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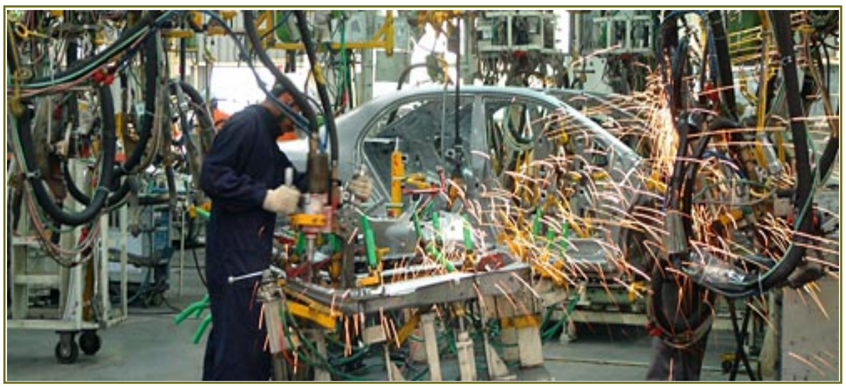
Section 199 Domestic Production Deduction: Time for a Closer Look



In 2004, Congress introduced the Domestic Production Deduction (the DPD) to encourage U.S. manufacturing and certain other "production" activity.

At the time of enactment, there was a decidedly lackluster reaction to the new incentive: the new provisions were complex, the computations and reporting could be difficult and the tax benefit often appeared relatively small or non-existent. Flash forward to 2010; the interest in Sec. 199 has swung dramatically upward and for good reason. The DPD can produce both significant tax savings and a meaningful reduction in a company's effective tax rate; however, it can also result in unexpected tax assessments, penalties and interest for those taxpayers who claim the benefits of Sec. 199 too liberally. Let's review why.

An Overview of the Domestic Production Deduction (Section 199)

Sec. 199 came into law on the heels of decades of incentives intended to reward those U.S. businesses that exported products overseas. Those incentives—which date back to the 1960s and included Domestic Sales Corporations, Foreign Sales Corporations and the Extraterritorial Exclusion Regime—often came under attack by the international community as unfair U.S. government subsidies of U.S. businesses. With the advent of the new millennium, Congress was less concerned with encouraging foreign export and much more concerned with the continuing exodus of U.S. jobs (particularly in manufacturing) to other countries. Thus, Sec. 199 was enacted to encourage the retention and growth of U.S. manufacturing without regard to whether the output of those manufacturers was exported out of the country or consumed domestically.

America's industrial backbone needed support and Sec. 199 was intended to provide it. Sec. 199 accomplishes this objective by effectively reducing the income tax assessed on the profits of targeted industries, principally manufacturing, construction and natural resource extraction (oil and gas, mining, forestry, etc.). For good measure, software developers, filmmakers and music publishers were also tagged to benefit from the new incentive. "Production" was to be rewarded while service, retail and distribution businesses generally were not. In 2005, qualifying taxpayers could take a deduction up to 3% of taxable income attributable to production activities. After the full phase-in of the DPD benefits in 2010, qualifying taxpayers could expect a deduction up to 9% of taxable income. To ensure that the incentive produced the desired U.S. job growth, Congress limited the deduction to 50% of the wages of the taxpayer's employees (initially all employees; later amended to include only those employees involved in the production activity).

This all seems attractive enough for U.S. taxpayers who fall within the targeted industries and, for many, the benefit is relatively easy to obtain. A significant number of small to midsize U.S. manufacturers conduct all of their operations within the United States, derive all of their recurring operating revenues from the sale of the products that they produce, and have little or no unusual income or expense items that might raise issues in the course of the computation. Certain de minimis rules often could be applied to prevent small amounts of nonqualified income from complicating the computation. If these companies operated as C corporations, the process of obtaining the DPD could be a simple one. But what about other types of corporate entities?

The Challenges and Complexities of Section 199

Many small to midsize manufacturers operate as S corporations, partnerships and LLCs with multiple owners. Because the DPD is computed at the taxpayer level, those entities cannot do the arithmetic to compute the deduction for the owners. Instead, they pass selected information out to each of the owners who must combine that information with similar information provided from other pass-through entities in which they have an ownership interest to compute the DPD to be reported on their individual returns. Because flow-through entities cannot presume to know whether or not the owners would take the deduction, such entities are required to provide the information to the owners notwithstanding how small the final numbers prove to be. This is not elective provision as to those entities. When Sec. 199 was first enacted, delays in getting the requisite information, inconsistent formats as to its presentation and confused K-1 recipients were the order of the day. Structures involving multiple tiers of flow-though entities as well as trusts and estates added further challenges.

