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The Tax Treatment of Bonuses Presents Audit Exposure to Businesses



A company's treatment of bonus accruals may create IRS audit exposure for accrual method taxpayers.

Under IRC Sec. 446, bonuses must meet an “all events test” to be accrued at year-end. The all events test requires that the bonus obligation be a fixed legal obligation at year end and the amount of that bonus obligation be determinable with reasonable accuracy. In short, the obligation must be payable in “all events.” In addition to the all events test, bonus deductions are deferred compensation that are subject to the Sec. 404 rule that the bonus must be paid within two and one-half months after the end of the year in which it is accrued. Both conditions must be satisfied for the bonus to be properly accrued.

Many bonus programs flunk the all events test because the bonus is subject to some discretion or risk after the end of the year. For example, the board may not approve the bonus pool until after financial statement earnings are determined or perhaps bonuses are paid only to employees who are still employed by the company on the date the bonuses are paid. Such discretion or risk is sufficient for the bonuses to fail to meet the all events test because it is not payable in all events, i.e., it is not payable if the board exercises its discretion not to approve the bonuses or one or more employees were to leave the company voluntarily or involuntarily before the bonuses are paid. Here, is it not important what actually happened but what might have happened. The fact that the board actually approved the bonus pool or no employee left the company does not cause the accrual to meet the all events test retroactively. Rather, it is the possibility that the bonus would not be approved and the possibility that an employee might leave

that causes the entire bonus accrual to fail the all events test. Many bonus programs do not meet this test and therefore present IRS audit exposure. As a result, this item can become an uncertain tax position that must be considered during financial audits.

On the positive side, there is an opportunity to eliminate this exposure by filing an automatic accounting method change with the IRS national office. These filings provide a sort of tax amnesty complete with audit protection, relief from any interest and penalties, relief from the obligation to amend returns, and a four-year spread of the catch-up adjustment (in this case unfavorable to the taxpayer) that adds back the bonus accrual at the end of the year preceding the year of the method change. Such a filing may provide a tax cash flow benefit because of the favorable terms and conditions for such changes. There is also a further opportunity to restructure the company's bonus program to meet the all events test in the future.

This issue has been the subject of heightened scrutiny by the financial audit firms and the IRS. Look for your financial auditor to give this item greater scrutiny this year.

To identify whether your company has this issue, here are the questions you need to consider:

- Do you offer bonuses to your employees?
- If so, is the bonus paid after the end of the year?
- If so, is the bonus accrued for financial reporting and tax purposes?
- If so, does the employee forfeit the bonus if not employed by the company on the payment date for the bonus? [If so, the bonus does not meet the all events test.]
- Does the employee forfeit the bonus only if the employee breaches a contract, violates a company policy or commits an act of malfeasance before the payment date for the bonus? [If so, the bonus may still be accruable because the forfeiture is a "condition subsequent" that unfixes the right to the bonus rather than a "condition precedent" that prevents the accrual of the bonus in the first place.]
- If the bonus is forfeited, is the forfeited bonus required to be allocated to other employees? [If so, the bonus may meet the all events test and be accruable.]
- Is the bonus approved by the board or other committee or person authorized under the bylaws to approve bonuses before year-end? [If not, the bonus does not meet the requirement that there be a fixed legal liability at year-end.]
- Is there a discretionary aspect of the determination of the bonus that has not been resolved at year-end, e.g., client satisfaction surveys, subjective evaluations by managers, etc? [If so, the bonus will not satisfy the all events test at year-end unless there is some portion of the bonus that is not discretionary.]

If the responses to these questions indicate that the company's bonus program does not meet the all events test at year-end, an automatic method change is available that generally can be made for either the 2009 or 2010 tax years under Rev. Proc. 2008-52 as updated by Rev. Proc. 2009-39. If the change is made in 2009 or 2010, and is then resolved by the end of 2010, there could be a substantial additional timing benefit from the change in method. This is because the catch-up adjustment to account for the change in method is spread over four years, the delayed 2009 deduction under the new method is taken into account in full in the year of payment, and the accrual at the end of 2010 may be deducted if the program terms are modified so that the deduction meets the all events test at year-end. Thus, an amount deducted in full incorrectly in 2009 may be deducted again in 2010, this time correctly under the new proper method. Additionally, the add-back from the 2008 deduction is spread over the 2009 through 2012 years, one-fourth each year. Depending on the numbers, a change in method in 2009 may be more beneficial than

one in 2010 or vice versa. Therefore, modeling is necessary to determine an appropriate year to change the company's method.

The opportunity to restructure involves correcting the aspect of the bonus program that causes it to fail the all events test, e.g., accelerate board approval, have the board approve a bonus pool that would be split among remaining eligible employees if one employee were to leave, make a portion of a fully discretionary bonus formulary so that at least part of the bonus meets the all events test at year-end.

