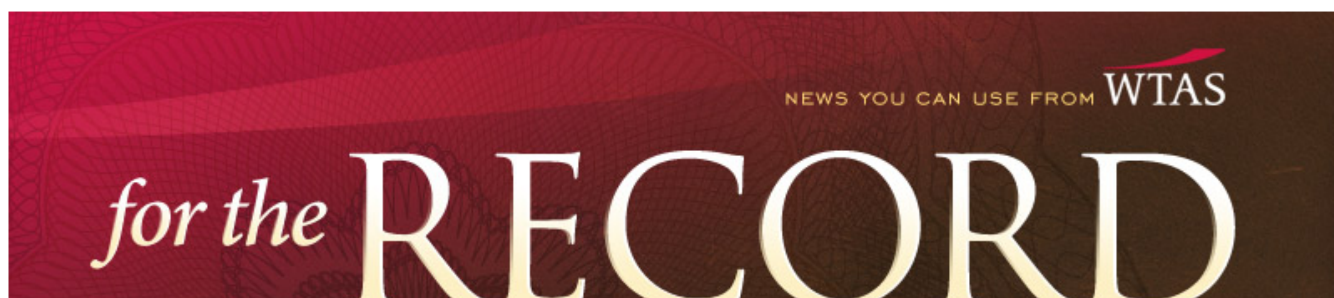

Tax Planning in Uncertain Times

As another tax year nears closure, WTAS reminds our clients of year-end tax savings strategies.

Most often, the techniques we discuss are some variation on two common themes: (1) the acceleration of deductions and losses into the closing year, and (2) deferral of income and gains beyond the closing year.

Unfortunately, as the 2010 tax year closes, we find ourselves in somewhat unprecedented territory. At the time of this writing, the current Democratic administration has at least agreed in principle with the new House Majority Republican leadership on an extension of the so-called Bush-era tax cuts, though it remains unclear whether Democratic Congressional leaders will agree. In the absence of any legislative action before year-end, we might anticipate: the largest tax increase in more than 15 years, the first increase in capital gains tax rate in more than two decades, and the return of itemized deduction and personal exemption phase-outs. Accordingly, tax strategies in 2010 might focus on income acceleration and loss deferral — the opposite of what we typically advise.

Also on the table is the fate of the gift and estate tax regime. As you may know, no estate tax was imposed in 2010. However, beginning on January 1, 2011, the gift and estate tax structure will revert to what it was in 2001, including a top rate of 55%.

With all the political and economic twists and turns of the past three years, we abandon any realistic hope of prognosticating future tax legislation. In that spirit, we offer a brief look at potential 2010 year-end strategies that include income/gain acceleration and deduction/loss deferral, assuming the Bush-era tax cuts are not extended. We also explore some of the tax provisions expiring in 2010 that — while running counter to deduction deferral —

nonetheless should be considered in case Congress does not extend those benefits beyond 2010.

	Individuals	**Businesses**
Income Rates. Projected to increase from the current top rate of 35% to a top rate of 39.6%.	Consider accelerating income (i.e., wages, bonuses, stock options, restricted stock, etc.) and reducing the deferral of income (i.e., 401(k) and other retirement and deferred compensation plans) prior to the end of 2010 and reverse accordingly in 2011.	
Long-term Capital Gains. Projected to increase from the current rate of 15% to a top rate of 20%.	Consider recognizing gains prior to the end of 2010. If proceeds are to be received in installments, consider making the affirmative election out of installment sale treatment. Preserve losses for future years.	Partners, LLC members, and shareholders of S corporations should discuss with management the consummation of any large dispositions prior to the end of 2010. If proceeds are to be received in installments, consider making the affirmative election out of installment sale treatment.
Dividends. Projected to increase from the current rate of 15% to a top rate of 39.6%.	Impacted only to corporations in which an individual owns shares and declares a dividend.	Closely-held C corporations and S corporations that previously were C corporations should review their accumulated earnings and profits, with an eye toward distributing any remaining earnings and profits in 2010. If sufficient cash is not available, consider the use of consent dividends. Finally, if the corporation needs capital, consider the use of a dividend followed by a loan from the shareholder to the corporation.
Election to Defer COD Income. Taxpayers realizing income from the relief of cancellation of debt (COD) income may elect to spread recognition ratably over a five year period beginning in 2014. This election expires at the end of 2010.	Restructure any debt prior to the end of 2010 and analyze whether the election is (1) available and (2) efficient. In some cases, the election can have the effect of making the income presently recognized.	Restructure any debt prior to the end of 2010 and analyze whether the election is (1) available and (2) efficient. In some cases, the election can have the effect of making the income presently recognized.
Increased Equipment Expensing and Bonus Depreciation. Currently, taxpayers can expense up to $500,000 of new equipment as well as claim first year 50% bonus depreciation for equipment acquired in 2010. This provision expires at the		Consider accelerating any large equipment purchases into 2010 as this benefit only applies to equipment purchases made in 2010.

end of 2010.	
Phase-out of Itemized Deductions.	Consider "bunching" of medical expenses, unreimbursed business expenses, miscellaneous expenses subject to the 2% adjusted gross income (AGI) limitation, and prepaying real and personal property taxes.
Energy-Savings Tax Credits.	Consider the purchase of alternative motor vehicles, energy efficient appliances and property (e.g., insulation, windows, doors, furnaces, boilers, heaters, pumps, central air conditioners, stoves, dishwashers, clothes washers, refrigerators, etc.) prior to the end of 2010.

While this table discusses some of the more noticeable expiring provisions, it is far from comprehensive. For a complete list of tax provisions expiring at the end of the year, feel free to contact us.

