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FAS 141(R) – Impact on the Accounting for Income Taxes

Statement of Financial Accounting Standards No. 141 (revised 2007), Business Combinations, *(FAS 141(R)) becomes effective for most organizations with fiscal years beginning during 2009, and significantly changes acquisition accounting and the accounting for income taxes.*

The issuance of FAS 141(R) in December 2007 and the issuance of International Financial Reporting Standard 3 (revised 2007), Business Combinations, completed a joint effort by the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) to improve financial reporting of business combinations and to further the international convergence of accounting standards.

The objective of FAS 141(R), per Paragraph 1, "…is to improve the relevance, representational faithfulness, and comparability of the information that a reporting entity provides in its financial reports about a business combination and its effects…" To accomplish this objective, FAS 141(R) establishes guidance for how an acquirer recognizes and measures identifiable assets, assumed liabilities, and any noncontrolling interest in an acquiree and also how an acquirer recognizes and measures goodwill related to a business combination. FAS 141(R) also requires additional financial statement disclosures to assist financial statement users with the evaluation of the economic impact of a business combination.

FAS 141(R) applies to all business combinations in which an acquirer obtains control of one or more businesses. However, it does not apply to the formation of a joint venture, the acquisition of an asset or a group of assets that does not constitute a business, a combination between entities or businesses under common control, or a combination of not-for-profit organizations or the acquisition of a for-profit business by a not-for-profit organization.

FAS 141(R) retains the “acquisition method” (formerly known as the “purchase method”) of accounting for all business combinations and requires an acquirer to be identified for each business combination. The acquirer is the entity that obtains control of one or more businesses in the business combination and the acquisition date is the date that the acquirer achieves control. The “measurement period” gives an acquirer up to one year after the acquisition date to finalize business combination accounting.

Effective Date

FAS 141(R) applies to business combinations that are completed during a year beginning on or after December 15, 2008. However, there are certain provisions that may apply to acquisitions completed in years beginning prior to December 15, 2008 (i.e. acquired uncertain tax positions and acquired valuation allowances as explained below).

Highlights - Accounting for Income Taxes

Some of the changes under FAS 141(R) that impact the accounting for income taxes, pursuant to Statement of Financial Accounting Standards No. 109, Accounting for Income Taxes (FAS 109), are discussed below:

Acquired Uncertain Tax Positions

Under FAS 141(R), the determination of unrecognized tax benefits of the acquired entity as of the acquisition date will be subject to the measurement and recognition provisions of FASB Interpretation No. 48, Accounting for Uncertainties in Income Taxes (FIN 48). Any changes to the unrecognized tax benefits during the measurement period (that do not relate to facts and circumstances that existed as of the acquisition date) and subsequent to the measurement period are recorded as an adjustment to income tax expense. Under prior guidance, any changes in acquired tax contingencies would generally have been an adjustment to goodwill and other intangibles.

As noted above, the accounting treatment for changes to uncertain tax positions is one exception to the prospective application of FAS 141(R). Regardless of the acquisition date of a business combination, changes in acquired tax uncertainties beyond the measurement period are recorded as adjustments to income tax from continuing operations.

Acquired Valuation Allowances

FAS 141(R) amended FAS 109 to include the effect of a reduction in an acquired entity’s valuation allowance to be recognized through the income tax provision. However, if the change occurs in the measurement period and relates to facts and circumstances that existed at the acquisition date, then the change will be recorded to goodwill. Reductions in acquired valuation allowances are also an exception to the prospective application of FAS 141(R), and are recorded as a reduction to income tax expense.

Change in Acquirer's Valuation Allowance

Prior to FAS 141(R), a reduction in an acquirer's valuation allowance due to a business combination was recorded in goodwill. After the adoption of FAS 141(R), the reduction is a discrete item in the acquirer's income tax provision for the quarter in which the acquisition is consummated.

Tax Deductible Goodwill in Excess of Book Goodwill

FAS 141(R) amended FAS 109 to require a deferred tax asset to be recorded for the excess of tax deductible goodwill over book goodwill as of the acquisition date. This change in accounting ultimately increases the deferred taxes recorded as of the acquisition date as part of a business combination and decreases goodwill recorded for financial reporting purposes. Under prior guidance, a deferred tax asset was not recorded and the tax effect of the excess tax deductible goodwill was reflected as an adjustment to book goodwill in the period in which it became deductible for tax purposes.

Restructuring Costs

Under FAS 141(R), restructuring costs of the acquiree that are not obligations as of the acquisition date are charged to post-acquisition earnings. In certain circumstances, if restructuring costs are "liabilities" as of the acquisition date, then the liabilities can be accounted for as part of a business combination. For acquisitions occurring after the effective date of FAS 141(R), the book and tax treatment of restructuring costs will need to be determined and deferred taxes established as required.

