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The Garden State Bears Some Fruit

A recent decision handed down by the New Jersey Tax Court (Beljakovic v. Director, Division of Taxation) not only provides taxpayers with a potential refund opportunity, it highlights the length to which some state taxing authorities will go in defense of an irrational result.

The facts of the case are straightforward and undisputed. The taxpayers were residents of New Jersey and owned and operated a business through an S corporation (S Corp). S Corp did not maintain any regular place of business outside of New Jersey, though it did derive income in other jurisdictions including New York State and City.

For the 2006 tax year, S Corp filed an S Corporation return in New York State and paid a minimum tax. Since New York City does not recognize S corporations, but rather, taxes them as C corporations, S Corp filed and paid tax as a general business corporation. As a result of having New York sourced income via S Corp, the taxpayers filed a New York non-resident income tax return and paid tax (approximately $34,000) on the New York sourced income.

In New Jersey, S Corp filed its S corporation return and, as was statutorily required, sourced 100% of its income to the State notwithstanding the fact that S Corp had New York sourced income. Prior to a change in law effective July 1, 2010, New Jersey did not permit corporations that did not maintain a "regular place of business" outside the state to apportion any of its income outside the state. In this case, S Corp did not have a regular place of business outside of New Jersey.

In computing their 2006 New Jersey Gross Income Tax (GIT), the taxpayers reported a credit against their GIT for the non-resident income taxes paid to New York. Had the taxpayers not taken the credit, they would effectively have been taxed twice on the same income - once in New York then again in New Jersey.

Upon audit, the Division of Taxation (Division) disallowed the taxpayers' utilization of the credit for the taxes paid to New York. The Division's primary argument stemmed from a hyper-technical reading and application of the regular place of business rule and another provision of law under the GIT that disallows a credit for taxes paid where, as here, income from a S corporation is sourced to New Jersey. At the heart of it, the Division's argument attempted to elevate form over substance.

The regular place of business rule under the Corporation Business Tax (CBT) created the fiction that a business without physical presence outside New Jersey would not have sourced income from other states and therefore, must apportion 100% to New Jersey. Obviously, as demonstrated in this case, it ignored the reality that a taxpayer could have nexus outside New Jersey (albeit not stemming from a permanent physical perspective), and thus, sourced income from other states.

Fortunately, the Tax Court saw through the absurdity presented by the Division and essentially ruled that the legislature could not have intended such a result. The Tax Court recognized a well-established and basic tenet of taxation is to avoid double taxation. By elevating substance over form, the Tax Court ruled in favor of the taxpayers, and in so doing, restored hope for a fair and equitable taxing regime to New Jersey.

As a result of the case there exists a refund opportunity for New Jersey taxpayers that followed the statutory construct in place prior to July 1, 2010, and did not report a credit for taxes paid to other jurisdictions as result of receiving income from a New Jersey based S corporation. As New Jersey imposes a three year statute of limitations for refunds of GIT, refunds may be available dating back to the 2008 tax year depending on when the GIT return was filed.

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I Received an IRS Collection Notice: What are My Options?

The July 2012 issue of WTAS' For the Record described the Internal Revenue Service (IRS) audit process and various options available to taxpayers to bring an audit to a successful close. This article will focus on the IRS collections process and measures that a taxpayer can take to minimize the sting of a collection action initiated by IRS.

IRS describes the collection process as "*a series of actions that IRS can take against you to collect the taxes you owe if you don't voluntarily pay them. The collection process will begin if you don't make your required payments in full and on time, after receiving your bill.*" The existence of an unpaid tax liability triggers the onset of the collection process.

Typically, tax liabilities are self-assessed (i.e., the voluntary filing of a tax return) or are the direct result of a tax return review/audit by IRS. In either case, if there are unpaid tax liabilities, IRS will send the taxpayer a bill that includes the tax, interest and penalties. If the taxpayer does not respond to this first bill, IRS will send a second one.

If the taxpayer still does not respond, the collection process will begin in earnest.

IRS has 10 years from the date of the assessment to follow through on collection, although this can be extended by such actions as bankruptcy, a Collection Due Process (CDP) Appeal petition or the taxpayer moving abroad. IRS has several tools at its disposal to collect the debt, including the issuance of a federal tax lien which can escalate to a levy, or seizure of property.

A federal tax lien is a legal claim made by IRS against the taxpayer's current and future property. A tax lien automatically comes into existence when an unpaid balance is due to IRS; however, it becomes public when a Notice of Federal Tax Lien (NFTL) is filed. This filing secures IRS' priority as a creditor and, unfortunately, makes the lien publically available. This makes it accessible by consumer credit reporting agencies and can have a negative effect on the taxpayer's credit rating and ability to obtain credit. The most powerful collection tool IRS has is the power to levy. Types of property that can be seized include wages, salary and other types of income including partnership and trust distributions. Additionally, IRS has the authority to seize funds in the taxpayer's personal bank accounts or pending state tax refunds. IRS will seize as much property as is necessary to satisfy a taxpayer's liability, and in some cases, will seize physical property, including houses and cars, to satisfy these debts.