For larger and more complex businesses, other challenges in computing the deduction quickly become apparent. Many of these challenges arise from the concern of Congress that Sec. 199 might benefit taxpayers for whom the benefit was not intended. To prevent this from occurring, Congress introduced an alphabet soup of new acronyms (MPGE, DPGR, QPAI, etc.) as well as principles not found elsewhere in the tax code. This led to a great deal of computational complexity.

Even at the most elementary level, consider the following:

- **Domestic:** Must be made in the U.S., right? Yes, although nearly 80% of the cost of a finished product could be produced overseas and still meet the safe harbor to qualify as domestic production. Further, 80% or more could be produced overseas if the taxpayer could successfully argue that the U.S. production was nonetheless "substantial" in nature.
- **Production:** So services are not rewarded, correct? Generally, but services that are "embedded" in the products can also qualify. Additionally, certain architectural, engineering and construction services qualify

for the deduction.
- **Deduction:** This should at least be clear, should it not? Sure, as long as one understands that the deduction is not necessarily computed by the entity that incurs the related costs. In the case of pass-through entities, it is computed by the taxpaying owner(s) or beneficiary instead. Further, regardless of who the taxpayer is, if that taxpayer otherwise has a loss from the activity generating the Domestic Production Deduction (either through current operations or due to a loss carryback or carryover), or if the taxpayer does not have U.S. payroll, then there is no DPD at all.

Deeper in the Sec. 199 regulations are a multitude of other complexities. The correct application of the rules can become much more difficult for taxpayers whose business models are even moderately complex and involve one or more of the following:

- Accounting systems that track revenue and expenses based on divisions, product lines and other broad criteria (as opposed to the "item" approach required in the Sec. 199 computation)
- A complex mix of qualifying and non-qualifying activities as to which revenues, costs and expenses must be allocated in some reasonable and manageable way; and in a manner that is not inconsistent with other allocations that the taxpayer may regularly make relative in managing its business operations; and in its approach to other allocations for tax purposes including those related to Sec. 263A or related to a foreign tax credit
- Industries that "produce" but not in the traditional manufacturing sense (software developers, constructions companies, film and music businesses, printers, etc.) that are subject to unique DPD issues
- Shared production responsibilities through sub-contractor arrangements, whether acting as the sub-contractor or the customer of a sub-contractor
- Provision of delivery services, installation services or warranties in connection with the produced property
- Production of products with multiple components with only some produced by the taxpayer
- Unusual or non-recurring types of income including Subpart F inclusions, litigation settlements, gains on the disposition of capital assets and others
- Unusual or non-recurring types of expenses and expenses that may relate to the stewardship of or allocations of costs and revenue among subsidiary and affiliated businesses

This is a lengthy list, but it is by no means an all-inclusive list of the potential sources of complexity.

Current Assessment

After reading this discussion of challenges and complexities, the lackluster initial response from many U.S. taxpayers is understandable. However, as the deduction percentage increased from 3% of qualifying income to 6% and then in 2010 to a fully phased-in 9%, both the current and cumulative benefits have become quite substantial. For many companies, the DPD has become the item that provides the greatest permanent tax benefit, and the item that has the most significant favorable impact on the effective tax rate reported in its income statement. The permanent cash flow savings from this benefit can quickly become quite sizeable.

Of course, with this heightened current and cumulative benefit comes the need to protect this cash and tax rate savings from challenge by the IRS. Pass-through entities are also appropriately concerned about the flow-through effect of adjustments to their owners and beneficiaries. Because the Sec. 199 deduction has been designated a Tier 1 audit issue for IRS examiners, a taxpayer that comes under examination and that has claimed a Section 199 deduction will be examined by the agent. Challenges of one year's computation may escalate to a review of other years. As part of the Tier 1 audit process, IRS examiners will likely issue standard Information Document Requests that focus on all aspects of the computations. Taxpayers must be prepared with workpapers that are responsive to these requests.

Further, analyses required under implementing accounting for uncertain tax positions (formerly known as FIN48) have appropriately become more rigorous to keep pace with the magnitude of the cumulative benefit. As a consequence, additional documentation of the DPD will likely be required in connection with financial audits as well.

Conclusions and Recommendations

The DPD represents a significant permanent tax savings for a very broad group of taxpayers. Most qualifying taxpayers are claiming some benefit from the DPD, but it is likely that all would benefit from a re-examination of the provisions and their application to their businesses. Have all of the issues and opportunities related to the identification of qualifying activities and the determination of the taxable income from those activities been properly understood and addressed, especially in light of the types of issues enumerated above? Have the mechanics of the computation kept pace with the evolution of the business and the current thinking as to the DPD? Have critical technical positions been appropriately analyzed and documented? Have the relevant records required to support the computation been properly maintained?