Given the dynamic nature of taxes and legislation, perhaps it goes without saying that 2010 is not over yet. We could still see legislative action between now and the holiday break, leaving tax practitioners to scramble in the last week of the year. Obviously, it is a difficult environment for proactive tax planning. Any acceleration of income before year-end could prove unnecessary if the Bush-era tax cuts are extended. We typically run multiple scenarios for our clients considering year-end income acceleration transactions, among other things, so that alternative proposals can be considered and discussed. Please do not hesitate to call your WTAS advisor to discuss these matters.

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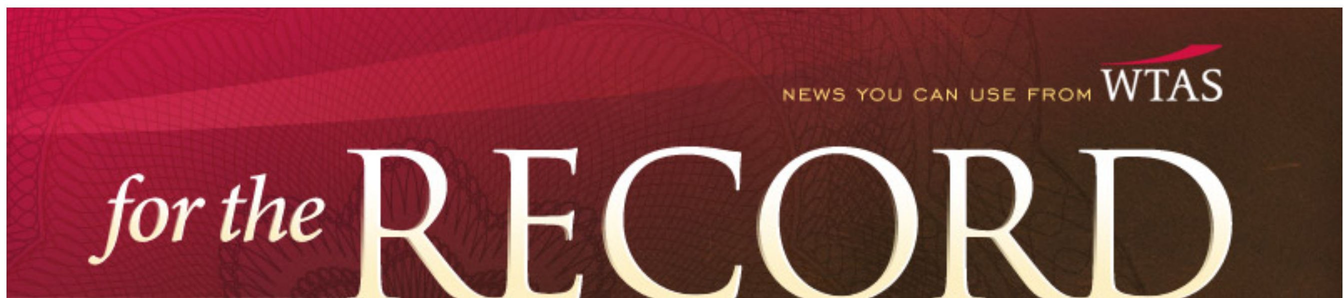

2010 California Legislative Update

California once again faced an enormous budget gap in 2010. With Republicans refusing to accept any tax increases and Democrats unwilling to make major cuts in spending, legislative gridlock pushed this year's budget agreement to its latest resolution ever. What emerged were relatively minor changes and temporary measures that ensure California will find itself in a similar position next year.

Falling under the category of temporary measures, the legislature extended the suspension of the deduction for net operating losses (NOLs) for both personal and corporate tax purposes for another two years. When the use of NOLs resumes in tax years beginning after January 1, 2012, the state will phase-in conformity to federal carryback and carryforward rules, such that carrybacks will be allowed starting in tax years beginning on or after January 1, 2013. While the previous NOL suspension did not apply to taxpayers with less than $500,000 of net business incomes for the tax year, the threshold was lowered this time to $300,000 of modified adjusted gross income for personal income taxpayers and $300,000 of pre-apportioned income for corporate taxpayers.

Another tax law change of interest to taxpayers is the modification of the sourcing of intangibles. Beginning in 2011, a taxpayer may make an annual irrevocable election to determine its California sourced income by using either the single-sales factor or the double-weighted sales factor apportionment formula. In conjunction with that move, California was set to repeal the "cost of performance" method of sourcing sales of intangibles and replace it with a "market rule." The change from the cost of performance method to the market rule would have required all taxpayers to include the following in the California sales factor:

1. sales from services if the purchaser received the benefit of the service in the state;
2. sales from intangible property if the purchaser used the property in the state (for marketable securities, sales are in the state if the customer is in the state);
3. sales from the sale, lease, rental, or licensing of real property located in California; and
4. sales from the sale, lease, rental, or licensing of tangible personal property located in California.

Under the provisions found in the newly-passed budget, any taxpayer electing to use the double-weighted sales factor must continue to use the cost of performance method to source sales. Taxpayers electing to use the single-sales factor starting in 2011 must use the market rule. The new provisions also clarify that sales under the market rule must be used in determining whether a taxpayer is subject to tax in the state. A taxpayer with 25% or $500,000 of its sales in California has nexus for income tax purposes.

In November, California voters rejected Proposition 24 which would have repealed the use of the single-sales factor, NOL carrybacks, and tax-credit sharing among affiliates - all of which/were corporate tax liability lowering measures that were passed as part of the 2008 budget deal.

Tired of perpetually late budgets and the seemingly intractable gridlock in Sacramento, voters passed Proposition 25, which now requires only a simple majority of votes (from a 2/3 supermajority) to pass a budget. However, in the same breath, voters also passed Proposition 26, which requires a 2/3 supermajority vote (from a simple majority) to pass any measure that results in taxpayers paying a higher tax or fee. In addition, the proposition contains a clause that voids any law passed between January 1, 2010 and the date of the enactment of the proposition if not passed under a supermajority vote. Among the laws impacted by Proposition 26 is the one which updated California's conformity to the federal code since it caused some taxpayers to pay a higher tax and was only passed by a simple majority. Moreover, many observers believe that the passage of Proposition 26 essentially reinstates the supermajority requirement because it covers so many of the typical budget-gap solutions. As such, California is left in the same position since structural budget deficits and legislative gridlock could plague the state for many years to come.