Transaction Costs

Under FAS 141(R), transaction costs incurred as part of a business combination such as fees for investment banking, advisory, attorneys, accountants, valuation and other experts are to be expensed as incurred. For tax purposes, a determination of the future tax treatment of such costs needs to be made as the costs are incurred. If the costs will be tax deductible in the future (i.e. not capitalized in the tax basis of stock), then a deferred tax asset should be established in the period the costs are incurred.

This change in financial accounting can result in a significant impact on an entity's quarterly and annual effective tax rates. For example, if an entity incurs significant non-deductible costs for a potential acquisition, the quarterly effective tax rate would be increased by the resulting permanent difference. If later the acquisition is abandoned, the costs incurred could be deductible, resulting in a favorable permanent difference.

Assessing the Impact

The financial accounting changes included in FAS 141(R) have a significant impact on the accounting for income taxes related to business combinations. Many of the changes not only impact an acquirer's net income, but they also impact the quarterly and annual effective tax rates, making it even more important for financial and tax professionals to focus on and plan for the tax treatment of transaction costs incurred and the financial statement implications related to current and prior acquisitions.

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Getting a Second Chance from the IRS

Have you ever closed a transaction only to realize that it has disastrous tax consequences?

If you answered yes, you are not alone. Such situations often occur as a result of conducting business in a fast-paced, dynamic economy, but a solution may exist to eliminate the negative tax consequences - rescission. Rescission provides an opportunity to void a transaction and thereby treat it as if it never happened – a true “do over.”

The rescission doctrine originated with Rev. Rul. 80-58 which outlined the following key requirements to rescind a transaction for Federal income tax purposes:

1. The parties involved must return to the positions they were in prior to the transaction.
2. The rescission generally must occur within the same taxable year as the original transaction.

In Rev. Rul. 80-58, a taxpayer sold a tract of land to a third party in exchange for cash. The third party was unable to secure the required zoning, so it was necessary for the buyer to reconvey the property back to the taxpayer. Since the original sale and the reconveyance occurred in the same taxable year, IRS concluded that the sale was void and was ignored (no gain was recognized). Because the rescission of the sale placed the taxpayer and the buyer at the end of the taxable year in the same positions as they were prior to the sale, the original sale was disregarded for federal income tax purposes. The rescission extinguished any taxable income for that year with regard to the transaction. However, if the rescission had not occurred within the same tax year as the original transaction, IRS concluded that the consequences of the sale transaction in the first year would have been respected and the taxpayer would have been treated as reacquiring the land in the second year.

Rev. Rul. 80-58 summarizes the legal principle of rescission as follows:

> *The legal concept of rescission refers to the abrogation, canceling, or voiding of a contract that has the effect of releasing the contracting parties from further obligations to each other and restoring the parties to the relative positions that they would have occupied had no contract been made. A rescission may be affected by mutual agreement of the parties, by one of the parties declaring a rescission of the contract without the consent of the other if sufficient grounds exist, or by applying to the court for a decree of*

rescission.

Although the rescission doctrine has typically been used to rescind contracts, recent private letter rulings ("PLRs") suggest that the principles of Rev. Rul. 80-58 may also be used to unwind the formation or dissolution of entities, to reduce taxes, and to provide financial statement benefits for public companies. In one ruling (PLR 200843001), IRS allowed a foreign corporation to maintain its status as a disregarded entity where the sale of its stock was rescinded. IRS ruled that the parent company could apply the rescission doctrine to disregard the sale of its foreign entity's stock to a third party and to continue to treat the foreign entity as a disregarded entity from the date of the initial transaction. IRS also affirmatively ruled that the rescission of the foreign entity stock sale would not be treated as a liquidation of a partnership.

In another ruling (PLR 200701019), IRS permitted a taxpayer to rescind the Sec. 332 liquidation of a subsidiary in its consolidated group to preserve the higher outside basis in the stock of the subsidiary. The higher outside basis allowed the taxpayer to minimize the gain from an impending sale of the subsidiary. This ruling permitted the taxpayer to use hindsight to unwind a transaction in order to achieve a more favorable tax result.

In PLR 200613027, IRS allowed a taxpayer to rescind the incorporation of a limited liability company ("LLC"). As a result of the successful rescission, the parties avoided tax on any corporate-level and shareholder-level gain that would have resulted had the conversion back to an LLC been treated as a fully taxable liquidation.

Finally, in PLR 200533002, IRS permitted a taxpayer to rescind the issuance of preferred stock to avoid terminating its S election. IRS concluded that the shareholders of the company (seller) and the venture fund (buyer) were restored to the relative positions they would have occupied if the stock had never been sold to the fund. Since the restoration was achieved within the same taxable year, IRS ruled that the rescission doctrine applied so the parties could disregard the issuance of the convertible preferred stock and the company continued to be an S corporation.

