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Tax Preparer Penalty Under Code §6694 Favorably Amended

There has been significant controversy over the May 25, 2007 amendments to the tax return preparer penalties under Code §6694. The 2007 amendments made a number of important changes to Code §6694, including: (1) expanding the definition of tax return preparer, (2) applying the penalty provisions to nearly all tax returns, including gift and estate tax returns, (3) raising the standards of conduct that tax return preparers must meet to avoid penalties, and (4) increasing preparer penalties.

One of the most significant changes in the 2007 amendments was the requirement that a tax return preparer reach a "more likely than not" conclusion (that is with a greater than 50% likelihood) in order to avoid penalties on an undisclosed tax position. This was controversial because the "more likely than not" standard is a much higher standard than prior law to meet and also because the standard is higher than the standard that taxpayers themselves are subject to in order to avoid penalties.

To the delight of many tax professionals, the Emergency Economic Stabilization Act of 2008, which President Bush signed into law on October 3, 2008 removed the "more likely than not" standard and replaced it with a lower "substantial authority" standard. Tax return preparers are now subject to the same "substantial authority" standard as taxpayers for undisclosed tax positions. "Substantial authority" exists if the weight of authorities supporting the taxpayer's treatment is substantial in relation to the weight of those that take a contrary position. As stated above, the "substantial authority" standard is less stringent than the "more likely than not" standard, but more stringent than the "reasonable basis" standard which applies to tax positions that are adequately disclosed. (For tax shelters and reportable transactions, the penalty provisions retain the "more likely than not" standard.)

The failure for a preparer or tax advisor to meet the "substantial authority" standard for an undisclosed return position will result in a penalty with respect to each return or claim in an amount equal to the greater of $1,000 or 50% of the income derived with respect to the return or claim. Under the proposed regulations, reasonable cause and good faith may still form a basis for penalty relief.

Should you have any questions, contact Geoffrey Weinstein at (201) 525-6282, or gweinstein@coleschotz.com.

New Jersey Supreme Court Limits the Availability of Punitive Damages in Estate Litigation

A recent New Jersey Supreme Court decision limits the availability of punitive damages in estate disputes involving undue influence claims. In In re Stockdale, 196 N.J. 275 (2008), the Court considered the propriety of a punitive damage award entered against two individuals who pressured an elderly woman to sell her residence on inequitable terms and convinced her to create a new will naming one of them as the sole beneficiary of her estate. These individuals offered the new Will for probate following her death, but a beneficiary under the woman's prior will argued it was invalid because they had procured it through undue influence. Agreeing with the beneficiary, a judge refused to probate the new will and ordered the individuals to pay the beneficiary's attorneys' fees as a form of punitive damages.

The Supreme Court noted that punitive damages are typically inappropriate when an estate dispute involves family members and a claim that one member employed undue influence to gain a greater share of an estate's assets. Under those circumstances, the Court indicated that the appropriate remedy generally involves reducing the inheritance or statutory commissions the family member otherwise would have received from the estate by any amount obtained through undue influence. In contrast, the Court noted that a punitive damage award remains a viable possibility when those accused of undue influence do not possess any lawful inheritance or commission rights to reduce, such as third parties who are essentially strangers to the decedent. In those situations, the estate may sue to recover both compensatory and punitive damages.

The Court ultimately concluded that the individuals who had unduly influenced the elderly woman could be held liable for punitive damages because they were unrelated to her and did not possess any lawful inheritance or commission rights to abate. However, the Court rejected the method the judge used to calculate the award and instructed the judge to reconsider the matter in light of the evidence and general standards for awarding punitive damages.

In sum, the Court's decision has the practical effect of limiting the potential for punitive damage awards in most estate disputes involving a decedent's family members, while at the same time confirming that wrongdoers outside the decedent's family face the specter of punitive damages when they obtain an estate's property through undue influence.

Should you have any questions, contact Chris Massaro at (201) 525-6272, or cmassaro@coleschotz.com.

Estate Planning for Special Needs Children

Estate planning is an important aspect of an overall financial plan for any individual, but it takes on even greater significance for the parents of special needs children. Parents of special needs children face a number of unique estate planning decisions that should be carefully considered with professional assistance. These considerations include:

Naming guardians. If parents pass away, who will provide day-to-day care for a special needs child? This is a critical and difficult decision and must be provided for in the parents' wills.

Creating a special needs trust. A special needs trust is a trust that permits (but does not require) distributions to a special needs child for a variety of reasons. Often, distributions are permitted only to supplement but not supplant monetary support that the individual is receiving from governmental benefit programs such as Social Security Disability Income ("SSDI"), Supplemental Security Income ("SSI") and Medicaid. Failure to create a proper special needs trust can inadvertently disqualify the special needs child for these programs. The trust structure is also important to ensure that assets are not placed in a child's hands before the child is responsible enough to invest and use the assets prudently (if ever).

The choice of trustee for a special needs trust is another critical decision. A trustee should have financial savvy, should have the parents' complete trust, and should be or become knowledgeable regarding the child's needs.

