

RECENT LEGAL TRENDS

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New Hurdles for the Sale of NY Real Estate by Nonresidents

Effective September 1, 2003, New York State ("NYS") has added a new hurdle for sellers of real estate throughout NYS. Pursuant to an amendment to the NYS Tax Law, a new section 663 was added. The new section states, in part, "Upon the sale of real property within the state by a nonresident taxpayer, the nonresident shall estimate the personal income tax liability on the gain, if any, from such sale or transfer." Moreover, proof of payment of this tax, or proof that the taxpayer is not subject to the tax, must be furnished in order to record the deed. Therefore, unless this new tax is correctly addressed, the closing will not be properly effectuated!

When applicable, this new tax law requires the seller to pay an estimated withholding tax of 7.7% on the gain received by the transferor in connection with the sale. Unlike other real estate taxes in New York, this tax, is calculated on the gain earned by the transferor, and not on the total sale price.

Although this new NYS Tax Law places another significant burden on the sellers of real property in NYS, there are exceptions and exclusions. For example, if the property being sold or transferred is a principal residence of the seller, then no tax liability will be imposed. Moreover, through prudent legal counsel, a buyer can make certain choices when purchasing the property to minimize and possibly eliminate any tax liability under this new tax provision when they sell or otherwise transfer the property.

This new NYS tax illustrates the importance of retaining legal counsel early in the transaction. By providing a thorough analysis and proper counsel before the transaction is finalized, E&J can provide our clients with import taxes savings that, potentially, are significantly greater than the transaction costs associated with the deal.

Prepared by Steven R. Ebert, Esq.

The "Do's and Don't's" of Having a Foreign Bank Account

As in other well-to-do cities across the country, many area residents have foreign (non-U.S.) bank accounts. Unlike in certain other countries, it's entirely legal for U.S. citizens to hold foreign bank accounts. Area residents are often drawn to open foreign bank accounts or foreign financial accounts in order to gain access to certain financial institutions or offshore hedge funds or, in some cases, because of a misguided effort to evade tax.

Contrary to popular belief, there are no lawful tax benefits to simply having a foreign account. The opening of a foreign account does, however, trigger a number of very important disclosure obligations.

For example, regulations issued under the Bank Secrecy Act require that U.S. citizens report their interest in any foreign financial accounts. Form 1040 asks the following question: "At any time during the . . . [current year], did you have an interest in or a signature or other authority over a financial account in a foreign country, such as a

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bank account, securities account, or other financial account?” (Certain exceptions to this disclosure requirement do exist, such as for accounts with a combined value of \$10,000 or less for the entire year.)

“Many people think they can secretly make transfers to offshore accounts by transferring amounts of \$10,000 or less.”

If you answer “yes” to either part of this question, you are required to disclose the name of the foreign country and to complete a “Foreign Bank Account Report” (T.D. Form 90-22.1). This report requires the disclosure of detailed information about the foreign account, including the name of your bank, the approximate balance in your account, and a list of all your other foreign accounts and account numbers.

If you provide a false answer to the foreign bank account question (such as by checking off that you do not have an interest in a foreign account when in fact you do), you could face criminal charges of perjury. Also, any intentional failure to file a Foreign Bank Account Report that occurs in the context of tax, currency, or money-laundering offenses can be prosecuted as a separate felony. Can you simply then not respond to the foreign bank account question? It’s estimated that only 1 out of 10 U.S. taxpayers reports their interests in foreign accounts, but it is a misdemeanor to intentionally fail to supply any information required under the Internal Revenue Code. The government usually prosecutes this offense as a felony, since it will typically allege other fraudulent activity. The IRS is also authorized to impose a civil penalty of up to \$25,000 for each willful failure to file a Foreign Bank Account Report. This is in addition to the civil tax penalties that may apply if you fail to declare income on

your return, including the negligence or “substantial understatement” penalties of 20% or the fraud penalty of 75%, tax evasion charges, and tax-related conspiracy charges.

Many people think they can secretly make transfers to offshore accounts by transferring amounts of \$10,000 or less. It is true that banks and other financial institutions (but not the Postal Service) are required to report transactions of more than \$10,000. What most people don’t know, however, is that a transaction of merely \$5,000 or more is automatically considered “suspicious activity” that can trigger a financial institution’s requirement to report the transaction.

It’s also not a good idea to depend on the banking secrecy laws in effect in tax haven countries to protect you from your obligation to disclose your foreign account. The banking secrecy laws in effect in tax haven countries (such as Switzerland and many Caribbean countries) tend to be qualified secrecy laws. In most instances, the secrecy laws will crumble in the face of allegations of non-tax criminal acts. Additionally, the operation of the international banking system tends to negate the effectiveness of secrecy laws. If you or your bank executes a wire transfer, whether by Fedwire, CHIPS (Clearing House Interbank Payment System), or SWIFT (Society for Worldwide International Financial Telecommunications), that wire transfer is often discoverable by the IRS. And using a bank or credit card company that is within subpoena-reach of the U.S. is a sure-fire way to get caught.