If your company has this issue, it is not too late to make a change for 2009. Even companies that have already filed tax returns can amend those returns to make an automatic method change by taking advantage of an automatic extension to file by the extended due date of the return. Alternatively, the company may choose to make this change in 2010 instead. There is no obligation to make the change in the earlier of the two years. In short, a change in accounting method change can give this cloud a silver lining.



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Choosing the “Right” Form of Entity: C-Corp, S-Corp, GP or LLC



Successful businesses choose an organizational structure based on its future goals.

These businesses consider both the current and future capital needs of the business, owner’s liability for the actions of the business and tax minimization that may be achieved by selecting the proper form of business. While it is important to choose the proper entity structure at the beginning, key changes in the business environment—whether economic, regulatory or legislative—should also lead a business to consider whether its current organizational form is optimal. While changing the form of an ongoing business is possible, careful consideration should be made to avoid possible unintended tax consequences from the restructuring.

The four main entity structures in use today are the C Corporation, the S Corporation, the General Partnership and the Limited Liability Company. The most popular entity choice for large businesses is the C Corporation. The major advantage of doing business as a C Corporation is that, except in very rare circumstances, shareholders are not liable for the actions of the corporation. The C Corporation is also the simplest form of ownership in a business as there are no issues of special allocations or flow-through activity as there are in other entity forms. These advantages make it easier for a corporation to raise capital. Additionally, the graduated tax bracket structure for corporations may make it an attractive alternative for businesses with lower levels of income, such as small closely held businesses. For example, a C Corporation with \$75,000 of taxable income will pay \$13,750 in tax or an average rate of 18.33% in 2009. In contrast, a single individual with \$75,000 of income would pay \$14,937 in tax or an

average rate of 19.92% in 2009. The difference becomes more apparent when the individual has personal income from other sources that would cause income to be taxed at the higher tax bracket (the top individual bracket was 35% in 2009). This distinction is likely to become an even more important consideration with the probable increase in individual tax rates anticipated in 2010. Ownership through a C Corporation, however, is the least tax efficient solution for most businesses because its income is taxed twice; once as income to the corporation and once as dividend income to shareholders. Additionally, C Corporations may be subject to the Corporate Alternative Minimum Tax, Accumulated Earnings Tax, Personal Holding Company Tax as well as the personal service corporation rules.

The S Corporation is a special form of corporation that has been popular for closely held businesses. S Corporations have the advantage in that the income earned is not taxed at the entity level, but rather flows out of the entity and is taxed at the individual level. In addition, this income may not be subject to additional employment taxes. As this form of entity was intended to provide this special treatment to small business owners, there are significant limitations on the qualification of an S Corporation. S Corporations are also limited to having one hundred or fewer owners. The S Corporation may only issue one class of stock. Additionally, shareholders can only be natural persons, ESOPs, or certain trusts. These restrictions may significantly limit the ability of an S Corporation to raise equity capital. Like C Corporations, owners of S Corporations enjoy limited liability for the actions of the corporation. S Corporations also offer the advantage of not being subject to the Corporate Alternative Minimum Tax, the Accumulated Earnings Tax or the Personal Holding Company Tax. Provided the current or anticipated income is sufficient, the avoidance of double taxation is important and the future capital requirements of the entity would not require investment from disqualified owners (see above), then the S Corporation form may be advantageous.

Partnerships are perhaps the oldest form of business entity. Modern partnerships are usually formed with one General Partner that bears liability for the actions of the partnership along with many Limited Partners who bear no such liability. Unlike S Corporations, owners of a partnership are not limited to natural persons, ESOP and certain trusts; therefore, it may be possible to achieve total limited liability if the General Partner is an entity with limited liability (i.e. a C Corporation). Partnerships are still less likely to be used than the Limited Liability Company, discussed below, because of liability issues. Additionally, accounting for partnership items such as contributions to the partnership, special allocations to partners, the treatment of undistributed income and the basis for non-recourse liabilities of the partnership can be extremely complex. While they are complex, these special allocations may help to achieve an appropriate economic result for an investment. For example, a partnership may issue preferred interests that would provide a more consistent return on investment and may attract new investors. The main advantages of the partnership are that it is a pass-through entity whose income is only subject to one level of tax and its distribution of assets is typically tax free. It should be noted that the income from a partner who is actively involved in the business will be subject to self-employment taxes, in contrast to the S Corporation owner who may not be after considering reasonable compensation.