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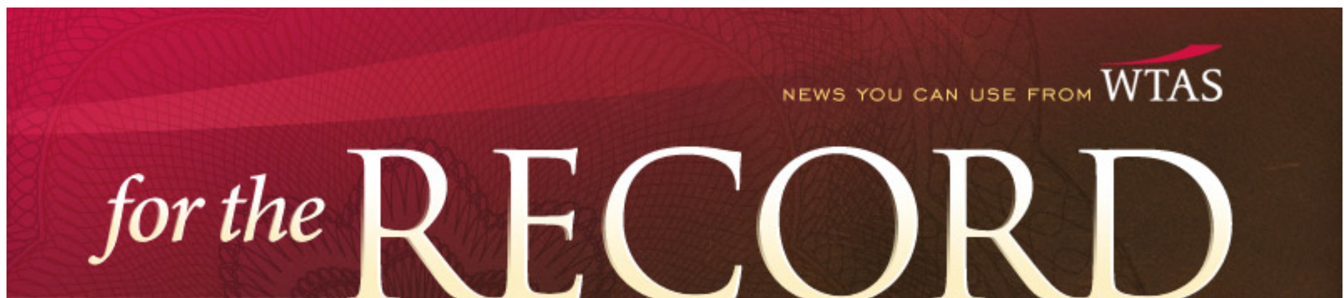


Pulling the Plug on Estate and GST Tax Savings

Now that the November 2010 elections are over and control of the House shifted from the Democrats to the Republicans, all eyes are on Congress to see how they address various estate, gift, and generation skipping transfer (GST) tax issues.

As discussed in previous newsletter articles and under the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), the federal estate and GST taxes were repealed for the 2010 tax year. The gift tax is still in place—but with a reduced top rate of 35% (the $1 million lifetime exemption amount is the same). Under the sunset provisions of EGTRRA, the gift, estate and GST tax provisions return to pre-2002 law on January 1, 2011. Thus, without Congressional action in 2011, the gift, estate and GST tax exemption would be $1 million with a top tax rate of 55% (plus a surcharge of 5% on transfers between $10 million and $17,184,000). A few days ago, the President and the Republicans reached the framework of an agreement that would, among other income tax considerations, reinstate the estate tax in 2011 with an exemption level of $5 million and a top rate of 35%. However, it should be noted that legislation based on this agreement has yet to be passed by Congress. Given these forthcoming changes, serious consideration should be given to a number of estate and gift planning ideas.

Consider making gifts prior to year-end. At this point in the year, there is a very low likelihood of a retroactive rate change being implemented, so one could take advantage of the 35% gift tax rate. Given the exclusive nature of the gift tax versus the inclusive nature of the estate tax, it is always cheaper to pay gift tax than estate tax (assuming that there is an estate tax) and the 35% rate makes it even cheaper. For example, assume you want to transfer $10 million to your child. If you transfer it via gift prior to year-end 2010, you could transfer approximately

$7.4 million to your child and pay gift tax of approximately $2.6 million. However, if you wait until January 1, 2011, to make the gift, you could only transfer approximately $6.45 million to your child and pay approximately $3.55 million of gift tax. The result is even worse if the transfer is subject to estate tax in 2011. In that case you could transfer only $4.5 million to your child and pay $5.5 million of tax.

Serious consideration should also be given to making gifts to grandchildren prior to 2010 year-end, as unlimited gifts may currently be made without paying GST tax (although gift tax may still apply). Please note, however, that there is an important caveat to address if the gift is not made directly to the grandchild. Since there is no GST tax for 2010, there is no GST exemption amount to allocate to transfers in trust. Accordingly, it is uncertain whether gifts to such trusts in 2010 may be subject to GST tax when future distributions are made to skip generations. To minimize this risk, gifts to a "skip person" could be made outright. If there are concerns about doing so, then assets such as interests in LLCs, partnerships, etc. might be considered. These types of assets would provide less control and liquidity to the grandchildren. Please also note that there is recent case law concerning gifts of such interests and whether they will qualify as present interest gifts for purposes of the gift and GST tax laws. As such, a great deal of caution must be taken and a discussion with your tax advisors is recommended in this area.

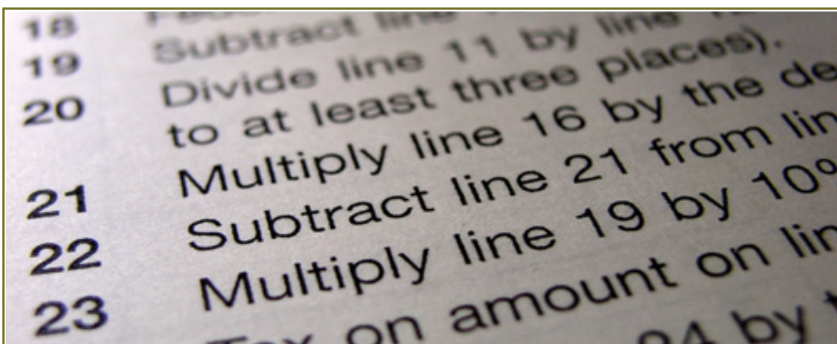
Regardless of whether the tax rates rise after year-end, it remains an ideal time for planning as interest rates and asset valuations are historically low, volatility is up and valuation discounts currently remain in effect despite certain legislation proposals. There are a number of effective techniques that may be utilized under these conditions to maximize the effectiveness of transfers. The following are examples.

Consider inter-family loans. With interest rates still historically low, it may be a good time to make loans to children and grandchildren to purchase assets and let them capture any future appreciation outside of your estate.

Consider planning techniques such as an installment sale to an intentionally defective grantor trust (IDGT) or a grantor retained annuity trust (GRAT). Both of these techniques involve transferring assets to children or grandchildren via a trust and then receiving either note or annuity payments in return. For these techniques to be successful, the assets transferred to the trust should appreciate at a rate greater than the interest rates used to calculate the note or annuity payments. Since the interest rates are currently so low, the likelihood of success is greater. Please note there are legislative proposals regarding GRAT that, if enacted, could add significant challenges to the success of this technique. It may be important to consider creating GRATs in a timely manner.

If one has charitable inclinations, consider creating a charitable lead annuity trust (CLAT). A CLAT works much like a GRAT, but the annuity payments are made to a charity instead of the grantor. This technique is also often more beneficial for estate planning purposes in a low interest rate environment, such as now. Depending on the exact structure of the CLAT, additional benefits may be the annual charitable deductions created by the annuity payments.