Powers of attorney. A power of attorney allows an individual to appoint people to manage his or her assets and make investment decisions on his or her behalf. Having this document avoids the necessity of having to go to court to get someone appointed as a guardian if an individual cannot manage his or her own affairs. A power of attorney is important for all individuals, but in a special needs situation, it is important for both the parents and the special needs child.

Parents of an adult special needs child should also consider whether a power of attorney is adequate or if parents should be named as legal guardians of the adult child to better protect the child's interests. If there is a concern that the child cannot adequately manage his or her own affairs at all or could be taken advantage of, a guardianship (full or limited) may be more appropriate.

Life insurance. Life insurance is typically used to ensure that sufficient assets are available to provide adequate income to the surviving spouse and to provide for the care of children until they finish schooling and are able to earn a living. In a special needs situation, life insurance can be used to fund a special needs trust to provide assets for the rest of the child's lifetime. This may be especially important if parents can no longer provide the care the child needs.

While estate planning is essential for any individual, for a special needs parent it takes on additional significance. In addressing the estate plan, a parent should make sure he or she is being counseled by an attorney with experience in this area.

Should you have any questions, contact Lori Wolf or Mary Browning at, respectively, (201) 525-6291 or (201) 525-6247, or loriwolf@coleschotz.com or mbrowning@coleschotz.com.

Code §121 Exclusion of Gain on the Sale of a Principal Residence Negatively Changed to Tax the Gain from Periods of Nonqualified Use

The Housing Assistance Tax Act of 2008 (perhaps intended to assist the IRS?) was signed into law on July 30, 2008, and significantly changes the Code §121 exclusion of gain on the sale of a principal residence by taxing the gain on a property that is attributable to periods when the property was not used as a principal residence.

Under the old law, homeowners qualified for the exclusion of $500,000 for married couples filing jointly ($250,000 for single filers) if they used the home as their primary residence for two of the past five years.

Under the new law, for sales and exchanges after Dec. 31, 2008, the exclusion of gain rule will not apply to the extent gain from the sale or exchange of a principal residence is allocated to periods of nonqualified use. Generally, nonqualified use is any period (other than the portion of any period before Jan. 1, 2009) during which the property is not used as the principal residence of the taxpayer or spouse. Use of a residence as rental property or as a vacation home is nonqualified use. The gain in the property is allocated proportionately over the total period of ownership.

For example, assume that Marie purchased a vacation residence on January 1, 2005, converted it to her principal residence on January 1, 2011, and sold it on Januray 1, 2015 for a gain of $200,000. Marie qualifies for the Code §121 exclusion because she used the residence as her principal residence for four out of five years (2011 to 2015) prior to selling. Her period of nonqualified use is the period from January 1, 2009 to January 1, 2011 (the generous effective date rule provides that periods prior to January 1, 2009 do not count as nonqualified use). Marie's $200,000 gain over 10 years of ownership is deemed to occur $20,000 per year (note that appraisals are not needed to allocate the gain between periods of qualified and nonqualified use). Thus, $40,000 of gain (for the two years of nonqualified use) will be subject to tax.

If the taxpayer moves out of a principal residence, the period after the move is not counted toward nonqualified use, and the old two out of five year rules apply.

Should you have any questions, contact Jamie Kerstetter at (201) 525-6254 or jkerstetter@coleschotz.com.

Tax, Trusts & Estates Department

Name	E-Mail	Direct
Michael H. Forman, Chairman	mforman@coleschotz.com	(201)525-6333
Henry M. Matri	hmatri@coleschotz.com	(201)525-6235
Marc R. Berman	mberman@coleschotz.com	(201)525-6270
Samuel Weiner	sweiner@coleschotz.com	(201)525-6260
Steven D. Leipzig	sleipzig@coleschotz.com	(201)525-6340
Alan Rubin	arubin@coleschotz.com	(201)525-6325
Jeffrey H. Schechter	jschechter@coleschotz.com	(201)525-6315
Lori I. Wolf	loriwolf@coleschotz.com	(201)525-6291
Gary A. Phillips	gphillips@coleschotz.com	(646)563-8931
Steven M. Saraisky	ssaraisky@coleschotz.com	(201)525-6259
Geoffrey Weinstein	gweinstein@coleschotz.com	(201)525-6282
Tishya M. Signorelli	tsignorelli@coleschotz.com	(201)525-6353
Mary R. Browning	mbrowning@coleschotz.com	(201)525-6247
Leopoldo D. Matarazzo	lmatarazzo@coleschotz.com	(201)525-6220
Jamie A. Kerstetter	jkerstetter@coleschotz.com	(201)525-6254
Andrew L. Baron	abaron@coleschotz.com	(201)525-6238

Cole, Schotz, Meisel, Forman & Leonard, P.A.
A Professional Corporation
Attorneys at Law

www.coleschotz.com

Court Plaza North
25 Main Street
Hackensack, NJ 07602-0800
201.489.3000

900 Third Avenue
16th Floor
New York, NY 10022
212.752.8000

1000 N. West Street
Suite 1200
Wilmington, DE 19801
302.652.3131

300 East Lombard Street
Suite 2000
Baltimore, MD 21202
410.230.0660