Taxpayers have the option to appeal a NFTL or a Notice of Intent to Levy at a CDP hearing. This program can provide the taxpayer a little breathing space, particularly in the case of a proposed levy, to seek administrative and judicial relief. These measures include innocent spouse relief, an Installment Agreement, an Offer in Compromise or even bankruptcy. Note that bankruptcy may only eliminate the debt in certain circumstances.

An Installment Agreement (Form 9645) is IRS' version of a payment plan. IRS realizes that due to circumstances beyond a taxpayer's control he or she may not be able to pay the liability off in full. If an agreement can be reached with IRS all applicable interest and penalties will still be charged until the balance is paid in full; however, IRS will not proceed to seize any of the taxpayer's property, and could release or withdraw any tax liens filed against the taxpayer. To be eligible to pay-off a tax liability through an Installment Agreement, the taxpayer must be current with all of his or her tax filings. For agreements of a significant size, the taxpayer can expect to be asked for proof of his or her financial status. The taxpayer should be prepared to create a personal balance sheet and income statement. They will also need to provide their day-to-day cash flows and have supporting records to validate all of this information.

If the tax liability cannot be paid in either one lump sum or through installments, the taxpayer might consider submitting an Offer in Compromise (Form 656) petition. By filing a request for an Offer in Compromise, the taxpayer is asking IRS to consider full settlement of all unpaid taxes for an amount less than the tax owed. IRS may accept an Offer in Compromise if the taxpayer can prove that they have insufficient assets and income to pay the amount due or that paying the amount due would cause economic hardship to the taxpayer.

In general, IRS is looking to collect what they are owed and sometimes a case can be made that its ultimate collection efforts will be enhanced if IRS delays enforcing collection through a levy action. Consider a case where the taxpayer has little equity in the assets he or she holds title to, but has a stable future income potential. By delaying enforced collection, IRS may realize greater collection from future payments. Making this case to IRS could be useful when trying to prevent a levy and reach an Installment Agreement. Alternatively, in order to protect future cash flows, the taxpayer could seek an Offer in Compromise and settle for less than the full amount owed using the little personal equity available. While this may cause some short-term turmoil as the taxpayer's current assets are depleted, it could preserve his or her income over the long run.

There is much more that can be said about the collections process and the various approaches to handling a

collection action. It can oftentimes be confusing and overwhelming. Taxpayers should consult a tax advisor when dealing with any IRS action as professional guidance can provide a solid strategy for working through the IRS collections maze.

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The Basis Trap of Gifting Depreciated Assets

Much of family wealth planning is predicated on the concept that assets appreciate over time.

However, over the past several years planners have often found themselves in a world made up of depreciated or "loss" assets. While these depressed values, along with historically low interest rates and favorable legislation, have presented great wealth transfer opportunities, what can easily be overlooked in these transactions is a potentially important income tax consideration, namely basis. As a result, without careful planning, the ability to recover an economic loss, at least in part, could be jeopardized.

The rule governing the basis of gifted assets is commonly referred to as the carry-over basis rule. In the case of loss assets however, this short-hand is misleading. Although a gift of appreciated property will cause the donee's basis to be the same as the donor's (with adjustments for any gift or generation-skipping transfer (GST) tax paid), a donor may not gift a tax loss. Thus, any gift of depreciated property will trigger the so-called dual basis rules under Section 1015(a). This section states, in pertinent part, that for property acquired by gift, "the basis shall be the same

as it would be in the hands of the donor...except that if such basis is greater than the fair market value of the property at the time of the gift, then for the purpose of determining loss the basis shall be such fair market value."

By way of example, assume a taxpayer gifts stock with a basis of $7 million and a fair market value of $5 million, the current gift tax exemption. If the donee later sells the stock for $8 million, the stock basis is $7 million and the gain is $1 million. If, however, at the time of the sale the stock price is $4 million, the basis would be $5 million and only a $1 million loss is recognized. If the stock is sold for a price between $5 million and $7 million, the basis would equal the date-of-gift value resulting in neither gain nor loss. In this example, if sold at $5 million, the $2 million of economic loss could not be deducted. A similar, if not more confused, result could occur in more complex transactions such as a gift to a grantor retained annuity trust (GRAT).

A GRAT is a transaction whereby a grantor gifts property to a trust but retains an annuity interest in that trust. Because of this retained interest, the GRAT can be structured so that the net gift is valued near zero. Once the GRAT terminates, provided the grantor is alive, whatever is left in the trust passes to beneficiaries tax free. The GRAT is a grantor trust that is ignored for income tax purposes. Its assets are still treated as owned by the grantor, so one would expect that there would be no impact on basis as far as the income tax system is concerned. However, because the initial transfer to the trust is a gift, albeit a gift of nominal net value, the dual basis rule arguably could apply.

Assume the taxpayer above makes the same stock gift to a GRAT. If the dual basis rule applies and the trustee then sells the stock for $5 million, once again the $2 million economic loss could not be recognized. If the GRAT is successful and some of the stock is distributed to beneficiaries, the dual basis rule also could apply to them since the trust distribution would not impact basis. Even more problematic are the annuity payments made back to the grantor. If those payments are made in kind with the stock originally contributed to the trust, it is possible that the dual basis rule could apply to those shares in the hands of the grantor as well.