Understanding the Alternative Minimum Tax (AMT)



The alternative minimum tax (AMT) is frequently a misunderstood tax that represents opportunities for effective tax planning.

It is estimated by the Congressional Budget Office that the AMT will affect 27 million people (one in six taxpayers) in 2010. Given its insidious nature, AMT is frequently mentioned by legislators as a law that should be repealed, but the cost of doing so is projected to be $620 billion over 10 years. This would be difficult to accomplish given our current, uncertain economic environment.

The AMT is a parallel tax system in which taxpayers must calculate their tax liability under both the regular tax and under the alternative minimum tax. Taxpayers must pay the higher of the taxes calculated under these parallel regimes.

How AMT is Calculated

Taxpayers begin the AMT computation with their taxable income as determined for regular tax purposes. Taxpayers must then “adjust” various deductions and loss items, resulting in a taxpayer’s alternative minimum taxable income (AMTI). From the AMTI, a taxpayer subtracts an exemption amount. (Please note that it is this exemption amount that Congress adjusts annually to “patch” the AMT.) Lastly, from this net AMTI, a taxpayer then applies the tax rates. Unlike the regular tax system, the AMT has only two tax rates.

AMT Rates for 2010

Rate	Married Filing Separate	All Others

		(Single, Head of Household, Married Filing Jointly, Qualifying Widowers)
26%	**Up to $87,500**	**Up to $175,000**
28%	**Amounts greater than $87,500**	**Amounts greater than $175,000**

AMT Exemption Amounts for 2010

Prior to 2010, Congress passed a series of AMT patches that raised the amount of the AMT exemption. Currently, there are proposals to increase the exemption for 2010 and beyond. As it stands today, the AMT exemption amounts for 2010 are scheduled to be the following:

- $33,750 for single and head of household filers;
- $45,000 for married people filing jointly and for qualifying widows or widowers ; and
- $22,500 for married people filing separately.

AMT Adjustments and Tax Preference Items

While far from an exhaustive list, the following are the most common items we see that impact AMT liability:

- Certain itemized deductions are disallowed for AMT purposes including property taxes and state and local income taxes.

  Years in which state income taxes are abnormally high, such as in the year of a large capital gain, need to be reviewed carefully to avoid unnecessarily incurring AMT in the year after the sale. This can happen when a taxpayer pays the majority of the state income tax related to a large gain on April 15 of the year following the sale. While the state income tax payment is deductible for regular tax purposes, it is added back for AMT and can cause the AMTI to be significantly higher than regular taxable income, thereby creating an AMT liability. Proper planning may dictate accelerating some or all of the state income tax payment into the year of the sale so that this disparity is avoided.

  Owners of unimproved and unproductive real estate may elect to capitalize real estate taxes instead of deducting them, if they are in AMT and, not receiving the benefit of the real estate tax deduction.

- Miscellaneous itemized deductions subject to the 2% of adjusted gross income (AGI) limitation are not deductible for AMT. The most common item in this category is investment expenses that are incurred directly or via pass-through entity investments. In some cases it is possible to structure investment holdings to remove such expenses from the 2% miscellaneous itemized deduction category, and make them deductible for both regular and AMT tax purposes. A discussion of this planning is beyond the scope of this article.

- Investment interest expense may be larger for AMT purposes than regular tax. Investment interest expense is deductible to the extent of net investment income; generally, gross investment income less investment expenses. However, because investment expenses are not deductible for AMT purposes, it does not reduce net investment income for the AMT calculation. As a result, the interest expense deduction may be larger for AMT purposes.

- AMT net operating loss (NOL) deduction differs from the regular tax NOL deduction. The AMT NOL is

basically the regular tax NOL with several AMT-specific adjustments, it must be calculated separately and applied separately in any carryback or carryforward of the NOL. It is important for taxpayers to be aware of the difference in any regular tax and AMT NOL. The difference is typically a significant amount and can result in an unexpected AMT liability despite there being no regular tax liability.

- AMT passive losses may be different than regular tax passive losses after the separate AMT rules are applied to the passive loss calculation.

- Certain assets must be depreciated more slowly for AMT. As a result, AMT income may be higher. Any potential gain/loss on the disposal of property must also be determined separately for regular tax and AMT. Many investors who left the equities markets in recent years invested cash in the tax-exempt bond markets. Certain specified private activity bonds, while not taxable for regular tax, are taxable for AMT. This is a particularly important issue as investors move into high yield funds. These private activity bonds are issued by state or local governments to help non-government entities fund construction projects. So, it is important for investors to review municipal bond portfolios to determine if the tax-exempt bond portfolio is indeed tax-exempt. Please note that interest income from private activity bonds issued in 2009 and 2010 are not subject to AMT in 2010.

Conclusion

Evidently, the AMT contains numerous pitfalls; however, many planning techniques exist to minimize the effects of AMT. To effectively navigate AMT, it is necessary to take a holistic approach and view the AMT impact over multiple tax years to ensure that the combined regular and AMT liabilities are minimized.