One should keep in mind that the computation of the Sec. 199 deduction is not a tax accounting method. As a result, a deduction from prior years can be adjusted through an amended return without requesting the permission of IRS. Also, the approach to the computation can change from year to year; however, to the extent that the underlying facts remain the same, a consistency to the approach from year to year enhances the likelihood that the approach would be deemed reasonable. As is the case with most tax incentives, a thoughtful and thorough analysis will be key to identifying opportunities to maximize the benefit, and comprehensive documentation will be key to sustaining the benefit.

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State Tax Issues Related to Flow-Through Investments Part Three: Federal Limits on State Taxing Power

This article is the final part of a three-part series on tax opportunities and issues facing nonresident owners of multistate flow-through entities (i.e., partnerships, limited liability companies, etc.).

Part One discussed statutory and regulatory safe harbor provisions that may protect nonresident investors in multistate investment partnerships from state income taxes. Part Two discussed partnership withholding and apportionment of multistate income. This article discusses federal law that may limit a state's ability to assert a tax reporting obligation on nonresident partners.

The principle that a state may not tax value earned outside of its borders is well established. However, the issues still remain: what business activity is sufficiently connected to a particular state to create a tax obligation, and how much of the income or value related to such activity may a state tax?

When a taxpayer conducts business activity in various states, the portion that one state may tax turns on the unit of activity sufficiently connected to the state. In limiting the reach of state taxes to activities connected to the state, the Supreme Court declared that "the linchpin of apportionability [the scope of the activity states may apportion and tax] in the field of state income taxation is the unitary business principle".[1] This concept of unity has become an ever increasing area of controversy and scrutiny. Under the unitary principle, businesses are considered unitary if there is some flow of value between the businesses, generally evidenced by functional (operational) integration, centralized management, and an achievement of economies of scale (the operation of one activity impacts the value of another).2

The Supreme Court issued a landmark opinion on the issue of unity in *Allied-Signal*.3 In *Allied-Signal*, the Court found that a state need not "isolate the intrastate income-producing activities from the rest of the business," but "may tax an apportioned sum of the corporation's multistate business if the business is unitary." The Court found that dividends received from an unrelated subsidiary located outside of New Jersey could not be taxed by New Jersey because neither the dividends nor the subsidiary payor bore any unitary relationship to the corporation's activities in New Jersey.

Allied Signal and its progeny created uncertainty as to when an investment may be viewed as unitary with other business activity. The Supreme Court addressed this issue in 2008 when it decided *Meadwestvaco*.4 Mead acquired a corporation that later evolved into the research service Lexis/Nexis. Mead was not involved in Lexis's day-to-day affairs, and the operations of Mead and Lexis did not overlap in any form. When Mead sold Lexis for a large gain, the Supreme Court found that the gain was not required to be apportioned to the states where Mead conducted business after determining that Mead and Lexis were not unitary. The Supreme Court rejected the lower court's application of a separate "operational function" test that would look to whether the investment in Lexis—and the income derived from that investment—served to further Mead's business.

While there is voluminous law in a corporate context, the partnership rules are a patchwork of provisions that apply unitary principles inconsistently—or not at all. When investors own multiple business activities in flow-through entities that may or may not have related business activities, how do the unitary principles and the decision in *Meadwestvaco* impact the unit of activity a state may tax?

The states address the taxation of individual partners who invest in partnerships in various ways. A few of the states, including South Carolina, Utah (starting 1/1/2009) and Vermont, require all of the income and all of the factors to flow up to individual partners, thereby commingling all activities at the partner level. Vermont, for example, takes the following position with regard to partnership investments:

The partnership is merely a conduit for business income taxable to the partners. Income and losses flow through to the partners and are reported on their returns.5

On the other end of the spectrum, a majority of states allow a partnership to directly allocate the income to the state and flow that income to the partners, rather than flowing through the income and the factors. Arkansas incorporates the following regulation:

Every partnership filing an Arkansas partnership return shall state specifically the items of its gross income and the deductions allowed by this act and shall include in the return the names and addresses of individuals who would be entitled to share in the net income if distributed and the amount of the distributive share of each individual.6

However, it is important to consider the operational-function test. While a partner and a partnership might not be unitary, the partnership investment itself might serve an operational function to the business of the partner. In such a case, the flow through of income and apportionment factors may still be required. This is an area that is not yet fully resolved. The Court's holding in *Meadwestvaco* challenges the existence of such a test. By finding that there was no need for additional analysis after concluding that two businesses are not unitary, the Court appears to invalidate the operational-function test.