Short of making full disclosure on your Form 1040 and on the “Foreign Bank Account Report,” you can in many circumstances assert your Fifth Amendment privilege against testimonial self-incrimination. In order to be valid, though, your

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claim of privilege must be explicit on the face of the return. You may not simply fail to respond to Form 1040's question about foreign accounts or fail to file the Foreign Bank Account Report. Also, while you may be able to rely on your privilege against self-incrimination as a basis for declining to identify the location or source of your income, you can't use the privilege to withhold disclosing the amount of your taxable income. So, while you may be able to avoid disclosing whether or not you have a foreign account, you must still report your income from monies in that foreign account (such as interest or capital gains).

Asserting your Fifth Amendment privilege in response to the foreign bank account question will certainly raise a red flag at the IRS, but it may ensure that your return contains no self-incriminating information and save you from civil and criminal penalties.

Prepared by Tyler B. Korn, Esq.

Where are Mortgage Rates Going?

WHERE ARE MORTGAGE RATES GOING? Most of us see an article "predicting" the direction of interest rates, or of a stock, and eagerly scan the page for an insight that includes specific advice from the author. Ah.....if only we could rely on these predictions. Unfortunately, the direction of interest rates depends not only on economic data, but also on the psychology of investors and institutions trading stocks and bonds. And finding a majority

of economists in agreement is rare, indeed. On July 10 of this year, Bankrate.com, reported they had surveyed numerous economists regarding the sudden uptick in rates -- which had jumped, in 3 weeks, from 5% to 5.6% for a 30-year fixed rate mortgage -- and the majority expected the rise would *not continue*. As of mid-August, however, mortgage rates are in the 6.5% range, a full 1% higher.

So, if no one can be sure of where rates are headed, what do we do? My answer is, "That depends." If you are planning to buy real estate to live in, a home or vacation home, mortgage rates are only relevant in terms of affordability. Of course, your monthly payment will depend on rates. But once you have determined what you can comfortably pay at current rates, take the plunge, make your offer, and buy the home or apartment you want. You need to look at these "homes" differently from an "investment" decision one makes when buying a rental property. We don't know where real estate prices will be in the future, and while you wait for interest rates to go down (if that happens), you could be priced out of the housing market.

What if you thought of refinancing, but now hesitate because rates are higher? It's all relative. Last fall, when rates hit 6.5% after a decade of being between 7.5 and 8.5%, homeowners marveled at the 35 year low of 6.5%, and hurried to refinance. That's the same 6.5% we offer today, yet those who missed the lowest rates now think rates are too high to make it worthwhile. Many have heard the "2% rule" and think a new loan only makes sense if the rate is 2% lower. But what if your balance is \$320,000 at 7.5% and your saving would be only 1%. You would save \$215 every month by refinancing at 6.5%! Depending on a lender's charges and the property type, you could recoup the closing costs in as few as 7

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months.....if you stay longer than that, you're home free! Other options would include the tens of thousands of dollars you could save by taking a 15 year instead of a 30 year loan, where the rates are lower, also. Or, if you anticipate selling within 5 years, there are 5-year adjustables with a lower rate that will not change for 5 years.

So don't let the unpredictable nature of rates be a reason not to move forward with buying a home or refinancing. A lender will be happy to "crunch the numbers" with you so that you can make a wise and informed decision.

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Avoiding Unwanted Tax Costs in a Divorce Settlement

“Why is divorce so expensive?” is a question that attorneys often hear. Experienced family law practitioners usually respond “Because it's worth it.”

Indeed, costs to the client often continue well after legal fees are paid because of unanticipated tax costs. Unexpected tax burdens cause the pain of divorce to persist, exacerbating the client's resentment of the ex-spouse, which is often transferred to the attorney. With effective tax planning, however, divorce need not be unnecessarily expensive or distressing for clients.

Significant tax implications exist for all three types of financial settlements incident to divorce:

property transfers, alimony and separate maintenance payments, and child support.

In general, upon a transfer of property between spouses or former spouses incident to divorce, no gain or loss is recognized to the transferor, and the transferee does not include the value of the property in income. Alimony payments received by a divorced or separated spouse are generally treated as gross income to the recipient spouse and deductible from adjusted gross income by the payor. And child support payments, for their part, are non-deductible by the payor and non-includible in income by the payee.

However, the apparent simplicity of these general rules belies the complexity in the tax law governing divorce settlements.

In the case of alimony, not all payments to a former spouse qualify for deductibility. For example, if a payor is required to continue making payments after the death of the payee spouse, or to make any payment as a substitute for the payments after the death of the payee spouse, the payments do not qualify as alimony for tax purposes. The rationale for this rule is that alimony payments are intended for the support of the payee spouse. If the payments continue after the death of the payee spouse, they are considered to have been intended as property settlement or child support – both non-deductible. This rule often surprises clients when they discover (too late) that their payments for certain of their former spouse's expenses (e.g., mortgage payments) are non-deductible because liability for those expenses does not necessarily terminate upon the payee's death. Payments made to third parties on behalf of the payee spouse and “indirect” payments made to a recipient spouse, such as from the payor's company, also often fail to qualify as deductible alimony if they are not properly structured. Complex “anti-front-loading” recapture rules also apply to alimony payments in