With some foresight, these potentially negative results could be avoided whether the transaction is an outright gift or one made to a trust such as a GRAT. For example, the taxpayer could first sell the asset, recognize the loss and then give the cash. Keeping in mind potential application of the wash sale rules, the asset then could be repurchased by the donee, effectively working around this issue.

Although Sec. 1015(a) applies to gifts, it should not apply to a sale to a grantor trust. By using a grantor trust, the sale is not recognized for income tax purposes and the basis remains intact.

For a variety of reasons, grantor trusts are an extremely useful tool in family wealth planning. One of the most common methods of creating a grantor trust while still avoiding estate tax inclusion is for a grantor to retain a power to substitute assets in and out of the trust for other assets of equal worth. Rather than giving loss property (that is expected to appreciate) and incurring the dual basis issue, the grantor could substitute the loss property for cash or other assets held by the grantor trust. Since the substitution is not a gift, the basis would be retained. If the asset is later sold for less than basis, the capital loss would be recognized.

A number of factors make right now an extremely favorable time for transferring wealth. While these factors should be taken advantage of, thought must be given not just to the transfer tax implications of such planning, but to the income tax implications as well. Although the tax code recognizes that individuals should have the ability to deduct economic losses, it also contains specific provisions like the dual-basis rules that can prevent a deduction in certain situations. Without proper planning, the benefit of this transfer tax planning could be reduced by a potential income tax trap that might have been avoided.

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Tax Independence – Not just for Public Companies

The tenth anniversary of the enactment of the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley) reminds us of the many changes that have occurred during the last 10 years in the accounting industry.

The scandals of Enron, WorldCom, and others helped lead to Sarbanes-Oxley, and also helped the American Institute of Certified Public Accountants (AICPA) and the Securities and Exchange Commission (SEC) create stricter professional ethics requirements in working with audit clients. The AICPA provides the framework for professional ethics in the "Code of Professional Conduct."

Independence Requirements

Specifically, ET 100-1.06 in the Code of Professional Conduct defines independence as:

1. Independence of mind—The state of mind that permits the performance of an attest service without

being affected by influences that compromise professional judgment, thereby allowing an individual to act with integrity and exercise objectivity and professional skepticism.

2. Independence in appearance—The avoidance of circumstances that would cause a reasonable and informed third party, having knowledge of all relevant information, including safeguards applied, to reasonably conclude that the integrity, objectivity, or professional skepticism of a firm or a member of the attest engagement team had been compromised.

Further in ET 100-1.13, independence concerns related to self-review are identified.

- Self-review threat—Members reviewing as part of an attest engagement evidence that results from their own, or their firm's, non-attest work such as, preparing source documents used to generate the client's financial statements.

It should be noted that the safeguards related to self-review are strictly applied for audits of public companies based on the SEC requirements. However, for private companies the requirements are accounted for under the AICPA standards, which appear to have more subjectivity. For non-public companies, if management approves all account classifications, provides source documentation for journal entries, and takes responsibility for the resulting financial statements, the auditor may be able to assist in providing journal entries during the course of the audit. As significant judgment may be applied in this evaluation, there are widespread differences in the application of these rules.

Tax Independence

Typically, the concern related to self-review for tax professionals focuses on the preparation and audit of the accounting for income taxes. The accounting standard for this area is ASC 740 (formerly FAS 109). For many companies, the provision for income taxes may represent the single largest expense on their income statement and the deferred or current tax accounts may be a significant component on the balance sheet. Evaluating the considerations for recording a valuation allowance or liabilities for uncertain tax positions often require a significant amount of judgment. As a result of the above concerns, this area has received more scrutiny during the last 10 years.

Who Should Care about Tax Independence?

Clearly, public companies have focused on the SEC requirements and typically have sufficient internal resources to prepare the accounting for income taxes. However, many smaller private companies may not have internal resources and will look to outside service providers to prepare the income tax provision.

Since the prior three years of financial data and audit certifications may be included in certain public filings (i.e., IPO offerings), companies that are intending to go public or be acquired by a public company in the next three years, should evaluate independence now. Certain industries, such as high tech, that are more likely to meet the above criteria should be focused on tax independence.

For many private equity funds, the public market is a significant exit strategy for their portfolio companies. Private equity firms may work with a significant number of different audit firms either directly or through their portfolio companies, therefore, identifying independent firms can be difficult.

In addition to the possibility of being a public company, the second AICPA definition, "independence in appearance," should cause non-public companies to pause. Have companies considered if the readers of their

financial statements (i.e., lenders, stockholders or others) could “believe” that the independence of the audit was impaired because the auditor was auditing their own work?

Summary

Following the numerous scandals and increased focus on audit transparency and independence, it is apparent that the SEC has determined that tax independence is essential for public companies. For private companies, careful consideration should be given by management and shareholders to evaluate the importance of tax independence.