IRS continues to issue favorable rulings on rescission transactions – eight rulings in the last three years, including three in the last three months. If you have been adversely affected by the tax consequences of a transaction, consult your WTAS tax advisor to discuss rescinding the transaction and to work through the potential issues:

- Is it possible to restore the parties to their relative tax and legal positions prior to the rescinded transaction?
- Do the parties have different taxable years that may impact the ability to rescind the transaction?
- Does state law impact the ability to rescind the transaction?
- Is an IRS ruling desired because of the materiality of the transaction or the risk tolerance of the parties?
- Have you considered and discussed with your auditor the financial statement ramifications of the planned rescission?

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Changing the Landscape on International Taxes

On Monday, May 4, 2009, the Obama Administration proposed significant changes to the taxation of international investments.

These proposals, together with proposals from Senator Carl Levin of Michigan and Senator Max Baucus, chair of the Senate Finance Committee, will likely form the basis for major international tax reforms that may be enacted this year or next. These proposals could significantly impact individual and corporate taxpayers with offshore bank accounts and foreign business operations. In this article, we examine key provisions of the proposals.

The President's Proposals

The Administration's proposals address two perceived loopholes. First, the proposals address the deferral of foreign income with the objectives of encouraging domestic job creation and funding a permanent research and experimentation credit. Second, the administration proposes to eliminate advantages for income earned through tax haven jurisdictions by both individual and corporate taxpayers. While no bill language has been proposed, the key provisions of an outline unveiled by the administration would:

- ***Disallow deductions for expenses attributable to income earned through foreign***

corporations while such income remains in foreign corporate solution. This proposal would take effect in 2011 and is similar to a rule contained in Section 3201 of H.R. 3701 proposed by Chairman Rangel on October 25, 2007. Under the Rangel bill, deductions for interest and other expenses allocable to deferred foreign income would themselves be deferred until the related deferred income is taken into account for U.S. federal income tax purposes. In addition, under H.R. 3701 the amount of the allowable foreign tax credits would be calculated by reference to deferred income of the taxpayer's CFCs. This provision, if adopted, could severely reduce the tax available for credit against the taxpayer's nondeferred income because any low-taxed deferred income would result in a scale back of the credit under the statutory formula.
- ***Tax the income of so-called tax haven "check the box" entities that are disregarded for U.S. but not for foreign tax purposes.*** This proposal would significantly increase the effective tax burden on many multinational enterprises, both public and private, that have tax haven finance centers and would likely nullify assertions that offshore earnings are "permanently reinvested" under APB 23. As a result, the proposal could significantly decrease corporate share value by permanently reducing the after-tax cash flows of an enterprise with non-U.S. income.

The Administration has also proposed several other initiatives including enhanced disclosure, enforcement and penalties with respect to the use of offshore accounts, a shift in the burden of proof for individuals that use tax haven jurisdictions, and allowing foreign tax credits only when the income giving rise to the foreign tax is currently taken into account. Funding for 800 new international examiners would also be provided.

The Stop Tax Haven Abuse Act (S. 506).

As proposed by Senator Levin in March, 2009, S. 506 would have far reaching effects on a variety of international tax activities and is by far the most comprehensive proposal being considered. Among other things, the bill would:

- ***Treat certain foreign corporations as domestic corporations fully subject to U.S. corporate taxes.*** The bill would apply to foreign corporations that are either (i) publicly traded or (ii) have gross assets of $50 million or more and are "managed and controlled" in the U.S. For this purpose, a foreign corporation is "managed and controlled" in the U.S. if substantially all of the executive officers and senior management of the corporation who exercise day-to-day responsibility for making strategic, financial and operational decisions and policies of the corporation are located primarily in the U.S. Corporations primarily holding investment assets are managed and controlled in the U.S. if the assets of such corporations consist primarily of assets being managed on behalf of investors and investment decisions are made in the U.S. *This proposal could significantly increase the overall tax burden on (i) U.S. multinational corporations that have "inverted" to a foreign parent structure where senior management continues to reside in the U.S. (e.g., in a U.S. subsidiary) and (ii) offshore funds and their investors where the funds' assets are principally managed from the U.S.*
- ***Treat substitute dividends and dividend equivalents on derivative transactions as arising from U.S. sources to the extent such payments are determined by reference to actual U.S. dividends.*** This provision could result in substantial withholding taxes for non-U.S. investors (including offshore funds and individual investors) who use derivative products to obtain exposure to U.S. equities.

Senator Baucus offers a much more moderate alternative to Senator Levin's proposals. Baucus' bill provides enhanced penalties and reporting obligations but does not contain any of the substantive provisions contained in Senator Levin's or the President's proposals. While it is far from clear what action Congress will take, the Administration's and Senator Baucus' proposals offer hope that any final legislation will be less sweeping and more moderate in scope than the provisions of S. 506. Only time will tell.

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SFAS 123(R) Valuation Issues in Today's Environment

The unusually high volatility in the financial markets in late 2008 and early 2009 has created a need to reassess the assumptions used to estimate the fair value of stock compensation under Statement of Financial Accounting Standards No. 123(R), Share Based Payment ("SFAS 123(R)").

