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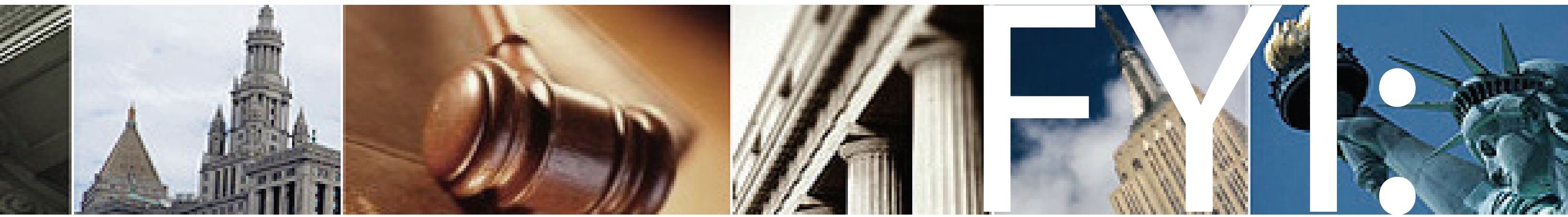


# To File or Not to File?

Various reasons and events can cause a taxpayer to neglect or be unable to file one or more required tax returns, often for multiple periods. Poor health, depression, age, unexpected income and erroneous advice are just a few common factors. Especially when it is likely that balances will be due, a taxpayer is often faced with the decision of whether to have the returns prepared and file them, or to just "wait it out" until the taxing authorities request the missing returns.

The consequences of not filing a required tax return are numerous and can be severe. While criminal liability can result in some cases, the more common consequences are the imposition of interest and monetary penalties on past due balances, and monetary penalties for failure to file a required return on time. In addition, a taxing authority can file a "substitute return" on behalf of the taxpayer using the income data that they have for the applicable period(s), and then begin collecting the tax shown on the

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# Mixing Business and Personal Travel

With many people trying to schedule or take one last vacation this year, businesspeople or professionals may qualify for a travel bargain by combining a vacation with an out-of-town domestic business trip.

Round-trip transportation costs for a mixed-purpose trip are deductible if a trip is undertaken primarily for business reasons. The cost of lodging, plus 50% of meal expenses while on business status, is deductible. Employees reimbursed for those expenses under an accountable plan (that requires a timely accounting of the time, place, and business purpose of the travel, plus receipts) can be reimbursed for those expenses tax-free. The personal portion of meals (i.e. the other 50%) and other personal expenses while on the trip are not deductible by a self-employed person, and reimbursement of those expenses by an employer is taxable compensation income to the employee.

Whether a trip is "primarily" for business reasons depends on the facts and circumstances of each case. The way in which travelers split their time between business and personal pursuits is an important factor. The personal portion of the trip need not take place at the location of the business portion of the trip. However, the deductions will be computed based on the costs that would have been incurred had the personal portion not occurred, such as the round-trip cost of traveling to the business destina-

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# In The News

Charitable IRA distributions: Recent legislation (discussed in the Fall 2006 edition) that allows IRA account owners who are over 70½ years of age to make their required minimum distribution ("RMD") in whole or in part (up to $100,000 per year) directly to an eligible charity without having to include the distribution in their gross income. Since then, massive donations have flowed into charities across the country. A Wall Street Journal article, entitled "Charities Love IRA Rollover", states that as of January 2007, overall gifts under this provision exceeded $25 million. Harvard University had already received gift distributions of the maximum $100,000 amount permissible under the legislation from eleven individuals. It is certain that charities across the country will be making their best efforts to have this provision, which currently expires on December 31, 2007, made permanent.

New York City unincorporated business tax: City residents can take a credit against their City personal income tax (currently ~3.6%) for a portion of their unincorporated business tax (currently ~4%) for the year. In 2007, the credit percentages will increase to 100% for

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# Charitable Planning for Retirement Benefits

If you are charitable-minded, there are numerous tax advantages of designating or distributing qualified retirement plan (401(k), 403(b), SEP, etc.) or individual retirement account (IRA) (collectively, "retirement plan") benefits to one or more charities.

Withdrawals from retirement plans by noncharitable beneficiaries such as a family member are subject to federal income tax of up to 33%. After adding state and city income taxes, a New York City resident can face an overall net tax burden of up to 43%. In addition, retirement funds owned at death may be subject to substantial federal and/or state estate taxes. It is important to remember that although the Federal estate tax exemption is currently $2,000,000, many states including New York ($1,000,000) and New Jersey ($675,000) have not increased their exemption amounts.

