors shall report their income or loss as net profits from business.
>
> [N.J.A.C. 18:35-1.1(b) (emphasis added).]

As initially proposed, N.J.A.C. 18:35-1.1(b) did not include the reference to limited liability companies. That language was thereafter included in response to a comment from the public. See 31 N.J.R. 779(a) (March 15, 1999) ("the additional sentence" referencing single

[6] Nowhere within the provisions of the Bill does the phrase "sole proprietorship" appear, see S. Comm. Substitute for S. 378 (March 23, 1998), and the Assembly Judiciary Committee Statement does not provide any further clarification of its statement.

member limited liability companies "conforms with provisions in a pertinent limited liability company statute, N.J.S.A. 42:2B-69 . . . . ").

> Agency regulations are presumptively valid, Med. Soc'y of New Jersey v. Dep't of Law and Pub. Safety, 120 N.J. 18, 25 (1990), and should not be invalidated unless they violate the enabling act or its express or implied legislative policies. Pub. Serv. Elec. & Gas Co. v. Dep't of Envtl. Prot., 101 N.J. 95, 102 (1985). Generally, courts accord substantial deference to the interpretation an agency gives to a statute that the agency is charged with enforcing. Merin v. Maglaki, 126 N.J. 430, 436-37 (1992); see Cedar Cove, Inc. v. Stanzione, 122 N.J. 202, 212 (1991).
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> [Ge Solid State v. Dir., Div. of Taxation, 132 N.J. 298, 306 (1993).]

The court finds little support in the specific language of N.J.S.A. 42:2C-92(b) for the treatment of a single member limited liability company as a "sole proprietorship." However, there is a clear indication in the Assembly Judiciary Committee's statement referenced above for that interpretation. In light of the presumption of validity accorded to the Director's regulations, as supported by the Assembly Judiciary Committee statement, the court concludes that N.J.A.C. 18:35-1.1(b) properly treats a single member limited liability company as a sole proprietorship for purposes of the classification requirements of the GIT Act.

iii. GIT Treatment of Sole Proprietorships

Plaintiff argues that even if the Director's classification of Beacon as a sole proprietorship is correct, he failed to properly apply the sole proprietorship regulations. For the reasons that follow, the court finds plaintiff's argument persuasive.

N.J.A.C. 18:35-1.1(a) provides that "[e]ach taxpayer is subject to gross income on the taxpayer's net profits from business within the meaning of N.J.S.A. 54A:5-1.b, which shall be determined as provided in this subchapter." The regulations continue by providing that "[s]ole proprietors shall report their income or loss as net profits from business." N.J.A.C. 18:35-1.1(b).

Without more, the treatment of the net income from a single member limited liability company as net profits from business would seem to be a foregone conclusion. Such a determination however would be entirely too simplistic and could potentially create the anomalous and unintended result of classifying the net income from purely personal assets into net profits from business solely because such assets were owned by a single member limited liability company. Such a result cannot be intended, and the court finds that the regulations cannot be applied in such a manner.

Indeed, the regulations specifically provide for an inspection of the underlying income of a sole proprietorship to determine whether the asset or activity is truly business income. Specifically, the regulations define "net profits from business" as including,

> all income the taxpayer derived from the conduct of a business, professions, or any other activity intended to produce income, provided such activity qualifies and reports as a trade or business for Federal income tax purposes . . . . All other income of the taxpayer subject to gross income tax that is not attributable to the conduct of a trade or business shall be included in one or more of the other categories of income specified in N.J.S.A. 54A:5-1 according to its character and shall not be includable in the category of income net profits from business . . . .
>
> [N.J.A.C. 18:35-1.1(c).]

Thus, the income, or activity producing the income, of the sole proprietorship must constitute a trade or business in the first instance. The position that the simple ownership of assets, regardless of their nature, by a single member limited liability company converts the income therefrom into "net profits from business," cannot be maintained.[7] Instead, the court finds that the

[7] Compare that position with the facts of Kaplan v. Dir., Div. of Taxation, 23 N.J. Tax 594 (Tax 2008), where the Director recategorized income from a single-member limited liability company owning real property as reportable under N.J.S.A. 54A:5-1(d), net gains or net income derived from rents. Interestingly, no discussion of the classification of the income as net profits from

Director must undertake the same investigation into the underlying assets and activities of the single-member limited liability company required by the Director's regulation at N.J.A.C. 18:35-1.1(c) to determine whether a trade or business exists.

The Director implicitly recognizes this distinction by arguing that the "business" of Beacon is "to invest in partnerships such as F&S." In reaching that conclusion, the Director relies on the general purpose clause of Beacon's operating agreement in which Beacon is authorized to "acquire, own, hold . . . invest in . . . intangible property and interests in entities." The quoted language of the operating agreement is simply a portion of a larger, multi-purpose provision, essentially permitting Beacon a wide and unfettered ability to acquire all manner of assets, including "real property, personal property, intangible property and interests in entities." Nothing set forth in the "purpose" clause can be interpreted as creating a "business" purpose of "investing in partnerships" for GIT purposes. Certainly, the mere authorization for the limited liability company to acquire a wide array of assets, without more, cannot be interpreted as meaning its business is "investing in partnerships such as F&S."

