GDB LAW

Spring 2018

LEGALUPDATE

Providing current information about legal developments for our clients and friends.

Offshore Assets, Virtual Currencies and the "Kiddie Tax"

By: David N. Milner, Esq. and Asher Rubinstein, Esq.

As the tax season is upon us, our tax partners address recent tax law developments in three different areas:

- ***Offshore Assets:*** IRS decision last month to end its voluntary disclosure program for taxpayers who failed to report foreign income and assets;
- ***Bitcoin:*** Recent IRS efforts to gather information about bitcoin and other virtual currency transactions; and
- ***"Kiddie Tax":*** Recent changes to the taxation of children's investment income.

IRS Offshore Voluntary Disclosure Program Ending September 2018

The IRS Offshore Voluntary Disclosure Program (OVDP) has been an opportunity for U.S. taxpayers who failed to report foreign income and assets to come into compliance, pay back taxes, lower their potential penalties and avoid criminal prosecution. The OVDP has been in effect in various incarnations since 2009, coinciding with the U.S. Department of Justice (DOJ) offensive against foreign banks, bankers and U.S. taxpayers who commit tax fraud, and the implementation of the Foreign Account Tax Compliance Act (FATCA). Thus, while the government went after wrongdoers, it also encouraged voluntary compliance via the OVDP, with the reward of leniency and lower penalties. The IRS announced in March that the OVDP will close on September 28, 2018.

If readers have foreign assets and are not in IRS compliance, now is the time to address the issue. Soon, it will be more difficult, and probably more expensive, to become compliant. A few items to keep in mind:

- The IRS "Streamlined Compliance Procedures" will continue to be an option for those taxpayers whose non-compliance was non-willful, i.e., unintentional.
- The OVDP submission must be completed and submitted by September 28, 2018. This means that the taxpayer must go through the steps of obtaining pre-clearance and requesting preliminary acceptance by the Criminal Investigations Division of the IRS, and obtain all relevant foreign financial statements from foreign sources by September 28, 2018.

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NYC Cooperatives and Condominiums Must Adopt Smoking Policies

By: David L. Berkey, Esq. and Marc J. Luxemburg, Esq.

New York City recently enacted a new local law that requires all owners of Class A multiple dwellings, which includes most cooperatives and condominiums, to adopt and distribute to shareholders, tenants and unit owners a smoking policy prior to August 28, 2018.

The New Smoking Law

The new law, Local Law 147, does not state what the smoking policy should be — i.e., it does not require a total smoking ban. But smoking is already prohibited by local law in enclosed areas in public places, which includes common areas of apartment buildings, elevators, and areas where a child care or health care facility is located, as well as in certain outdoor areas such as playgrounds and pedestrian plazas. Some cooperatives and condominiums have adopted complete smoking bans and New York City offers a guide for smoke-free living entitled "Making Your Building Smoke-Free: A Guide for Landlords and Managing Agents."

Recommendation for Boards

We recommend that, if Boards do not already have a written smoking policy, they should develop one now, so they can meet the August deadline to adopt and distribute or post their policy.

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When Your Insurance Company Declines Coverage: Is Your Broker Liable?

By: Randy J. Heller, Esq.

An insurance broker dodged a bullet when a court held that he did not mislead his client about the scope of coverage or fail to provide appropriate advice—even though the client was left with no coverage and no defense against a construction accident on its property.

When one pays for insurance, one hopes it will be there to protect you in the event of a jobsite accident. It is hard enough to get proper insurance from your contractors. It shouldn't be so hard to get your own insurance right. That's why you use a broker.

In this case, a property owner made a generalized request of its broker to procure commercial general liability (CGL) insurance. During work by a contractor at the property, an individual was injured when he fell off a ladder. When the owner gave notice to its carrier, coverage and defense were denied. As it turns out, the CGL policy which had been obtained did not cover injuries to employees, contractors or employees of contractors.

> *Perhaps a more important lesson is that one cannot assume there is adequate insurance merely by looking at the limits of coverage set forth on a Certificate of Insurance.*

With no remedy against the insurance company, the owner sued its broker for failing to obtain appropriate coverage. But the broker was able to establish that he had warned the owner that the policy had an exclusion for injuries to construction workers. Not only that, the broker had informed his client that such coverage could be obtained for an additional $5,000—an option which the owner declined. Accordingly, the broker was found not to be liable to the owner on the facts of this case.

There are a few interesting takeaways from this appellate case. First, the court recognized that on appropriate facts, the broker might very well be liable. If he was paid for his advice (not just a commission on the

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Trusts Provide a Flexible Vehicle to Accomplish Many Different Beneficial Purposes

By: David I. Faust, Esq.