In light of *Meadwestvaco* and other Supreme Court decisions, there may be alternative approaches to reporting income and apportionment factors when an individual partner is invested in multi-state flow-through entities. For an individual who is only investing in a partnership for pure investment purposes, the question arises as to the impact *Meadwestvaco* has on the income that flows through from the partnership to the partner. Take, for example, an individual who holds an investment in two separate partnerships: one operates a shopping mall and the other operates a gold mine. Both partnerships do business in Vermont.

Under the general rule in Vermont, the partner would flow up the income and the apportionment factors from both partnerships and apportion the income from both partnerships together on its state return. After *Meadwestvaco*, this may not be an appropriate result. If there is no operational connection between these two partnerships, they would not be unitary businesses and should be taxed separately.

What if, however, the partner used the income from the shopping mall to provide working capital for the gold mine? In this case, the businesses would not be unitary at a functional level. However, there is a connection between the two—the mall activity is funding the operation of the mine. Would this be enough of a connection to treat these businesses as unitary and blend the income and apportionment factors? *Meadwestvaco* may require that the businesses be separately apportioned notwithstanding the flow of funds.

What if the partnerships were held in a tiered partnership structure (i.e. the partner is invested in the shopping mall partnership, which is in turn invested in the gold mining partnership)? There may be a connection by common ownership and a flow of funds (i.e. the shopping mall partnership would be making capital contributions for its investment in the gold mining partnership), but would there be a *unitary* connection? Similar to the above situation, without a unitary connection, *Meadwestvaco* would appear to require separate apportionment of each business activity.

The same result most likely would occur when a single partnership operates multiple lines of business under the same partnership umbrella, or multiple partnerships that roll up into a single entity as with a hedge fund. As long as the lines of business do not commingle their operations, the businesses would not be unitary.

Investors in flow-through entities should take a fresh look at the state tax footprint of their business ventures. The state laws may be overreaching in taxing activities unrelated to the state, or by commingling activities that bear no relation to one another. The separation of business activities may impact the overall state tax cost and the return on flow-through investments.

To view Part One in this series from the May 2010 newsletter, click here.
To view Part Two in this series from the July 2010 newsletter, click here.

1*Mobil Oil Corp. v. Commissioner of Taxes Vermont*, 447 U.S. 207 (1980).
2*Id.*
3*Meadwestvaco Corp. v. Illinois Dept. of Revenue*, 553 U.S. 16 (2008).
4*Meadwestvaco Corp v. Illinois Department of Revenue*, 128 S. Ct. 1498 (2008).
5Vermont Formal Ruling 88-18, 01/06/1989.
6Ark. Code Ann. Sec. 26-51-802.

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The IRS "Holistic" Audit: A Misnomer?

Last fall IRS Commissioner, Douglas Schulman, announced the creation of a new "holistic" audit program.

The term "holistic" is defined as that which relates to or is concerned with wholes or with complete systems rather than with the analysis of, treatment of, or dissection into parts. The word itself is most commonly related to medicine where a doctor focuses on the health of a person's entire body versus just a specific part. Therefore, the word tends to conjure up feelings of well-being. However, this new audit focus will be anything but as it is specifically designed "to crack down on tax evasion and increase the overall tax compliance of wealthy Americans."1

The New Holistic Audit Program

"You cannot assess compliance among the nation's wealthiest individuals by looking at their 1040s," Schulman said.2 Wealthy individuals often make use of sophisticated financial, business and investment arrangements with complicated legal structures and tax consequences. Rather than auditing each tax return in the enterprise as a single and separate entity, IRS now plans to look at everything that may be connected to a single taxpayer and analyze the entire picture holistically. "Our goal is to better understand the entire economic picture of the enterprise controlled by the wealthy individual and to assess the tax compliance of the overall enterprise."3

Targeted Taxpayers

The holistic audit program targets high wealth taxpayers. Although "high wealth" is still undefined, it is expected to cover individuals with $10 million or more in assets or income.

Income will not be the only criterion. Ownership of certain assets will likely attract IRS attention. Some of these assets include real estate investments, royalty and licensing agreements, revenue-based or equity-sharing agreements and privately-held companies. Also, taxpayers owning, controlling or having a beneficial interest in trusts, foundations, partnerships and other flow-through entities will be under heightened scrutiny as well.

Other tax considerations include international sourcing of income, tax residency, and offshore structures and bank accounts. Dual citizens with assets in another country, legal resident aliens, or individuals who simply have assets outside of the United States may be more likely to be targeted.