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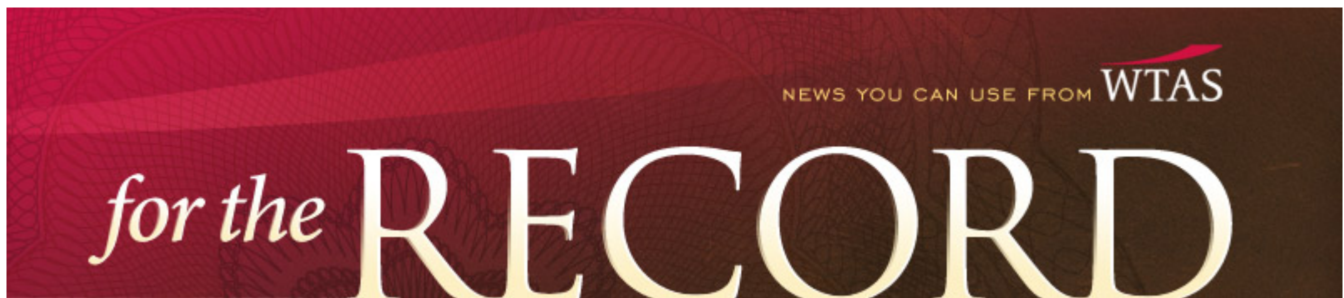
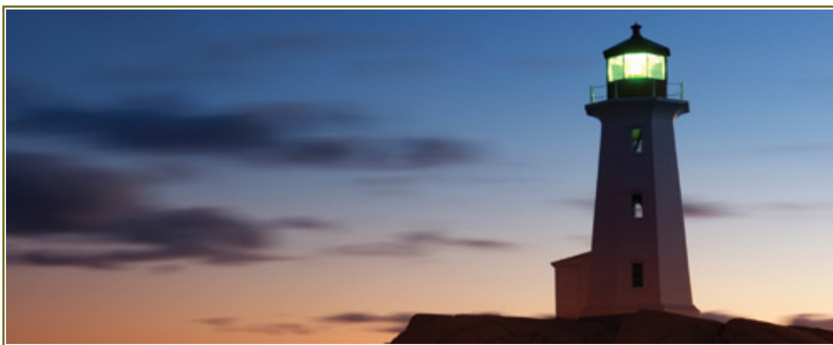


Prudent Management of Institutional Funds



Over the past few years, nonprofit and charitable organizations faced a multitude of economic challenges.

Endowments and foundations were hit hard by an economic downturn not seen since the 1930s. A decrease in donations and available funds put pressure on spending policy, and a number of investment schemes and scandals cost billions. These events contributed to the increased scrutiny of the management of nonprofit funds and the boards responsible for oversight.

As often is the case during times of uncertainty and challenge, new rules or regulations are introduced to provide clarity and direction. The Uniform Prudent Management of Institutional Funds Act (UPMIFA, 2006) provides specific guidance regarding investment and spending policies. UPMIFA is a result of the merger of two state laws, the Uniform Management of Institutional Funds Act (UMIFA, 1972) and the Uniform Prudent Investor Act (UPIA, 1994). On September 17 of this year, New York became the forty-seventh state to pass UPMIFA legislation; however, each state may have a unique interpretation and requirements.

Where UMIFA did not apply to private foundations, UPMIFA does apply to most private foundations. There is an exception for private foundations that are organized as charitable trusts AND have individual or institutional trustees. These private foundations fall under the UPIA, where adopted. Nevertheless, as most are established to exist in perpetuity, it is strongly recommended that the board of all private foundations (especially those structured as nonprofit corporations) be familiar with UPMIFA and the policies established for endowments.

The key provisions of UPMIFA are as follows:

- allows the delegation of investment management authority;
- defines standard of care and factors to consider when making investment decisions;
- eliminates historical dollar value limitation;
- establishes guidelines for releasing restrictions on assets; and
- establishes a prudent spending amount.

Not only is the delegation of investment management allowed, it is also deemed prudent if the organization does not have a sophisticated investment committee. The board can demonstrate procedural prudence by selecting an agent in good faith, establishing the scope and terms of the delegation and periodically reviewing the agent. Although the board is not responsible for the actions of the agent, it is responsible for establishing guidelines for performance, progress toward goals and objectives, and adherence to the investment policy.

UPMIFA modernizes the rules governing investments and the standard of care for investment decisions. It directs that investments be made "in good faith and with the care an ordinarily prudent person in a like position would exercise under similar circumstances, considering the purposes, terms, distribution requirements, and other circumstances of the institutional fund." UPMIFA also explicitly provides that, as long as the investment is prudent, the institution may consider any investment for inclusion.

A significant change made by UPMIFA is the elimination of the historical dollar value limitation. Previously, growth or net appreciation could be spent, but the "historical dollar" value of an endowment had to be preserved. Under the new law, institutions are no longer limited in their ability to spend "underwater" endowment funds. Given the market losses of recent years, this is a critical and beneficial change. Boards can now authorize prudent spending of principal of an endowment fund so long as a good faith determination is made that the spending aligns with the "uses, benefits, purpose, and duration for which the fund was originally established." One caveat is if the donor puts a limit on how much principal can be spent, that limit controls or overrides even a prudent approach.

Recognizing that restrictions may become outdated, wasteful, or at times unworkable, UPMIFA provides rules and/or guidelines for releasing donor restrictions on funds. The most straightforward and often most effective method is to simply seek the permission of the donor to remove the restrictions. Often times the board may offer a modification consistent with the purposes of the gift interest that is as close as possible to the original donor intent. If the attempts to work with the donor fail, the board may seek legal action. The board can petition the courts for approval to either modify or fully release a restriction.

One of the most important considerations for any organization and its board is to develop a well thought, prudent spending policy. UPMIFA spending policy rules promote a total return approach to spending. The goals resemble those of many individual investors. Two key components to both spending and investment policies are to invest at an expected rate of return to preserve purchasing power of the principal over the long term (possibly in perpetuity) and to spend at rates that reflect the donor's intentions. UPMIFA provides greater flexibility to spending policy. Some states, such as New York and Rhode Island, adopted a rebuttable "presumption of imprudence" for any spending in excess of 7% of the market value of the endowment per year. In determining whether spending is prudent, UPMIFA requires the board to consider the following:

- the duration and preservation of the endowment fund;
- the purposes of the organization and the endowment fund;
- general economic conditions;
- the possible effects of inflation or deflation;

- the expected total return from income and the appreciation of investments;
- other resources of the organization; and
- the investment policy of the organization.