Trusts can be used for a variety of beneficial purposes: estate and tax planning, avoidance of probate, continuity of a family business, provision for heirs who may not be able to take care of their own financial affairs or needs because of age or lack of capacity, charitable giving and asset protection.

A trust is created by a grantor. The beneficiaries of a trust are rarely involved in the preparation of the trust. They may not even know that a trust is being created for their benefit. This is the case with a common trust, created in a will which provides that an inheritance be delayed beyond legal adulthood. This kind of trust puts a special burden on the grantor, who must anticipate the needs of beneficiaries as well as the intent of the client who commissioned the trust. The grantor must decide what discretion the trustee should have regarding distributions of income or principal and at what age the beneficiary should receive his or her inheritance free of trust.

A common trust used for tax purposes is a life insurance trust. If an insurance policy is owned by the insured person, its benefits are included in the insured's estate for estate tax purposes. A simple way to avoid this is to hold the policy in an insurance trust.

Two Basic Types of Charitable Trusts

There are two basic types of charitable trusts — GRITS and GRATS.

GRITS are Grantor Retained Interest Trusts: designated charities receive the income realized by the trust, with a guaranteed minimum return. At the end of the term of the trust, the remaining principal goes to persons designated by the grantor. The grantor gets a charitable deduction based on the current value of the bequest to charity and may have to pay a gift tax based on the value of the residual gift. But this could be a way to make charitable contributions and pass property expected to increase in value to one's heirs without an estate tax.

> *Generally, with the exception of special rules for GRITS and GRATS, if the grantor retains an economic interest in, or management rights over, the trust, it will be treated as a grantor trust for tax purposes.*

GRATS are Grantor Retained Annuity Trusts. The grantor gets the income from the trust, again with a stated minimum return. On the grantor's death or after a fixed term, the remaining principal goes to charity. In either event, on funding the trust the grantor gets a charitable deduction.

Trusts can be used to gift assets, which are expected to appreciate in value, thus transferring wealth or prospective wealth to children or grandchildren. A gift tax may be incurred but it would be on a much lesser value than the anticipated increased value of the assets put in trust.

Generally, with the exception of special rules for GRITS and GRATS, if the grantor retains an economic interest in, or management rights over, the trust, it will be treated as a grantor trust for tax purposes. This means that the income from the trust will be "passed-through" to the grantor who must report the income on his or her income tax return and pay any resulting taxes. It is also generally includable in the grantor's estate on death. If the trust is not a grantor trust, then it is a separately taxable entity. Distributions of income to beneficiaries of a non-grantor trust are deductible from trust income – and taxable to the beneficiaries. However, tax rates for trusts are higher than those for individuals, so trusts are generally not good vehicles for accumulating income.

Asset Protection Trusts

Asset protection trusts, as the name suggests, are vehicles to protect assets. Particularly in a litigation-prone society such as the United States, many people in high-risk professions or businesses want to insulate portions of their assets from potential claimants. People contemplating marriage, or who are married but contemplating divorce, may also seek to protect assets from a spouse.

With most asset protection trusts, the grantor wishes to retain beneficial use of the trust principal and its income. Trusts in which the grantor is a beneficiary are called "self-settled trusts." The grantor of an asset protection trust typically also wants to maintain some degree of control over the assets of, and/or distributions from, the trust. Thus, a basic tension is created between the grantor's desire to retain beneficial interests and control, and the essence of a trust, namely the separation of the legal and beneficial ownership of assets.

Asset protection trusts are typically formed outside the U.S. This is because most state laws do not provide for asset protection for self-settled trusts. Many offshore jurisdictions do provide such protection. Some states now offer such protection but their asset protection laws have yet to be fully tested.

The variety and flexibility of trusts provides many benefits, but their complexity requires that careful attention must be paid in structuring a trust.

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Smoking Policies

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- The law requires the smoking policy to address all indoor locations, including all common areas and dwelling units, and all outdoor areas, including common areas and terraces, balconies and patios connected to dwelling units.
- The Board of a cooperative must incorporate the smoking policy into the proprietary lease or house rules.
- The Board of a condominium must incorporate the policy into the condominium by-laws or rules and regulations.

Although virtually all proprietary leases, condominium by-laws or rules already generally prohibit unreasonable odors, these general provisions are not specific enough to comply with the new Local Law requirements.

Boards should adopt a comprehensive policy, addressing each of the areas specified in the Local Law and stating where one can smoke and where one cannot.

Since the policy must be incorporated into existing rules, the rules need to be revised to incorporate the new smoking policy. It is not enough to pass a policy and leave the rules as they now exist.