The Global High Wealth Industry Group (GHWIG)

In order to implement this holistic audit approach, IRS launched a specialized task force to target wealthy individuals and their related entities. The Global High Wealth Industry Group (GHWIG) will be part of IRS' Large and Mid-Size Business Division (LMSB), which has the most experience dealing with high wealth and understanding complex relationships among various tax entities. Thus, taxpayers targeted by GHWIG can expect to be audited by more experienced agents who are accustomed to complex audits and examination of intricate tax issues. IRS has also embarked on a hiring campaign to add more staff including economists, appraisal experts and technical advisors to provide industry or specialized tax expertise.4

According to Shulman, tax agencies around the world—including Australia, Canada, Germany, Japan and the United Kingdom—have formed similar audit groups focusing on high wealth individuals.5

"Economic Substance" Doctrine

The recent codification of the economic substance doctrine may become an audit tool for IRS to challenge transactions entered into by high wealth individuals.

Before economic substance was codified, common law doctrine was used by IRS to attack transactions that did not result in a meaningful change to a taxpayer's economic position other than a reduction in tax. The codification of the economic substance doctrine clarifies that a transaction (or series of transactions) will not have "economic substance" for purposes of the economic substance doctrine unless:

1. The transaction changes in a "meaningful way" (apart from U.S. federal income tax effects) the taxpayer's economic position.
2. The taxpayer has a "substantial purpose" (apart from U.S. federal income tax effects) for entering into such transaction (or series of transactions).6

The new legislation also imposes substantial strict liability penalties for transactions that are found to lack economic substance—20% on the underpayment of tax for disclosed transactions and 40% for undisclosed transactions, with no exceptions.7 In other words, even if the taxpayer believed that the transaction was bona fide and even if the taxpayer had no tax-avoidance intention in entering into the transaction, the penalty still applies if a transaction is determined to lack economic substance.

In undertaking holistic audits, IRS may use the economic substance doctrine to pierce certain arrangements or transactions of high wealth taxpayers that may literally comply with the Internal Revenue Code but violate the spirit of its provisions.

Planning Ahead

The formation of GHWIG means that the likelihood of audits for high wealth individuals are on the rise and the new holistic strategy will likely make audits more costly and more extensive than they have been in the past.

Taxpayers and their advisors can use information from IRS announcements to prepare for a holistic audit. For example, high wealth taxpayers may want to review the scope of their business and investment affairs with their advisors to determine their risk of being selected for an audit. Furthermore, taxpayers can plan future transactions with their advisors and even maintain written explanations of their objectives and purposes in their advisor's files. Finally, taxpayers and advisors should keep thorough and well-organized files and be prepared to provide significant information if they are selected for an audit by GHWIG.

In order to assist clients in dealing with the intensity of these audits, WTAS has convened a national team, headed by a former IRS trial attorney and supervisor in the General Counsel's office.

1Remarks of Douglas H. Shulman, Commissioner of Internal Revenue Service, before the AICPA National Conference on Federal Taxation, Oct. 26, 2009, http://www.irs.gov/irs/article/0,,id=215606,00.html (Shulman AICPA Remarks).
2*Ibid.*
3*Ibid.*
4Prepared Remarks of IRS Commissioner Doug Shulman to New York State Bar Association Taxation Section Annual Meeting in New York City, Jan. 16, 2010, http://www.irs.gov/newsroom/article/0,,id=218705,00.html (Schulman NYSBA Remarks).
5Schulman AICPA Remarks.
6Internal Revenue Code Section 7701(o).
7H.R. 4872, The Health Care and Education Reconciliation Act of 2010, Section 1409(e).