In more recent years, the Limited Liability Company (LLC) has become a more popular choice of business entity for small and medium size businesses because it combines many of the advantages of the C Corporation, S Corporation, and the partnership. Like the C Corporation and Partnership, LLCs allow for unlimited ownership, which allows for a wider range of possible investors. The LLC also allows for the same limited liability enjoyed by the owners of a C Corporation. Unlike the C Corporation, however, the LLC is a pass-through entity, thus the income of the business is only subject to one level of tax. The LLC does have many of the same complexities as the

partnership, including the requirements to calculate the equity basis for contributions to the LLC by its members and issues involving both special allocations of income, the treatment of undistributed income and self-employment taxation of actively involved partners.

Many important considerations go into choosing the form of entity including owner's liability, raising equity capital, potential exit strategies and the tax effects of the form chosen. Businesses should consult with their tax advisors when choosing the form of entity in which they want to operate and should continue to consult with their advisor when the business environment changes.



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2010 State Tax Update



It is no surprise that the economic recession has resulted in serious revenue shortfalls and driven state legislatures to consider tax increases to support their budgets.

In order to close their budget deficits, many states opted to either pass new legislation that modifies existing tax law or implement new tax measures. For example, many of the legislative changes that states have chosen to implement range from simply imposing tax rate increases to other more creative legislative solutions such as the following:

- Modifying state income tax filing methodologies
- Adjusting the rules for allocation and apportionment of income
- Adopting different nexus standards
- Changing certain aspects of conformity to the Internal Revenue Code
- Revising related party transaction rules
- Imposing limitations on certain deductions
- Implementing various tax amnesty programs

These legislative changes will affect a range of state taxes including, but not limited to, personal income taxes, corporate income taxes, and sales and use taxes. Ultimately, each of these modifications shares the common goal of creating the additional revenue necessary to balance state budget deficits. Following is a summary of some of the changes that are effective in 2010:

Personal Income Tax

- California increased income tax rates by up to .25% for all income tax brackets for the 2009 and 2010 tax years.
- Delaware increased its highest marginal tax rate from 5.95% to 6.95%.
- New York passed legislation that adds new tax brackets and tax rates for high net worth individuals. The new provisions are effective for tax years 2009 to 2011 and provide for a highest marginal rate of 8.97% for individuals with taxable income in excess of \$500,000.
- Colorado and Vermont enacted new provisions which reduce capital gains deductions or exclusions.

While we clearly see a trend towards states imposing tax increases such as those illustrated above, some states have either enacted or are contemplating some form of tax reduction such as the following:

- Vermont decreased its highest marginal tax rate by .45%.
- New Jersey previously increased its highest marginal tax rate for 2009; however, beginning in 2010, New Jersey's highest marginal tax rate will revert back to the rate that was in effect for 2008 (a 1.78% reduction in the rate from 2009 to 2010).
- The Maine legislature passed a new law that implements a new tax with a top rate of 6.85% - a decrease from the 8.5% rate in effect prior to 2010. The law will be put to a citizens' referendum vote in June 2010.

Corporate Income Tax

- Massachusetts, West Virginia and Wisconsin adopted mandatory unitary combined filing provisions for the 2009 tax year (i.e., returns due in 2010).
- The District of Columbia enacted legislation that will require unitary combined reporting for tax years beginning after December 31, 2010.
- New Mexico recently announced plans to reintroduce combined reporting legislation during the state's 2010 legislative session.
- In conjunction with the switch to unitary combined filing, Massachusetts also lowered the tax rate for the income measure of the state's excise tax from 9.5% to 8.75%.
- Indiana and Pennsylvania modified their apportionment factor weighting methodologies to provide for increased emphasis on the sales factor. The sales factor weighting in both states is now 90%.
- New York modified its annual filing fee for flow-through entities to apply to regular partnerships for 2009 tax returns due in 2010.
- New Jersey elected to extend the life of its 4% business tax surcharge through tax years ending prior to July 1, 2010. The surcharge was initially scheduled to expire in 2009.
- Pennsylvania elected to postpone the phase out of its capital stock and franchise tax until 2014. The tax was originally due to phase out in 2010.

Sales and Use Tax

- Beginning April 1, 2009 through June 30, 2011, the California state sales tax rate is raised one percentage point.
- The governor of Arizona is advocating a one cent increase in the state's sales tax that will be in effect for three consecutive years. The proposal may appear on a ballot sometime in 2010.
- Kansas reduced its statute of limitations for sales and use tax refunds. The statute was reduced from three years to one year from the due date of the return.

- A growing trend that we witnessed among the states over the past twelve months is the adoption of legislation to impose sales tax on digital goods and/or other services provided electronically. Examples of such states include: Kentucky, North Carolina, Vermont, Washington and Wisconsin.