> *Cooperatives and condominiums should act now to adopt a comprehensive written smoking policy, amend their existing rules to conform to the new policy and distribute or post the policy by August 28, 2018.*

Boards must annually provide a copy of the smoking policy to all tenants, subtenants and owners, or post the policy in a prominent location. Boards must also advise tenants, subtenants, and owners of any material change in the policy. Presumably, this can be accomplished by including the policy in the same mailing with the annual window guard notice.

Boards must incorporate the policy into any agreement to rent or lease an apartment. For cooperatives, the policy must be added to the proprietary lease or to the house rules.

Cooperative shareholders and condominium unit owners who sell or lease their apartments must incorporate the policy into any lease, sublease or contract of sale of the apartment. We recommend that the application packages for subleases, leases and sales be amended to incorporate this requirement.

The law provides that the new smoking policy shall not be binding on an existing rent-stabilized or rent-controlled tenant; or on other tenants during the term of the lease in effect at the time of the adoption of the policy, unless otherwise provided in their lease. By definition, this applies to proprietary leases and, if read literally, it could mean that the new smoking policy could not be applied to any existing tenant-shareholder. However, the power to change the house rules should be interpreted to mean that the proprietary lease provides otherwise, and the new smoking policy should be binding on all tenant-shareholders.

Failure To Comply Is Costly

Failing to comply with the new law can be costly. The law provides for civil penalties up to $2,000 for multiple violations of the smoking policy law.

The bottom line is that cooperatives and condominiums should act now to adopt a comprehensive written smoking policy, amend their existing rules to conform to the new policy and distribute or post the policy by the August 28, 2018 deadline.

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David L. Berkey *is a partner at Gallet Dreyer & Berkey, LLP and head of the firm's Cooperative and Condominium Practice. A seasoned litigator, Mr. Berkey is a trusted advisor to numerous cooperative and condominium boards, banks, insurance companies and individuals. Mr. Berkey can be reached at dlb@gdblaw.com.*

Marc J. Luxemburg, *is a partner at Gallet Dreyer & Berkey LLP. His practice focuses on real estate transactions, cooperative and condominium law, and real estate litigation. Mr. Luxemburg represents numerous buildings and sponsors in the New York City area. He is the President of the Council of New York Cooperatives and Condominiums, a non-profit membership organization with more than 2,300 cooperative and condominium members, which provides educational activities and monitors legislation that affect its members. He has taught numerous seminars on the legal aspects of operating cooperatives and on the role of the board of directors. Mr. Luxemburg can be reached at mjl@gdblaw.com.*

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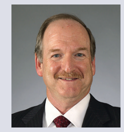
- *Real Estate Law*
- *Tax Law*
- *Trusts and Estates*
- *White Collar Criminal Defense*

GDB ANNOUNCEMENTS

Alyssa C. Goldrich

In March, Alyssa C. Goldrich became a litigation associate at Gallet Dreyer & Berkey, LLP, focusing on a variety of litigation matters, after working for the firm for three months as a clerk. Ms. Goldrich received her J.D. from Maurice A. Deane School of Law at Hofstra University and her B.A., magna cum laude, from St. John's University. Ms. Goldrich was the Editor-In-Chief of her law school's *Journal of International Business and Law* and a recipient of the Law School Conscience Endowed Scholarship.

Roger L. Stavis and David L. Berkey



Gallet Dreyer & Berkey, LLP is launching a new Crisis Management practice area, spearheaded by partners Roger L. Stavis and David L. Berkey. Our firm's Crisis Management team has the expertise, experience and judgment to help steer our clients through any business or life altering crisis. If your company's brand or reputation are at stake, GDB's Crisis Management team will develop an integrated and rapid approach to resolving a crisis.

FIRM NEWS AND HONORS

Randy J. Heller

In January, partner Randy J. Heller lectured to the Construction Law Committee of the New York State Bar Association's Real Estate Division on the subject of the Prompt Payment Act and its interplay with a contractor's right to expedited arbitration of certain disputes.

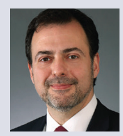
GDB Tax Law Department

In January, GDB's Tax Law Department article regarding Tax Reform was republished in the Halstead Property's Newsletter, which is distributed to hundreds of the company's brokers and clients.

David T. Azrin

In February, partner David T. Azrin was once again honored by Franchise Times magazine as a "Legal Eagle." Legal Eagles are the top 125 lawyers in franchising, as nominated by their peers and as determined by a Franchise Times editorial panel.