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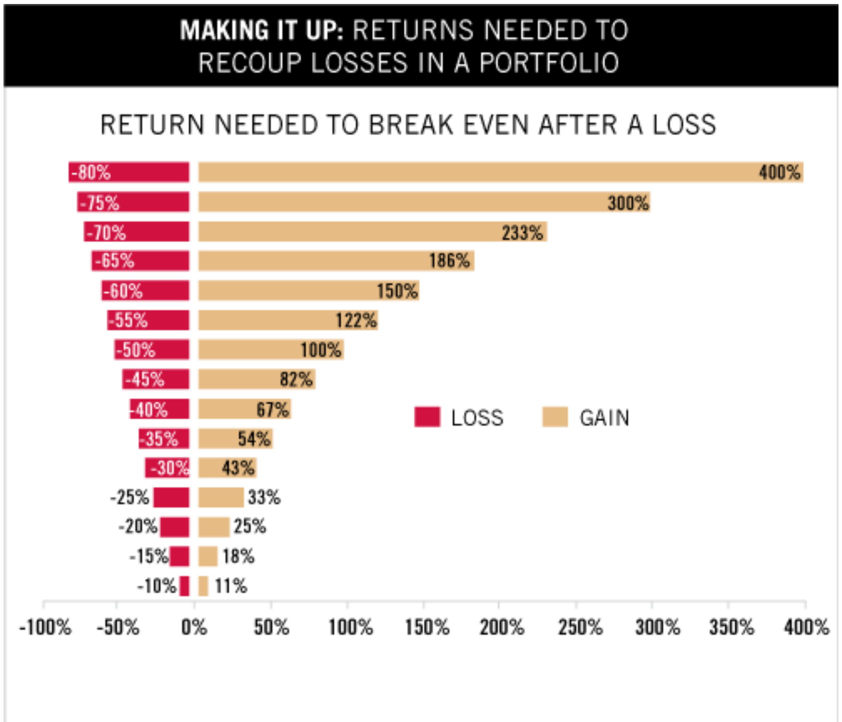
Reducing Volatility in Turbulent Times

The past 10 years reminded investors of just how volatile markets can behave. The decade witnessed two drops in the S&P 500 in excess of 40%, corporate bonds severely underperforming government bonds in 2008 before strongly outperforming in 2009, and commodities experiencing wide price ranges illustrated by oil prices hitting highs of $140 and testing lows in the $30s.

Many categorize the past 10 years as a “lost decade” and some challenge the merits of asset allocation and equity investing in general. As worries over the sustainability of an economic recovery are fueled by both media headlines and investors’ reactions to seesawing economic indicators, it would seem that heightened volatility is here for the foreseeable future.

We hear investors asking if they have to accept high levels of volatility to achieve the returns they desire and if not, how they can construct a portfolio with lower volatility. The practice of predicting volatility tends to be futile and recent market swings have only reinforced that notion. What matters is not the volatility itself, but rather how an investor reacts to the volatility.

The importance of reducing the effect of negative returns within a portfolio is a matter of both math and psychology. Illustrated by the chart below, the relationship between losses and recovering from those losses is not linear. Simply put, it is exponentially more difficult to recover from larger losses than it is to recover from smaller losses. In dollar terms, more consistency and minimizing losses equates to more wealth.



Reprinted from "Carpet Balming," by Mike Patton, 2010, *Investment Advisor*. 5 May 2010

From a psychological standpoint, many investors let emotion drive their decision making and tend to abandon their investment plan in the face of losses. This was the case in early 2009 when investors fled equities and missed out on the impressive recovery in the equity markets which began in March of 2009. Those who waited for the recovery to gain more solid footing and reinvested in early 2010 experienced significant volatility in spite of the apparent recovery.

Prudent advisors advocate that investors need to develop and implement investment strategies based on their unique goals, needs, time horizons and risk tolerance. All investments fall on a risk spectrum and at any point in time, equity investments will inherently carry more risk than bonds and bonds will inherently carry more risk than cash. The additional risk associated with equities is why investors have been historically rewarded with higher relative returns. We believe investors' exposure to equities and the types of equity strategies chosen should be based on a combination of the investor's need for growth in the portfolio and their tolerance for volatility.

How can one build an effective portfolio when buying equities feels like riding a never ending roller coaster? There are several ways to pursue the objectives of lowering volatility and growing a portfolio.

First, formalize and adhere to a strategic asset allocation aligned with your goals and objectives. Having a disciplined approach to rebalancing forces an investor to sell high (trimming outperforming asset classes) and buy low (adding to underperforming asset classes). Rebalancing can be periodic or more active based on thresholds or the utilization of cash flows (dividends, interest or additional investment) into the portfolio. Investors may also reallocate among asset classes if they feel they do not need to take as much risk (reducing overall equity exposure). The latter is a wealth management approach and keeps the portfolio aligned with one's goals.

Second, a vital component of developing a strategic asset allocation is incorporating low-correlation assets. To fulfill different areas of the strategic asset allocation, an investor will seek strategies that move or react differently at different stages of the market cycle. These can be style (growth/value), size (large, small, micro-cap), sector and country (domestic/international) among others. The concept is simple to explain and works fine unless risk changes. In 2008 this proved not a failsafe plan. Correlation is a moving target and when all asset classes moved towards a correlation of nearly one (perfect correlation), investors found there were few equity investments that provided a safe haven. Although investors who held more fixed income and cash were cushioned, diversification among equities did not dampen volatility as one would expect or hope.