Company values and assumptions of expected volatility have been particularly impacted. Many companies will want to reconsider the appropriateness of their historical assumptions in today's environment. We have summarized the key issues below.

Overview

Stock option valuations use option pricing models such as Black-Scholes and lattice models, which require inputs for exercise price, fair value of the underlying stock, expected volatility, expected dividend yield, risk-free interest rate, and expected term. Exercise price is established by the terms of the stock option award. In contrast, judgment is required in developing the remaining five inputs. Considerations related to developing these inputs in light of recent market conditions are briefly discussed below.

Fair Value of the Underlying Stock

For public companies, this input is evident – it is the publicly traded price of the company's stock. Private companies, on the other hand, must rely on the appraised fair value of their common stock. This value is often derived from the most recent appraisal obtained by the company to satisfy the requirements of the Internal Revenue Code Sec. 409A. The appraisal of private common stock involves two parts: i) the valuation of the equity or invested capital of the company, derived from methods such as discounted cash flows, public company multiples, transactions, or implied values from recent rounds of financing; and ii) the valuation of the common stock, which considers the rights, preferences, and liquidity of the company's various classes of stock, often using option pricing models. The valuation of private company common stock requires material judgment, and must withstand scrutiny from parties such as the SEC, IRS, and audit firms.

Given the market turmoil over the last several months, both company values and the value of common stock have generally experienced substantial declines. Company values have been affected by a number of factors including reduced earnings expectations, the increased cost of capital, lower comparable company stock prices, and distressed transactions. The value of common stock, apart from the obvious affect of the reduced company values, has suffered because of a general increase in liquidity discounts caused by longer expected terms to liquidity and increased company volatilities.

Volatility

The assumption of expected volatility is based on consideration of both historical and implied volatilities witnessed in the marketplace (for the subject company if public, or for comparable public companies if private), weighted in some fashion. Both have been impacted by recent market conditions but to differing degrees. Although volatilities have risen substantially over the last several months, the increase will only have a limited impact due to overall historical volatility being based on a longer period consistent with the expected term assumption, typically several years. Implied volatilities, which reflect the volatility assumption implied in current prices of publicly traded options (typically one to two years in term), have increased significantly. In cases where trading volume for options is low and bid-ask spreads are wide, it may be more appropriate to consider alternate methods for calculating implied volatility, such as using shorter-term, more liquid options or analyzing volatility data for time periods prior to your valuation date. Since SFAS 123(R) emphasizes consistency of methodologies, however, we recommend you discuss available methods with your auditors before making any changes to your volatility assumptions, including changes related to the weighting of implied and historical volatilities.

Expected Dividend Yield and Risk-Free Interest Rate

For many dividend-paying companies recent declines in stock prices have brought substantial increases in dividend yields (calculated as current dividends divided by current stock prices). In estimating the dividend yield assumption appropriate for use in an option model, an assessment should be made as to whether using current yields is appropriate. It may be more appropriate to use longer-term average dividend yields, prior to the recent market turmoil, to better reflect future dividend expectations. In addition, recent U.S. Treasury yields, used as a proxy for the risk-free rate, are at abnormally low levels.

Expected Term

Expected term is usually impacted by market conditions less than volatility and dividend yields. With significant declines in stock prices and increased volatility in the market, many options that were previously in-the-money may now be out-of-the-money, leading to potentially altered exercise patterns. In this market, it may be appropriate to analyze historical option exercise history over a longer period of time when making a determination of expected term. Given the current market environment, it may be prudent to contact your advisors before developing any current SFAS 123(R) assumptions.

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The Ins and Outs on Leases

As a result of the economic downturn, are you turning to leasing as a way to preserve cash and shore up your balance sheet?

If so, have you considered whether leasing transactions are a true lease or a financing transaction for tax purposes? Are you relying on the analysis performed for book purposes to determine the tax consequences? Does the lease incorporate tax indemnification provisions?

Many companies structure leases to achieve favorable tax treatment, favorable book treatment, or both. And the trend is for the agreements to include tax indemnity provisions to protect one party from adverse tax consequences and to require the parties to report the lease for tax purposes in a consistent manner. The increasing complexity of leases, the difference in the book and tax accounting treatment of leases, and the failure to analyze the lease terms in light of the tax rules may lead to tax exposure that could in turn have a negative impact on the company's tax provision or lead to exposure under the tax indemnification provisions of the lease.

Characterizing a Transaction As a Lease

Whether a transaction is a true lease or a financing transaction for tax purposes is determined based on the facts and circumstances, including:

- The contractual provisions of the lease agreement;
- The lease term compared to the useful life of the asset;
- The amount of any purchase option compared to expected fair market value;
- Whether the lessee is under an economic compulsion to purchase the property at the conclusion of the lease; and,
- Other considerations set forth in IRS published guidance and case law.