Asher Rubinstein



In February, partner Asher Rubinstein co-hosted a seminar at J.P. Morgan Global Headquarters in New York, "Cybersecurity: Protecting Yourself and Your Assets."

Roger L. Stavis

In March, partner Roger L. Stavis was on a panel at the New York City Bar Association titled "Federal Practice 101: An Introduction to the Nuts and Bolts of Federal Civil Practice." In March, Mr. Stavis was also on a panel at Queens College titled "A Look Inside the Extraordinary Legal Careers of QC Alumni."

Broker Liability for Insurance Denial

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premium), or if there was a long "course of dealing" which would indicate that his expertise was being relied upon, he could be found to have a "special relationship" with his client and be liable for giving poor advice. But here, whether or not there was a special relationship, the broker was found to have discharged his duties without fault.

Perhaps a more important lesson is that one cannot assume there is adequate insurance merely by looking at the limits of coverage set forth on a Certificate of Insurance. These days, policies are being written all the time which do not cover the most basic types of injuries and damages (here, injuries to construction workers). Endorsements abound in which coverage is excluded for damage to the work itself, or to third parties, or to neighboring properties, or for Labor Law violations, or for damages which occur as soon as the work ceases. Without reading the policy and all its endorsements, it is impossible to tell if there will be coverage.

And that can be a very expensive lesson.

Offshore Assets

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- Penalties inside the OVDP (27.5% of the highest aggregate value of the foreign assets) are almost certainly lower than penalties if discovered by the IRS. Penalties outside the OVDP include as much as a 50% penalty for failure to file the Report of Foreign Bank and Financial Accounts (FBAR) form; penalties for failure to file IRS Form 8938; penalties for substantial understatement of tax; civil and criminal tax fraud penalties, as well as criminal prosecution.
- Taxpayers who avoid the OVDP and its 27.5% penalty and merely file amended tax returns (known as a "quiet disclosure") will be specifically targeted by the IRS for additional penalties.

The OVDP presents an opportunity to bring unreported offshore assets into IRS compliance and avoid more onerous penalties and costs. This opportunity will end on September 28, 2018. In light of FATCA, cooperation by foreign banks, IRS summonses, subpoenas and information-sharing agreements with foreign governments, continued non-compliance is very risky and inadvisable. For all taxpayers, proper disclosure of offshore assets and income requires the filing of various forms, including the following:

Reporting Foreign Assets

If you owned or had signatory authority over a foreign financial account (including a bank account, securities account, brokerage account, virtual currency account, etc.) at any time during 2017, you must "check the box" on your income tax return to disclose that ownership, specifically on IRS Form 1040, Schedule B, Part III, Line 7.

You must also complete IRS Form 8938, Statement of Specified Foreign Financial Assets, to report foreign bank, brokerage accounts and other foreign financial assets, including interests in offshore trusts and corporations, bonds, foreign mutual funds, foreign annuity and insurance policies.

> *As an indication of the seriousness of the IRS focus on tax compliance for virtual currencies, the IRS recently served Coinbase, the largest public virtual currency exchange, with a summons seeking information on Coinbase customers who may not have properly reported profits to the IRS.*

You must electronically file the FBAR (FinCEN Form 114), if you had beneficial ownership of, or signature or other authority over, any foreign financial account, if the aggregate value of such account(s) exceeded $10,000 at any time during 2017. The FBAR is due on the same day as your income tax return. The FBAR also applies to foreign insurance policies, annuity policies, retirement plans and other financial products. A recent change extends the FBAR to online gambling/gaming accounts. The FBAR must be filed electronically on FinCEN's website.

If you had an interest in a foreign entity such as a foreign trust or foreign foundation, or if during 2017 you received assets from a foreign entity, then you may also be required to file additional IRS forms, including IRS Forms 3520 and 3520A. If you had an interest in a foreign corporation, and the foreign corporation is a "Controlled Foreign Corporation" (which generally means that more than 50% of the voting power was owned by U.S. shareholders), then you must file an additional form, IRS Form 5471.

Reporting Foreign Income

You must report all foreign income (including overseas wages, interest, capital gains, dividends, pension distributions, rent and royalties). If you held investments in foreign mutual funds or hedge funds, you may be required to file additional tax forms applicable to Passive Foreign Investment Companies, such as IRS Form 8621.

Bitcoin and Virtual Currencies

By: Asher Rubinstein, Esq.

An IRS offensive against virtual currency non-reporting is similar to the way the IRS has pursued foreign banks to uncover "secret" offshore accounts that had not been properly reported.