These considerations drive both spending policy and investment decision making. Today's market realities have shifted priorities from maximizing returns to achieving desired goals, cash flow, and liquidity needs. Although many nonprofits, foundations, and endowments currently have strong investment and spending policies in place, it is advisable and prudent to perform reviews of the current procedures. Advisory boards and investment committees dealing with endowments must adhere to a fiduciary standard of care set forth by UPMIFA. Adherence is not measured in returns but in the prudent process implemented. A uniform fiduciary standard of care provides that boards and investment committees should:

- know the standards, laws and trust provisions;
- diversify assets to the specific risk/return policy of the entity;
- prepare a detailed investment policy statement
- use "prudent experts" (e.g., money managers and consultants) and document the due diligence process;
- control and account for investment expenses (full transparency);
- monitor activities of "prudent experts;" and
- avoid any conflicts of interest and prohibited transactions.

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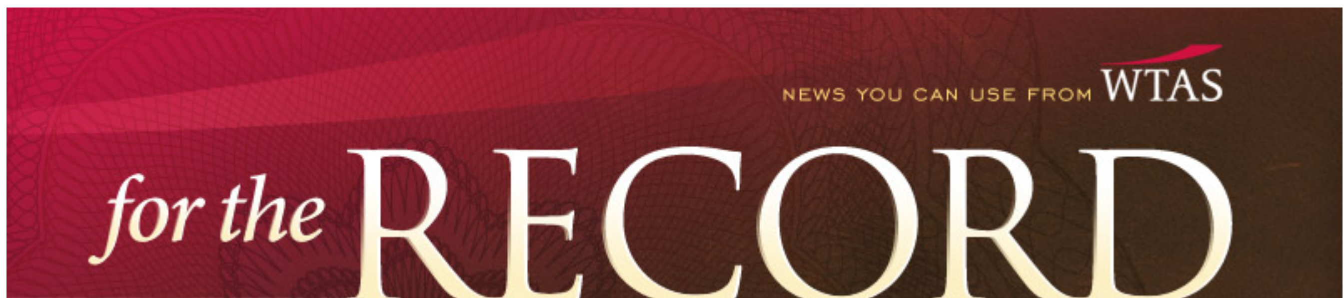

Cutting Through the Hype: What You Really Need to Know About the Bush-era Tax Cuts

"Nothing is certain but death and taxes." Well, Mr. Franklin, that is no longer entirely true. With the impending expiration of the Bush-era tax cuts and a Congress full of "lame ducks," taxpayers are anything but certain about whether they will be subject to tax rates not seen for nearly a decade.

As the sun begins to set on the 10-year Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) and the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA), rampant political jockeying from both sides blur the essential elements of the issue. In an effort to provide clarity amidst the political fog, this article will outline: (1) what major provisions are set to expire, and (2) what alternatives or compromises are being proposed before the clock strikes midnight on January 1, 2011.

The Expiring Provisions

Unless President Obama and the members of Congress can reach a compromise in the next few weeks, the following list of major provisions affecting all taxpayers will expire at the end of this year.

Tax Rates

- The 10% tax rate (the lowest tax bracket) will disappear and be replaced by a 15% rate.
- The 25% rate will rise to 28%.
- The 28% rate will rise to 31%.

- The 33% rate will rise to 36%.
- The 35% rate will rise to 39.6%.

Capital Gains and Qualified Dividend Rates

- The long-term capital gains rate will rise from 15% to 20%.
- The qualified dividends tax rate will rise from 15% to the ordinary wage tax rates of the filer (that is, a maximum of 39.6%).

The Child Tax Credit

- The child tax credit will decrease from $1,000 to $500 and eligibility standards for such will become more stringent.

Estate Tax

- The estate and gift tax will be restored:
  - the top estate and gift tax rate will be 55%; and
  - the estate and generation-skipping tax exemption will be limited to $1 million.

Marriage Penalty

- The standard deduction for married couples filing jointly will no longer be twice that of a single filer; and
- The 15% bracket for married couples filing jointly will no longer be twice that of a single filer.

Personal Exemptions and Itemized Deductions

- The personal exemption phase-outs and "Pease limitations" will be restored, thereby eliminating many exemptions and deductions for high income taxpayers.

Section 179 Expense Limitation for Small Businesses

- The Sec. 179 maximum deduction for the purchase of depreciable business assets will drop from $250,000 (reduced by the amount by which the cost of property placed in service during the 2010 taxable year exceeds $800,000) to $25,000 (reduced by the amount by which the cost of property placed in service during the 2011 taxable year exceeds $200,000).

The Alternative Proposals

In trying to stimulate the economy and reduce the country's deficit, Congress and President Obama are torn between deciding whether extending tax cuts to encourage taxpayer spending is more effective than collecting higher taxes. One thing is certain, most Democrats and Republicans agree that allowing all of the Bush-era tax cuts to expire on December 31 would cause more harm than good, overall. As such, their main focus is extending the tax cuts for individual taxpayers whose income is below $200,000 (or $250,000 for joint tax filers), permanently (although nothing is ever permanent in taxes).

The main argument is whether the tax cuts should be extended for the top tax brackets. Many Republicans, like Minority Leader John Boehner (R-OH), insist on permanently extending the Bush-era tax cuts in their entirety and cutting spending elsewhere in order to reduce the deficit. Other Republicans say they would compromise on a two

or three year extension of the rates for the top tax brackets. Senator Chuck Schumer (D-NY) proposes a compromise in which the tax cuts will extend to taxpayers whose income falls below $1 million. Democratic Senator Mark Warner (D-VA) proposes extending tax cuts for the lower tax brackets and using the $65 billion (that would be saved by not extending the tax rates for the higher brackets) to cut taxes for small businesses.