When discussing low volatility strategies, the focus should be on the variation of returns versus full equity benchmarks such as the S&P 500 or Russell 1000. We consider strategies to have lower volatility if their beta is less than one. For example, a beta of .75 means the strategy has exhibited returns which are about 25% less volatile than the benchmark.

Third, an investor can introduce hedged or lower volatility equity strategies to the portfolio. The inclusion of lower volatility strategies as a core holding in a portfolio may reduce the effects of large market swings. Because uncertainty and risks always exist, a combined asset allocation approach, disciplined rebalancing and lower volatility equity strategies provide an investor the most likely opportunity to stick to his/her plan and achieve his/her goals.

Due to the lock-ups, illiquidity, high minimums, lack of transparency and scandals involving hedge funds, many investors are hesitant to invest in hedged or alternative strategies. However, investors can now access long-short, market-neutral, convertible, and merger and acquisition strategies as well as managed futures and option strategies, in both mutual fund and exchange-traded fund (ETF) structures. These publicly traded vehicles offer greater transparency, liquidity and, most importantly, potential low correlation/low beta returns versus broad market indices. These lower volatility strategies can offer investors time in the market (a full market cycle) and a comfort level that neither long only stocks nor bonds alone can provide. Most of these strategies seek to contain equity risk while eliminating market timing activities. Managers will stay fully invested and use a range of sophisticated risk management strategies and tools to maintain a consistent, acceptable risk posture. This allows the strategy to capture much of the market upside while providing downside protection as well. Strategies are most often actively managed in order to respond to the rapidly changing investment landscape.

And finally, when significant downside volatility does occur, investors should do their best to avoid significant draws from a portfolio. The best way to achieve the returns necessary to recover from a significant drop in the market is to stay invested. The most dramatic market returns typically occur early in the recovery, and investors who miss the upswing find themselves at a significant disadvantage. Reallocation to less volatile strategies may be appropriate for many investors, but retaining market exposure is critical to a portfolio's recovery.

Two of the most significant causes for draws are psychological reactions to the volatility and income taxes. Significant declines in the markets often cause investors to sell out, reducing their exposure to the markets. When they sell, the investors may not feel like they made money, but they often recognize significant taxable gains on securities that have been held for long periods of time. The unexpected tax bill that follows often causes further withdrawal from the markets. Proper tax planning is critical when investors are adjusting their allocations, even in the face of volatility, to avoid further damage to a portfolio from unexpected tax liabilities.

In conclusion, risk, volatility and uncertainty are going to be a perpetual part of the investment landscape. Currently, risk and volatility are more pronounced than they were just a few short years ago and perhaps more than at any time since the 1930s. It is increasingly important for investors to have a well-articulated and formalized investment policy in place as well as a prudent process for rebalancing. Investors can further look to reduce volatility by incorporating low volatility/low beta strategies within the portfolio. More consistent returns can potentially lead to higher, long-term returns and increased wealth. This overall wealth management approach should allow an investor to stick to an appropriate plan through turbulent times and ultimately allow them to achieve their most important goals and objectives.

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2010 Estate Planning Opportunities Discussed at IRS Valuation Summit

On August 24, 2010, the Southern California Chapter of the Appraisal Institute IRS Valuation Summit debuted with panel discussions focused on the 2010 repeal of the federal estate tax, and the return on January 1, 2011 to a 55% estate tax with a $1 million exemption amount.

Six panels of estate planning luminaries, IRS agents, sponsors and 175 wealth-serving professionals converged at the Century Plaza in Los Angeles to discuss the planning opportunities created by the current economy and 2010 repeal of the estate tax. WTAS' Keith Dolabson, Robert Kies, Timothy Croushore, Eric Garfield and Brian Gray joined planning experts from Jeffer Mangels Butler & Mitchell; Latham & Watkins; Lurie, Zepeda, Schmalz & Hogan; McDermott Will & Emery; Mitchell Silberberg & Knupp; Weinstock Manion Reisman Shore & Neumann; and IRS on panels focused on parting the stormy clouds ahead.