This article will not discuss these factors in detail, but rather will illustrate why a separate analysis of the tax consequences of a leasing transaction is advisable with a common example. To illustrate, assume a cash-strapped company has large net operating losses and long-lived equipment with substantial built-in gain. In order to obtain cash, the company enters into a sale leaseback transaction by selling the equipment at its fair market value, recognizing gain from the transaction, and then leasing back the equipment. The lease includes the following terms:

- A purchase option equal to 20% of the original sales price of the equipment;
- Rent payments over the duration of the lease substantially equal to the cost of the equipment;
- An option for the company to extend the lease beyond the stated term by continuing to pay the same monthly rent that applied during the lease term;
- An express statement that the tax benefits of depreciating the property belong to the lessor and that the lessee will take no action inconsistent with that treatment; and
- Lessee indemnification of the lessor's tax benefits.

The legal department does not consult the tax department or outside tax advisors before the lease is signed, i.e., the Federal tax treatment of the lease is not considered. Assume further that the lessee is likely to exercise the purchase option because the equipment has a useful life which extends substantially beyond the stated lease term and the equipment is critical to the lessee's business.

Because gain is recognized and the lessee is tax indifferent, this transaction lacks the usual tension that exists between contracting parties. The lack of a fair market value purchase price at the conclusion of the lease creates a possibility that the transaction is a financing transaction rather than a sale-leaseback. If factually, the company determines that the transaction is more likely a financing transaction for tax purposes, the tax indemnification clause nevertheless forces the company to report the transaction as a true lease. If the company were to do otherwise, it would be faced with a potential penalty under the indemnification clause of the lease agreement. Further, the company has exposure that the lessor's proposed tax treatment will not be sustained and it will still be obligated under the indemnification provision.

If a draft agreement had been reviewed for possible Federal tax implications, the company may have been able to renegotiate or clarify ambiguous terms to ensure that it would secure the desired tax treatment. Without clarity, the company must evaluate whether financial reporting reserves must be established for the tax indemnification under the lease.

As this example illustrates, a transaction intended to shore up the balance sheet may create exposure if the tax treatment is not considered before the agreement is signed. Timely cross-checking with tax counsel will permit resolution of most tax issues that arise in leasing transactions.

Timing of Rent Deductions for Tax Purposes

The complexity of leases relates not only to how the contracting parties characterize the transaction, but also to the treatment of rent deductions for book and tax purposes. The company's overall method of accounting for rent needs to be considered, since the book and tax rules are different for rent deductions and a temporary book/tax difference typically results.

The general rules for deducting rent for Federal tax purposes are:

- Rent is deductible for tax purposes when it accrues under the lease agreement;
- Economic performance occurs as the property is used; and
- Rent payments are deemed to occur as the property is used.

These general rules are not the only tax laws to analyze. The lessee must also consider the impact of Sec. 467 leasing rules and Sec. 263(a) capitalization rules. The interaction of these rules may result in the deferral of expected tax deductions.

By contrast, the book treatment of rent expense is usually fairly straight-forward. Book rent expense is usually spread evenly over the lease term using an average rent per month (total rent due divided by number of months in the lease term). The result is deferred rent or prepaid rent, both of which would create book/tax differences.

Alternatively, a lease could be classified as a true lease for tax and a capital lease for books. When this occurs, a company depreciates the capital lease asset recorded and reports no rent expense for book purposes.

As you can see, a variety of tax rules impact the deduction for rent. Book accounting is usually not a good proxy for determining the tax deduction for rent since the book and tax treatment of rent are usually different. Companies can avoid surprises through careful analysis of the book and tax accounting before the lease agreements are signed.

Have you reviewed your company's leases to confirm the proper characterization of the lease and the tax treatment of rent deductions? If you find a transaction that has been mischaracterized or a tax accounting method that is not proper, a tax accounting method change ruling offers a means to correct the treatment with possible back-year audit protection. Contact your WTAS advisor for assistance determining the proper tax accounting method and moving forward with corrective action, if needed.

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The Hidden Costs of Downsizing

In today's economy, businesses large and small are faced with the increasingly difficult goal of staying profitable.

To avoid operating in the red, many employers are downsizing their current operations. This trend has been monitored closely by the U.S. Department of Labor's Bureau of Labor Statistics (BLS), which recently reported that April nonfarm payroll employment continues to decline and the unemployment rate rose from 8.5 to 8.9. Since the recession began in December 2007, 5.7 million jobs have been lost. With many corporations making headlines with recent announcements of pending job cuts, it is unlikely that we have seen the end of these cutbacks.

The major objective of any downsizing is to reduce costs (e.g., reduction of payroll, streamlining functions, etc.). Whether this strategy involves the closing of a single plant, eliminating an unprofitable division, or laying off employees across the board, careful planning is necessary to minimize employment tax costs or to understand what the additional cost of a downsizing may be. Often overlooked in the downsizing process is the impact labor reduction has on state unemployment taxes and benefit costs. Because the employment tax function usually is separate from the tax and finance functions (and may even rest with an outside vendor), these issues often are never addressed during downsizing.

