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WINTER TAX
ISSUE

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CAN'T SELL AND WANT TO RENT: WHAT ARE THE TAX RULES AGAIN?

BY KIMBERLEE S. PHELAN, CPA, MBA, TAX PARTNER

THE HIGH CO\$T OF NONCOMPLIANCE

Congressional aversion to raising taxes in today's continuing difficult economy is abundantly clear. The Internal Revenue Service (IRS) is left in the position of trying to increase revenue for a government badly in need of funding without a corresponding increase in tax rates. If you think the IRS has it bad, pressure is even higher on the 7,645 state and local tax authorities.

What does this mean for taxpayers? The IRS and state and local tax authorities have begun an outright assault to increase revenue through the imposition of PENALTIES. Most of the penalties have been "on the books" for a very long time but have been assessed only in egregious situations. These days, any and every penalty that can be assessed will be assessed — and obtaining abatement of those penalties, even for "reasonable cause," can be an extremely frustrating and time-consuming activity. You can avoid the imposition of penalties by being reasonable and transparent in your tax positions, while also being diligent, prepared and not delinquent.

While this summary will focus on monetary penalties, bear in mind that penalties imposed by the IRS may also include forfeiture of property and even jail time!

(continued, overleaf)

PENALTIES IMPOSED ON INCOME TAX RETURNS

Late Filing Penalty

5% per month, up to 25%, of the tax due (if more than 60 days late, a minimum penalty of \$100).

Paying Late Penalty

0.5% per month, up to 25%, of the tax due. This penalty is not assessed during the extension period if 90% of the tax is paid by the original due date.

Estimated Tax Penalties

imposed when withholdings and/or estimated tax payments made throughout the year do not cover 90% of current year (or 110% of the prior year) tax.

Accuracy-Related Penalties

20% of the understatement of tax, when understatement is substantial, due to negligence or due to a disregard of the rules and regulations.

Frivolous Tax Return Penalty

\$5,000 for filing a return that does not include enough information to properly figure the correct tax, and the tax reported is substantially incorrect. If a joint return

THE HIGH COST OF NONCOMPLIANCE

(CONTINUED FROM FRONT PAGE)

is filed, the penalty is assessed on both taxpayer and spouse.

Penalty for Bounced Checks

2% of the check (if check is less than \$1,250, the penalty is the lesser of \$25 or the amount of the check).

Economic Substance Doctrine

20% penalty for an underpayment of tax attributable to a transaction lacking economic substance (increased to 40% if the transaction is not disclosed).

Failure to Disclose Reportable or Listed Transaction

a minimum of \$50,000 for each failure!

The bottom line regarding your income taxes is that you should: 1) report all of your income appropriately, 2) file your return on time and 3) pay your tax on time in order to avoid the imposition of penalties. Note: the penalties detailed above are calculated separately and do not offset—they accumulate.

INFORMATION REPORTING PENALTIES

The penalties for failure to furnish and/or the late filing of information reports (Forms 1099 and W-2) are small (\$15 to \$50), but are assessed on a per form basis. These small amounts can add up quickly; missing the filing deadline for 100 forms will result in a minimum penalty of \$1,500.

TRUST FUND PENALTIES

The penalties are quite severe for “responsible persons” who willfully fail to deposit taxes such as payroll taxes. The tax withheld on behalf of employees is not the employer’s money—it belongs to the employee, and the penalty for failure to pay-over these amounts in a timely manner is up to 100% of the tax. Additionally, this tax and penalty can be assessed not only on the employer (i.e., a business entity), but become personal liabilities of the responsible person and are not discharged in bankruptcy.

FOREIGN COMPLIANCE REQUIREMENTS

The President, Congress and the IRS have openly stated that the biggest opportunity for increasing the government coffers is through the strict application of U.S. tax law to the international operations of U.S. taxpayers. The IRS recently implemented programs in 2009 and 2011 to bring U.S. taxpayers into compliance through the Offshore Voluntary Disclosure Initiatives. The 2009 initiative was planned to have 7,000 taxpayers disclose their foreign bank accounts; over 14,000 taxpayers came forward. A second initiative closed this past September and was billed as the “last best chance” for U.S. taxpayers to avoid excessive

TAX EVASION, WILLFUL FAILURE TO FILE A RETURN, FILING OF A FALSE RETURN AND FRAUD ALL CARRY THE THREAT OF CRIMINAL PROSECUTION IN ADDITION TO MONETARY PENALTIES —AND THE LIST ABOVE IS BY NO MEANS ALL-INCLUSIVE. WHAT’S A TAXPAYER TO DO?

penalties and jail time for nondisclosure of foreign bank accounts.