Retirement benefits differ from most other assets, which are not subject to income tax when received from a decedent. For example, an individual who inherits stock worth $300,000 that was originally purchased by the decedent for $100,000 will not have to pay income tax on the $200,000 appreciation.

For retirement benefits, that is not the case. They are included in the gross estate for estate tax purposes, and then also subject to income tax when received by the beneficiary because the "cost basis" of the retirement plan assets is not "stepped up" to their date of death value. In some cases, the federal estate tax paid can be deducted from the beneficiary's income.

Even after the benefit of that deduction, the combined income and estate taxes can still be substantial. For example, an estate of $3,000,000 including a $1,000,000 retirement account would be subject to federal estate tax of approximately $450,000 (plus any state estate tax). Then, the distribution of the $1,000,000 retirement benefits, less a deduction of approximately $150,000 for the estate tax attributable to the retirement benefits ($450,000 times $1,000,000/$3,000,000), would be subject to income tax in the hands of the beneficiary. Assuming a 35% combined income tax rate, the net income of $850,000 would be subject to income tax of $297,500. The total estate tax plus the income tax on the benefits is $747,500, of which $447,500 ($297,500 + $150,000) is directly attributable to the retirement benefits.

To avoid both aspects of this double tax bite, someone who plans to make charitable gifts should consider naming one or more charities as a beneficiary of a retirement plan. For estate tax purposes, the amount of estate assets that pass to charities is deductible. Then, the tax-exempt charity does not have to pay income tax on the amounts that it receives. In the example above, the taxable estate would be reduced to $2,000,000, and no federal estate tax would be due. Nor would any income tax be due. In this case, the entire $747,500 of tax would be avoided by naming a charitable beneficiary.

An alternative, but less favorable, estate plan would be to bequeath non-retirement plan assets of $1,000,000 to charity. In that case, no estate tax would be due, but the retirement plan assets would still be subject to income tax of approximately $350,000. Accordingly, it is advantageous to bequeath retirement plan assets rather than non-retirement plan assets to charity.

Many people are not in a position to leave all of their retirement benefits to charity. In that case, several options are available:

- An individual with two or more retirment plans can leave one to a charity and the other(s) to family members.

- An individual with a single IRA can split it into two IRAs and leave one to a charity.

- A married individual can have benefits paid to a trust for his spouse, with a charity to receive the benefits that remain at the death of the spouse. The benefits will not be subject to estate tax in the estate of the individual or the spouse. Income tax would apply only to any distributions taken by the spouse during her lifetime.

- An individual can establish a charitable remainder trust to receive the retirement benefits. Such a trust would provide a family member with a stream of periodic payments for a set number of years or for life, rather than an up-front lump sum. The remainder goes to a charity at the end of the term.

# NY Transfer Tax: Transactions Between Exempt Organizations

New York City and Yonkers provide statutory exemptions from their real property transfer taxes for transfers of real property "by or to" an organization described in IRC Section 501(c)(3). New York State, however, does not have such an exemption. Although the state transfer tax rate of 0.4% is much lower than the City transfer tax rates, the state tax can still be substantial.

A 501(c)(3) organization owning about $25 million of real property in New York City ("grantor") recently implemented a restructuring plan pursuant to which the grantor became affiliated with another 501(c)(3) entity ("grantee"). The grantor's organizing documents provided that it was a membership organization, and it had one member at the time of the restructuring. As part of the plan, the grantee replaced the previous member and became the sole member of the grantor.

The parties filed a New York State transfer tax return, reporting a taxable transfer of a controlling interest and paid transfer tax on the fair market value of the real property. After the transaction closed, the grantor filed a refund claim. The grantor argued that there was no "conveyance" for transfer tax purposes because the interest went from one charitable organization to another. The grantor claimed that the ultimate "beneficial owner" of the property, both before and after the transfer was the general public. In further support, the grantor referred to the governmental oversight of the activities of the organization to ensure that its resources are used for public purposes and did not benefit private interests. The state approved the grantor's request for a refund of the transfer tax paid.