Unemployment Tax Consideration

The yearly state unemployment insurance (SUI) tax rate assigned to a company in each state is based on the organization's unemployment experience. Typically, "experience" is comprised of the organization's history of unemployment claims filed by former employees and taxes or taxable payrolls over a period of three years. Therefore, as layoffs increase, so do the number of individuals who will collect unemployment benefits. As claims increase, the SUI tax rate increases. Conversely, when claims are low in comparison to SUI taxes paid, the rate is reduced. The range between the highest and the lowest rate in any given state can be substantial. For example, the 2009 calendar year minimum SUI tax rate in Illinois of 0.6 applied against the taxable wage limit of $12,300 results in an unemployment tax of $73.80 per employee. At the maximum, a tax rate of 6.8 applied to the $12,300 wage limit escalates the tax to $836.40 per employee. Considering that the SUI rate may remain high for years, employers should budget for this increase and examine the ways in which they can control these increases.

Rate Control

Review of unemployment tax rate calculations, benefit charges, and unemployment claims is important following a layoff. Often employers accept as proper all claims and charges without any substantive review because they assume that the claimants are entitled to benefits or the state is overseeing the payment of benefits and has made a substantive determination on the appropriateness of the claims. In addition, some companies have a human resources policy to accept all reduction in force claims as appropriate without protest. Such complacence may cause the employer to lose its right to protest various types of disqualified income such as severance or vacation pay that will result in unnecessary and costly charges. It is therefore important to monitor unemployment tax rates and to evaluate any available voluntary buy downs or joint account opportunities. State agencies make mistakes and those mistakes may affect your unemployment tax rate. If these errors are not addressed in a timely manner and if available elections are not made within the timeframe allowed by the states, the employer may suffer an employment tax rate increase that could have been avoided with a timely response.

Reimbursable Account Option

Certain nonprofit employers may choose the reimbursement method of paying unemployment benefits. Employers who choose the reimbursement method reimburse the full amount of unemployment benefits paid to former employees based on wages earned while in their employ. No quarterly unemployment insurance tax is paid. Notices are mailed quarterly to reimbursing employers listing benefits paid and amounts owed. The election to become a reimbursing employer is generally made annually. It is important for nonprofit employers to understand what method they use to pay unemployment and to consider downsizing plans when making future elections.

Bottom Line

In the current environment where cost minimization is a priority, it is important to ensure that downsizing activities do not unnecessarily increase unemployment tax expense. With the appropriate unemployment tax control strategies, cost minimization objectives can be met.

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New York Tax Rates Are on the Rise (Again)

New York's budget package, Chapter 57, signed April 7, 2009, included several tax law and rate changes.

In particular, the state increased the personal income tax rate on high income individuals and limited the Empire Zone program.

Personal Income Tax

For tax years 2009, 2010, and 2011, a new rate of 7.85 percent will apply to single taxpayers who are not heads of household with adjusted gross income (AGI) between $200,000 and $500,000; $250,000 to $500,000 for single heads of household; and $300,000 to $500,000 for married couples filing a joint return. For taxpayers with AGI above $500,000, a tax rate of 8.97% will be imposed. Previously the top rate was 6.85%. New York State or City taxpayers with AGI of over $1 million must now use the standard deduction rather than claim itemized deductions. However, charitable contributions and college tuition may still be deducted. Further, nonresidents must include any gain from the sale of their interest in a partnership or other entity as New York source income to the extent it is attributable to the entity's ownership of real property in New York. As these provisions are retroactive to January 1, 2009, taxpayers need to consider the impact to their 2009 estimated tax payments. Please consult your tax advisor as you may need to remit additional tax if your first quarter estimated tax payments were based on the “old” law. Also, if your 2009 estimated tax payments were calculated using your 2008 tax liability as a “safe-basis,” you will need to recalculate your 2008 liability using the changes set-forth above.

Reformation of Empire Zone Program

The Empire Zone designation will sunset one year earlier on June 30, 2010. If a business is already certified in a zone prior to this date, the sunset does not impact the firm’s benefit period. As one of the criteria for a business to become certified for Empire Zone benefits, a new lower 10:1 cost benefit ratio (investment to state benefits) must be met by manufacturers. For businesses other than manufacturers, a 20:1 cost benefit ratio that was formerly set forth only in the regulations. The state continues to retain discretion to grant certification to businesses that do not meet the cost benefit ratios.

Zone benefits have also been cut back. Businesses certified in a zone after April 1, 2009 will only be allowed to take 75 percent of the real property tax credit. Also the state will no longer waive its portion of the sales tax for sales made within a zone if the county has not also waived its portion.