Moreover,

> the federal courts have consistently maintained the distinction between engaging in a trade or business and investing. Walsh [v. Dir., Div. of Taxation], . . . , 4 N.J. Tax [107], . . . 112 (Tax 1982)]. The Court in Snyder v. Commissioner, 295 U.S. 134 . . . (1935), held that an investor, seeking merely to increase his holdings, was not engaged in a trade or business. In Higgins v. Commissioner, 312 U.S. 212, . . . , rehearing denied, 312 U.S. 714 [(1941)]. . . the Supreme Court concluded that the management of one's investments does not constitute the carrying on of a trade or business. The expenses incurred were, therefore, not deductible as trade or business expenses. Further, the Court in Higgins concluded that whether the activities of a taxpayer constitute "carrying on a

business was undertaken in Kaplan notwithstanding that the contest involved assets owned by a single member limited liability company.

> business" or merely investment management requires an examination of the facts in each case. 312 U.S. at 217-218 . . . .
>
> [Gilligan v. Dir., Div. of Taxation, 11 N.J. Tax 414, 420 (Tax 1991).]

Here, plaintiff as the single member owner of Beacon reported its business activities on Schedule C. Those activities did not include the net income from its investment in F&S. Contrary to the assertion of the Director, the balance sheet of Beacon, submitted by the Director in its cross-motion, does not demonstrate that Beacon is engaged in the business of investing in partnerships. While F&S is a significant asset owned by Beacon, its balance sheet reflects that its assets consist of cash accounts, fractional interests in several aircraft and its interest in F&S.[8] The material facts presented to this court do not support the assertion by Director that Beacon is in the "business of investing in partnerships like F&S."

There is yet further reason why the Director's assertion that the income of F&S must be deemed business income is incorrect. Specifically, N.J.A.C. 18:35-1.1, in defining the meaning of "net profits from business," provides that

> [a] taxpayer's distributive share of income or loss from a partnership, S corporation, or estate or trust shall not be taken into account in determining a taxpayer's net profits from business, regardless of the character of the income or nature of the activities of the partnership, S corporation, or estate or trust. Reporting of such income or loss shall be as follows:
>
> i. Income or loss from a partnership shall be taken into account in determining the taxpayer's distributive share of partnership

[8] Although the balance sheet also reflects an ownership interest in a limited liability company known as Road Sciences, LLC, that interest is set forth as $0.00. Interestingly a review of the plaintiff's NJ GIT return for the year in question includes a loss from Road Sciences LLC of more than $700,000 as distributive share of partnership income. This entry was not disallowed by the Director. The court notes that there are any number of reasons why this might be the case, including that the limited liability company interest had been transferred to plaintiff individually. Thus, the court merely notes this fact in passing and places no weight on what might otherwise be deemed disparate treatment of two similarly situated assets.

> income described in N.J.S.A. 54A:5-1.k. For rules governing the taxation of income derived by a taxpayer from a partnership see N.J.A.C. 18:35-1.3.
>
> [N.J.A.C. 18:35-1.1(c)(6).]

The clear import of the regulation is to require that net profits of business from the sole proprietorship specifically exclude any income or loss from a partnership to a taxpayer. Arguing against that treatment, the Director maintains that plaintiff is not the "taxpayer" described in the foregoing regulation. Instead the Director asserts that Beacon is the taxpayer and that the reference in N.J.A.C. 18:35-1.1(c)(6) to "taxpayer" is to Beacon.

The difficulty with the Director's contention, however, is that Beacon is not a taxpayer at all. Beacon is a disregarded entity and its activities are deemed the activities of the plaintiff who is to be treated as the direct owner of its underlying assets. N.J.S.A. 42:2C-92(b). Here, the court reconciles the application of the regulation with the statutory provision by applying it to mean that the sole proprietorship income of Beacon is to be determined as if plaintiff, as its single member, is the sole proprietor. It is the only manner in which the court can reconcile the second sentence of N.J.S.A. 42:2C-92(b) and the application of the regulation to the facts before the court. To apply the reasoning of the Director that Beacon, and not the plaintiff, is the partner in F&S would render the second sentence of N.J.S.A. 42:2C-92(b) meaningless.

> [O]ne of the cardinal rules of statutory construction [is] that full force and effect must be given, if possible, to every word, clause and sentence of a statute. Oldfield v. New Jersey Realty Co., 1 N.J. 63, 68 (1948). A construction that will render any part of a statute inoperative, superfluous or meaningless, is to be avoided. 2 Sutherland, Statutory Construction (3d ed.), § 4705, p. 339.
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> [Hoffman v. Hock, 8 N.J. 397, 406-407 (1952).]

The court concurs with the over-arching position of the Director that a single member limited liability company is to be treated as a sole proprietorship. However, the court finds no support in either the Act, Revised Act, or the GIT regulation for the Director's conclusion that the calculation of the "net profits from business" from a single member limited liability company treated as a sole proprietorship should be determined any differently from the calculation of the "net profits from business" from any other sole proprietorship. Instead, the court finds that the calculation of net profits from business is to be determined as if the owner of the single member limited liability company were operating the activity constituting the sole proprietorship.

The court thus concludes that N.J.A.C. 18:35-1.1(c)(6) applies in this case to exclude the distributive share of partnership income from F&S to Beacon from the calculation of its net profits from business and that such distributive share is instead to be taken into account in determining the plaintiff taxpayer's distributive share of partnership income described in N.J.S.A. 54A:5-1(k).

III. Conclusion

For reasons stated above, plaintiff's motion for summary judgment is granted. The Director's cross-motion is denied.