The penalties related to noncompliance with foreign disclosure requirements begin at \$10,000 per form not filed. These forms do not necessarily result in additional U.S. taxable income or income tax, but are required to report foreign transactions and activities such as ownership of a foreign subsidiary, a foreign partnership, a foreign disregarded entity, or (beginning with 2011 tax returns) a foreign financial asset. Penalties are also imposed for failure to report transactions with related entities if the U.S. entity’s ownership is more than 25% foreign. In addition to the \$10,000 per form penalty, failure to file disclosure forms may also result in the loss of foreign tax credits, which could reduce a U.S. taxpayer’s federal tax due.

Unreported transfers to foreign corporations can result in a penalty of 10% of the value of the transfer up to \$100,000 and failure to furnish information related to foreign trusts or gifts can result in a penalty of up to 35% of the fair market value of trust assets or the foreign gift. Penalties also apply for non-reporting of treaty-based positions as well as transacting business with a list of “boycott” countries. Finally, the Treasury Regulations require that transactions with related parties should be undertaken on an “arm’s length basis.” Should the IRS determine that an appropriate “transfer price” was not utilized, or that proper documentation of that transfer price was not maintained, the penalty is 20% to 40% of the understatement of tax based upon using the incorrect transfer price.

Tax evasion, willful failure to file a return, filing of a false return and fraud all carry the threat of criminal prosecution in addition to monetary penalties —and the list above is by no means all-inclusive. What’s a taxpayer to do? Be reasonable; be diligent (and not delinquent); and be prepared. The best defense is not only a good offense, but common sense, along with a clear understanding of the rules and regulations, appropriate disclosure of transactions, and timely filing of all returns and payment of all taxes.

NEW BABY TAX BENEFITS

BY SARA A. PALOVICK



WHEN YOU SHOP FOR A GIFT FOR A BABY, CONSIDER A CUSTODIAL ACCOUNT, TUITION SAVINGS PLAN, A TRUST OR OTHER GIFTING STRATEGY DESIGNED TO HELP THE FAMILIES OF NEWBORNS MINIMIZE TAXES.

TAX BENEFIT

Open a custodial account for the baby under your state's Uniform Gifts or Transfers to Minors Acts using the baby's Social Security number. Income from the account is taxed at the baby's rates. The minor must be given complete access to the money by age 18 or 21, depending on state law. A parent is generally the custodian. For 2012, children under the age of 18 (or under 24 if a full-time student) can earn \$950 of investment income free of tax. An additional \$950 of investment income will be taxed at 10%. Investment earnings over \$1,900 are taxed at the parents' rate.

TAX BENEFIT

Open a Section 529 qualified tuition savings plan. Annual contributions up to \$13,000 (\$26,000 with a consenting spouse) are gift tax free. A special rule for 529 plans allows an election to spread a one-time transfer over five years for gift tax purposes, so initial contributions of up to \$65,000 or \$130,000 are permitted. Some states allow tax deductions for contributions. When the funds are used for college tuition, the income is completely tax free. Income included in withdrawals not used to pay college tuition is subject to income tax and a 10% penalty. If the designated child beneficiary does not attend college, the beneficiary can be switched to someone who uses the money to pay tuition.

TAX BENEFIT

Report U.S. savings bond interest annually by making an election on a child's first return rather than letting

income taxation be deferred. File the tax return even though it is not required to make the election. Reason: The baby will owe no tax as long as the interest accrued on the bond does not exceed \$950 a year, including any other unearned income the child might have. When the child eventually cashes in the bond, no tax will be due.

TAX BENEFIT

Set up a trust for the baby. Trusts provide greater control over the funds than a custodial account and funds can be kept in the trust long after the child turns age 21. Trustees can also make distributions contingent upon certain events, such as attending college or a summer vacation trip overseas. See your attorney for more information.

TAX BENEFIT

Buy additional life insurance on the parent. Have the policy owned by a trust to prevent the proceeds from being included in either parent's taxable estate and to provide asset protection for the proceeds. Set up the trust to permit current income to the surviving spouse with principal eventually to the child.