The new law eliminates a provision that grandfathered in zone benefits to companies that “shirt changed” prior to August 1, 2002. These “shirt-changers” and firms producing less than $1 in actual investment and wages for every $1 in state tax incentives will now be dropped from the program. If a firm does not meet the $1 to $1 test (calculated over 3 years), it will lose its tax year 2008 benefits. A company “shirt-changed” if prior to August 1, 2002 it caused individuals to transfer from existing employment with another business enterprise with similar ownership and located in New York State to similar employment with the certified business enterprise or if the enterprise acquired, purchased, leased, or had transferred to it real property previously owned by an entity with similar ownership, regardless of form of incorporation or organization. Previously, taxpayers that were certified prior to August 1, 2002 were not subject to the more stringent definition of “new business” incorporated into N.Y. Tax Law Sec. 14(j)(4)(B) in 2002.

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Cash Management in Today's Economic Rollercoaster

As interest rates have tumbled to historic lows and perceived market risk has increased, managing cash has become an increasingly challenging task.

After the Lehman Brothers failure in September 2008, the Reserve Primary Money Market Fund did the unthinkable by "breaking the buck". This event sent ripples through the cash management universe as investors fled to the safety of U.S. treasuries regardless of their historically low yields. Although the current period of illiquidity and frozen credit has modestly loosened, the perceived risk in the short-term fixed income market has increased. This low yield environment could possibly become the new standard since the Fed is likely to keep interest rates low in the near-term to supply added liquidity and entice investors to move out on the risk spectrum. Given the current investment landscape in which investors are reminded of the need to weigh their tolerance for risk against their tolerance for low returns, we want to summarize and compare some common cash management alternatives.

Besides hoarding cash under the mattress, investing in a U.S. treasury money market fund or individual U.S. treasury bills may be the next safest investment. However, in the current environment where many conservative investors have already made the "flight to safety", U.S. treasury-only money market funds are yielding approximately 0.07% annually. This return is taxable at the federal level, but is state tax-exempt. Further, with projected inflation at 2.5%, investors may realize a negative net return when adjusted for inflation. This forgone yield does purchase minimized risk and principal protection by investing in securities that are explicitly backed by the full faith and credit of the U.S. government. If not held to maturity, even U.S. treasuries carry risk of investment loss, but their default risk has historically been considered insignificant.

Whereby U.S. treasuries have an explicit backing by the full faith and credit of the U.S. government, U.S. agency notes have only an implicit backing. Government money market funds holding U.S. agency notes currently yield approximately 0.46% annually. Some of the U.S. agencies include the twelve Federal Home Loan Banks, Federal Farm Credit Banks, Fannie Mae and Freddie Mac. Just like the U.S. treasuries, agency notes are only state tax exempt and are federally taxable.

Tax-exempt money market funds hold issues from municipalities. Therefore, the underlying default risk hinges on the financial strength of the issuing municipality.

Investors looking for additional yield must accept an increased level of risk. Insured bank Certificates of Deposit (CD's) carry Federal Deposit Insurance Corporation (FDIC) protection. The FDIC is an independent U.S. agency also backed by the full faith and credit of the U.S. government. With this limited government backing, in the event of the bank's failure, insured bank CD's are considered a relatively safe cash management vehicle. On October 3, 2008, the FDIC temporarily increased deposit insurance coverage from $100,000 to $250,000 per FDIC insured institution through December 31, 2009. In some states, private insurance companies have been created by state statutes which provide insurance for deposits in excess of the FDIC limit for savings banks (not commercial banks). For example, in Massachusetts, at state chartered savings banks, accounts with deposits in excess of the FDIC limit are insured by Depositors Insurance Fund (DIF). Whereas FDIC is a federal agency, DIF is a private insurer specific to Massachusetts. Investors with deposits at state chartered banks should confirm with their banking representative whether any DIF-type incremental insurance exists. A three-month CD currently yields approximately 0.25% annually, and extending the maturity to one year will yield approximately 1.00% annually. Some banks have CD's which allow a certain number of penalty free withdrawals during the term of the CD as long as a certain minimum is maintained or a checking account is linked to the CD. CD's are generally taxable at both the federal and state level.

Tax-exempt money market funds hold issues from municipalities. Therefore, the underlying default risk hinges on the financial strength of the issuing municipality. There are some present concerns related to the difficulties municipalities and states may have balancing their budget due to declining revenues. Accordingly, to mitigate this issuer risk, a high quality and well diversified (even geographically) municipal money market fund is particularly important. Currently, municipal money market funds yield approximately 0.40% annually. Municipal money market fund income is generally exempt from federal taxes and in some cases exempt from state taxes. Under these circumstances, these funds are particularly attractive for investors in the higher marginal tax brackets. However, since certain municipal bond income may be subject to the alternative minimum tax, investors should work with their advisors to be sure they are maximizing the after-tax return on these investments.

Taxable money market funds invest primarily in the private debts of corporations, which increases the inherent risk of the investment. More conservative taxable money market funds predominantly invest in blue chip companies while the riskier funds venture into debts of lower-rated companies in pursuit of higher yields. The current annual yield for a taxable money market fund is approximately 0.70% to 0.80% annually, and is taxable at both the federal and state levels.