Tax Amnesty Programs

Finally, many states chose to offer tax amnesty to taxpayers in an effort to raise additional revenue. These amnesty programs allow taxpayers who failed to file a return, or underreported tax, to pay the prior year taxes owed while allowing many participants to avoid criminal prosecution, most civil penalties and sometimes a portion of the interest due.

A handful of states already scheduled or proposed amnesty programs that will become effective during 2010. These amnesty programs will apply to most individual and business taxes. The following states have amnesty programs that are scheduled for 2010: District of Columbia, Massachusetts, Maine, Michigan, New York, Pennsylvania and Tennessee.



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Navigating the Estate and Gift Tax Maze



The estate and gift tax law is generally a complex labyrinth, and with the arrival of the new year there is an added degree of uncertainty that makes it even more perplexing.

Under the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), the federal estate and generation skipping transfer taxes were repealed for one year starting January 1, 2010. The gift tax continues with a \$1 million lifetime exemption and a top rate of 35%, which is down from the highest gift tax rate of 45% in effect in 2009. However, due to increasing budget deficits and the political dynamics of the current Congress, there is a good chance an estate and generation skipping transfer tax will be reinstated, along with reforms to the gift tax, perhaps retroactively to January 1, 2010.

Whether and when Congress will act is difficult to predict, which increases the number of balls in the air for those planning transfers. Even though there is broad consensus to enact tax legislation, issues such as healthcare, financial regulations, and job creation are undoubtedly higher on the political agenda. Despite the inherent unfairness to some, many legal scholars believe legislation could be drafted to apply retroactively to January 1, 2010 in a manner that does not violate the Constitution. Of course, such retroactive legislation will likely spur litigation, further clouding the state of the law. Alternatively, Congress might enact legislation effective as of the date of its introduction, enactment or some other date in 2010. It is impossible to know what final form any Congressional action would take but, based on recent proposals, the estate and generation skipping transfer tax may be reinstated with tax exemption amounts of \$3.5 - \$5 million with a top tax rate at 45% on all transfers,

including gifts.

On the other hand, Congress could choose to take no action. Under the sunset provisions of EGTRRA, on January 1, 2011, the gift, estate, and generation skipping transfer tax provisions return to the pre-2002 law which imposed much more onerous taxes on transfers. Without Congressional action, in 2011 the gift, estate and generation skipping transfer tax exemption would be \$1 million with the top tax rate of 55% (plus a surcharge of 5% on transfers between \$10 million and \$17,184,000).

Gifts in 2010

Although each individual's circumstances are unique, many are reluctant to make gifts above the \$1 million lifetime exemption amount to avoid paying any federal gift tax. However, the potential that the current 35% gift tax rate will not be retroactively changed to a higher rate may tempt some to consider making taxable gifts. This 35% tax rate is far below the 55% tax rate imposed in 2011 if Congress takes no action. The difficulty is that, at this point in time, it is impossible to know the exact tax implications of making taxable gifts. If Congress successfully enacts legislation that retroactively increases the tax rate, then the gift tax owed may be higher than anticipated at the time of the transfer. Additional tax implications arise if such a gift could retroactively be considered a generation skipping transfer. As such, there is the risk that making taxable gifts now could unnecessarily accelerate the payment of gift and generation skipping transfer taxes that could be reduced over time with other planning opportunities.

Estate Tax Law in 2010

As discussed above, if Congress takes no action then there is no estate tax in 2010, which could result in substantial tax savings for large estates. However, problems may arise since many wills and trusts contain sophisticated clauses that reference the estate tax that may not be in existence. These clauses may, for example, cause an unintentional over or underfunding of marital trusts, credit shelter trusts, generation skipping transfer trusts, and charitable bequests in a manner that does not conform to the estate owner's true objectives. As such, wills and trust documents should be reviewed in light of the evolving tax law, particularly for those who are not in good health. Depending on the language in existing estate planning documents, it may be prudent to create a will codicil or amend revocable trusts to consider that there may be no federal estate tax or generation skipping transfer tax in 2010.

Carryover Basis

As part of the elimination of the estate tax, EGTRRA also added a twist on the income tax basis rules of inherited property. Prior to 2010, the income tax basis of property inherited was its fair market value on the decedent's date of death (or 6 months after death if an alternate valuation election was made). If a decedent owned highly appreciated assets then prior to 2010 the appreciation that occurred prior to death would escape capital gains tax. The income tax basis of property inherited while the estate tax is repealed is generally the lesser of the adjusted basis of the property in the hands of the decedent or the fair market value at the date of death. The new carryover basis rules thus eliminate the ability to avoid income tax on the unrealized appreciation in assets held by the decedent.