The IRS considers virtual currencies to be "property" subject to income tax, rather than currency like dollars. Thus, if you sell Bitcoin or any other virtual currency for a profit, that profit is income and is subject to capital gains tax. You must report the income on your tax return, specifically on IRS Form 8949, which is then attached to Schedule D of Form 1040.

If you exchange any virtual currency for goods or services, that too is a taxable event. For example, if you use Bitcoin to purchase a product on Amazon, the purchase is not considered the same as buying the product for cash. Instead, the IRS considers you to have "sold" the Bitcoin in exchange for the product, and you have earned taxable income equal to the price of the product minus your cost basis in the Bitcoin (i.e., what you paid for the Bitcoin used to purchase the product).

As an indication of the seriousness of the IRS focus on tax compliance for virtual currencies, the IRS recently served Coinbase, the largest public virtual currency exchange, with a summons seeking information on Coinbase customers who may not have properly reported profits to the

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IRS. Last November, a federal district court ordered Coinbase to hand over much of the information requested.

On February 23, 2018, Coinbase notified about 13,000 users that it expects to disclose the information covered by the court's order within 21 days. Coinbase will reveal client information to the IRS, including client names, taxpayer identification numbers and Coinbase virtual currency transactions. It is expected that the IRS will utilize this information to begin audits.

Please contact us regarding tax compliance issues for Bitcoin or any other assets — offshore, onshore, or virtual.

The "Kiddie Tax" Has Grown

By: David N. Milner, Esq.

While many provisions of the recently enacted Tax Cuts and Jobs Act (TCJA) received wide spread publicity, several provisions received little attention in the press. Among these were the changes made to the "Kiddie Tax" provisions of the Internal Revenue Code.

What is the "Kiddie Tax"?

In order to avoid parents and grandparents transferring investments to their children/grandchildren with the expectation that the income would be taxed at lower rates, many years ago Congress imposed a Kiddie Tax, which required that the investment income of children be taxed at the same tax rates as their parents.

The new Kiddie Tax rules, which take effect this year, change the method of taxing a child's investment income. Under the new rules, investment income will be taxed using the tax brackets applicable to trust and estates regardless of the rate at which the child's parents pay tax. While the maximum rate of 37% applies to both trusts and estates and individuals, for trusts and estates the brackets are compressed.

For example, under the new Kiddie Tax rules, a 37% rate will apply to ordinary net unearned taxable income in excess of $12,500. By comparison, a single individual who is not subject to the Kiddie Tax having the same income will be taxed at the 12% marginal tax bracket. Much the same is true for long term capital gains and qualified dividends. Under the Kiddie Tax regime, long term capital gains and qualified dividends will be subject to a 20% tax if taxable income exceeds $12,700, while those not subject to the Kiddie Tax will not reach the 20% bracket until taxable income exceeds $425,800.

The new Kiddie Tax rules will apply if:

- The child does not file a joint return with their spouse, and
- At least one of the child's parents are alive, and
- The child has positive taxable income after subtracting any applicable deductions, and
- The child's unearned income (interest, dividends, other investment income and capital gains) exceeds the threshold amount for the tax year (for 2018 the threshold is $2,100), and either
  - The child is 17 or younger at the end of the tax year, or
  - The child is 18 at the end of the tax year and does not have earned income that exceeds half of their support, or
  - The child is 19 to 23 at the end of the tax year and (a) is a full-time student for at least 5 months during the taxable year and (b) does not have earned income that exceeds half of their support.

The new Kiddie Tax rules only apply to investment income. The child's earned income (i.e. wages) will be taxed at the child's regular tax rate; however, the child's applicable deductions will be applied to first offset earned income before offsetting any investment income subject to the potentially higher Kiddie Tax rates.

Effect of the New Rates

It is now entirely possible for investment income received by a child to be taxed at a greater rate than had the income been received by their parent or grandparent.

For example, assume a 16 year old has investment income of $22,100 in 2018, has no earned income and that his or her parents have taxable income of $275,000 and file a joint income tax return. The child's tax on his net unearned income of $20,000 ($22,100 less the annual threshold amount of $2,100) using the income tax brackets applicable to trusts and estates will be $5,786.50. Had this investment income been received by their parents, effectively increasing their taxable income to $297,100, the investment income would have been taxed at their marginal income rate of 24%, yielding additional income tax of $5,304.00. As applied to this family, the Kiddie Tax rules result in there being an additional tax cost to the family of $482.50.

While there very well may be many reasons to make gifts of investment income property to children and grandchildren, the impact of these new rules should be considered.

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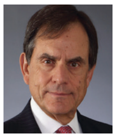

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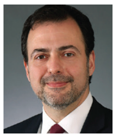

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