TAX BENEFIT

Shift future income to the child by transferring assets that produce little current income with future growth potential into a trust. The appreciation will be taxed at the child's lower rates when age 18 or older and will not be included in the donor's eventual estate.

TAX BENEFIT

Buy tax-favored investments in the baby's name, such as municipal bonds paying tax exempt interest, or stock index funds or growth stocks that pay low dividends. These investments are suitable until the child is no longer subject to kiddie tax.

There are also nontax reasons that should be considered, such as the effect on the child having control over large sums when he or she reaches majority or is on college assistance. Taxes are part of family financial planning, not the be all and end all.

Please contact your local WS+B tax advisor for more information on new baby tax benefits.

REAL ESTATE PROFESSIONALS: THE IRS SIMPLIFIES AVAILABLE RELIEF

BY BRIAN T. LOVETT, CPA, JD

FOR INDIVIDUALS WITH INVESTMENTS IN REAL ESTATE, QUALIFICATION AS A REAL ESTATE PROFESSIONAL CAN RESULT IN FAVORABLE TAX CONSEQUENCES. WHILE LOSSES FROM REAL ESTATE ACTIVITIES ARE PASSIVE *PER SE*, THE LOSSES OF A REAL ESTATE PROFESSIONAL ARE CONSIDERED ORDINARY LOSSES AVAILABLE TO OFFSET OTHER ORDINARY INCOME.

In order to qualify as a real estate professional, a taxpayer must pass both tests of Internal Revenue Code Section 469(c)(7)(B). First, more than one half of the overall personal service hours performed by the taxpayer in the tax year must be performed in real estate trades or businesses in which the taxpayer materially participates. Second, the taxpayer must perform at least 750 hours in real estate trades or businesses in which that taxpayer materially participates. For purposes of the second test, the IRS looks at each real estate activity separately. A taxpayer would only qualify as a real estate professional for real estate activities in which he or she performs more than 750 hours during the tax year.

A solution for a taxpayer trying to qualify as a real estate professional lies in a special election available to taxpayers under Regulation Section 1.469-9(g). This regulation allows a taxpayer to aggregate all real estate activities into one activity. After aggregation, a taxpayer must perform 750 hours across the grouped activities. This election may be made in any year in which the taxpayer qualifies as a real estate professional and must be made on an originally filed tax return. If this election is not timely filed, a taxpayer must request a ruling for late relief under §301.9100-3 and pay a user fee.

Revenue Procedure 2011-34, issued in May 2011, simplifies the process of requesting late relief to file a §1.469-9(g) election and allows qualifying taxpayers to retroactively aggregate real estate activities. In order to qualify under Rev. Proc. 2011-34, a taxpayer must meet the following requirements:

1. The taxpayer failed to make an election under §1.469-9(g) solely because the taxpayer failed to timely meet the requirements in §1.469-9(g);
2. The taxpayer filed consistently with having made a timely election under §1.469-9(g) on any return that would have been affected if the taxpayer had timely made the election;
3. The taxpayer has timely filed each return that would have been affected by a timely filed election; and
4. The taxpayer has reasonable cause for its failure to timely meet the requirements of §1.469-9(g).

Taxpayers who meet these requirements may attach the statement required by §1.469-9(g) to an amended return for the most recent tax year. The statement must contain all of the information required under §1.469-9(g) and must explain the reason for the failure to file a timely election. Last, the statement should identify the taxable year for which it seeks to make the late election.

Since the election required by §1.469-9(g) is the difference for many taxpayers between qualifying and not qualifying as a real estate professional, the late election relief provided by Rev. Proc. 2011-34 is a welcome opportunity. Taxpayers requiring late relief for failure to timely file the §1.469-9(g) election should capitalize on the chance to make the election retroactively without the cost and burden of a ruling request.

CAN'T SELL AND WANT TO RENT: WHAT ARE THE TAX RULES AGAIN?

BY CAROLA KNOLL, CPA



With the current instability in the U.S. housing market, many potential sellers are renting their homes. Accordingly, there are several tax rules to be aware of if renting. As with many areas of tax law, knowing and understanding the general rules are equally as important as knowing the exceptions to them.