Under the new carryover basis rules, executors may generally elect to increase the basis of estate property by up to \$1.3 million for assets left to any designated beneficiaries, but not in excess of the fair market value of the property at the date of death. Also, executors may elect to increase the basis of up to \$3 million for assets passing to a

surviving spouse, but not in excess of the fair market value. In light of the ability to increase the basis by \$1.3 million and \$3 million, planning may need to be done to make sure each spouse has enough appreciated assets to take advantage of the basis adjustment.

Of course, compounding the complexity, if the estate tax is reinstated in 2010 then the new carryover basis rules would not be applicable, which, as discussed above, could be done retroactively. In addition to the federal estate tax, many states impose separate estate and inheritance taxes that can be substantial and need to be considered as part of any estate plan. WTAS is prepared to assist you in navigating the bewildering maze of the estate and gift tax law, as well as help you develop tax planning opportunities for these uncertain times.



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Charting a New Course: Investing in a Volatile Market



2009 began with the worst two-month start in S&P 500 history, but by the end of the year a rally led largely by high-beta, low-quality stocks, helped the S&P 500 recover about half of its total bear market loss.

While this run up was certainly encouraging, the S&P 500 is still over 28% shy of its all-time high and ended the decade with the worst 10-year period on record for the index, producing an average annual loss of 1.0% over that period.

Reservations persist and there is still no official declaration that the recession has ended. However, many indicators signal that the economy has been improving since mid-2009. GDP increased by 2.2% in the third quarter and showed a strong improvement for the fourth quarter, increasing by 5.7% (best since 2003). Corporate earnings, which have improved faster than expected thanks to aggressive cost-cutting, closed out 2009 with another solid reading. Housing prices have stabilized in recent months, retail sales have rebounded, and consumer sentiment is moving higher. Corporate and consumer balance sheets alike have been improved by cutting spending and paying down debt.

We enter this new decade with the economy in a delicate balance of hope and hesitation. The challenges we will encounter in the coming months are likely to be pivotal in both the direction and magnitude of change to the economy and markets going forward. Some of the more significant challenges of today's investment climate include but are certainly not limited to:

- Anticipation of future government and central bank policy
- Aftershocks of fiscal and monetary stimulus and the effect on markets, long-term interest rates, inflation, and the value of the U.S. dollar
- Stubbornly high unemployment and its effect on consumer spending (historically comprising about 70% of U.S. GDP)
- Probable higher tax rate environment
- A fatigued housing market subject to a possible rise in mortgage rates (after the Fed ceases its purchasing mortgage-backed securities) as well as the risks of additional foreclosures and “shadow inventory” in the residential and commercial real estate sectors

Looking forward to the new year, our strategic recommendations are necessarily broad in the context of this piece. However, as the year develops we will expand on specific areas of opportunity for investors. At this juncture, however, we propose that it is most prudent for investors to focus on their asset allocation policy, assumptions, and methodology before implementing any tactical asset decisions.

The Importance of Asset Allocation & Liquidity Management

To many, the recent recovery may have seemed like a tidal wave raising nearly all asset classes as it made its way ashore, similar to how it had swept them all away in the previous decline. Investor patience and asset allocation commitments were tested, but for those who stayed the course, a significant amount of their bear market loss should have been recovered.

Seminal studies have indicated that over 90% of investor returns are derived from strategic policy decisions (1986, Brinson, Hood & Beebower). We advise investors that it may be even more imperative at this point in the markets to revisit asset allocation and the specific goals and objectives of the investment policy. However, we also suggest that the process of asset allocation has fundamentally changed from merely charting a course and periodically monitoring the progress, to a more intensive and continuous function whereby long-term targets are thoughtfully compared and contrasted to shorter-term environmental conditions. The assumption that returns will revert to historical trends and follow the concept of a normal distribution over time must constantly be tested against current obstacles and opportunities. Further, while we think asset allocation policy should be within finite bounds to maintain objectivity within the investor’s constraints, it should be fluid enough to accommodate the “economic reality” of the time, placing liquidity at the forefront of the investment process.

Management of liquidity has been extremely challenging in the recent environment and the vast majority of programs have endured less than desirable results. Cash vehicles experienced rapid growth within securitized sub-asset classes (most notably mortgages) and the changing world of liquidity management blindsided cash management professionals and investors. As portfolio managers extended their liquidity pools amongst a variety of spread sectors, cash was—and continues to be—exposed to unintended credit risk.

