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Tax Law Alert

November 2011

New Jersey Madoff Victims Receive State Income Tax Refunds

In an opinion released November 15, 2011, New Jersey Tax Court Judge Gail Menyuk gave relief to John and Gail Dalton, New Jersey taxpayers who invested with Bernard Madoff. The Daltons filed refund claims for New Jersey Gross Income Tax paid in 2005, 2006 and 2007 taking the position that they were entitled to refunds for New Jersey Gross Income Tax ("GIT") paid on the fictitious Madoff income.

In filing their New Jersey GIT returns, the Daltons reported dividend and capital gains income from Madoff investments for the years at issue. In 2008, when the Madoff fraud was made public, the Daltons filed their Federal income tax returns in accordance with the "Safe Harbor" federal Revenue Procedure 2009-20 and also timely filed amended GIT returns for 2005, 2006 and 2007, excluding the Madoff income and gains and claiming refunds for the New Jersey tax paid on those phantom amounts. Much to the chagrin of the Daltons, the Director disallowed the amended returns. Feeling frustrated like other taxpayers in the Madoff mix, the Daltons filed an administrative protest, and after exhausting all administrative remedies, timely appealed their case to the New Jersey Tax Court.

The Division of Taxation had previously taken the position that the relief available to Madoff victims was to report a capital loss for the fraud year (2008) which could be used to the extent a taxpayer had a capital gain for that year. In an interesting turn of events, Judge Menyuk opined that all of the income the Daltons reported with respect to the Madoff accounts was income that did not fall within any of the enumerated categories of gross income subject to taxation under the New Jersey statutes. Therefore, there was no statutory basis to deny the Daltons permission to amend and correct their returns to remove income that was never properly taxable.

Many New Jersey taxpayers filed similar refund claims for 2005, 2006 and 2007. Those taxpayers will likely see action on their claims as a result of this decision and should consult their tax advisor about it, although in the meantime, the Dalton case could be appealed by the State as far as the New Jersey Supreme Court. Other taxpayers should consult their tax advisors to discuss their individual facts as they relate to the Dalton case.

Of note in the case is a footnote stating that the court was specifically not addressing the case of a "net winner" or a taxpayer who actually received money exceeding their original capital investment, or a "net winner" who is subject to a clawback claim and then forced to return the "net winnings." Such New Jersey taxpayers who are "net winners" who then have to return the net winnings arguably also do not have income within the broad meaning of the statute, perhaps, and should then be entitled to similar protection following the reasoning of the opinion. Let's watch this issue.

This *Tax Law Alert* was written by **Melinda Fellner Bramwit**, **John J. Eagan** and **Robert C. Gabrielski.** Melinda, Of Counsel to the firm, is experienced in many aspects of tax planning, including corporate issues and partnership and estate tax issues. John, a senior member of the firm's Taxation Group, concentrates his practice on international and domestic tax law issues. Bob is the Chair of the Business and International Law Groups and concentrates his practice on domestic and international business transactions, e-commerce and taxation. If you have any questions regarding the information in this alert or any other related matters, please feel free to contact John, Melinda or Bob by email at **jjeagan@nmmlaw.com**, **mfbramwit@nmmlaw.com**, or **rcgabrielski@nmmlaw.com**, respectively.