GENERAL RULE - RENTAL ACTIVITIES ARE PASSIVE

Before the Tax Reform Act of 1986, losses from rental real estate activities and other “passive activities” were allowed to offset “ordinary” income. To stem perceived abuse, that Act created the rules for “passive activities” which defines all rental activities as passive. Why does this matter? Because passive activity losses are only allowed to offset passive activity income, and unless some exceptions are met, you will not be able to deduct your passive rental losses currently if you don’t have passive activity income. Any passive activity losses that are not allowed during the year will carry over to future years until you either have passive income to offset it or completely dispose of the property.

EXCEPTION 1: Passive activities are activities in which a taxpayer does not “materially” participate, so if you are involved in the rental activity on a regular, continuous and substantial basis, and you meet at least one of the various tests for material participation, you may be considered a “real estate professional” and then be able to treat your rental activities as “nonpassive.” Losses from the activity would then be allowed to offset wages, interest and other nonpassive income. The rules for meeting the qualification to be treated as a “real estate professional” are discussed in this issue; however, it is best to consult with your tax advisor to determine if you do qualify.

EXCEPTION 2: Individuals may be eligible to deduct up to \$25,000 of rental losses without regard to the passive activity rules if they “actively” participate in their rental real estate activity. That allowance phases out when adjusted gross income (“AGI”) exceeds \$100,000 and is completely phased out at \$150,000 of AGI. If your filing status is “married filing separately,” you are allowed only half of those amounts. Most individuals who make management decisions for the rental (e.g., approval of tenants, of repairs, of service providers to be hired) will be considered to “actively” participate.

EXCEPTION 3: Your “rental” may not be a “rental activity” if you only rent to short-term tenants. The definition of a rental activity excludes rentals of property if the average period of customer use is seven days or less. There are some additional exceptions, but if your rentals are not “rental activities” as defined, then you are not entitled to the \$25,000 allowance for active participation rental activity losses described above. Also, depending on the level of participation, the short-term rentals may be considered passive or nonpassive activities so losses may still be limited under the passive activity rules.

GENERAL RULE - PERSONAL USE OF RENTAL PROPERTY LIMITS DEDUCTIONS

Generally, if personal use of a home exceeds the greater of 14 days or 10% of the time it’s rented out, the home is not a rental property and the “vacation home” rules limiting deductions will apply. “Vacation home” tax rules limit the deductions according to a ratio that ensures that the rental expenses are limited to rental income.

EXCEPTION 1: If you rent at fair market value for at least 12 consecutive months, the use of the home as your principal residence for any day during a tax year that includes the beginning or end of the rental period is not considered “personal use” for the purpose of applying the vacation home limitations. This rule also applies if the home is sold before it is rented or held for rent for the full 12-month period.

EXCEPTION 2: If the home is a residence of the taxpayer, and it is rented for less than 15 days, neither the rental income is includable in gross income, nor are any of the rental expenses allowed as a deduction. This is a rare exception where you can receive income and not be taxed on it!

There are many other tax considerations for renting out a residence. Please contact your WS+B tax advisor to discuss your specific situation.



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EISNERLUBIN LLP MERGES WITH WS+B

EisnerLubin llp, a New York City-based Certified Public Accounting firm, has merged its practice with WS+B. With an effective date of November 1, 2011, the union adds 55 professionals to the WS+B roster, including nine partners. The EisnerLubin staff currently based in the office located at 1411 Broadway between 39th and 40th Streets will remain at that location, under the WithumSmith+Brown name.

Robert Simon, former managing partner of EisnerLubin who will continue to be the partner-in-charge of the NYC office within the merged firm, commented, "We are very excited about the opportunities this merger means for both of our firms and our clients. It has been EisnerLubin's goal to expand its presence in New Jersey and by joining WS+B, we now have offices in seven New Jersey towns as well as Pennsylvania, Maryland, Florida and Colorado. EisnerLubin clients will maintain the same personal relationships they have enjoyed with our firm's professionals but now will have access to a much broader array of service offerings and expertise to assist them in meeting their goals."

William R. Hagaman, Jr., CEO and managing partner of WS+B, is equally enthusiastic about the merger. "We have been seeking a NYC-based partnership for a long time to solidify our position in Manhattan in order to better serve —and expand —our Metropolitan NY client base. The EisnerLubin team is a great fit given the natural synergy between our two firms in terms of work ethic, growth strategies and culture. Both firms share a common commitment to excellence, putting our staff, our clients and our communities in a position of strength. The possibilities resulting from this merger are endless."