Investors must step back and re-examine the role of liquidity in their portfolio. Specifically, the timing and magnitude of their liquidity needs, whether their needs are predictable or “on demand,” whether they are focused on capital preservation or income generation, and their general capacity to take risk. Once a framework is developed, liquidity goals and objectives can be met by spreading cash or short-duration investments across successive tiers, thereby reducing risk. Beginning with a tax-exempt money fund, investors can move up the yield spectrum by implementing tiers of short-term municipal bonds, prime money market funds, laddered CDs, or

other higher yielding fixed income options. Structuring liquidity into tiers will distinguish the capital-preserving buckets from the yield-enhancing liquidity segments and ensure compliance with the pre-determined framework. Cash is paramount in lending elasticity to a portfolio, enabling rebalancing, facilitating tactical shifts and changing strategic directions without being bound by the cost of transitioning the portfolio.

Portfolio Strategies for 2010

As previously noted, the economic headwinds are numerous. Many investment professionals assert that we are entering a multi-year period with deflated consumption, increased savings and massive de-leveraging. If a recovery is not likely to be led by the consumer or by leverage, where can investors look to enhance returns and reduce risk?

In the new environment, differentiation between the winners, survivors and losers is likely to be more apparent. Those companies with clean balance sheets, free cash flow, and top and bottom line earnings growth should lead their peers, since they should be able to expand earnings organically rather than relying on financing. To execute a strategy based on this premise within the domestic equity arena, investors should retain holdings of well capitalized, high dividend yielding institutions in recession-resistant sectors that still offer relative value. In the international and emerging market equity space, the focus should be placed on countries where debt is coupled with strong reserves. Exposure to these markets can also simultaneously offer some protection against a further decline in the U.S. dollar when utilizing non-hedged strategies. Real estate investments (including REITs) should be approached with caution as the landscape for this asset class is cluttered with obstacles including pending foreclosures, rising interest rates and oversupply. For investors willing to digest additional risk, alternative assets—including hedge funds and commodities—may be able to provide attractive risk-adjusted returns in markets such as this given the right mix of strategy and manager acumen.

For fixed income investors, employing a portfolio of shorter maturity securities can provide some protection from impending interest rate risk and medium- to long-term inflation risk. Bonds at or near investment grade are recommended to avoid the potential default risk associated with some of those institutions that could end up on the wrong side of differentiation. If credit quality suffered further deterioration, high-yield debt would be another sector for which we would urge cautious consideration.

When considering investment in any sector of the market, gradually implementing additional capital by means of a dollar cost averaging timetable is recommended for investors who strive to make the investing process less susceptible to timing risk. By sacrificing potential upside to reduce potential downside in volatile markets, a strict commitment to a dollar cost averaging schedule also removes much of the emotion involved with executing an asset allocation, and frees the investor from hastily altering course at the whim of a market pundit or newspaper headline.

Please contact a WTAS investment consultant should you have any questions relating to this newsletter article or your investment portfolio.



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State Tax Impact of Widening State Budget Gaps



With the economy in one of the worst downturns in history, state governments have begun to face the stark realities of the recession.

Most states have seen unprecedented unemployment and unemployment claims draining the system. While the funding for these claims is supplemented by the federal government, the states have seen total revenues drop to an extent they have never experienced.

California has been the hardest hit to this point. California implemented numerous program cuts and revenue enhancers in order to balance their budget, but to no avail. Yet, California is not the only state in this situation. According to the Pew Center on States, more than ten states are showing the same symptoms that led to California's crisis. Illinois and New Jersey have specifically been singled out as states that have "punted" responsibility for their fiscal problems. They have used borrowing schemes and accounting adjustments to delay the inevitable pain of enacting actual revenue raising provisions to balance their budgets.

Unlike the federal government, states must find a way to raise revenue or cut expenses anytime a budget gap arises (all states, except Vermont, have balanced-budget statutes in place). Many states have cut funding for all non-essential programs already. States are now focusing more than ever on ways to raise revenue, as there is very little "fat" left to cut from their budgets. Revenues continue to drop and spending continues, opening additional gaps in the current budget and in next year's budgets. With the fiscal year 2011 budget process beginning soon, states need to continue to find money to close their budget gaps.

The most prevalent way for a state to balance its budget is to raise taxes. The District of Columbia recently raised its sales tax rate by .25%. They also raised excise taxes on cigarettes and gasoline. Personal income and corporate income tax rates are also being raised. North Carolina just placed a 3% surtax on top of its corporate income tax to raise additional revenue. Connecticut imposed a surtax on high-income households.

Another way some states have been able to raise money quickly is through the creation of an amnesty program, where taxpayers with unpaid liabilities can file back tax returns with the state and make good on the unpaid liabilities. In exchange, the state will generally abate any penalties accrued by the taxpayer and in some cases abate a portion of the interest. These programs have been very successful in states where implemented, and the revenue received has in many cases exceeded expectations, making this the perfect opportunity for other states to implement.