On December 6, President Obama announced his intent to extend the Bush-era tax cuts to all income levels despite the Democratic Party's—and his own—opposition to such a plan. The proposed package includes a $5 million estate tax exemption and a maximum rate of 35%. Additionally, it would reduce the Social Security payroll tax for all wage earners by 2%. The marked concern, however, is the $900 billion price tag attached to the enactment of this plan. So while the fear of massive tax hikes is allayed, the national debt will continue grow. Still, as Republicans are ready to sign off on the deal, most Democrats continue to show their unwillingness to agree on any such proposal.

Conclusion

As it stands, taxpayers are left scratching their heads as the forthcoming expiration of the Bush-era tax cuts looms closer. Although the proposed plan may not be the most ideal situation given its steep cost and the increasing national debt, inaction can be equally, if not more, detrimental. Nevertheless, with interest rates still low, there are many planning ideas that will yield tax benefits irrespective of the outcome. Please consult your tax advisor for assistance with this challenging process.

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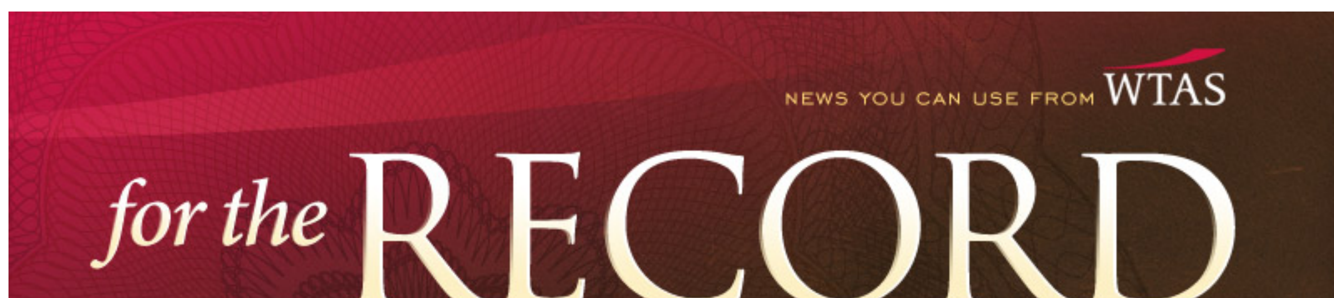

Appellation Values and Amortization Benefit

An appellation or American Viticultural Area (AVA) is a grape-growing region distinguishable by geographic features only, the geographic boundaries of which are defined by the Alcohol and Tobacco Tax and Trade Bureau.

California and Napa Valley are appellations that have approximately 76 and 14 sub-appellations within them, respectively. Due to the abundance of various regions and wine types available to consumers, labels serve as an important differentiator in the wine selection process. As such, grapes and wine from well-known AVAs can command significantly higher prices than their non-AVA counterparts.

On August 10, 1993 (i.e., the enactment date), Congress enacted Section 197 of the Internal Revenue Code (Sec. 197) providing for a 15-year amortization period for certain intangible assets. In general, to qualify, the intangible asset must have been acquired after the enactment date and held in connection with the conduct of a trade or business. Some practitioners may have questioned whether appellations fall within the guidelines of Sec. 197. In October 2010, the National Office of IRS released a Chief Counsel Memorandum concluding that the right to use an AVA designation, or appellation rights, upon a purchase of a vineyard is considered a license, permit, or other right granted by a government unit (rather than an interest in land) and is therefore an amortizable asset under Sec. 197. The amount of the vineyard's fair value allocated to the right to use the AVA designation is amortizable for a period of 15 years.

For example, upon the purchase of a vineyard, value may have been assigned to depreciable assets such as vines, trellis, buildings and irrigation systems, and the balance of the purchase price may have been allocated to land. This may have resulted in an existing AVA either not being considered or being included in the value of the land. In

either situation, no current tax deductions in the form of amortization would have been taken. For taxpayers who acquired vineyards after the enactment date and who did not separately allocate value to existing appellation rights, an automatic change in method of accounting may be available. This would allow taxpayers to deduct in the year of change accumulated amortization related to the appellation right (a catch up of prior missed deductions) with the remaining unamortized amounts available for amortization in future years. We have outlined an example below.

On January 1, 2005, Taxpayer A completed the acquisition of vineyard Property B for a total of $5 million. The property cost included vines, buildings, an appellation, machinery and equipment, irrigation systems, trellis and land. Taxpayer A, however, has not taken deductions related to AVA rights related to the purchase. A valuation expert determines that the fair value of the land acquired included appellation rights of $1.5 million, which would provide annual tax amortization of $100,000 over a 15-year period. With an assumed combined federal and state tax rate of 40.7%, the calculated annual amortization tax benefit would be $40,700 or a total of $610,500 over the 15-year amortization period. For the 2010 year, Taxpayer A elects to change its accounting method. Since the change is deemed effective as of the beginning of the tax year, Taxpayer A would be able to deduct $500,000 in “catch up” deductions related to the appellation rights, providing a tax benefit of $203,500 – a considerable tax savings. Beginning in 2010, Taxpayer A would also be able to recognize the related amortization expenses of $100,000 per year for each of the next 10 years (a 15-year total amortization period) totaling $1 million and providing tax benefit of $407,000.

WTAS has significant experience with regard to the valuation issues related to vineyard property (including appellation values) as well as the issues related to accounting method changes.

