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Tiger Schulmann Karate KO'd by NJ Division of Taxation

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New Jersey's gross income tax system is unique because (1) it allows few deductions (that's what they mean by "gross income") and (2) income is separated into different categories or baskets (such as partnership income, interest income, etc.). Allowable deductions in one basket cannot offset income in another basket. This system can create mismatches with a taxpayer's federal income tax liability and traps for the unwary.

Danny "Tiger" Schulmann is a successful karate practitioner, instructor and franchiser of karate schools, with over 40 schools in the New York metropolitan area, but he was recently KO'd by New Jersey's Division of Taxation due to such a mismatch between his income and deductions.

Schulmann created an S corporation management company which provided management services to each karate school. Each karate school in turn was structured as a separate corporation co-owned between Schulmann and the instructor who would run the school. Each instructor also could receive up to 20% commissions when one of his or her students opened a new school.

Schulmann paid the 20% commission from a personal account rather than a business account. He testified that he did this to guarantee the instructors that there would be cash available for the payments, which

totaled \$863,000 - \$1.025 million for the years in question. This was a mistake, however, for New Jersey gross income tax purposes.

The Division of Taxation denied the deductions, taking the position that the commission payments were personal expenses, not S corporation expenses (even though they were obligations of the business). In a January, 2011 opinion, the New Jersey Tax Court agreed, holding fast to the concept that expenses in one category cannot offset income in another category. Having chosen to make the commission payments personally rather than through the business, Schulmann could not avoid the structure when it resulted in unfavorable tax consequences.

Tax advisors, as senseis to their clients, should guide them with care through the challenging tests of New Jersey's income tax system.

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