The IRS Valuation Summit covered current estate planning law, progressive estate planning strategies, minority interest valuations, conservation easements and IRS penalties. Panelists made the following points:

- Most were astonished that Congress did not reinstate the estate tax in 2010 and are uncertain as to what the future holds in 2011. Most predict a return in 2011 to a 55% top estate tax rate and a $1 million exemption.
- "Blockage," or market absorption discount related to the sale of large blocks of poorly diversified assets, remains a subject of debate between valuation experts and IRS notwithstanding recent taxpayer wins.1
- Conservation easement appraisal reports continue to receive intense scrutiny by IRS because of perceived appraiser incompetency. The penalties for appraisal inaccuracy are severe.
- Two-year rolling GRATs, sales to defective grantor trusts and charitable lead trusts remain estate planning tools of preference for transferring wealth in 2010. Real estate, business and minority interest valuations continue to serve an important role in planning for these transactions.
- Unless the law changes, experts estimate the number of taxable estates will rise from 6,000 in 2009 to 44,000 in 2011. The demand for estate planning and valuation services will rise as well.
- In a recent Tax Court decision,2 Judge Halpern held that the preferred valuation methodology for undivided interests was the cost of partition adjusted 1) for the likelihood partition would be necessary and 2) for the

risk that after the partition, another reasonable buyer would be willing to pay more. This case is notable and was the subject of much panel discussion

The overall message of the summit was that estate and generation skipping taxes will likely return on January 1, 2011, and Congress is unlikely to make any changes to the estate tax in 2010.

Given the current economy—depressed values of real estate, business assets and stock as well as low interest rates and economic uncertainty—the last few months in 2010 provide an excellent (albeit limited) opportunity to catch the estate planning wave and take steps to reduce estate taxes.

1*Astleford v. Comm'r*, T.C. Memo 2008-128 (T.C. 2008).
2*Ludwick v. Comm'r*, T. C. Memo 2010-104 (T.C. 2010).

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WTAS Announces Argentine Desk

With the exponential growth of cross-border activities between the U.S. and Latin America, particular attention should be paid to U.S. and international tax obligations and reporting requirements. In this expanding global context, WTAS announces the launch of a dedicated Argentine Desk.

Argentina is an important export market for the U.S. With a population of 40 million people, it is the fourth most populous country in Latin America. Argentina and the U.S. share a distinguished bilateral commercial history with new opportunities for future trade and investment. The U.S. is Argentina's third largest trading partner and is among the most active country investors. Given the vast number of individuals seeking an education, working, living or investing across the U.S./Argentina borders, important tax implications need to be considered. As such, WTAS recently established an Argentine Desk headed by Carolina Strobino. Carolina is an Argentine lawyer who graduated from Universidad de Belgrano with previous law and marketing experience at Grupo GNP Tax & Legal Consulting in Buenos Aires. The Argentine Desk can assist in all tax matters involving U.S./Argentina cross-border issues impacting individuals and families, including income tax planning and compliance.

For Argentineans who are considered non-residents for U.S. tax purposes, our Argentine Desk can assist with the following:

- Structuring of investments in U.S. operating businesses or U.S. real estate in a tax efficient manner.
- Understanding the income tax implications of U.S. investments or business activities that yield U.S. source income, including the complicated income tax rules dealing with the gain from the sale of U.S. real property.
- Minimizing U.S. gift taxes which could arise from transfers of real property or tangible property located in the U.S.
- Designing trusts set up for the benefit of U.S. citizen(s) or U.S. resident beneficiaries to minimize U.S. income and transfer taxes.
- Planning regarding the holding of U.S. stock in a manner to avoid being subjected to the U.S. estate tax as well as post-mortem tax planning with regard to the ownership in foreign corporations left to U.S. beneficiaries.
- Preparing U.S. nonresident individual income tax, gift tax and estate tax returns, as well as complying with

other U.S. tax filing requirements.
- Pre-immigration planning for Argentine individuals who are considering becoming U.S. residents such as the potential savings by accelerating income, recognizing gain on appreciated assets, restructuring ownership interests in foreign entities and gift tax planning.

For U.S. citizens and Argentineans considered U.S. residents (who are generally subject to U.S. income tax on their worldwide income) the Argentine Desk services include:

- Analyzing existing investments in Argentina to identify the applicability of U.S. anti-deferral rules such as those imposed on Passive Foreign Investment Companies or Controlled Foreign Corporations.
- Developing and structuring investments in Argentina in a tax efficient manner and foreign tax credit planning with Argentina source income.
- Complying with the various complex U.S. informational reporting requirements for activities in Argentina and other countries such as for foreign partnerships, foreign corporations and foreign bank accounts.
- Gift and estate tax planning with regard to assets located in Argentina, as well as transfer tax planning between a U.S. citizen and non-U.S. citizen spouse.
- Planning opportunities for income earned while working in Argentina such as with the foreign earned income exclusion, foreign housing cost exclusions and foreign tax credits.
- Relinquishing of green card or U.S. citizenship under the new expatriation tax regime.

For more information on U.S./Argentina cross-border tax issues as well as other international tax planning opportunities, please contact Carolina Strobino at 646-213-5100.