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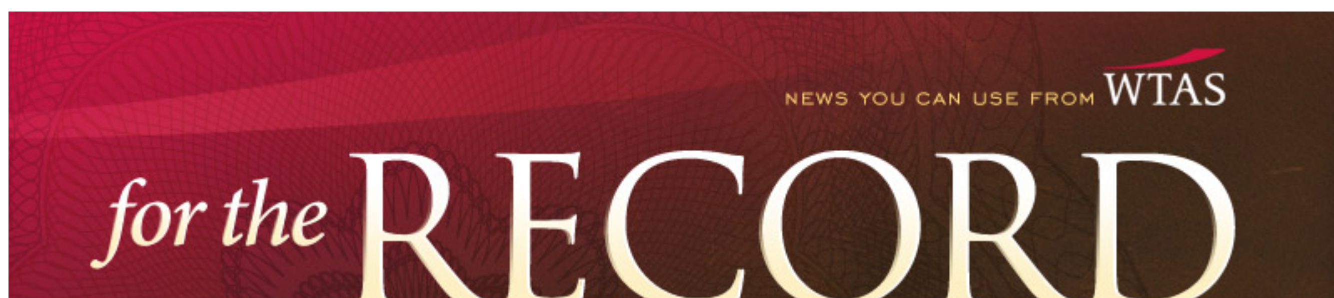

2010 State and Local Tax Legislative Update

With the close of the 2010 calendar year approaching, states are still looking for ways to minimize budget deficits. What measures did states take during 2010 to close their budget gaps and what can taxpayers expect to see in 2011? This article highlights some of the changes we saw in 2010 with a look ahead to some of the trends we expect to see in 2011.

Corporate Income/Franchise Tax

The root of state taxes relies on the existence of nexus or a taxable presence. States continually attempt to expand the definitions of nexus in an effort to increase their tax base. Within the last few years concepts of economic, affiliate, and agency nexus developed and started to spread throughout the country. Among these concepts, economic nexus is the most common. Some states adopt this standard for income, franchise, and gross receipts tax purposes. For example, Michigan, Ohio, and Washington now apply an economic nexus standard for purposes of their gross receipts taxes. Similarly, Oregon and Wisconsin also apply economic nexus standards for corporate income/franchise tax purposes. More recently, Colorado and Connecticut revised their corporate income/franchise tax laws to include economic nexus for tax years beginning on or after January 1 of this year. Finally, California will apply an economic nexus standard effective for tax years beginning on or after January 1, 2011. Thus, many states are clearly seeking opportunities to expand their tax bases by adopting broader nexus standards–a trend we expect to continue during 2011.

With the economic recession and added pressures on state budget deficits, we also witnessed many states turn to changes in filing requirements in order to generate additional revenue. One recent trend is the transition from

separate filing to a mandatory combined filing for members of an affiliated group. For example, Massachusetts, West Virginia, and Wisconsin are the most recent states to change their filing methodologies and require combined filing. Other states such as Connecticut, Florida, Missouri, New Mexico, North Carolina, Pennsylvania, Rhode Island, and Tennessee proposed bills to enact required combined reporting. We also expect to see more states consider this approach in an effort to increase their tax bases during 2011.

Throughout the last few years, many states began moving toward adjusting apportionment formulas in order to shift the tax burden to out-of-state businesses and create additional revenue. While several states revised their tax laws to reflect the double-weighting of the sales factor, the movement toward adopting a single-sales factor apportionment formula is the trend we expect to continue in 2011. The following is a summary of some of the states that already adopted a single-sales factor formula:

- Indiana and Minnesota both began phasing in a single-sales factor formula on January 1, 2007. This will be fully phased in on January 1, 2011, and January 1, 2014, respectively;
- Georgia adopted a single-sales factor for tax years beginning on or after January 1, 2008;
- Colorado adopted a single-sales factor for tax years beginning on or after January 1, 2009;
- this year, Utah passed legislation to enact the phase-in of a single-sales factor formula which begins in 2010 and is expected to be fully completed by January 1, 2013; and
- for tax years beginning on or after 2011, California is allowing an irrevocable single-sales factor election for certain taxpayers.

As states continue to do their best to close their budget deficits, we expect to see many states look for other ways to increase revenue. For example, some states will likely look to establishing gross receipts taxes such as Michigan's Business Tax which includes both an income and gross receipts tax component. We may also see more states suspending or temporarily disallowing certain tax credits and/or incentives. These measures could include suspending the use of net operating losses, decoupling from certain federal provisions, revising state credit and incentive programs, or making modifications to minimum taxes (as Oregon had done in 2009 when it changed from a flat minimum tax to a minimum tax based on gross receipts).

State Sales and Use Tax

State sales and use tax issues continue to develop as the consumer market evolves. States will likely look to make changes in this area to raise additional revenue. Over the last few years, advances in technology changed the way companies do business. These changes present unique challenges to states in determining how to tax these new products and services. As a result, many states recently changed their laws to impose sales/use tax on digital products and services. For example, North Carolina, Washington and Wisconsin recently enacted state laws to address the taxation of digital products/services, yet another trend we expect to continue to evolve in 2011.

One of the more recent changes we witnessed in the digital world is a move toward "cloud computing." Cloud computing allows companies to use the technology infrastructure of another company by renting space on the "cloud." Examples of large cloud providers are Amazon, Microsoft, Google, and AT&T. These companies provide access to business applications online and store their software and data on the cloud provider's servers. These emerging business models will continue to create uncertainty with respect to the application of sales tax and we expect to see a lot of change and controversy in this area. Many states that do not currently address the taxation of digital products and services could soon revise their laws accordingly in an attempt to increase revenue and balance their budgets.

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