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# NYC Nonprofit Real Property Tax Exemption Improved

Ordinarily in New York, real property acquired by an exempt owner for exempt use remains subject to real property tax until the next taxable status date. There has always been an exception pursuant to which property acquired by the federal government becomes exempt as of the date that it acquires title. There is also a requirement that an exemption application be filed by the taxable status date. In some cases, the interaction of these two rules means that, depending on the three dates involved (acquisition, application filing and taxable status), an exempt organization could be burdened with real property taxes for over a year.

To provide relief to nonprofits affected by those rules, the State Legislature recently amended Sections 420-a and 420-b of the Real Property Tax Law to provide a similar date-of-acquisition rule, effective August 1, 2007, for property acquired by nonprofits in New York City. It also allows exemption applications to be filed by nonprofits at any time after the acquisition date.

# In The News

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taxpayers with income under $42,000 and 23% for taxpayers with income over $142,000. The credit reduces the net UBT rate for city residents by reducing their city resident income tax payable. Under the old 15% credit, the effective UBT rate for a city resident was 3.4% (4% less an income tax credut of 0.6%). The new credit results in a lower effective rate of 3.08% (4% less an income tax credit of 0.92%).

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# Business and Personal Travel

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tion. You should keep records of what such costs would have been.

Certain portions of a trip can be treated as business related under "common sense" test that has been applied by the IRS. For example, an employee's out-of-town business chores conclude on Friday. However, he extends his business trip to take advantage of a low-priced fare requiring a Saturday night stayover. The employee doesn't pay tax on the reimbursement for his Saturday meal and lodging expenses. The common sense test provides that payments are deductible if "a hardheaded business person would have incurred such expenses under like circumstances."

Similarly, an away-from-home business trip may straddle a weekend. For example, one may have to attend business meetings on Thursday, Friday, and Monday. Because he must remain at the location for business reasons, the weekend days (Saturday and Sunday) should under the "common sense test" be treated as business days, the expenses for which are deductible (50% of meal costs, 100% for other expenses) or excludible if an employee is reimbursed under an accountable plan.

Eligible expenses of a spouse (or companion) accompanying a traveler are not deductible unless the spouse is an employee of the taxpayer and travels for a bona fide business purpose. Nevertheless, even if the spouse's travel expenses are not deductible, a tax benefit may still be salvaged from traveling together. The deduction is not based on 50% of the trip expenses. Rather, it is based on what it would have cost to travel alone. For example, if the cost of a hotel room is $150 per night for one occupant and $200 for two, a taxpayer on business status may deduct $150 per night, not $100, if he gets a room for two. The entire cost of a rental car is deductible, because it would have been the same even if the spouse did not come along.

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## To File or Not to File?

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return. Substitute returns are prepared in a manner favorable to the government. For example, no itemized deductions are incorporated into a substitute return, and substitute returns for married taxpayers are normally prepared on a married filing separately basis. This is done in part because of a lack of information, but also to give the taxpayer a further incentive to file actual returns for the periods at issue.

Filing a return also causes the "statute of limitations", which is a period of time after which the government can no longer assess additional tax relating to a return (such as by result of an audit), to begin to "run". For example, if a 2006 personal income tax return was filed on April 17, 2007, the government has until April 15, 2010 (or 2013 or a later date in some cases) to assert that additional tax is owed for 2006. Or, if the return was filed late on November 15, 2007, the period ordinarily expires on November 15, 2010.

If a return is not filed, the statute of limitations period never begins to "run", so the government can audit a return or assess tax at any time, even 10 or 15 years later, if a return has not been filed. At that time, it may be difficult for the taxpayer to produce evidence to support any deductions claimed or other relevant facts relating to the year at issue.

Practical issues also arise in the administrative and collection processes when returns are not filed. It may be tempting for a taxpayer who has an outstanding balance due or an audit issue with a particular year to stop filing required returns for subsequent years, on the theory that any new liabilities will be "rolled into" a comprehensive settlement package.

However, in the eyes of a revenue agent, a taxpayer who has an isolated problem relating to a single year but has continued to file and pay any balances due for subsequent years has a much more sympathetic position. This is particularly true at the initial stages of the collection process, when revenue agents exercise significant discretion with respect to many issues. Those issues incluide requests to put a "hold" on collection until returns can be filed or payments can be made, and whether to begin levying assets and garnishing wages in a manner that can publicize the taxpayer's problems in an undesirable manner. It also puts an administative burden on third parties, such as employers.

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