While some of the cash management instruments described above are designed to maintain a stable value or protect principal, all investments in securities, even U.S. treasuries, are subject to market fluctuations and carry a risk of investment loss. Every investor needs to determine and balance risk tolerance against both pre-tax and after-tax cash flow requirements. It is also important to remember that cash allocations are generally geared toward capital preservation and serve as the lowest risk component in the portfolio. That being the case, it may be more prudent to sacrifice a marginal amount of yield to provide peace of mind, especially in these troubled times.

NEWS YOU CAN USE FROM WTAS

for the RECORD

Foreign Bank Account Reporting Due June 30, 2009

In January 2003, the IRS announced an initiative to encourage the voluntary disclosure of unreported income by people who have used offshore payment cards or other offshore financial arrangements improperly to avoid paying taxes.

As a further tool to identify noncompliance, the IRS has expanded the scope, disclosure and penalties associated with the filing of Treasury Form 90-22.1, the Report of Foreign Bank and Financial Accounts. The revised form applicable to 2008 calendar year activity must be filed on or before June 30, 2009.

This filing requirement is separate from income reporting requirements. Filers, however, are also required to check a box on their income tax returns indicating whether they had a financial interest in a foreign account. The purpose of the Foreign Bank Account Reporting (FBAR) is to gather information about foreign accounts for government agencies such as federal and state law enforcement agencies.

Filing Requirements

Who: Each U.S. person who has a financial interest, signature authority, or other authority over foreign financial accounts, including bank, securities, or other types of accounts, if the aggregate value of these accounts exceeds $10,000 at any time during the calendar year.

When: The form must be delivered to the Department of Treasury **on or before June 30** of the succeeding year.

[Note: The FBAR filing requirements can be complex to determine in many situations as some key definitional terms are not well defined. IRS has posted guidance on frequently asked questions to its website and established a FBAR hotline to assist taxpayers with filing requirements.]

Penalties

Failure to disclose this information can result in either civil or criminal penalties, or both.

The maximum civil penalty for non-willful failure to file is $10,000 and for willful failures is a fine up to the greater of (i) $100,000, or (ii) 50% of the amount in the account at the time of the violation (e.g. each annual failure to file).

The criminal penalties for willful failure to file is a fine up to $250,000, five years in prison, or both.

Summary of 2008 Reporting Requirements

Definition of U.S. Person

This term has been expanded and includes both individuals and entities that are U.S. citizens, U.S. residents, or any person "in or doing business in the U.S". A U.S. Person includes:

- Entities that are disregarded for income tax purposes (such as single member limited liability companies) are not disregarded for FBAR reporting purposes and must file separately.
- Both the corporation and corporate employees with signature or other authority over the account have to file even if the employees have no personal interest in the account.
- Spouses may have to file separately.
- Foreign persons required to file a FBAR must now provide a foreign identification number.

Definition of Financial Interest

Any person who is the owner of record or has legal title on the account has a financial interest in the account whether or not the account is maintained for that person's benefit or not. This includes persons appointed as a trust protector.

The **owner of record** or **holder of legal title** is:

- A **person** acting on behalf of the U.S. person such as an agent or attorney,
- A **corporation** in which the U.S. person owns, directly or indirectly, more than 50% of the total value of shares of stock or more than 50% of the voting power for all shares of stock,
- A **partnership** in which the U.S. person owns an interest in more than 50% of the profits or more than 50% of the capital of the partnership,
- A **trust** in which the U.S. person has a present beneficial interest, directly or indirectly, in more than 50% of the assets or receives more than 50% of the current income.

Expanded definition of Financial Accounts

This term has also been expanded and includes:

- Holdings in accounts in which assets are held in a commingled fund, and the account holder owns an equity interest in the fund (such as certain offshore mutual funds),
- Debit and prepaid credit card accounts issued by a bank operating outside of the U.S.,
- **Excluded accounts:** individual bonds, notes, and stock certificates held by the filer are not a financial account.

Corporate Officers or Employees

A general reporting exception exists for a corporate officer or employee with signatory authority over a foreign financial account. It is available to publicly-traded corporations or corporations with assets exceeding $10 million and 500 or more shareholders of record, where the CFO has filed a Form TD F 90-22.1 and has advised, in writing, officers or employees having signatory authority of that filing that such form has been filed. This exception has now clearly been extended to corporate officers and employees with signatory authority over a foreign financial account of a 50 percent or greater owned domestic and foreign subsidiary of the U.S. parent where the CFO has made the Form TD F 90.22.1 filing and has advised, in writing, officers or employees of these subsidiaries of that filing.

Guidance for late filings

For taxpayers who reported and paid tax on all their taxable income for prior years but did not file required FBARs, the IRS will not impose a penalty for failure to file if the delinquent FBARs are filed by September 23, 2009.