States are also expected to substantially step up audits while simultaneously slowing the issuance of refunds. While states are trying to work with taxpayers by offering amnesty programs, states will be more aggressive in going after taxpayers with unpaid liabilities who do not participate in such a program. It is expected that new amnesty program legislation will drop the hammer on non-participating taxpayers with ever-increasing post-amnesty penalties.

Types of Tax Law Changes

The states use many methods to raise taxes. The most obvious method is a tax rate increase. Yet, other legislative possibilities exist. For business entities, combined reporting seems to be a trend. Already we have seen the District of Columbia pass a combined reporting statute as part of their 2010 budget. Maryland required groups to file a combined informational report for the 2006 through 2011 tax years, and based on the information collected so far, the state would have collected over \$100 million of additional revenue for the 2006 tax year (the report projected that 70% of companies with incomes over \$25 million would have paid additional tax to the state if combined reporting had been in effect for 2006).

The domestic production activity deduction (DPAD) is another taxpayer beneficial provision that could come under fire by the states. DPAD was created by the federal government in 2004, and as most states conform to the federal tax code, the benefit was enjoyed by taxpayers on the state level as well. Originally, the federal DPAD was computed at 3% of qualifying income. However, in 2007, the percentage allowed was raised to 6%, and is increasing to 9% for the 2010 tax year. Currently, twenty-one states and the District of Columbia do not conform to DPAD. In 2009, Connecticut and Wisconsin decoupled from this provision. According to the Center on Budget and Policy Priorities, twenty-five states will lose revenue due to this provision in 2011, totaling an estimated \$505 million. Illinois, Florida, Pennsylvania and Virginia are expected to be the four biggest losers from this provision.

The current economic climate also gives states the opportunity to completely revamp their tax systems in order to provide for a more stable income stream in the future. Both Michigan and Texas are recent examples of this phenomenon. California enlisted a Commission to offer tax recommendations for a steadier income stream. The Commission's proposal was essentially a complete overhaul of the state's current tax structure. The proposal included dropping the current sales tax and corporate income tax. The Commission instead proposed a tax on the net receipts of businesses.

What will happen down the road remains to be seen. Some of the budget measures put in place by states now will

have a direct impact on future revenues. According to the Rockefeller Institute of Government, the long-term outlook is even worse, with estimated gaps two to four times larger than they are now.

Now is the time for states to begin looking at serious tax reform. While we don't know what changes are forthcoming, we do know with certainty the states will attempt to make many changes this budget season. Further, while tax increases may not be passed this year, rest assured the states will try again, as raising revenue seems to be a necessary part of the budgetary process as the states attempt to balance their budgets.



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California Use Tax: Do You Report Your Purchases On Your California Income Tax Return? It Now May Be Moot.



Have you noticed the line on your California Income Tax Return marked “Use Tax?”

The statement appears on all California Income Tax Returns but may be overlooked or misunderstood.

By way of definition, use tax is the complementary tax to sales tax and is generally imposed on transactions where the sales tax cannot be imposed on the seller but the tax is still due (e.g., purchases made from out-of-state vendors). Until recently the “Use Tax” line on the Income Tax Return was the main mechanism used by California to collect use tax from individuals and businesses not required to register with the Board of Equalization (“BOE”) as a “retailer.” However, the passage of Assembly bill AB X4-18, which added Section 6225 to the Revenue and Taxation Code, changed that.

Key Provisions of Section 6225

- a. Requires “qualified purchasers” to register with the BOE and report and pay by April 15th the use tax owed for purchases made during the calendar year.
- b. Defines “qualified purchaser” as a person that meets all of the following **conditions**:

1. The person is not required to hold a seller's permit.
2. The person is not required to be registered pursuant to Section 6226.
3. The person is not a holder of a use tax direct payment permit as described in Section 7051.3.
4. The person receives at least one hundred thousand dollars (\$100,000) in gross receipts from business operations per calendar year.
5. The person is not otherwise registered with the board to report use tax.

c. This provision becomes effective January 1, 2010.

The first two **conditions** required for classification as a “qualified purchaser” essentially limit the tax to use tax by eliminating any business that is defined as a “retailer” and thereby required to report sales tax on its sales. The third and fifth conditions eliminate from registration businesses that are currently registered for use tax purposes. Finally, discussions with and written guidance provided by the BOE indicate that *total* gross receipts, not merely California sourced gross receipts, are considered for purposes of the \$100,000 gross receipts threshold.

The Effects of Section 6225

Based on the criteria for “qualified purchaser,” the legislative committee summary supporting the legislation estimated that approximately 200,000 businesses would be required to register. This includes all professional service providers (e.g., attorneys, accountants, doctors) that meet the \$100,000 gross receipts threshold. However, this estimate may be conservative as many businesses may have several separate legal entities, such as single member LLCs, which are disregarded for income tax purposes but would individually be required to register for use tax reporting purposes.