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order to prevent property settlement payments from qualifying for alimony treatment. The recapture rule can be triggered by a decrease or termination of alimony payments during the first three calendar years, and requires that the payor spouse report the excess alimony as income. The recapture rule can be triggered by modifications to the divorce or separation instrument, a failure to make timely payments, a reduction in the payor's ability to provide support, or a reduction in a payee's support needs. Certain exceptions to the recapture rule do exist. It should be noted that it is generally to the advantage of the alimony payor to have the payments treated as alimony in order to deduct the payments for tax purposes. The parties, however, may elect that the payments be treated as non-deductible by the payor and excludible from gross income by the payee. This designation is relatively uncommon in practice but is sometimes advantageous where it results in a lower tax bill for the two parties. Counsel for the recipient spouse may also negotiate for this designation so that it is the payor spouse who pays the tax on the amounts used for payments. This ensures that the recipient spouse receives the full benefit of the payments.

"Without proper planning, even the best settlement can yield disaster for one or both of the parties because of the underlying tax consequences."

Tax mistakes are often made in the treatment and classification of child support payments. For example, if a divorce instrument provides that alimony payments will be reduced upon the occurrence or non-occurrence of certain child support contingencies, then the amount of the specified reduction may be treated as non-deductible child support from the outset.

Even more significant tax implications (beyond the scope of this article) will arise if IRA interests, debt, promissory notes, or certain types of

preferred stock are to be transferred.

Seemingly slight differences in payment classification and structuring can significantly affect the tax cost of divorce. Proper and timely tax guidance can minimize these effects. Without proper planning, even the best settlement can yield disaster for one or both of the parties because of the underlying tax consequences. A review of the tax implications of the settlement agreement is essential to identify planning opportunities and avoid unwanted tax results.

Prepared by Tyler B. Korn, Esq.

NY Real Estate Roundup

Two recent events have the potential to greatly impact NY area residential real estate transactions.

The first matter directly impacts the relationship of a sponsor to the cooperative corporation or condominium association and its unit owners. Real estate professionals and lenders are all too familiar with the critical role that a sponsor can have in a building. While sponsor units can provide buyers with unique purchasing and rental opportunities, sponsor units can have a negative impact on a building. Not only can sponsor ownership reduce the independence of unit owners, but the level of sponsor ownership has an important correlation to the ability of buyers to receive unit purchase financing and the overall stability of a cooperative or condominium.

In response to a litigation addressed last summer, the NY State Department of Law has found that "explicit disclosure of the Sponsor's intent to sell or withhold from sale units included in an offering plan and the ramifications of the sponsor's retention of a substantial number of units are

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material terms of the offering” of condominium and cooperative units for sale. Accordingly, the NY State Attorney General has issued proposed regulations that, if adopted, would require sponsors to disclose their intentions as to whether or not they truly intend to sell all of the condominium or cooperative units they currently own. In the event the sponsor plans on withholding from sale certain units, then the sponsor will be required to disclose the percentage of the total number of units they wish to retain ownership of, and disclose the consequences of their ownership of a significant number of units over a prolonged period of time.

Sponsors, under the proposed regulations, will be under a heightened level of scrutiny. Sponsors will lose some flexibility and may find it harder to respond to market forces when determining whether to lease or sell certain units under their control. Moreover, the disclosure may help buyers by providing additional information to make a more informed decision in connection with a purchase of a sponsor unit. However, even if the proposed regulations are adopted, buyers need to seriously weigh the facts and circumstances of purchasing a sponsor unit, as each building contains certain risks that can be elevated by a particular sponsor.

If a buyer defaults on a contract how much in damages can a seller claim?

Typically, residential real estate purchase contracts require a 10% downpayment. In the event the buyer defaults, the seller is entitled to keep the downpayment to compensate for the seller’s losses. While a seller is entitled to keep the downpayment to compensate him for his actual or probable loss, the seller is not entitled to receive punitive damages for a breach of contract. In other words, while the seller is allowed to be made whole for

the economic damages he suffered, within the parameters of the contract of sale, he cannot seek such moneys if they are merely meant to punish the defaulting buyer.

Since the seller can only retain the amount of consideration that reasonably relates to his economic harm, what is the permissible level of damages that a seller can retain?

In *Uzan v. 845 UNLP*, the Supreme Court of New York County stated that a liquidated damages provision entitling the seller to retain 25% of the purchase price of a defaulting buyer is “plainly or grossly disproportionate to the probable loss”, and was thus an unenforceable penalty. Therefore, sellers must recognize that there are restrictions to penalty provisions in real estate purchase contracts.

Although 10% represents the market standard, it does not mean it is the only permissible option for sellers. E&J recognizes that certain real estate transactions have unique considerations that may not have been considered in this case. E&J has the ability to work closely with sellers to customize purchase contract default provisions to assist sellers in achieving the customized level of protection against breaching buyers.

Prepared by Steven R. Ebert, Esq.

NEXT ISSUE HIGHLIGHTS...

-What Every Employee Should Know about their Office Environment and Rights.

-New Federal Tax Rules for International Transferors of U.S. Real Estate.

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