Additionally the BOE is requiring that upon registration, registrants file past returns for 2007 and 2008 purchases, with the 2009 return due on April 15, 2010. Even if all 2007 and 2008 purchases were reported on the appropriate income tax returns, use tax returns must be filed with a credit taken for taxes previously paid. For any amounts previously unreported, the BOE will charge interest and penalty. A request for an abatement of penalty may be made but interest is imposed under a statutory provision and will not be waived. Finally, with limited exceptions, the BOE is requiring electronic (online) filing and payment of returns, which becomes available on March 1, 2010.

The Mechanics of Registration and Filing

Upon passage of the bill, the BOE began notifying potentially affected businesses by sending letters with the intention of businesses completing the registration process by January 1, 2010. While January 1, 2010 has passed, there are still a significant number of businesses that still need to register. In order to register, an application (BOE-404-A) must be completed and submitted to the BOE. The applicant will then receive the use tax registration number and be required to file the past returns. As previously indicated, online filing becomes available on March 1, 2010; however, if there are significant past due liabilities, the taxpayer should file paper returns prior to March 1, 2010 in order to stop interest from accruing. The taxpayer should then file the 2009 return by April 15, 2010. Even if the taxpayer made no purchases that are subject to use tax, a \$0 return must be filed.



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The Fair Market Value of Alternative Investments



Alternative investments include a variety of different asset classes, such as hedge funds, private equity funds, limited partnerships, venture capital funds and funds of funds.

The increasing use of alternative investments as an asset class within Family Limited Partnerships (FLPs) has drawn attention to the challenge of determining a fair, market-based value for an asset which essentially does not have an active market and thus impacts the value of the FLP. Simply relying on reported pro-rata Net Asset Value (NAV) may not be appropriate, as the fair value of the investment may be materially less.

The Financial Accounting Standards Board and the Internal Revenue Code basically state that the fair value of an asset or liability should be determined based on a hypothetical transaction at a measurement date, considered from the perspective of a market participant. In some cases it may be relatively easy to determine the value of an alternative investment fund as represented by the fund's NAV. However, if provisions within the fund restrict the investor's ability to redeem, the NAV may not represent fair market value as these restrictions create illiquidity, which would cause the investment to be traded or exchanged at a discount.

An approach to determine the value of an investment in an alternative investment involves finding similar transactions with the same or similar type of investments. Information on transactions involving Limited Partnership (LP) interests is not usually available in the public domain. Although there are some sources that can be used to gather information on historical transactions, these sources typically exclude important background

information on the nature of the transactions. For example, information provided may not reveal if the buyer was selling the shares to reallocate an existing portfolio or to raise cash to meet other obligations. These types of transactions may have been entered into under distress and therefore may not represent fair value.

Absent an active market or data representing a fair proxy to the fund investment, the valuation of the investment can be quite complicated. Liquidity discounts should be considered in determining the fair market value of an alternative investment (or an FLP that holds the investment) whereby no active market exists and the investor's ability to withdraw from the fund is restricted. A detailed analysis is required to determine the economic impact of these restrictions and arrive at an appropriate and defensible discount. Some factors that may impact the discount include the following:

- Assessment of any transactions involving the transfer or sale or an interest in the fund including an analysis of terms, price per unit, date of transaction, and other relevant factors.
- Consideration of any transactions presented and not permitted by the General Partner (GP)/Investment Advisor.
- Transactions that took place over the previous twelve months involving alternative assets of identical or similar characteristics.
- Additional "lock-up" provisions imposed over the previous twelve months or modifications (redemption fees, extension of lock-up periods, notification periods, gates, etc.) to redemption policies.
- Distributions paid to investors over the previous twelve months.
- If dividends or distributions are expected in the future.
- Whether or not there were redemptions made from the fund. If so, were the withdrawn interests perfected at NAV, below NAV or above NAV?
- Whether or not there were any fund subscriptions over the previous twelve months. If so, were the subscriptions being accepted? Are subscriptions under the same terms as previous subscriptions?
- Whether or not there were any liquidations of investments within the portfolio during the previous twelve months.
- The existence of allegations of fraud against the fund or fund manager.
- Any changes in financial strength within the fund or changes to key personnel within the fund's management team.
- The track record of the fund over the last five years, three years, one year and six months.
- The fund's vintage.

While assessing these factors and determining the impact of each on the investment's illiquidity is subjective and reasonable minds will differ, most parties agree that there are additional costs in terms of time and money when trying to locate a willing buyer for such an interest. A well reasoned assessment of the facts and circumstances can quite often result in a fair value of an alternative investment that is materially less than the pro-rata net asset value.



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